



# **Review of the Marketing and Sale of Trackers**

**Submission by the Society of Actuaries in Ireland**

**May 2004**

## Introduction

The Society of Actuaries in Ireland welcomes the opportunity to make this submission to the Regulatory Authority in relation to Tracker Investments.

The Society had already prepared a Briefing Note in December 2003 for discussion with the Regulator on the subject of Tracker Bonds and similar products. This note stated:

*“A number of financial institutions are offering derivative-based products, mainly tracker bonds (and geared versions of same), to the retail market. Institutions and intermediaries also put together combination arrangements, comprising products from a number of different legal entities, but which are sold as a single package. Considerable volumes of such products are being sold to consumers at present. **The Society of Actuaries in Ireland is concerned that buyers of these products are not being made fully aware of the associated risks and costs on the one hand and, on the other hand, the likely range of returns they should expect.**”*

The Society therefore is fully supportive of providing investors in tracker products with additional information in order to foster a safe and fair market for the consumer.

### A. Costs and charges

#### 1. Fees paid

All providers should be subject to the Disclosure Regulations, Life Assurance (Provision of Information) Regulations 2001, currently applicable to life assurance products.

The disclosure of fees paid to an intermediary of a non-life assurance tracker should be disclosed on the same basis as applies to life assurance based trackers.

#### 2. Lock-in provisions

The Society has no particular comment to make in relation to lock-in provisions.

### B. Disclosure

#### 3. Dividends and interest income

It should be made clear in the documentation that the return on the equity index being tracked does not include dividends, if this is the case. The impact of this will be captured under the disclosure standards that we are proposing.

#### **4. Death benefit provisions**

The benefits available on death should be made clear along the lines that apply to life assurance trackers. The impact of fees for death benefits will be captured under the disclosure standards proposed.

#### **5. Reference to guarantees**

In relation to the use of the term “*guaranteed*”, the Society considers that the most important issue is that the source of the guarantee should be clarified – this will either be from the product provider or from a third party. Where the product provider is not providing the guarantee, but is merely undertaking to pay the proceeds arising from a third party, this should be stated prominently. In addition, the credit rating of the third party should be stated.

Details of early encashment penalties, and any potential liquidity difficulties in unwinding part of the structure early to pay encashment, should also be disclosed to investors.

#### **6. Third parties**

Disclosure of a third party is only required if this third party is providing the guarantee.

#### **7. Front page of tracker document**

The Society considers that it would be more appropriate to put on the front page of an “Important Information” document a statement along the following lines:

*“You should read this document carefully before you make a decision on whether this product is suitable for your investment needs.”*

#### **8. Suitability of investment**

The Society agrees with the proposal and suggests that this would be included as part of the “Important Information” document.

#### **9. Currency risk**

Currency risk is not normally a feature of these contracts. If this is not the case, this should be clarified fully by qualifying any statement made about the return being promised. Where the currency risk has been hedged away, one could say “*this contract promises a return equal to 80% of that achieved by the FTSE over the period*” but where the currency risk remains, one should qualify this by adding “*but changes in currency exchange rates may mean that the actual return achieved in Euro may be higher or lower than this*”.

### ***10. Averaging***

A statement should be included to say “*averaging will protect the value of your investment in a falling market but will restrict the gains you achieve in a rising market.*”

The impact of averaging will be captured as part of the Disclosure requirements proposed.

## **C. Documents issued to clients**

### ***11. Standard note***

If the full provisions of the Life Assurance (Provision of Information) Regulations 2001 are introduced for all tracker products, the need for an additional standard note may not arise.

### ***12. Full set of terms***

Yes - the current disclosure regulations for life assurance contracts provide full information on the terms of the contract and should be used as a model for the type of information to be provided to the client.

## **D. Projections and past performance**

### ***13. Information about growth and return***

The information provided should be in a format designed to ensure that the prospective investor has a full appreciation of the range and relative likelihood of the outcome; if a result is unlikely, the prospective investor should be made clearly aware of the fact. The Society supports the disclosure of the probability of particular levels of investment return being achieved but envisages practical difficulties in immediately implementing such a regime. However, the financial techniques to provide this are available and the Society would be pleased to work with the Regulator in developing a practical solution.

In the absence of such information, the Society proposes that the average projected return from the tracker product should be quoted prominently, along the lines of the CAR on a deposit account. The average projected return can be calculated from the combination of the guaranteed minimum benefit, plus the amount available to buy derivatives (the premium less the amount required to provide the guarantee less charges) rolled up at a prescribed rate. The Society considers that a suitable roll-up rate would be equivalent to the assumed equity return on PRSA investments, currently 7%. The Society would be pleased to expand on the detail of this proposal, if required.

This disclosure should be underpinned by a prohibition on back-testing and misleading advertising such as “*returns of up to 100%*” where such returns are extremely unlikely.

Where the range of returns provided by the tracker is stated, and achievement of the higher end of the range is considered unlikely, this fact should be stated.

**14. Should “back-testing” be prohibited?**

Yes

**15. Health warnings**

Past performance should be prohibited, and it should be made clear that projected performance is not guaranteed and is indicative only.

**E. Taxation treatment**

**16. Highlighting taxation**

Returns to policyholders should be shown after tax as applies under the Life Assurance (Provision of Information) Regulations 2001.

**17. Particular tax implications**

See above.

**F. Geared trackers**

**18. Specific restrictions**

In its initial Briefing Note, the Society stated

*“Geared trackers, whereby the initial investment is funded by a bank loan repayable from the maturity proceeds of the bond, accentuate the problems.....and also introduce new risks:*

- (a) the emphasis given to the guarantee that principal will be repaid at maturity from the proceeds of the tracker can distract attention from the risk that, if the investor wishes to or is forced by circumstances to terminate the arrangement early, then not only will all the interest payments be in vain, but the proceeds from the investment may not be sufficient to repay the principal on the loan*
- (b) sales illustrations showing regular interest payments may not highlight the risk of future increases in interest rates*
- (c) gearing can introduce additional tax inefficiencies”*

The Society therefore considers that specific additional disclosure should apply to geared trackers and these are set out in the next section. It is more difficult to determine whether there should be restrictions on the marketing of geared trackers; however we would certainly caution against the introduction of these products into the wider retail market.

***19. Disclosure about geared trackers***

The following additional measures should apply to geared trackers:

- The client should sign a separate declaration confirming that all interest payments on the borrowing may be lost where this is the case and noting that, on early encashment, the principal on the loan may not be repaid and that, in this instance, all interest payments will be lost. There may be merit in requiring a separate illustration on a “worst case” basis to reinforce this point.
- The interest rate used in the projection should be that applicable over the full term. In the case of a variable rate loan, this would require the use of the fixed rate equivalent.
- The tax treatment of the various payments should be fully described

**G. Complexity**

***20. Signing a declaration***

Yes