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

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

Freedom and Choice in Pensions
Pensions and Savings Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

11 June 2014

Freedom and Choice in Pensions

This is the Financial Services Consumer Panel's response to the Government's consultation paper 'Freedom and Choice in Pensions'.

In December 2013, the Consumer Panel called for radical changes to the annuities market[1]. The Financial Conduct Authority's subsequent work[2] reinforced our findings. In light of this, we welcome the proposals to tackle the lack of choice and reduced value suffered by consumers, particularly those with smaller pension pots. Greater freedom and choice should also mean more competition in the decumulation market. Annuity providers now know consumers have a choice, and should sharpen up their act accordingly.

Nevertheless, these are far-reaching proposals which carry uncertainty and risk for consumers.

Unintended consequences and risks

The Panel is concerned about the unintended consequences and risks which may arise from these proposals.

The Panel believes there is a real risk that industry will develop inappropriate products (in relation to risks and cost) to replace the lost sales and profits obtained from selling annuities. The liberalising 1986 Social Security Act was followed by years of mis-selling of personal pensions, and a compensation bill that in 2002 was expected to run to around £12bn,[3] despite reassurances from the industry that all was well.[4] We do not want to see history repeated. While we have a very different regulatory regime in place now, we still need the FCA to intervene proactively, which means tight supervision, and use, where appropriate, of temporary product bans. We believe the FCA needs to develop, as a matter of urgency, a coherent risk mitigation strategy.

We have specific concerns about drawdown products, which will expose consumers to risks that they may not be able to manage adequately. It is well known that people underestimate their life expectancy, and therefore the risk of outliving their savings by

---

1 FSCP Time for Regulatory Reform 2013
2 TR14/2 FCA Thematic Review of Annuities 14 February 2014.
3 FSA press notice PN/070/2002, 27 June 2002.
4 Publications.parliament.uk/pa/cm199798/cmselect/cmtreasy/712/8070207.htm.

drawing too high an income too soon, is a very real one. Drawdown products expose people to investment risks they may find difficult to understand and manage, and often carry high product charges. Drawdown may continue to be an option for those with larger pots, or for the early phase of retirement, but lifetime annuities may still be the best option for some consumers in later retirement e.g from mid to late 70's onwards.

The Panel is also concerned that the search for return in a low yield environment will increase the risks of mis-selling and mis-buying. There is already speculation that the buy-to-let market will be aggressively promoted and appeal to DC investors. If an individual's main capital is tied up in their home and in buy-to-let schemes, this will result in overexposure to a single asset class, with all the risks that brings. The same quest for yield might make consumers more vulnerable to firms that sell unsuitable (high risk, high cost) non-pension regulated investments, unregulated investments, and fraudulent schemes.

There is also a risk that people will not understand how the tax system operates in relation to their pension pot, and pay too much tax by withdrawing the money too quickly.

Finally, it is not clear how the changes will affect the Deliberate Deprivation rules for long term care. People may find themselves penalised for accessing their pension pot early; inadequately managing the funds due to lack of knowledge; and then having disposed funds treated as 'notional capital' for the purposes of means testing. It would be helpful if the Government could clarify this as soon as possible.

Protecting and addressing flaws in the existing annuities market

An annuity is the only financial product that provides a full hedge against longevity risk. More than 400,000 annuities are purchased each year in the UK[5], this number will almost certainly decline but annuities will still be right for some people, and the problems in the market need addressing.

Our research into the annuities market highlighted distribution problems, particularly in the 'non-advice' market where we uncovered opaque fees, misleading information and regulatory arbitrage, resulting in reduced consumer protection. We also found tentative evidence of profiteering by some providers.[6] We made the following recommendations:

1. *The FCA should undertake a rigorous market study to examine the 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.* [7]

2. *The FCA should strengthen the operation of the OMO by (a) outlawing barriers to its use in pension contracts (such as exit penalties), (b) exclude tied annuity sales (provider to provider, provider to adviser) from its definition, and (c) setting*

[5] New annuities business is valued at £12bn per annum.
[6] 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 £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 the adviser.
[7] On 14 February 2013, the FCA announced plans to undertake a market study to assess competition around annuity sales. This work is ongoing.

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.

3. *Embody in regulatory rules and required standards the equivalent of a code of conduct for the non-advice market, 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.*

4. *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.*

It is the Consumer Panel's strong view that these recommendations should be taken forward where appropriate and relevant. The Government's extensive proposals and the FCA's re-scoping of its market study should not detract from the necessity of ensuring that the annuities market operates as well as it can, for those consumers who will continue to want a secure income in retirement.

Guidance

The Panel fully supports the 'guidance guarantee' proposal. However, we have significant concerns about implementation. The pensions landscape and the decisions consumers have to make are already complex, and will be made more so by liberalisation. The effectiveness of the guidance will depend on it not being a one-off conversation. It needs to be holistic. For many people, their home will be their largest asset, maybe worth 10 times their pension pot. They may have other savings, a spouse's pension, or significant debts. Guidance needs to look at the whole balance sheet. At the end of the process, people should understand what decisions they need to take, when, and any trade-offs they may need to make. There need to be appropriate hand-offs, for example to regulated advice or debt advice.

The Government says it wants the retirement guidance it proposes to be impartial, of good quality, comprehensive, and, if desired by the individual, given face-to face. We wholly agree. We set out some of the features we would like to see, below.

Independent: Consumers have to trust the service on offer, otherwise the result will be low take up, or a sub-optimal outcome for individuals. This means it needs to be wholly separate from the sales process and on the consumers' side. We seriously doubt that financial services providers could deliver such a service because of the inherent conflict with the need to sell products. Moreover, even if providers could truly deliver an impartial service, consumers would not believe it to be impartial. We draw on the history and culture which preceded the introduction of The Retail Distribution Review,[8] which was intended to tackle consumer detriment arising because the quality of regulated advice was undermined by firms' financial interest. We also found in our annuities research that the industry is not clear with consumers about the commission they get from selling annuities via the non-advice channel.

[8] 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), instead advisers are remunerated by a fee paid by the 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.

We acknowledge that pension providers and pension schemes have an existing relationship with the customer or member and therefore often will be the first point of contact when an individual wishes to access their pension pot. It is therefore important that pension providers and pension schemes encourage customers and members to seek independent guidance before making a decision, and to explain the benefits of them doing so. We would like to see the Government set out a clear marketing and communication strategy that ensures there is maximum take-up of this important new service.

Quality assured and professional: It is important that the people administering the guidance are fully trained, experienced and qualified. Qualification and professionalism must be accredited and backed by a code of conduct which guidance givers must sign up to. Such a code should prescribe minimum criteria, and be established by experts who develop standards, with inputs from consumer groups and pension professionals.

Sustainable: There needs to be a transparent funding stream for future years. It is critical that the Government sets out at an early stage how the service will be funded.

Seamless: Whichever organisation and or partnership provides this service, the experience and interface for consumers must be seamless, for example there should be just one telephone number and one website for consumers. Passing consumers from one guidance provider to another will result in complexity and confusion, and consumers will drop out of the process.

We believe that the guidance service should be reviewed, say, two years after implementation. The review should be independent, published and include a user satisfaction survey.

What the guidance should cover

As we say above, the guidance needs to take into account the whole of an individual's 'balance sheet'. We also offer some thoughts below on particular issues the guidance service should cover. The list, which is not intended to be exhaustive, also raises questions about the handover from guidance to full advice and the latter's cost and scalability.

1. **Annuities**: The guidance should explain the nature of annuities, the risks and benefits, and in particular cover the choices faced by consumers who have significant life-shortening lifestyle/medical conditions. Annuity providers and advisers might recommend enhanced annuities in these cases. However, under the new regime, it might be preferable for the consumer to draw directly from their fund as much annual income as is required. Apart from full flexibility over the level of income, the use of drawdown could mean death benefit for dependants that would be lost on the purchase of an annuity. Guidance should explore all of the available options with the individual and where it appears appropriate for the individual to purchase a regulated product, should give a clear explanation of how to make the best use of the OMO, so that the consumer buys the right product at the right time and at the best price, and from a reputable firm of genuinely independent, whole of market advisers.

2. **Myopia and biased expectations** – there is a risk that people under-estimate longevity and over-estimate investment returns. The IFS annuity study[9] found that amongst those aged 50-60, men underestimate life expectancy by around 2 years on average; women underestimate by around 4 years on average.

[9] Expectations and experience of retirement in Defined Contribution pensions: a study of older people in England. Nov. 2012.

Professionals have also been shown to make systematic errors in mortality projections. Guidance is therefore required on likely longevity and on plausible returns, net of charges, on re-invested liberalised pots in investment vehicles, including drawdown and collective investments. Consumers will need guidance on how much income to draw if they wish their saving to last a lifetime.

3. **Moral hazard.** Consumers may choose to run down their pension savings believing that the state pension will offer the equivalent of an adequate annuity. Guidance is therefore required on state pension and/or welfare entitlement.

4. **Long-term care and rainy-day savings.** Non-insured health shocks raise the need to access funds even as the implicit value of any annuity falls. There is a requirement to understand the need to keep liquid balances, the costs of long-term care (before and after the 'Dilnot' reforms) and the distinction between universal state health care (NHS) and means-tested state social care.

5. **Tax planning and bequests**. Guidance is also required on tax smoothing to avoid jumps in the marginal income tax rate. Those who wish to provide for others after their death will need guidance on wills and inheritance tax; this is likely to involve hand off to specialist advisers.

Answers to HMT's consultation questions under chapter 3 and 4

A new tax framework for retirement (Chapter 3)

HMT's Question 2: How could the government design the new system such that it enables innovation in the retirement income?

- There needs to be a concerted effort to ensure that drawdown products and sales distribution channels are improved. Apart from the minority of cases where the need for capital is more pressing than the need to avoid unnecessary tax, under the proposed regime for April 2015, DC customers with smaller pots who do not qualify for trivial commutation are likely to draw their capital over a short period i.e to split withdrawals over one or more years in order to avoid payment of a higher rate of income tax. Those with larger pots will draw from their fund over a longer period; again to avoid higher rates of income tax. For this category, the new freedom will come at a cost, namely, they will also continue to bear the investment and longevity risk that hitherto has been borne by insurance companies through annuitisation.

- It is important to note that the existing alternatives to annuities like drawdown, fixed–term (aka short term) annuities, phased annuity purchase, investment-backed annuities etc are not designed for the mass market and are risky in relation to charges and costs i.e explicit charges and undisclosed costs, investment risks and longevity risk. In some cases total costs can be in the region of 3.5% to 4.5%.

Therefore the FCA should:

- Urgently review existing products and their suitability for the mass market

- Urgently review the advice regime – at present drawdown is mostly sold via full advice, whereas short-term annuities, which are a subset of drawdown,

can be sold via non-advice. We anticipate that providers might seek to exploit regulatory arbitrage and launch products that can be sold under the current non-advice regime.

- Explore, with TPR and the industry, the advantages of scheme drawdown, whereby trustees of multi-trust schemes provide suitable funds for drawdown that benefit from the lower costs and improved governance of large-scale schemes introduced for auto-enrolment.

Supporting Choice (Chapter 4)

HMT's Question 6: Is the prescription of standards enough to ensure the impartiality of guidance delivered by the pension provider? Should pension providers be required to outsource delivery?

- No. The prescription of standards is not enough to ensure the impartiality of guidance delivered by pension providers. The Government must ensure that there isn't an embedded structural weakness that fosters bias as outlined above. The guidance regime should guarantee professionalism, qualifications, code of conduct and genuine impartiality.

HMT's Question 7: Should there be any difference between the requirements to offer guidance placed on contract-based pension providers and trust–based?

- No. The guidance should be the same for all DC customers, irrespective of whether they are in contract based or trust–based arrangements, in scheme or have retail products.

HMT's Question 8: What more can be done to ensure that guidance is available at key decision points?

- As noted above the guidance needs to recognise the greater complexity the new regime will introduce, under which for instance new customers using drawdown will require ongoing advice in relation to tax, investment risk and longevity risk. The Panel's research found that full advice is rarely made available to DC customers with pots worth less than £50,000.