Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

Annuities and the annuitisation process: the consumer perspective

A review of the literature and an overview of the market

The Financial Services Consumer Panel (FSCP) undertook this literature review in order to identify and evaluate the existing research on annuitisation from the consumer's perspective, including the consumer's understanding and experience of the annuitisation process. The review, which includes an overview of the market, helped to shape the Panel's broader annuity research programme and positioning paper.

In 2011 economists Edmund Cannon and Ian Tonks (Cannon & Tonks 2011) said that annuities represent the most common form of decumulation for defined contribution (DC) pension scheme and plans in the UK and, increasingly, around the world. In 2012 the National Association of Pension Funds (NAPF) and Pensions Institute (NAPF & PI 2012) said that the UK has the largest annuity market in Europe. New business is worth about £12bn per annum and is expected to increase rapidly; doubling by about 2015 and then increasing exponentially over the following years.

The reasons for this predicted growth have been explained by, among others, HM Treasury (HMT July 2012), which attributed the phenomenon to the growing maturity of the existing DC market (voluntary workplace schemes and individual plans) and the introduction of auto-enrolment in the private sector (2012-18). These developments, combined with the demise of defined benefit (DB) schemes in the private sector, mean that the future non-state retirement income of private sector employees and the self-employed will depend on DC. It is essential, therefore, that DC customers secure a good outcome when their accumulated DC funds are converted at retirement into a lifetime income stream.

The format of the paper is as follows:

1. Summary of findings from the literature review
2. What is an annuity?
3. The supply side
4. The demand side
5. What is the Open Market Option (OMO) and how is this being promoted?
6. How many DC customers use the OMO?
7. The dwindling market for 'full' advice; the rise of 'non-advice'
8. How much support do DC customers need?
9. Can annuities offer better value for money to all DC customers?
10. Conclusion
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12. Bibliography

Methodology

This paper was prepared primarily by Dr Debbie Harrison, a member of the FSCP. The paper, endorsed by the Panel, examines reports published between 2002 and September 2013, with the majority of research drawn from the period 2006 to 2013. It considers qualitative and quantitative consumer studies and also the research that explores the impact of the asymmetries in information between the demand-side (the customer) and the supply-side (the companies that provide annuities and the companies that sell them).

While the main focus of the paper is consumer behaviour, it also considers concerns about the value for money annuities offer. This is important because a perceived barrier to DC customers' engagement with the annuitisation process is that they believe the product offers insufficiently good value to justify the effort of shopping around. This negative view of annuities has been exacerbated by the impact of falling annuity rates, which reached an historic low in mid-2012. In addition, questions have been raised about the effectiveness of competition in the annuities market – a matter of concern both to DC customers, who may be paying too much, and to the new Financial Conduct Authority (FCA), which now has a statutory competition objective and duty. Although the annuity market is considered to be quite separate from the DC accumulation market (investment in individual plans and workplace schemes) it is relevant that the key finding of the September 2013 Office of Fair Trading report on DC schemes (OFT 2013) was that the weakness of the buyer (demand) side undermines the role of competition in driving good customer outcomes.

Finally, the review includes two examples of articles published in the press in 2013 that indirectly provide access to unpublished research or data on insurance company profitability. In these cases we contacted the author of the research or data to verify that their material was reported correctly.

Works cited are indicated by the author and/or by the organisation that commissioned the research, followed by the year (and also the month where there was more than one publication in the given year). Additional references are shown in the footnotes. A bibliography is provided at the end of the paper.

Note on terminology: we use the description 'DC customer' to denote both consumers who buy defined contribution (DC) personal pension plans and members of DC schemes that are offered by employers.

October 2013

1. Summary of findings from the literature review

1.1 The multi-billion annuity market is growing rapidly due to the rise of DC

- More than 400,000 annuities are purchased each year in the UK
- New business is valued at about £12bn per annum
- The market is expected to double in size by about 2015 and then triple in subsequent years. This expansion is due to the growing maturity of the DC market and the expected impact of auto-enrolment, which is expected to increase DC scheme membership from around 4-5m pre-auto-enrolment to 12m+ by 2018. Auto-enrolment legislation requires private-sector employers to auto-enrol most employees into a pension scheme between 2012 and 2018.

1.2 Annuitisation is a very complex process for most DC customers

- It requires the exchange of the lifetime pension savings in one or more DC funds for a long-term insurance product that is often poorly understood.
- It is a one-off and generally irreversible purchase, for which the DC customer typically has no learning curve.
- The range of annuity types and features is complex and the jargon is a deterrent.

1.3 A 'good' annuity outcome requires expert help in most cases

- The technical definition of 'exercising the open market option' (OMO) is to buy an annuity from a provider other than the original pension provider. By contrast, the research stresses that in order to achieve the best outcome, the process involves four stages:
  - Making the purchase or purchases at the right time; this might not be the same date that the DC customer retires and it might involve multiple pots.
  - Checking older DC pension contract terms: for example the pension provider might offer a guaranteed annuity rate. Such features might mean that the customer would not benefit from shopping around.
  - Selecting the right type of annuity and the right features from a complex range which requires a careful weighing up of costs and benefits in order to make an informed decision.
  - Securing a competitive rate using a whole-of-market search.

1.4 A high proportion of DC customers do not shop around for the best deal

- There is a consensus in the literature that in most cases using the OMO benefits the DC customer.
- Nevertheless, depending on sources, between one-half and two-thirds of DC customers do not take advantage of this right. However, certain sources have identified an increase in the use of the OMO in recent years.

- Of the DC customers that do use the OMO, the data sources are not clear about the proportion that take advantage of the full OMO process, as defined in 4 above, and the proportion that use only a partial OMO process, for example where just one alternative insurance company's quotes are sought by the DC customer or are offered by the provider or adviser.

1.5 Many consumers do not understand the differences between advice channels; they do not know where to go for professional help

- Most DC customers do not understand the regulation of advice and its implications for
  - Customer protection post-sale
  - The cost
  - The way that the adviser remuneration is arranged in relation to fees and/or commissions
  - The influence of the remuneration arrangements on product searches and recommendations where the adviser has a single or multi-tied arrangement with providers.
- They struggle to find a good adviser because they do not know where to go, whom they can trust, and the criteria on which the choice of firm should be based.

1.6 The 'solutions' to promote better consumer outcomes reflect very different approaches to the level of help DC customers need

The two main options, which are not mutually exclusive, are:

- Provide better information: The insurance industry solution is for pension providers to give clearer information about the OMO to DC customers approaching retirement. This puts the onus for action on the DC customer.
- Make the OMO the default: Several independent reports and trade associations have proposed that the OMO should be automatic. Possible ways to achieve this include:
  - To make it a requirement for employers and trustees to include a good quality whole of market annuity brokerage service as part of the DC scheme. For customers with personal pension plans (e.g. the self-employed) this might be achieved via a recognised national directory of specialist annuity advisers that adhere to a robust code of conduct and offer a whole of market search facility.
  - To make taking good-quality, whole-of-market advice by annuitants the default option, with a clearing house to lower the supply price of advice and to facilitate economies of scale. This might take the form of a 'national annuity service', for example.
  - To make the OMO mandatory and to make taking advice mandatory. Advice is already mandatory in the equity release and mortgage markets, for example.

1.7 In future the debate about the OMO and value for money is likely to encompass the profits insurance companies make on their annuity books

- There have been several unpublished investigations into annuity pricing and profit margins which suggest that in some cases providers might be extracting super-normal profits from their annuity books.
- Following the publication of the OFT report on the DC market, which revealed a worrying lack of competition, it is possible that the OFT and/or FCA will investigate competition and pricing in the annuity market.

2. What is an annuity?

An individual who saves into an employer's DC pension scheme or into a private personal pension plan does not receive a guaranteed retirement income linked to earnings, which is the way that defined benefit (DB) pension schemes work.[1] Instead the contributions are invested to provide a fund. At retirement, or later if the individual has other sources of income, the DC customer can take up to 25% of the fund as tax-free cash and converts the rest of the fund into an income stream via a decumulation vehicle.

The main product used for DC decumulation is a lifetime annuity, which is a long-term insurance policy. This is the only financial services product that offers complete longevity insurance, i.e. it provides a guaranteed lifetime income irrespective of investment returns and how long the annuitant lives. Lifetime annuities are the primary subject of this paper.

Not every DC customer buys an annuity. The main exceptions are:

- Those with very small DC funds, with a combined value of up to £18,000 in 2013, who can take the fund as cash. This process is known as 'trivial commutation'.[2]
- Those with large DC funds and/or other sources of retirement income, who might opt for income drawdown, whereby they draw an income directly from the fund. The fund remains invested, usually via a self-invested personal pension (SIPP). Broadly speaking, for those with secure annual pension income worth less than £20,000, it is necessary to annuitise by age 75 at the latest.[3]

The annuity 'rate' is the level of annual income that is guaranteed in return for the DC fund, which technically is an insurance premium. Put simply, the rate the insurance company offers represents a return of the fund plus the return on gilt yields (insurance companies buy long-dated gilts and bonds to match their income payment liabilities), less expenses. The rate takes into account the expected mortality of the annuitant, based on mortality tables and, where an enhanced annuity is purchased, any life-shortening lifestyle features (e.g. smoking) or medical conditions (e.g. diabetes).

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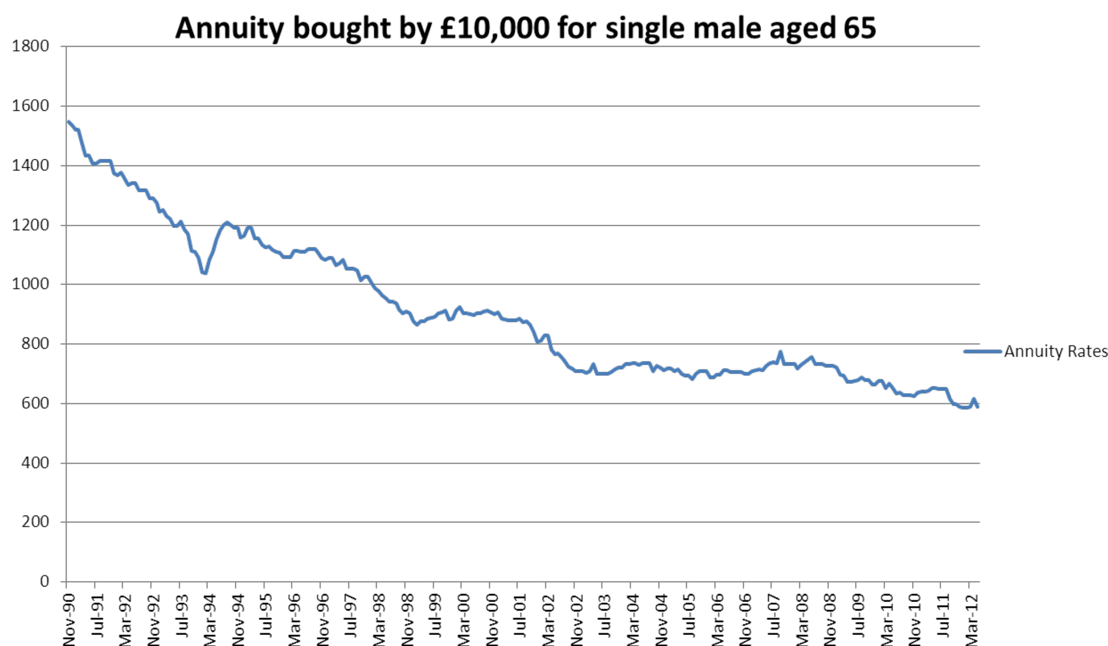
[1] DB schemes were very common in the private sector, but since 2000 most employers have closed these schemes, due to the associated rising corporate liabilities, and have replaced them with DC schemes. DB is still the norm in the public sector.
[2] For the rules on trivialisation, see, for example, the Pensions Advisory Service guide: http://www.pensionsadvisoryservice.org.uk/media/943864/spot008trivialcommdetailedv1.5.pdf.
[3] See HoC Library Standard Note: SN 0712, 30 April 2013

Annuity rates have fallen steadily over the past 20 years, due to increasing longevity and falling gilt yields, among other factors.[4] This decline in rates is shown in the following graph, which charts the rate of guaranteed income a 65-year-old man would have secured per £10,000 of DC assets.



Source: Annuity Direct (www.annuitydirect.co.uk)

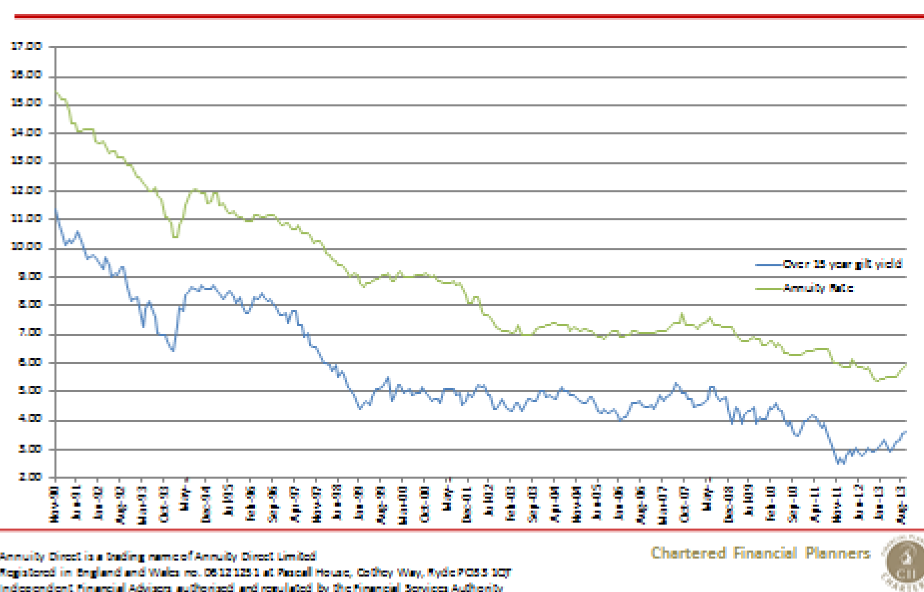
Insurance companies that sell lifetime annuities underwrite the guarantee for the lifetime income (the longevity insurance) and therefore they bear the longevity risk and the investment risk. Insurers spread longevity risk across a pool of lives (their annuity customers), so that the 'surplus' funds of those who die earlier than expected (based on mortality tables) help to support the income payments of those who live longer than expected. This pooling mechanism, whereby annuitants who die early cross-subsidise those who survive (known as 'mortality drag') is the insurance principle that underpins the annuity market.

Annuity rates closely track the yields on long-dated gilts, which, as mentioned above, are the main instruments insurance companies hold to back their guarantees. The following graph demonstrates this alignment between the rate for 15-year+ gilt yields and the corresponding annuity rate (horizontal axis).

[4] Gilt yields rise and fall with interest rates.

Historic gilt yields and annuity rates

Annuity rates



Source: Annuity Direct (www.annuitydirect.co.uk)

DC customers can buy different types of lifetime annuities:

- **'Conventional' or standard lifetime annuities**: The rate is based on average health and mortality assumptions.
- **Enhanced annuities**: The rate is higher as it takes account of potentially life-shortening medical and/or lifestyle conditions.[5]
- **Fixed-term annuities**: For those who want to annuitise for a short period of five or 10 years, perhaps because they expect rates to improve when they are older (and when they might qualify for enhancements) and/or because they want to delay making a commitment to a specific type of annuity and annuity features.
- **Investment-linked annuities**: Offer the potential for a higher income because the annuitant shares in the profits of a multi-asset (usually with-profits) fund. The mortality drag principle still applies and a baseline income is established, but the actual annual income can rise or fall, depending on investment returns. This is considered a more risky product than the standard lifetime annuity, but the standard annuity does not benefit from investment growth.
- An alternative to an annuity is income drawdown, where the income is drawn directly from the fund, which remains invested. Drawdown is not an 'annuity'.

[5] Although the medical underwriting is the same, 'impaired-life' refers to serious medical conditions that result in a very short life expectancy, e.g. terminal cancer. 'Enhanced' refers to a wide range of health and lifestyle conditions that can reduce the individual's lifespan to a more limited extent, for example where the individual is overweight, smokes regularly, and/or has type 2 diabetes. Some insurers offer higher rates to people who have followed certain occupations, but like postcode underwriting this is another proxy for health. See HM Treasury, Dec. 2006. Smaller pots might secure a higher rate than larger pots, as 'wealth' is also used as a proxy for health.

It is possible to buy a range of features, which provide additional insurance, but at the cost of a lower income:

- **Joint life annuity**: A single-life annuity (in the absence of a guarantee), will only pay out during a person's lifetime, whereas a joint-life annuity pays an income to a partner after the main annuitant's death. The income (e.g. 50% of the main annuitant's) continues until the partner's death.

- **Increasing annuity**: A level annuity pays the same income each year, whereas an increasing annuity pays a lower initial income which then increases each year in line with inflation or at a fixed rate.

- **Guaranteed income period**: The income from an annuity 'without guarantee' stops on the death of the annuitant, whereas an annuity with a guarantee continues the income payments for the period protected (typically five or 10 years) if the annuitant dies during this time. In this case the income is paid to the deceased's beneficiaries or estate.

To summarise, in addition to the impact of prevailing interest rates, the annuity rate depends on a number of factors, including:

- The size of the fund or aggregated funds, where there are several pension plans, which is common.

- The decision to take tax-free cash: this can be up to 25% of the fund.

- Age: rates generally increase with age due to the shorter payment period.

- Disclosed life-shortening medical conditions and lifestyle features, which are taken into account in the underwriting process.

- The choice of annuity features.

3. The supply side

The supply side can be divided into providers (manufacturers) and advisers (distributors), although for reasons we explain below the distinction has become somewhat blurred in recent years.

The annuity provider market consists of traditional life insurance companies, which sell both DC pensions (accumulation market) and annuities (decumulation market), and insurers that only sell annuities and usually specialise in enhanced products. In recent years many of the traditional insurers that sell annuities have launched an enhanced version, but the top rates still appear to be offered by the specialists in the open market.[6]

Most life offices that operate in both the pensions and annuities markets sell annuities direct to their DC pension customers or have a third-party arrangement with another insurer. In some cases they might refer DC customers to an advisory service that in

[6] This can be seen through worked examples using an annuity rate calculator, such as the Money Advice Service's: http://pluto.moneyadviceservice.org.uk/annuities

effect forms part of the scheme.[7] This makes the inter-relationships between providers and between providers and advisers complex. Moreover the ABI told the FSCP:

> 'It is an over-simplification to describe all of these [arrangements] as the 'default' or as 'internal' because:
> - In some cases the pension provider will compare their own rates to the annuity provider's rates, and sometimes the pension provider's rates will be higher (especially when there is a GAR [guaranteed annuity rate]).
> - Not all customers can or do use the service. It might only be available to certain books of customers, or a subset of customers, like those eligible for enhanced.
> - Some have both a panel / IFA referral in place, as well as a tie with one other provider.'

Where pension providers sell DC customers their own annuities retention levels typically are 40-50%, but can be as high as 80-90% (NAPF & PI 2012). A minority also sell via the open market where they compete on price with the specialist providers in order to distribute their products via advisers. There are about 12 providers in the open market at present.

Advisers might offer whole-of-market quotes, quotes based on a panel of providers of varying numbers, or quotes from just one provider with which the ('tied') adviser has an exclusive arrangement. In addition there are firms of advisers that act as 'introducers' to specialist annuity advisers. In this case the introducing firm would be paid by the receiving adviser. Apart from the traditional advisory firms, several providers have established an open market service, which means they compete as distributers as well as 'manufacturers'.

In January 2013 the FSA introduced a new regulatory regime for advisers, known as the Retail Distribution Review (RDR). Under a full advice service the adviser is responsible for the product recommendation (the sale) and is remunerated by a fee paid by the DC customer. Non-advice, which now appears to be the main distribution channel for annuities (NAPF & PI 2012; NAPF 2013), refers to web-based services (often with phone help-lines) that can offer extensive information and guidance, but through which the customer takes responsibility for the decision (the purchase). Under non-advice, the adviser receives a sales commission from the provider, which is deducted from the customer's fund. In regulatory terms, non-advice is classed as execution-only, which does not confer the same rights to redress as full advice.[8]

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[7] The ABI provided the Panel with the following examples of pension providers' third-party arrangements. Insurance company ties (some of which are for all annuities and some of which are for special cases, e.g. enhanced-only) include: Axa Wealth with Legal & General; B&CE with Partnership; Co-operative with Just Retirement; Countrywide with Prudential; Equitable Life with Canada Life; Phoenix with Just Retirement; Royal London with Prudential; Standard Life with Partnership; Zurich with Legal & General. In addition, there are several pension providers who refer some or all customers to a panel or an adviser. Others have their own in-house shopping around service. Those that have told the ABI they do either of these are: Aegon, Co-operative, Fidelity, Friends Life, HSBC Life, Lloyds Banking Group, NFU Mutual, Phoenix, Standard Life, and Wesleyan.

[8] Full advice gives customers the right to complain to the Financial Ombudsman Service (FOS) if they believe there has been a mis-sale. This is not the case where the customer 'knowingly' buys a product via a non-advice (execution-only) service, as in this case they take responsibility for the decision. There is concern that the regulatory distinction between advice and non-advice has become blurred and that annuitants might perceive non-advice as advice.

Commission rates for non-advice vary. For a standard annuity the commission typically is 1% or, more commonly 1.5% of the pot; for an enhanced annuity typically it is 3% (PI 2006 and NAPF & PI 2012), although 3.5% is increasingly common. Higher rates of commission might be paid where an adviser sells a large volume of a provider's products. This practice is thought to explain why some advisers prefer dealing with a limited panel of providers rather than using a whole of market search.

Historical developments partly explain the reason for higher rates of commission on enhanced annuities. When individual underwriting for lifestyle and medical conditions was introduced, cases could be time-consuming and there would usually be a requirement for a general practitioner's (GP's) report. These days, however, the underwriting via websites is fully automated (with the exception of very serious medical cases that might still require a GP report). As a result, recent press reports have questioned the continued need for the higher rates of commission.

The monetary value of commission, as a percentage of the fund, is considered reasonable for smaller pots, but it can be substantial for the larger pots – often more than the individual might pay for full fee-based advice (NAPF & PI 2012). Fee rates vary and in many cases are quoted as a percentage of the fund rather than on a per-case or hourly basis; a practice that might serve to blur the distinctions between advice and non-advice.

As the above description of the market indicates, the supply chain for annuities is complicated, with providers and advisers competing at different stages via different business models and different remuneration systems.

4. The demand side

There is a general school of thought that a combination of healthy competition and informed customers prompts, indeed forces manufacturers and distributors of products to cut costs and improve efficiency, the results of which are passed on to the customer in order to maintain or develop market share. Such conditions might not apply in the annuities market, however. The literature reports that although the demand for annuities is growing, it is not necessarily matched by a corresponding increase in DC customer knowledge and confidence, and therefore it is weak in terms of competition. Auto-enrolment is expected to weaken further the demand side, at least in the early years. This is because the system is partly based on the behavioural economics principle of member inertia – i.e. once automatically enrolled the employee will stay put, especially as employers are only required to make contributions to the designated auto-enrolment scheme and not to employees' individual pension plans. For this reason, there might be significant parallels between the poor competition in the DC accumulation market, due to the weak demand side (OFT 2013), and the decumulation market.

The position of DC customers facing the annuitisation process is considered in most of the literature examined. In 2002 Financial Services Authority (FSA[9]) research found that there 'was a low level of understanding of the annuity purchase process' (FSA 2002). A report on the annuity market published by the Pensions Institute in 2006 (PI 2006) said: 'annuities, and the process of annuitisation, are complex, as are the rules that apply to

[9] In 2013 the FSA was replaced by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

the DC pension scheme or plan, which generates the fund used for purchase'. The report said that DC customers had no idea how the rate was determined and that the overall complexity 'deters consumers from a positive engagement with the open market option'.

The same report also questioned whether better information was the solution to improved customer outcomes:

> *This point cannot be over-stressed. To make a rational choice, consumers must understand the nature of their DC pension arrangements and any reasons why making use of the OMO is not beneficial, including features such as a loyalty bonus, an exit penalty, and the availability of a guaranteed annuity rate (GAR). For a layperson this information may not be obvious from the pension documentation.*
>
> *The choice of annuity type and the range of features offered also require an understanding of key financial concepts. These include the impact of 'lifestyle' factors, about which the individual may be in denial (refusal to acknowledge an unhealthy habit or condition), longevity (most people underestimate this by between four and six years), and the impact of inflation on an income that may last for over 20 years.*

Concerns about what reasonably can be expected of DC customers in relation to taking responsibility for their annuity decisions arose again in the 2012 report published by the Institute of Fiscal Studies (IFS 2012), which used the English Longitudinal Study of Ageing (ELSA). The report found that one-third of people cannot estimate, even within a broad range (worst/best scenario) how much their total retirement income, including the annuity, would be worth. The research found that most DC customers plan to retire at a certain date but do not know how long they might live and usually underestimate longevity.

Importantly, like PI 2006, the IFS report stressed the need for a better understanding of the ability of DC customers to make rational and well-informed decisions in relation to complex pension and annuity products:

> *Defined contribution pensions require people to make complex decisions both while they are accumulating their pension savings and when they want to start drawing an income. Understanding how people have been coping with annuitisation decisions over the last decade is important as policymakers consider and implement further reforms to this market.*

These concerns were again raised in NAPF & PI 2012, which argued that financial literacy was a major barrier in an effective demand side for the annuity market. The report said that the average adult financial literacy (based on evidence that on average adults have age 13 levels of English and Maths) indicated that they could not be expected to understand annuities. This point was also highlighted in a report published by the Organisation of Economic Cooperation and Development (OECD) on the way that DC customers interpret their pension statements and their likelihood of achieving their desired pension income (OECD 2012). What academics understand as mathematical probability, the report said, DC customers perceive as a lottery.

Moreover NAPF & PI 2012 said that DC customers do not have – and cannot get – access to information about the complex ways in which providers set their annuity rates, which include 'cliff edges and rate manipulation'. DC customers conducting a superficial review of annuity rates understandably might assume that pricing is graduated proportionately; that a good rate for £10,000 means an equally good rate for £14,499, which is not the case.

Further, the report said that DC customers might be misled by the term 'enhanced', which is not defined in regulation and therefore could mean anything from a £1 difference in the monthly income to a 30% increase that might be available via the OMO, depending on the relevant health and lifestyle factors.

5. What is the Open Market Option (OMO) and how is this being promoted?

Individual pension plans have been around for many decades, but until 1975 customers bought their annuity from their pension provider. Since this date they have had a choice: they can buy their annuity from their existing provider or use ('exercise') the Open Market Option (OMO), which enables them to purchase their annuity from a different provider.

The purpose of the OMO was to stimulate competition and improve consumer rights. However, there appear to have been concerns for many years about the effectiveness of the mechanism, due to the comparatively high proportion of DC customers who have not used it and who might (unknowingly) have suffered financial loss as a consequence.

In September 2002, the Financial Services Authority (FSA) introduced new rules that required pension providers to inform customers who were about to retire that they had the right to buy their annuity elsewhere. Initial findings regarding the impact of the new requirements were encouraging (FSA, 2003).

However, in October 2007, the Labour Government found it necessary to announce a number of measures to improve the operation of the OMO. This was in response to continued concerns that the OMO failed to serve consumers effectively, due to the high levels of unawareness and lack of information (HMT Oct. 2007). The measures included the establishment of an annuity comparison tool on the Pensions Advisory Service (TPAS) website.[10] The present Government set up a working group to examine how to encourage people to use the OMO, for example by making it easier to find a suitable adviser. In addition, the Money Advice Service (MAS), that began in April 2010 as the Consumer Financial Education Body, acts as an independent organisation with responsibility for improving people's money management; a responsibility that includes guidance on pensions and annuity services and on advice channels.[11]

In March 2012, the ABI published its Code of Conduct on Retirement Choices (ABI Mar. 2012), which aimed to ensure pension providers deliver clear and consistent information to customers about their retirement choices.[12] The code became compulsory for ABI member firms in March 2013 and, among other features, requires pension providers to draw attention to the OMO and provide sources of further information.

There is consensus in all the literature that using the OMO can be beneficial, although the research also stresses that there are important exceptions, such as where the DC customer has a with-profits policy that confers a guaranteed annuity rate (GAR). While GARs have long since been dropped from new products, they are an important

[10] http://www.pensionsadvisoryservice.org.uk/press-releases/2007/october/tpas-to-participate-in-dwp-open-market-option-initiative
[11] https://www.moneyadviceservice.org.uk/en/static/background
[12] https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/ABI%20Code%20of%20Conduct%20on%20Retirement%20Choices.ashx

consideration for the generation of DC customers coming up to retirement, who are likely to have been sold plans in the 1980s GARs were common.

A better way of describing the DC customer's needs, therefore, is to say that they require a thorough review of their funds and annuity options (PICA 2009) and, where appropriate, they should use the OMO to secure the most competitive rate for their selected annuity type and features (PICA 2009; NAPF & PI 2012).

Quantitative analysis of the benefits of using the OMO reveals different results depending on which factors are taken into consideration. In 2009 the Pensions Income Choice Association (PICA) commissioned a report from Oxford Economics (PICA, 2009), which said that a male and female about to purchase a fixed income (level) annuity could increase their annual income by an average of 19% and 22% respectively by switching from the lowest to the highest paying provider. Other reports (e.g. NAPF & PI, 2012) stated that the difference between the best enhanced rate and the lowest standard rate could be up to 40%.

6. How many DC customers use the OMO?

Until comparatively recently it was estimated that about one-third of DC customers bought their annuity from an insurance company that was different from their pension provider. By 2013 the figure appeared to have increased to almost 50%, but there were some concerns about the data, as we explain below.

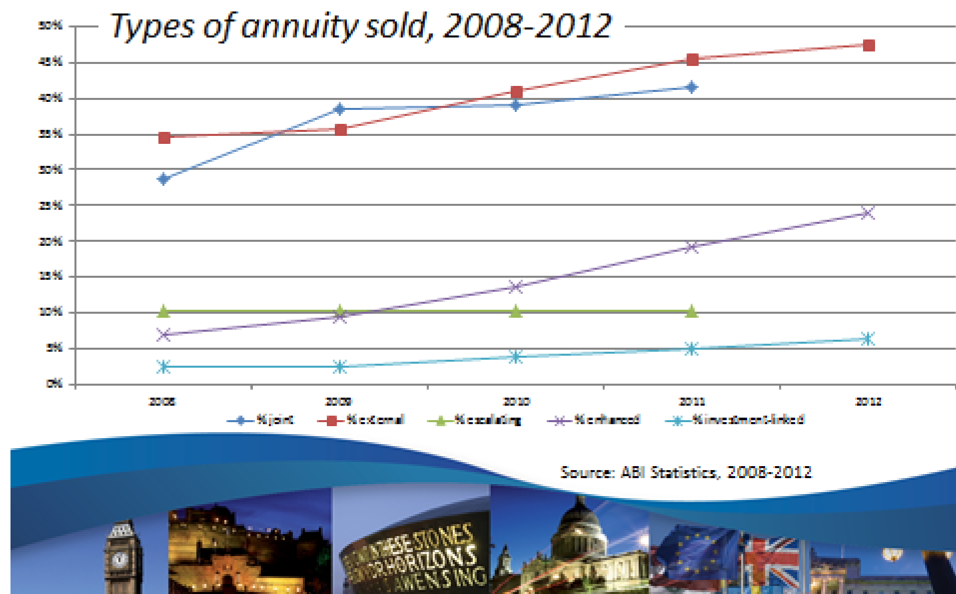
A survey carried out by the FSA (FSA, October 2002) estimated that two-thirds of personal pension holders bought their annuity internally in the year 2000. The internal proportion measured by value of the annuity was lower at about 50%, reflecting the fact that DC customers with larger funds were more likely to buy externally. Similar estimates of the internal-external split of annuity purchases were reported in HM Treasury 2006, ABI 2008 and ABI 2010.

The IFS research (IFS 2012) found that between 20% and 30% of annuitants remained with their original pension provider between 2002 and 2010 and that purchasing externally was more common among those who held a relatively large proportion of their wealth in DC pensions. The report said:

> 'We find that the third of annuitants for whom DC wealth is most important (among whom, at the median, DC wealth accounts for 31% of total wealth) are more than twice as likely to buy externally as the third of individuals for whom DC wealth is least important (among whom, at the median, DC wealth accounts for only 2% of total wealth).'

The report also said: 'Only 27.7% of individuals with a major health condition actually do buy externally, suggesting that many might be missing out on the best annuity rate available, given their circumstances.'

The IFS found some evidence that the proportion of annuitants buying from an external provider has 'increased in recent years'. A similar impression emerges from the ABI sales data: the ABI's headline figure in 2013, based on OMO data from 2012, indicated a significant increase in the use of the OMO. Of the 420,000 annuity contracts sold in 2012, 52% were internal contracts, where the customer purchased their annuity directly from their pension provider, and 48% were OMO purchases. The following graph indicates this upward trend.



Source: ABI

There are two qualifications. First both the ELSA data used in the IFS study and the ABI sales data are affected by the inclusion of annuities sold under tied arrangements. These occur in two quite different circumstances:

- Where a pension provider does not offer annuities (or has decided to withdraw from the market) and therefore strikes a deal with an insurance company whereby the latter's annuity products become the 'default' for its customers. If the DC customer accepts this annuity then he or she has in effect 'stayed put', but technically has 'exercised the OMO'. ABI (2012) claims that this type of tied arrangement makes a 'minimal difference' to the sales data, however.
- Similarly a DC customer who uses an adviser that is tied to just one insurer for annuities will only be offered that insurer's products. This is also classed as exercising the OMO.

The definition of an OMO process that leads to a good member outcome, which we set out in 1.3 above, therefore is crucial to the analysis of data.

The second qualification is that the ABI's 2013 baseline survey (ABI, May 2013) found that 68% of purchasers were internal – and therefore little changed from the year 2000 figure estimated by the FSA (FSA, October 2002). However, the ABI (ABI, May 2013) suggests its sample may have been biased, overstating the proportion of internal sales.

7. The dwindling market for 'full' advice'; the rise of 'non-advice'

The reports examined for this paper agreed that DC customers need support during the annuitisation process. However, opinion differed on the type, extent and source of the help required. It also differed on the availability of appropriate advice.

As mentioned earlier, from January 2013 advisers can offer fee-based full-advice services, where they take responsibility for the sale, and/or commission-based, 'non-advice' services, which represent a more developed form of execution-only and where the customer takes the responsibility for the purchase. NAPF & PI Feb. 2012 said that the full advice market was likely to shrink after the new rules were introduced, when it was expected that an increasing number of advisers would direct most annuity clients towards their non-advice sales channel. The report stressed that good quality non-advice sites are a suitable source of help, especially for those with smaller pots for whom the cost of fee-based advice is uneconomic; a point also made in NAPF June 2013.

However, NAPF & PI 2012 also pointed out that the quality of non-advice varies considerably. Importantly customers might not appreciate that they are responsible for making the decision and that the adviser or website owner continues to be remunerated through commission. The report said that most DC customers are unlikely to understand the regulatory rules for advice categories and their implications, both pre- and post-RDR. The research supported this argument with reference to an advisor survey which found that 85% of intermediaries thought clients do not understand the difference between independent and non-independent distribution channels.

The concern about the 'advice gap' in relation to DC customers with small pots had already been flagged up in 2011 in a report published by the Association of Independent Financial Advisers (APFA) and Prudential (AIFA & Prudential 2011). This report found that the rising cost of fee-based advice meant that fewer than half of IFAs were willing to advise DC customers who had pension funds worth less than £50,000 (44% in 2011, compared with 56% in 2010). Where the DC customer had pension assets worth less than £25,000 (the average DC pot size was about £26,000 at this time), more than half of advisers (54%) would only offer an OMO quote via non-advice (up from 42% in the previous year). The report pointed to the rise of 'DIY decumulation' and warned the Government of the potential risk of reduced access to financial services

The pension consultant and administration firm Equiniti Paymaster published a report in 2013 (Equinity 2013) which included a survey of 'annuity experts' and their views on the emerging advice gap. It said:

> 'The majority of experts felt that the predicted advice gap is now a real concern and the transparency of cost that RDR would bring has not been achieved. The experts also feel that an FCA push for compulsory OMO is a good thing, but likely to be very challenging.'

8. How much support do DC customers need?

In 2008, the Personal Accounts Delivery Authority (PADA) undertook extensive consumer research before the National Employment Savings Trust (NEST) introduced its annuity process. NEST's target market is employees who earn up to about £40,000, but it is expected that the national scheme will attract a high proportion of low and average earners.[13] In aggregate, the PADA reports (PADA, 2008) found that there were low levels of awareness and understanding of pensions and annuities, and that even those who were more confident and capable with finances in general were poorly informed about annuities in particular, and had given little thought to what had to be done to

[13] Average earnings in January 2013 were £26,664: http://www.ons.gov.uk/ons/guide-method/surveys/list-of-surveys/survey.html?survey=Annual+Survey+of+Hours+and+Earnings+(ASHE)

convert their fund to an income stream at retirement. Retired respondents were often no better informed, the research said: many had no memory of making significant decisions about annuities, apparently because they had ticked the box accepting their provider's default option.

The PADA evidence also suggested that consumers had limited access to sources of information. While consumers cited the internet, advisers, banks, building societies, and friends and family as sources of information, they rarely mentioned public and third-sector sources.

PADA's research revealed that members of workplace DC schemes were less informed than those who actively took out a personal pension. The former group said they had joined the scheme because they had been told to, and 'did not really know what happened to their money each month'. The research said that two main attitudes – 'indifference to detail and the future, and cynicism and lack of confidence that the pension will be worth anything', discouraged respondents from thinking hard about their pensions both now and for the future.

In addition PADA found that jargon and technical language used in statements and correspondence from pension providers had prevented most DC customers from thinking about what they would need to do to convert their pensions into income, and had left them ill-prepared for the types of decision they would need to make when that time came. Importantly the research found that at this time, few people knew about and understood the OMO.[14] The most common assumption was that the pension provider would somehow take the pension fund and distribute it as income.

Also in 2008, RS Consulting conducted 60 face-to-face interviews with DC customers who had recently purchased an annuity in the previous 3-9 months and prospective annuitants those who had recently received the pre-retirement 'wake-up' letter from their provider. The key findings were very similar to the PADA 2008 reports above, i.e. poor awareness, and difficulty with terminology in the literature, among other factors.

The ABI's solution to the perceived low uptake of the OMO was enshrined in the 2012 code of conduct (ABI Mar. 2012), which came into force in March 2013. This solution is predicated on the assumption that if DC customers have clear information they will take appropriate action.

The 'better information' approach was also posited by the International Longevity Centre in its 2012 report. The research identified and set out practical solutions to address the advice gap post-RDR. It argued that greater transparency in the annuities industry, better targeted information for DC customers and a greater role for technology could play a significant part in mitigating any negative impact of new rules which change the way people pay for financial advice.

However, the Pensions Institute October 2012 report on auto-enrolment (PI 2012) pointed out that member 'inertia' is hard-wired into the new pensions regime for the private sector, whereby employees do not choose to join and in most cases do not

[14] Those who did check out the OMO showed 'a definite tendency to favour short-term gain over long-term security once they had seen the illustrative figures involved'. They were often 'irked by the morbid nature of the decisions' – they had not thought about their life expectancy in such stark terms before'. When different purchase routes were described, few wanted to do everything online. They were happy with online forming a part of the process saying that, for example, 'online fine for initial research', but that they 'wanted a more traditional channel for purchasing an annuity'. Others said they used the traditional channel for the initial process, but were happy to make the actual purchase on an online system once the choice was made.

choose their investment fund but are automatically put in the 'default' fund. The report argued that from a behavioural perspective the very success of auto-enrolment is predicated on member inertia and that as a result it was very unlikely that after a long period in an accumulation scheme where decisions were made for them, members would be actively engaged and fully understand how the annuitisation process worked. The same point was made in NAPF & PI 2012:

> *For those who have relied on the default fund in the accumulation phase, this decumulation lottery is likely to lead to poor outcomes and significant losses of income in retirement, potentially wiping thousands of pounds off the value of the pension pot that the member and employer have worked so hard to build. And while decisions about contributions and investments can be changed, the process of buying an annuity is a one-off event which cannot be reversed or corrected later.*

While the NAPF stressed its support for the ABI code, in its June 2013 report (NAPF June 2013), it repeated the proposal made in NAPF & PI 2012, that to tackle the inertia in the auto-enrolment market and secure better outcomes for DC scheme members, an effective shopping around service should be made part of the pension scheme. Better information for members was not the answer, the NAPF said:

> *Much of the activity remains predicated on the DC saver navigating their way through this very complex market alone, prompted by sign-posting to a number of different sources of information and guidance, adviser sites, and annuity rate comparison tables.*

The report concluded that the same behavioural principles that are embedded in the auto-enrolment accumulation stage, designed to exploit employee inertia, should be applied to the decumulation stage:

> *That would ensure that, in the event that the DC saver did nothing, they would still be guided through a process that led to a good outcome. Whilst this could come in different forms, it would tend to be predicated on an agreement between the employer, trustees or the provider, with an adviser that has the expertise and capacity to provide cost-effective advice and the OMO service even for smaller fund sizes.*

The success of this model would depend on the ability of employers (contract-based DC schemes) and trustees (trust-based DC schemes) to appoint the best annuity brokerage service for their DC members. The research found that non-advised guidance was the most common service selected for supporting members at retirement, but that both fee- and commission-based charging models were 'capable of delivering good member outcomes'. Whichever model employers and trustees select, the NAPF said, they should take more responsibility for vetting the adviser and negotiate to secure a good deal for members, for example in the case of non-advice there should be a cap on the level of commission deducted from the member's pot.

A similar proposal was made by former financial services regulator David Severn in his 2010 report on safer products (FSCP 2010). He argued for a default position operated by PADA (now NEST) in which all consumers reaching retirement age should be offered not only the Open Market Option but also "more importantly" professional advice. He recommended the establishment of an "annuities clearing house" which, "dealing with very high volumes of business", should be capable of providing advice at low cost, with the regulator and PADA setting the advice fee at an acceptable level.

While these proposals might provide a solution for private sector employees in DC schemes (including those with pots from previous employment and self-employment), it does not tackle the needs of the self-employed who rely wholly on personal pension plans. The ABI code, however, applies to all contract-based DC arrangements and so would include the self-employed.

A third initiative that was expected to be launched in 2013 emerges from the government's consultation with consumer groups and regulators in relation to the OMO. At the time of writing this OMO Review Working Group was expected to lead to the launch of a web-based annuity advisor directory that would make it easier for DC customers to find an appropriate adviser for their needs.

9. Can annuities offer better value for money to *all* DC customers?

The main focus of this paper has been the literature that considered the extent to which DC customers feel able and equipped to use the OMO and the associated barriers to the effectiveness of the OMO. However, there was an embedded assumption in many of the reports examined that that a more efficient market for DC customers could emerge from a more informed demand side. For example, NAPF & PI 2012 presented evidence to suggest that each annual cohort of pensioners loses around £500m-£1bn in lifetime income as a result of not shopping around. An earlier report (PICA 2009) said that the implementation of the OMO as a default would increase pensioner incomes by £13.9m in 2010 and that pensioners would gain an estimated £3,308 million in extra income in today's prices between 2010 and 2030.

Such estimates are subject to qualification, a point noted by the FSA as long ago as 2002 (FSA Oct. 2002), which said that what might be true for individual DC customers, in terms of personal benefit, might not be true for all customers. In other words, if some DC customers get a better deal – for example through enhanced rates – this might be offset by a fall in the rates for customers in average health. Under this scenario, the more extensive use of the OMO might not lead to an aggregate gain; just a different set of winners and losers.

Even if this were the case, the 2002 FSA report emphasises other possible benefits were all DC customers to shop around: it would make the market more competitive and tend to drive down average prices. This would be so if firms were previously earning super-normal profits and/or were inefficient – scenarios that might be evident in a market that is not competitive, for example due to oligopolistic powers and/or a weak buyer side.

Reports such as NAPF & PI 2012 and NAPF 2013 posited that the increased use of the OMO, whether via more informed customers or the implementation of the use of good quality annuity advisers as a default, might produce an aggregate customer gain. This argument was predicated on the assumption that such a scenario would lead to the elimination of excessive insurance company profits and also spur insurance companies to increase efficiency. In this case, provided the results of these processes were passed on in the form of better annuity rates across the board, the greater good for the greatest number might be achievable.

This leads to the question of the competitive nature of the annuities market. Since this was an emerging issue at the time of writing, the literature is necessarily more limited and therefore our review is very brief. The conventional view is that there is no evidence of uncompetitive market practice in the supply of annuities. The economic study of value

for money in relation to the proportion of the DC fund that is distributed as the annuitant's income and the proportion that is retained by the insurance company is known as 'money's worth' (Cannon & Tonks, 2009 and 2011).[15] Money's worth describes 'the expected present [discounted] value of the annuity payments divided by the actual price paid'. The closer money's worth is to 100%, the better the value for money received by the annuitant and, Cannon and Tonks infer, the lower the likelihood of monopoly pricing by annuity providers.

When Cannon & Tonks wrote their report for the DWP in 2009, they indicated that the 'load factor' on annuities was 'fairly priced', calculated at an acceptable 10%, i.e. 'money's worth was 90% of the annuity premium [the DC fund exchanged for an annuity] distributed as income'. The 10% 'load factor' covered 'normal profits' and administration, including distribution costs, which would have taken account of adviser commissions in the OMO. However, the report said that where the pay-out plus load factor equalled less than 100% this would indicate 'excessive profits or that there was some other problem'.

Importantly, the report focused on rates in the open market, as internal rates are not usually available for independent academic scrutiny.[16] Therefore the assessment of money's worth does not take into account providers' internal rates, which can be significantly lower than rates quoted on the open market, particularly where the provider only sells to internal customers. In August 2013 the ABI launched 'Annuity window',[17] which shows sample rates for external (OMO) and internal customers provided by ABI member firms, which means the examples exclude certain annuity providers. Nevertheless the rates showed that there could be a 30% difference between internal rates and the top rates in the open market. In one scenario, where the internal provider did not offer enhanced rates, the differential was 100%.

In 2013 Cannon and Tonks wrote a paper (Cannon & Tonks 2013) that raised questions about the extent to which 'a regulated life assurer with concerns about predicting long-run mortality may price annuities to reduce these risks which will affect the money's worth'. While the authors argue that it is essential for insurers to be prudent in relation to mortality risk, nevertheless an implication is that annuity providers might be *overly*-prudent in their mortality assumptions, which means that they might assume a longer payment period than was justified by mortality tables and 'pocket the difference' when annuitants die at the expected age.[18]

Other evidence has not been subject to peer review, but is nevertheless worthy of note.

In March 2013 an article in the press written by a respected actuary, who had examined the limited disclosed information on load factors, suggested that the profits on rollover annuities (the pension providers' sales to its annuitizing clients) were excessive:

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[15] In their 2013 paper for the Pensions Institute (Cannon & Tonks 2013) the authors introduce the concept of the 'stochastic money's worth' which takes into account the uncertainty faced by annuity providers predicting long-run mortality.

[16] The data used in the 2009 report were the OMO rates quoted in Moneyfacts from July 1994 to March 2007.

[17] https://www.abi.org.uk/Insurance-and-savings/Products/Pensions/Annuity-rates/Example-rates

[18] See also Casassus & Walker 2013. In June 2013 the Daily Mail published an article (Daily Mail 2013) that highlighted the impact of the use of overly-cautious mortality assumptions, which it said gave insurance companies an additional six years' of annuitant income as profit on average. We noted that the style of the article was 'populist' and confrontational, but we confirmed that the findings were as provided by the annuity expert (Alan Higham, Director of Annuity Direct) to the journalist.

> '[An example] provider shows that the average profit margin it makes on rollover [retention of existing pension customers] annuities is nearly 20-times the profit margin it makes on the rest of its UK business. In fact, its total profit from rollover annuity business is almost the same profit they make from their much-trumpeted corporate pensions business.'[19]

In June 2013 the Daily Mail published an article (Daily Mail 2013) that highlighted the impact of the use of such overly-cautious mortality assumptions, which it said gave insurance companies an additional six years' of annuitant income as profit on average. We noted that the style of the article was 'populist' and confrontational, but we confirmed that the findings were as provided by the annuity expert to the journalist.[20]

Finally, in 2013 the FSA announced that it would conduct a thematic review of annuities. The main component of this work seeks to estimate how much better off consumers would be buying an annuity from the open market, rather than their existing pension provider. The work also proposed to identify providers that pose greater risk of poorer outcome to their consumers. Depending on the findings, this work may result in a market study as indicated in September 2013.
http://www.fca.org.uk/news/firms/competition-and-conduct-regulation-in-financial-services)

10. Conclusions

The literature review highlighted several key concerns in the annuity market that might lead to DC customer detriment and also identified the need for further research:

- To receive best value from their lifetime pension savings, DC customers (those with personal pension plans and members of employment-based schemes) need a high level of support to shop around effectively, so that they buy the right type of annuity at the right time and at a competitive price.
- Given the consensus on the asymmetrical relationship between sell-side and buy-side knowledge, the continued application of behavioural economics theory to the subject of annuities is important, as it highlights the underlying reasons for what otherwise might appear to be 'inertia' on the part of DC customers and draws attention to the potential lack of competition in a market with a weak buyer side.
- If employers and trustees take responsibility for appointing an annuity adviser to the workplace scheme, they need to be equipped with sufficient knowledge to ensure the firm offers high standards of service and that the adviser's remuneration is set at a fair level for members with different pot sizes.
- DC customers who are not in a workplace scheme with a default annuity service need to understand the implications of the different advice channels through which they can make their purchase in relation to the different levels of regulatory protection and different pricing models. One solution suggested would involve the construction of some form of national annuity service that would provide a good quality OMO process as a default mechanism, but from which DC customers could opt out.

[19] The author was John Taylor, formerly of Scottish Widows and now at NEST.
[20] Alan Higham, Director of Annuity Direct

- Emerging research is likely to shed further light on the question of 'money's worth' and whether or not insurance companies retain a reasonable percentage of the DC customer's fund to cover profits and other components of the 'load factor'. In due course it is possible that the OFT and/or FCA will launch a competition investigation into the annuity market, similar to the OFT's investigation of the DC workplace scheme market, which lead to the OFT's September 2013 report.

Glossary of terms

Accumulation: In *defined contribution* this refers to the period of pension contributions and investment, after which the fund is used to provide the lifetime income in retirement (known as *decumulation*).

Annuitant: The purchaser of an annuity.

Annuity: A lifetime annuity is an insurance policy that guarantees an income for life in return for the DC pension fund (the 'premium'). See *annuity rate*.

Annuity rate: The annual income the insurance company guarantees to pay in return for the DC fund. Rate tables usually show annual incomes for funds of foxed sizes, e.g. £10,000. The purchaser is described as an *annuitant*.

Auto-enrolment: The new system of pension scheme provision for private sector employees in the UK, which is being phased in by all employers between October 2012 and 2018. Employers and qualifying workers (those earning at least £9,440 in 2013-2014) must make minimum contributions based on band earnings, but the latter have the right to opt out. Qualifying auto-enrolment schemes do not have to be DC but, in practice, the majority will be so. They must offer a default fund for members who do not wish to make their own investment decisions.

Commission: This is paid by the provider to the adviser that sells its products. It is calculated as a percentage of the fund. Commission rates for annuities range from about 1.5% to 3.5%.

Contract-based DC: DC schemes can be established under contract or trust law. In a contract-based scheme, the contract is between the member and the provider, for example a life office. Contract-based DC is regulated by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). See also *trust-based DC*.

Decumulation: In *defined contribution* pensions this refers to the process whereby the fund built up during the *accumulation* stage is converted into a lifetime income in retirement. Typically this involves the purchase of an annuity, but the member might also draw directly from the fund (*income drawdown*).

Defined contribution (DC): In DC, the member's pension is based on the contributions invested and the charges deducted, among other features. The fund is used at retirement to generate a lifetime income, usually in the form of an *annuity*. Therefore the investment and longevity risks fall solely on the individual members.

Enhanced annuity: An annuity available to DC customers whose lifestyle and /or medical profile indicates a shorter than average lifespan and who therefore qualify for a higher rate that would be available to annuitants in average health.

Group personal pension (GPP): A *contract-based* workplace pension scheme. In effect a grouping of individual *personal pension plans*.

Guarantee: An additional insurance feature that ensures the annuity income will be paid for at least the period of the guarantee, e.g. five or ten years. If the annuitant dies before the end of the guarantee period the income is paid to the estate

Income drawdown: At retirement, instead of purchasing an annuity, the member draws a regular income directly from the fund. The maximum amount that can be drawn generally is linked to the prevailing *annuity* rate to avoid overspending.

Increasing ('escalating') annuity: An annuity that pays a yearly income that rises by a fixed percentage, for example 3%, or rises in line with the retail price index (RPI), for example.

Independent advice: Here the adviser is responsible for the recommended product, which is sold on a fee basis (*commission* is stripped out of the product price/annuity rate). See *non-advice* and *introducers*.

Introducer: This type of firm's website can look very similar to those run on an independent advice and non-advice basis. However, the introducer is more lightly regulated, as it is not selling any products directly. Instead the firm passes on customer details to another adviser with which it has a remuneration-sharing arrangement.

Investment-linked annuity: This offers the potential for a higher income than a conventional *annuity* because the annuitant shares in the profits of a multi-asset (usually with-profits) fund. The *mortality drag* principle still applies and a baseline income is established, but the actual annual income can rise or fall, depending on investment returns.

Level annuity: An annuity that pays the same amount each year for the annuitant's lifetime. The alternative is an *increasing ('escalating') annuity*.

Life expectancy: The length of time that an individual can expect to live. In practice this is not known and must be estimated. Actuaries do this by estimating the mortality and then calculating the life expectancy using appropriate mathematical formulae.

Load factor: A measure of the extent to which the money's worth will be less than 100% due to the administrative and regulatory costs and normal profits incurred by the annuity provider.

Money's worth: The expected present [discounted] value of the annuity payments divided by the actual price paid. The closer money's worth is to 100%, the better the value for money received by the annuitant.

Mortality: Underwriters use mortality tables to predict how long an *annuitant* might live in order to set the annuity rate.

Mortality drag: The annuity insurance pooling mechanism, whereby *annuitants* who die early cross-subsidise those who survive.

Non-advice: The regulation classes this as execution-only, since the customer makes the purchase based on the information provided on the website and/or through a phone help-line. Non-advice is *commission*-based. The adviser might offer a whole of market search, a limited search (i.e. it has a deal with several providers), or it might be tied to a single provider. See *independent advice* and *introducer*.

Normal profit: The minimum reward required by the annuity provider to remain in business. This takes account of business overheads, regulatory requirements for reserving, the insurer's mortality assumptions, gilt yields, and distribution costs, among other factors. See *super-normal profit*.

Personal pension plan (PPP): An individual (retail) *defined contribution* pension plan, introduced in 1988.

Retail Distribution Review: Introduced in January 2013 by the FSA, the RDR banned *commission* for the sale of investment products by 'independent' advisers, who are

responsible for the product recommendation (the sale) and are remunerated by a fee paid by the DC customer. Non-advice describes web-based services that offer information and guidance, but where the customer is responsible for the purchase decision. This is commission-based.

Retention rate: The percentage of DC customers who buy their *annuity* from the pension provider. Also known as the 'roll-over' rate, the retention rate can be as high as 80-90%.

Stakeholder pension scheme: Introduced in 2001, stakeholder schemes are like *group personal pensions*, but must meet certain requirements in relation to accessibility and fair terms and conditions.

Super-normal profit: Also known as supra-normal profits, these are earned in excess of normal profits. They can be due to monopoly or oligopoly pricing, innovation (for example the introduction of new underwriting techniques), but the appearance of super-normal profits might also be an indication of inefficiencies in pricing and administration, for example.

Trust-based DC: Schemes set up under trust law where the trustees are the legal owners of the assets on behalf of members. Trustees have a fiduciary duty to act in members' best interests. These schemes are regulated by The Pensions Regulator (TPR).

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