Annuities: Time for Regulatory Reform

1 Introduction

1.1 Britain's large annuities market provides the main means by which ordinary people turn their defined contribution (DC) pension savings into retirement income. New annuity business is expected to at least double over the next few years, due to the impact of maturing pension plans and to the introduction of auto-enrolment in the private sector, under which all but the lowest paid employees will be enrolled into a DC scheme.

1.2 The market is changing rapidly. Increasingly insurance companies offer people annuity incomes that are "enhanced" to reflect more accurately annuitants' state of health. From a consumer perspective, product complexity has increased, while professional advice is harder to find. Increasingly too, retirees are purchasing annuities, by exercising their Open Market Option (OMO), without taking advice, buying instead through "non-advice" internet websites, and, as a result, losing valuable consumer protection. Irreversible mistakes affect retirees for the rest of their lives.

1.3 To examine market developments, the Panel has over the last year undertaken a literature review, summarising more than a decade's worth of relevant research, and commissioned three original qualitative studies. These examine, in turn, consumers' annuity purchasing experience; the adequacy of annuity quotation and purchase websites; and experts' views on market developments. This compendium of research, published separately, helped to inform our key recommendations for regulatory and structural reform.

2 Recommendations

2.1 To protect consumer interests and promote effective competition, the *Financial Conduct Authority* (FCA) should:

i. Undertake a rigorous market study to examine (a) possible exploitative pricing of "rollover" annuities sold by insurance companies to their DC customers who have saved with them for a pension and (b) the distorting impact of embedded and opaque charges and regulatory arbitrage that may well seriously impede informed consumer choice between rollover and OMO providers and between non-advice and professional advice distribution channels. The study should be followed by remedial action to promote effective competition in the short and long term.[1]

ii. Strengthen the operation of the OMO by (a) outlawing barriers to its use in pension contracts (such as exit penalties), (b) excluding tied annuity sales (provider to provider, provider to adviser) from its definition, and (c) setting

[1] The FCA has indicated that it may undertake a market study following a thematic review.

minimum standards of service. Such minima should include the use of best practice ("deep") underwriting of enhanced annuity quotations and the requirements to ensure product suitability and to explain clearly the fee and commission practices across the market.

iii. Embody in regulatory rules and required standards the equivalent of a code of conduct for the non-advice market. An annex sets out a tentative code, which emphasises the need for high professional standards, the transparent disclosure of charges, and a clear explanation of the implications of non-advice for consumer protection.

iv. Investigate the role of "introducers" – who use their existing consumer brand image or franchise to generate business for annuity providers and advisers - and consider embodying in regulation the equivalent of a code of conduct comparable to that for the non-advice market.

2.2 To increase annuitants' financial capability, the *Money Advice Service* (MAS) should fully develop its proposed annuity advisers directory and associated guidance, meeting high standards, and launch a targeted educational campaign.

2.3 To address structural weaknesses in the annuities market, especially the advice gap and excess cost of annuitising small pension pots, due to lack of scale economies, the *Government* should actively consider reforms to:

i. Amend tax rules that prevent those with several small pension pots, together worth more than £18,000, from taking their pension as a lump sum.

ii. Introduce a national default annuities service that meets the standards described under 2.1 ii above. This reform would extend to annuities the concept of the public obligation service that was conferred on the National Employment Savings Trust (NEST) in the auto-enrolment accumulation market for all annuitants, irrespective of their pot size and financial capability.

iii. Require employers and trustees to establish a non-advice service that meets the standards described under 2.1 iii above for members of workplace schemes.

3 Key findings

Consumers poorly placed to drive effective competition

3.1 As in the market for DC workplace pensions, recently investigated by the Office of Fair Trading, consumers are poorly placed to drive effective competition amongst providers and distributors of annuities. There are many barriers inhibiting consumers' full engagement when they decide to annuitise: low financial capability; fear of product complexity and of making an irreversible, high-cost mistake; general distrust of professional advisers, and inability to find appropriate advice at acceptable cost.

3.2 Annuitants show a growing awareness and use of their right to shop around under the Open Market Option, with perhaps half taking this course of action. However the degree of true consumer engagement is questionable. Annuitants may "shop but stop", put off by complexity, information overload and the perceived cost of a full-scale search. Complexity is systemic. Our website research revealed a lack of clarity about charges, the difference between the protection offered through advice and non-advice routes, and the extent to which searches for quotes covered the whole or only part of the market. Some annuitants stay with their existing pension provider for good reasons; others do so because they have not shopped, or shopped diffidently, deciding, for safety's sake, to take the annuity offered as a "rollover" product by their pension saving provider or by its tied business associate.

3.3 As one respondent said, *"I found a lot of confusing sites – thought it (buying an annuity) would be like confused.com but I was bombarded with calls – if I'd found a decent website I might have kept going, but I got fed up with it."*

Distribution market confusing and a lottery for consumers

3.4 Annuitants in the mass market who shop around are looking for help. Many do not actively seek non-advice services; they use them because these are the "shops" open for business. Annuitants may not check the small print that mentions, "this is not advice", or, if they do, do not understand the ramifications. By taking responsibility for the purchase, annuitants forfeit the right to a number of valuable consumer protection services, such as recourse to the Financial Ombudsman Service (FOS). Annuitants do not necessarily understand that non-advice services are not free ("commission invisibility"). Most people are unlikely to be able fully to apprehend the quality of rival non-advice services, arising from, for example, the use of tied agents, restricted or broad panels, and whole-of-market quotations. Only two out of fifteen websites examined clearly stated that they offered a whole-of-market search.

3.5 There appear to be around a dozen firms of advisers that offer a "straight through" service online that leads to an annuity purchase. Many more firms act as "introducers". Their regulatory status and true identity is frequently unclear, as is their location (some are based offshore). Consumers often do not appreciate that an actual purchase would be with another firm with which they have had no contact. There is evidence of poor conduct – persistent unsolicited emails and telephone calls - allied to light regulation. Unprofessional and intrusive behaviour can deter consumers from continuing their open market search: they "shop but stop".

3.6 There has been a significant shift to non-advice in the mass market for annuities partly driven by reforms to charging structures introduced by the retail distribution review (RDR). There is a danger that this shift in distribution channels will undermine the intentions of the RDR, leaving most customers with no choice but to use commission-based, non-advice services.

3.7 Advisers' preference for non-advice is due in part to the need to deliver efficient services for smaller pots. However, it is also due to advisers' preference for commission (still permitted for non-advice services under the RDR but banned for advised sales) and, more importantly, for the lighter regulatory regime, under which advisers do not take responsibility for the suitability of sales. Non-advised services range in quality, but many appear to use limited panels of providers and to operate "shallow" (superficial) underwriting processes for enhanced terms. Few disclose such practices clearly and explain the implications.

3.8 Non-advice services are often more profitable than advice services because they have lower delivery costs, yet can often charge more, especially for enhanced annuities. Some enjoy very high commissions (5% to 6% as compared with an average of 1.5% to 3%) from providers keen to secure high-volume distribution channels. The higher profit margins for non-advice mean that although advice is theoretically economic for pots worth about £25,000, in practice it is rarely offered for pots worth less than £100,000, unless the customer has other investible assets or a pre-existing relationship with an adviser.

3.9 The non-advice market is further complicated by the entry of annuity providers as distributors. Providers are either establishing their own brokerage or buying an existing service to secure distribution. If they cannot retain the customer as a "rollover" annuitant, they can still benefit from commission in the non-advice market.

3.10 Our research found examples of very high quality services in the non-advice market, where firms voluntarily adhere to a code of conduct that includes a whole-of-market search and puts the consumer's interests first. However the many examples of poor practice mean that the general outcome for consumers can be akin to a lottery.

Annuities are increasingly complex and may not offer good value for money

3.11 Expert opinion reports that enhanced annuities are "*now taking half or more of annuities purchased by consumers when switching from their existing pension provider …*". This switch is compressing annuity rates offered to healthy retirees. It also adds to the complexity of the product offered to consumers, who may be reluctant to disclose medical conditions that would enhance the value of their annuity.

3.12 There is an emerging concern that insurers' profits on their rollover annuities might be excessive. The conventional wisdom that annuities provide value for money is open to question, not least because the relevant academic research into "money's worth" is based on open market rates and does not take account of rollover rates, which appear to be significantly lower in certain cases. Moreover, experts report that rollover annuity rates frequently embed the equivalent of a non-advice commission, payable by the unwary rollover annuitant. Oversight of the rollover market by the regulator appears to be extremely weak.

Need for regulatory and structural reform

3.13 Consumers are unlikely to drive effective competition in the annuities market. Although more annuitants are taking advantage of the Open Market Option, they are making their decisions in an increasingly complex and confusing marketplace. Recent initiatives, such as the Code of Conduct introduced by the Association of British Insurers (ABI), and market developments, such as the online automation of the annuity purchase process, may prove helpful, but rely on effective enforcement by the ABI and may overload consumers with information. The chances of mass consumer detriment are, in our judgement, too high to trust to current market-driven solutions alone: hence our recommendations for further regulatory and government-led structural reform.

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Annex : Outline of possible code of conduct for non-advice services (to be incorporated into FCA rules)

The firm:

- Adheres to the ABI code of conduct
- Has the facility to offer full (fee-based, regulated) as well as non-advice (commission based)
- Sets out the service choice clearly on the web home page, including:
  - A ban on the use of the term “free”
  - The difference between a fee-based service, where commission is rebated to the fund, and a commission-based service, where commission is deducted from the fund and is accommodated in the rate.
  - Clear comparisons between fees and commissions relative to the pot size
  - The difference in adviser and consumer responsibility:
    - Fee based: the adviser is responsible for the sale and the customer has recourse to the FOS if it proves to be the wrong recommendation
    - Commission-based: the customer is responsible and cannot complain to the FOS.

The service:

- Whole of market
- All pot sizes accepted (with a caveat to allow commutation of very small pots)
- Deep underwriting for enhanced terms
- Skilled practitioners available to deal with queries
- Effective checks for:
  - Pension contract terms - for example, a guaranteed annuity rate, an exit penalty, a forthcoming with-profits bonus.
  - Choice of features to ensure customers are making an informed decision, about, for example, single versus joint life; level versus inflation-linked.
- No unsolicited emails, letters or telephone calls
- Clear information on non-annuity options