FINANCIAL SERVICES CONSUMER PANEL

THE MARKET FOR PURCHASING ANNUITIES – EXPERT VIEWS

A REPORT BY:

NICK HURMAN BSC, MBA, FCII

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1. EXECUTIVE SUMMARY

This paper reports on a piece of research commissioned by the Financial Service Consumer Panel into experts' views of developments in the UK annuity purchase market. The research was qualitative in nature and covered 11 organisations active in the market. It was conducted in August – October 2013.

Key findings were that the market was undergoing significant change. Key drivers cited were:

- The growth of funds invested in Defined Contribution (DC) pension arrangements being brought to the annuity market
- An increase in numbers of consumers seeking to shop around for better annuity in part generated by more stringent requirement on existing providers to inform customers of the Open Market Option (OMO)
- Increased pressure on those approaching retirement to access capital funds and/or an income due to the economic recession
- The historically low annuity rates resulting from increasing longevity and very low interest rates
- The rapid growth of new enhanced annuity providers in the market splitting the traditional 'standard rate' market into a 'healthy rate' and an 'enhanced rate' market with the consequent transfer for value from the former to the latter
- Increasing questions over the value for money of conventional annuities, at least in the current economic circumstances
- The expected increase in importance of workplace DC pension schemes as a source of annuity purchases with the advent of auto-enrolment further accelerating this trend
- The stimulus for non-advised annuity purchase services resulting from :
    - The banning of commission on advised sales under the Retail Distribution Review (RDR) reforms
    - The increasing withdrawal of advisers from the middle-market for packaged investment products (including annuities)
    - The reduced risks to distributors selling non-advised without liability to consumers for the suitability of the product purchased
    - The reductions in costs of acquiring and processing annuity enquiries through the development of web-based services, automated quotation and straight-through processing systems for non-advised businesses
- The increasing interest of non-specialist consumer brands in propositions introducing their customers to annuity purchase services

Views on the outcomes for consumers in the changing market were mixed:

- On the one hand, by exercising their OMO, more consumers were finding better annuity rates (increases of around 20% were considered typical).
- On the other hand, others were potentially missing out on even higher 'enhanced' rates, more appropriate annuity 'shapes', valuable guarantees under their existing pensions or access to alternatives to conventional annuities if the annuity service they used had too narrow offering, did not operate to best practice or did not offer full regulated advice with its added regulatory protections.

The paper concludes that:

- There are a significant number of specialists focusing on non-advised sales of annuities using a commission model. This may be accompanied by a reduction of advised sales. It is not yet clear whether this later reduction is short-term or a longer term trend
- There are a range of aspects to what is considered best practice in non-advised sales which are detailed in the report
- The division of the market between commission and fees post-RDR has been a significant stimulus to the growth of non-advised sales but avoidance of compliance with suitability obligations is a more fundamental driver
- Non-advised sales are seen as significantly more profitable than those on an advised basis. Whilst some data suggested advised sales may be viable for pots as low as £25,000, there is an open question as to how much advised sales of annuities will be actually used in the absence of strong demand from consumers for advice
- There is a range of advantages for consumers of non-advised services listed which centre on accessibility, convenience, speed and low perceived cost but a range of disadvantages that could arise if the consumer's circumstances and options are not fully considered or in the absence of regulatory protections around advice
- Whilst consumers are becoming more aware of the need to shop around, they are still unaware of how best to act on this information
- The perceived importance of introducers would appear to lie in their ability (or otherwise) to engage more consumers with the OMO market more economically than existing players and with acceptable outcomes
- The Panel may also wish to consider the impact on consumer outcomes of some other important findings from the research, namely :
    - The changes in annuity products
    - The responses of existing pension providers to the market changes
    - The importance of technology to new annuity purchase services and
    - Outcomes for members of workplace DC schemes seeking to secure retirement income

2. INTRODUCTION

The Financial Services Consumer Panel (the Panel) represents the interests of consumers in advising the FCA on its policy and practices from a consumer perspective.

One of the significant issues the Panel is focusing on in 2013 is decumulation - the conversion of an asset into income in retirement. The Panel's aim in this regard is to influence the debate on issues impacting consumers' income levels in retirement, focusing on one of the areas of potential detriment and seeking to promote better consumer outcomes. One such area of potential detriment in this space is the annuity purchasing process.

The Panel believes that various factors suggest there are growing problems in the annuities market**:**

a) There is an expected massive rise (from c. 3-4m up to c. 10-12m by 2018) in the number of consumers in Defined Contribution pensions (DC) due to auto-enrolment and also the maturing pots of the existing DC market.

b) Research (by the FSA and National Association of Pension Funds) indicates that accumulation providers want to maintain/increase retention at retirement.

c) Annuity rates are at an all-time low (although for apparently valid economic/demographic reasons) which may mean consumers are likely to seek / be offered more complex and risky investment-linked annuities.

d) Levels of financial literacy are low and there is a clear asymmetry between the supply (providers, advisers) and demand (consumers) side, which means that making what is a one-off decision with no learning curve is a major challenge for consumers

e) Advice choice issues for smaller pots (<£25k) will increase over the next 5-10 years, as older employees will be auto-enrolled for just a few years before retiring

f) Historically, (pre-RDR) it has been difficult for consumers with smaller pots to get independent advice. Commission is a percentage of the pot (typically c. 1.5-3%), but the workload is the same for a pot of £10k and £100k.

g) Post-RDR a significant number of advisers are focusing on 'non-advice', which FSA rules categorise as execution-only (commission-based). In practice this is akin to a 'guided advice' OMO. Consumers may well believe they are receiving advice but do not have the same recourse to the Ombudsman.

The Panel is therefore concerned that consumers are buying unsuitable annuities and are being steered towards riskier products due to the higher commission rates on offer (double for investment-linked compared with standard). The rationale for the differential in commission pre-RDR was that independent advice was more demanding/time-consuming for complex products than simpler standard annuities. Post-RDR, the 'work' of the adviser selling standard and investment-linked annuities via non-advice is the same.

The Panel recently commissioned in-depth qualitative research to analyse consumers' experiences of purchasing annuities. This research assessed how consumers' shopped around for annuities, whether they make active decisions, the type of advice they are receiving, their level of satisfaction etc.

3. Scope and Approach

To partner this consumer research, the Panel commissioned the author[1] to speak to a range of experts in the annuities market to capture their views on the trend towards non-advice and the post-RDR economic argument for offering non-advice vs. advice from the 'supply side' (adviser and provider) perspective.

The Panel sought evidence on the following specific points:

1. the trend towards non-advised services,
2. their benefits and dis-benefits,
3. what constitutes 'good' non-advised services and what aspects should be cause for concern,
4. the ability of consumers to understand the benefits and limitations of non-advised – and hence get good outcomes and
5. the comparative post-RDR economics of advised and non-advised services in terms of charging levels, structures and costs.

The approach adopted was to conduct a programme of semi-structured 1½ - 2 hour interviews with a small sample of experts within firms active in the annuity purchase market.

The focus was on speaking to the specialist annuity distributor firms directly involved in providing advisory and non-advisory services to consumers. This was supplemented by interviews with those involved with the wider advice propositions and in dealing with workplace defined contribution scheme and also those developing product propositions.

A topic guide was developed and agreed with the Panel and a summarised version of this was provided to the interviewees prior to the meeting to allow them to prepare. Notes were taken during the interviews and where agreed, they were also recorded and transcribed for later analysis by the author. All interviews were conducted on the basis that the views expressed by participants would remain anonymous.

11 interviews were conducted in total, with 16 experts contributing. The very small scale and the selective nature of the sample mean that this study should be treated as purely qualitative in nature. The expert nature of the respondents is designed to give insight into the drivers, strategies and attitudes of key 'supply side' participants in the market. It is also worth noting that the topic guide was extensive and it was not possible to cover every question in detail with each respondent.

A list of the individuals and their roles/organisations is provided in Appendix 2. All responsibility for content and errors rests solely with the author.

4. Context for the Interviews

Before setting out the findings from the study, it is worth noting some context around the interviews.

The interviews were conducted in the period from the last week of August to the first week in October 2013. As a number of respondents stated, there had been significant coverage in the trade and consumer press on the annuity market during the spring and summer and this should be borne in mind when considering the views reported.

Comments in the media included those reporting and commenting on:

- Frank Field's open letter in August 2013 to the OFT calling for an investigation into annuity broking,

[1] A profile of the author is included in Appendix 1.

- the profitability of annuities for providers following Standard Life's disclosure in March 2013 of 18.6% profits on annuities in 2011,
- the ABI annuity rates survey published in July 2013 and
- FCA update statement on the thematic review of the annuity market in August 2013.

5. Research Findings

The findings from the interviews are now set out in this section. The interview topic guide was used to structure analysis of the findings.

Quotes, indicated by the use of 'quote marks' and *italics*, are not attributed to individuals or specific organisations and have been amended for ease reading where necessary:

- The use of …, indicates the removal of some intermediate superfluous words or discussion; and

- The use of [square brackets] indicates the insertion of a word or phrase to help clarify the meaning or the modification of the wording to protect anonymity.

5.1 Overall Market Developments

Respondents were first asked to comment on overall developments in the retirement savings market and the impact this had on the market for annuity purchase.

The Trend to DC

Respondents all acknowledged the growing importance of Defined Contribution (DC) pension funds as a vehicle for retirement savings. As one respondent put it *"so the world is turning DC".*

Some saw this as a steady underlying driver and remarked that the number and size of DC funds annuitising was still relatively small when compared to retirement income from Defined Benefit (DB) schemes. Others sensed an acceleration of the trend as most DB schemes in the private sector are now closed to further accrual of benefits as well as to new entrants.

One respondent cited research suggesting that accumulated funds held in DC pension arrangements would reach parity with those in funded DB arrangements in the next 2-3years.

One respondent started by pointing out that a fundamental feature of the move to DC is the transfer of risk from the employer to employee. In the accumulation phase the investment risk is borne by employee under DC and at retirement the risks of securing income are similarly transferred, creating the need for annuity purchase services.

A number of respondents commented on the increased complexity for consumers who had accrued rights in a range of different DB and DC arrangements. This created multiple decisions at retirement and multiple – sometimes apparently contradictory[2] – communications from different schemes and/or providers. Another respondent noted that annuity purchase wasn't necessarily just for DC but *"also for DB where one can actually secure at a higher income in … some cases by coming out of the DB[3]".*

[2] For example, a DC pack would say you have the right to shop around but a DB pack that you could only take an income from the existing scheme

[3] The main reason cited for this "*re-shaping*" was to avoid index-linked benefits - clients were reported as "*wanting a much higher level pension and to enjoy the money in the early years when they knew they were*

The changing demographic of the UK population was also frequently mentioned as a fundamental driver as larger cohorts reached retirement age.

These fundamental drivers were seen as long term and as providing a powerful logic for accelerating growth in the market for annuities. One respondent summarised this, saying *"we are looking at a market of 400,000+ annuity purchases a year currently, it's going to go up from there, and it is going to go up pretty rapidly I think."*

Consumer Awareness and Understanding

In general, respondents' experience was that consumer awareness and understanding of the annuity market remained low. As a 'one time' purchase, consumers could not build up an understanding of the market and buying process. Annuity products and features were seen as complex by consumers. One respondent commented, *"They're really nervous … because unlike the car insurance thing which you do on a regular basis they've never done this before. So therefore they're not even sure if they're asking the right questions or getting the right answers …"*

However, most reported a modest increase in the awareness of the need to shop around for the best rate and that higher rates may be available for those in poor health. This knowledge was reported as highest amongst those consumers with the largest pots.

Awareness of how best to shop around and what conditions qualified for enhanced rates was still low. One respondent elaborated *"it's things like enhanced annuities that often concerns people. I'm aware of the fact that it is counter-intuitive to a lot of people whom you speak to. They are still masking their levels of smoking because they're used to filling in life insurance proposals, for example … I don't think they are aware, with the things on the enhanced rates. On something like asthma, diabetes, bronchitis - you get pretty good enhancements on that - and people don't think they are ill."*

Retirement Changing Fast

Some respondents also referred to the impact of the changing nature of retirement. Comments were made that some consumers were deferring the securing of retirement income. Contributing factors were seen as the abolition of compulsory retirement ages from employment, the rising State Pension Age (SPA), particularly for women, and the economic consequences of the recession – such as falling values of pensions investments and higher rates of consumer debt - requiring consumers to work longer.

Respondents also referenced changes in working patterns leading up to retirement – some chosen by consumers and others forced on them by personal circumstances such as poor health or by their employers – resulting in increases in part-time and self-employed working. This was blurring the point at which 'retirement' took place and could result in the need for phasing in of income from pension pots or the need to withdraw capital to supplement reduced earned income.

For example, one respondent commented, *"…we see people who are significantly below their normal retirement date and state retirement date who are looking to retire now … just to take either some or all of their lump sum and a reduced income, or even no income in some cases, because they're continuing to work ..."*. Another said *"we have got people who carry on working but they have got an interest only mortgage so then they want to draw … the tax free cash from [their pension] to pay off a chunk off their mortgage or if not all of it."*

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healthy enough to do it and were prepared to take the chances" – and for single people who would not benefit from the spouse's pension benefit

A third respondent commented *"I think it's complicated for people retiring at the moment."*

Fundamental Change in Annuity Supply

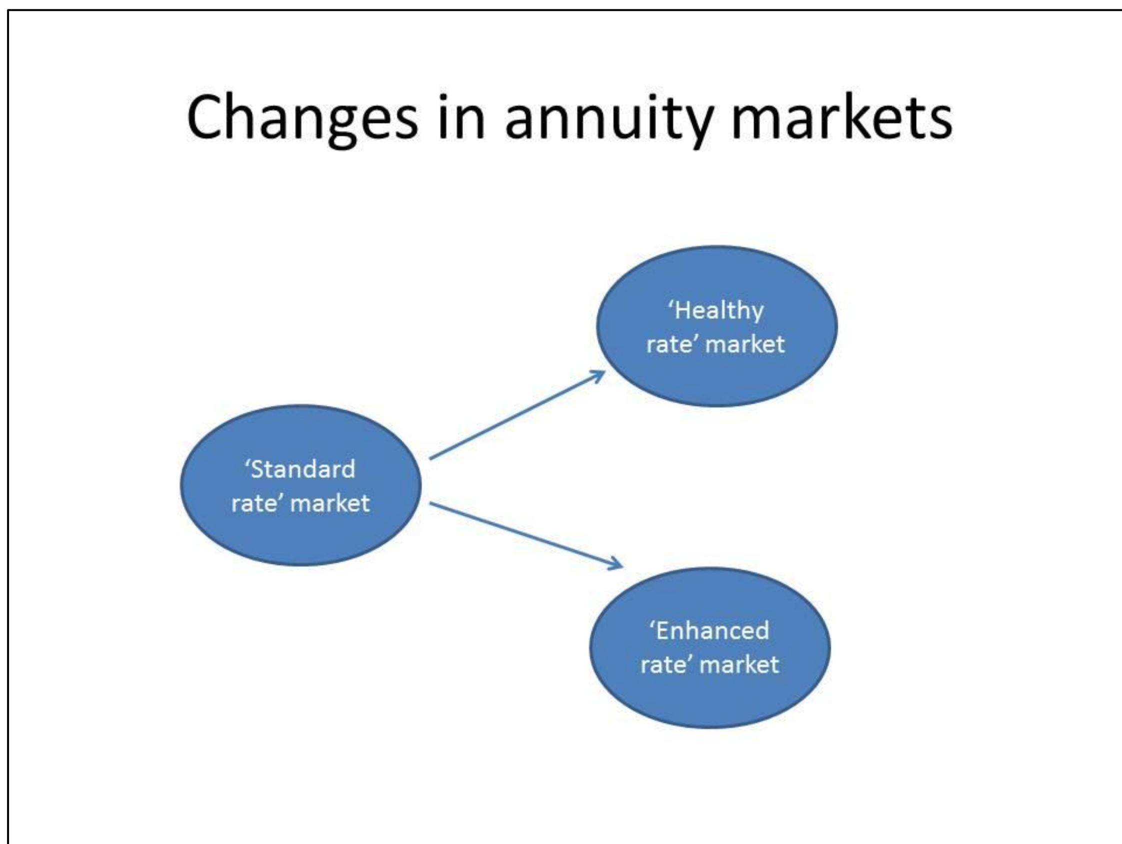
All respondents also stressed the fast-changing nature of supply in the annuity market. This was driven by the rapid growth of the enhanced annuity providers in the market. Enhanced annuities[4] were reported as now taking half or more of annuities purchased by consumers when switching from their existing pension provider using the Open Market Option (OMO).

Many respondents saw this as fast transition from a single market for 'standard' rates to a market split into one for 'enhanced' rates for those with health conditions, individually underwritten, and a second for 'healthy' lives based on a range of standard lifestyle factors and/or postcodes.

As one respondent explained "*I really don't know whether one annuity provider could be the sole provider across that whole space, because they've got all these reassurance arrangements that have been carefully crafted for the enhanced area.*"

A consequence of this was, as one respondent put it, *"…in the past you used to have all the healthy and unhealthy people in the same kind of pool and that drove a better rate [for healthy lives] but now what you have got is that pool is more and more becoming just all the healthy people…"*. Another expanded on this saying, *"… that move to enhanced annuities means that previous cross-subsidy that happened no longer exists. So actually you might find a lot of middle-income [consumers] get relatively worse value than they currently do from annuities."*

A common view was that this division was emerging fast but would take another 2-3 years to fully form.



[4] Enhanced annuities offer a higher rate than standard annuities for those whose life expectancy can be expected to be lower than average due to lifestyle or health risk factors.

Others questioned whether change would be even more fundamental and that the market would be ever more fragmented as providers increased the depth and complexity of their underwriting and pricing models – one respondent described this as an "*atomisation"*' of the market.

Another held the view that "*the line between standard and enhanced is it's a bit arbitrary anyway I think longer term we expect every annuity to go through some form of underwriting"* and recounted a conversation with an enhanced provider in which *"they said they've got 2 million different combinations of rating factors."* In these circumstances, the opportunities for cross-subsidy could be driven entirely out of the market.

The overall view was that these changes in annuity supply were making the market far more complex to navigate both for consumers and distributors.

Low Annuity Rates

All respondents commented on the historically low annuity rates. This was seen a consequence of current government policy on interest rates and the repurchase of gilts by the Bank of England (Quantitative Easing) resulting in very low gilt yields for insurers writing annuities.

A few respondents also referenced the impact of increased capital requirements placed on insurers by regulators (for example, under the Solvency II provisions). One had serious concerns that *"the annuities from an insurance company point of view do tie up capital. So I do wonder [if] at some point we will have market constraints on availability of annuities…"*

The continuing trend in longevity was also noted as placing downward pressure on rates and strain on capital – *"so annuities, if you are an insurance company [and] you get your mortality wrong is a death by a thousand cuts."*

A further interesting comment was that 'headline' rates – such as those quoted in newspaper surveys – were thought increasingly to reflect those for 'healthy' lives as the enhanced market withdrew the cross-subsidies inherent in 'standard' rates from those with lower life expectancies. This could be distorting the long-term trend in annuity data series.

As a result, almost all respondents commented on the impact this had on consumers. Many reported that consumers were often surprised by the low rate of annuitisation for their pension pots. This was seen by them as a double blow as the recession had already depressed the value of their pension pots.

One respondent suggested that low rates, combined with the introduction of the ABI Code, were causing a fall in annuity sales in 2013: *"I think there is a big group of customers who haven't been served this year. If that [drop] had just been open market, we might have drawn one conclusion but the fact that it is quite a drop in the overall market suggests that what you're getting is more people now not annuitising."* Another put the fall in sales down to the one-off effects of gender equalisation: *"we saw a spike at the back of last year, probably to do with gender. First quarter of this year continued to be high volumes but I think a lot of that was pipeline business transacting. We've seen market volumes fall I think over the last … 3-4 months following that spike tailing off."*

A number of respondents did comment that they had seen a slight upward trend in rates in the last 2-3 months but were not yet willing to see this as a sea change in the market.

Value for Money of Annuities

A number of respondents questioned whether the current conventional annuity product represented good value for many consumers.

One suggested the implicit investment returns, based on suppressed gilt yields, looked poor value against equity returns that could be accessed through other investments or income drawdown: *"… for providing the guarantee that you'll get that amount of money for the rest of your life [an annuity] does what it says [but] as an investment it will give you a lousy return unless you live until you've passed 100 - and some of you will, but most of you won't".*

Another thought was that this was unlikely to change, even if/when gilt rates rose: *"we are still waiting for the healthy annuity to be priced as a healthy annuity, not as a conventional old-style annuity. I think there is still going to be pressure on the annuity rates downwards and, because of overall life expectancy, then a 65-year-old will find his way into more of an investment solution" and "putting it off to 75 might be appropriate for a lot more people in the future."*

A third commented that with-profit annuities were popular with many of their advised clients, saying *"The clients generally feel comfortable - the right sort of client obviously with the risk profile - if there is a decent buffer so if they were getting 20-30% more income though actually if it did fall by 1-2% one year, 1% next year [the client] is still … better off".* Related comments were that investment-linked annuities are *"no longer fringe products"* and that *"the annuity market, as I am looking at it, looks too big compared to the alternative options."*

A fourth was of the view that there were too few active providers in the conventional market and that there was opportunity for and interest by new entrants to increase the competition and improve rates: "*the big three or four insurance companies have really got this carved up..*." But another disagreed, feeling, overall, the market was well served, saying *"You just have to look at the number of new suppliers … there's definitely lots of choice both from an insurance company or a provider point of view and from a distribution channel point of view."*

A final comment was that conventional annuities were particularly poor value for those with very small pots (say under £10,000) as the expenses of setting up and running the annuity outweighed any investment return from the backing assets. One respondent said "*… the annuity rate that you get on a small fund - like several grand - is terrible … the insurance company sitting there on a £7,000.00 quote - they don't want that business either*" and another commented *"how [do] you convert a pot of £5,000 to an annuity to get any real value from it?"*

One respondent had a very clear policy that "*the core offer is below £18,000 pot, you shouldn't really be having annuity you should just take that as cash*[5]."

RETAIL AND WORKPLACE MARKETS

By the nature of the sample, most of the respondents were focused on retail consumers – those shopping for annuities themselves to secure income from personal pensions policies (PPPs) or free standing additional voluntary contributions alongside employer schemes (FSAVCs).

But there was recognition amongst these respondents, as well as those focused on providing annuities to those saving in employer-sponsored workplace schemes, that these markets, whilst closely related, had important differences. The general perception was that this workplace market was lagging behind that for retail consumers in the development of annuity purchase solutions - but that this was changing quickly. There was also a recognition that, over time, the workplace market would become the more significant, with the advent of auto-enrolment into workplace pensions seen as a key factor powering this trend.

[5] Under the HMRC's trivial commutation rules that permit consumers with total pension assets under £18,000 to take part or all of their pension pot as cash after paying income tax.

5.2 The Impact of Public and Regulatory policy

Respondents were next asked what public and regulatory policy changes were significant and how these were influencing the market.

The Retail Distribution Review (RDR)

As noted above, a suite of regulatory changes resulting from the Financial Service Authority's Retail Distribution Review (RDR) were implemented on 1 January 2013. A key element of this was the banning of commission for advised sales of packaged investment products – which includes annuities, personal and other contract-based pensions – and the requirement to charge an explicit fee for advice on these products. Importantly, these requirements do not apply to annuities or other packaged investment products sold on a non-advised basis. Distributors can continue to receive commission on such non-advised sales.

All respondents commented on the impact of RDR on the market. Whilst RDR had had no direct effect on annuities sold by pension providers to their existing customers (retained annuities) as these sales are non-advised, all respondents reported a significant shift in sales for those consumers exercising their OMO from advised to non-advised. This shift was usually described as a combination of two factors:

- A retreat or withdrawal of financial advisers from the middle market for annuities – typically characterised as those with pots of between £40,000 - £60,000 and £100,000 (or even up to £250,000) and
- A growth in specialist non-advisory businesses providing annuity broking, particularly to this middle market

One respondent went as far as stating their policy was *that "above £250,000 we want to have a full advice conversation with you because we think at £250,000 you've got the right sort of level of assets where some of the more interesting things that you can give advice on come into fruition. So the core offer [below that] is a non-advice offer. However, in order to get into the non-advice offer we ask some triage questions which … are then trying to figure out or trying to help clients figure out is advice right for you."* The same respondent also said that this full advice conversation level had been £100,000 prior to the RDR reforms.

Another respondent reported an on-line discussion with an adviser who was arguing the benefits of advised sales of annuities for consumers but then conceded *"of course I wouldn't give anything to anybody under 60 grand". A further summarised the post-RDR adviser mind-set by saying "Well, £100,000 was advised but it isn't really now … to put it another way, £100,000 isn't worth me going out to chase, but if it arrives then fair enough and probably I will do it non-advised and make some money."*

The growth of non-advised annuity broking was recognised as a key feature of the market for the previous 2-3 years but the implementation of RDR was seen as a significant boost to the non-advised model as it continued to be remunerated by commission. One respondent summarised this by saying *"the regulator has created a fault line in the market between the advised and non-advised"* and another added *"… it shouldn't be an issue but problem is in the consumer's perception of fees"*. But another questioned this arguing *"I don't think RDR has made a blind bit of difference with the annuities because we're still on commission, we are still doing things in the same way as … we were before."*

Another described the market as changing in response to the anticipated RDR reforms *"…perhaps 12/18 months …, probably even longer ago. There was a general … swell of opinion that there was going to be loads of money to be made selling annuities non-advised to people who are going to be abandoned by financial advisers. So what we've seen is … a proliferation of people just arriving - kind of out of nowhere".*

Some respondents argued that the commission model was seen by consumers as essentially 'free' when compared to fee-based advice. However another said "*I'm always surprised by the types of clients who are quite comfortable to pay a fee and those who aren't*" but then went on "[*the acceptability of a fee] hinges at retirement as to whether the financial adviser is able to advise the individual on other issues that coincide with retirement, not just annuity purchase"*.

Another view was that the focus of value for the consumer in the non-advised model was on the annuity rate rather than the commission earned by the distributor and so did little to prompt a negotiation between the consumer and distributor to rebate commission to achieve a higher annuity rate.

Others argued that if the non-advised model delivered the best rate for the consumer then why should they be concerned about the commission level earned. The most important thing for the consumer was effective competition to secure them the best rate – and, by implication, that competition would ensure in turn that commission would arrive at a level economically justified to remunerate the service provided. As one respondent commented "*there is some evidence of that now emerging post-RDR of manufacturers being willing to say to distributors okay we will give you a better rate to pass onto your customer".*

Another view, however, was that a more significant factor in the perceived regulatory arbitrage between advised and non-advised was not commission, but the lighter regulatory burden for non-advised sales. In a non-advised sale the distributor does not carry regulatory responsibility for the suitability of the product for the consumer's needs. The non-advised model was therefore seen as having significantly lower regulatory risk and did not need to carry the costs of material provisions against compensation claims for mis-sold products.

THE ASSOCIATION OF BRITISH INSURERS' CODE OF CONDUCT ON RETIREMENT CHOICES (THE ABI CODE)

The ABI Code was introduced in March 2013 and placed new requirements on pension providers such as to inform those customers at prescribed points approaching their nominated retirement date about their options, the OMO and to refrain from quoting on annuity to retain the funds with them without an explicit request from the customer.

All respondents commented on the effects of the ABI code although the assessment of its impact varied. A common view was that it was a step in the right direction but many felt it could and would go further to encourage or even compel consumers to actively consider exercising their OMO when purchasing an annuity.

There was a general view that the existing pension provider's position was still too dominant in the retirement process – as one put it, *"… you need the point in time to know when to contact them and only the provider has that"* and another commented *"it is just still too easy for that consumer to get fed back into the life co solution and it is too easy for the life co to sell them a suboptimal outcome".*

However, most believed the ABI Code had prompted more shopping around and greater awareness of the availability of enhanced rates to a greater or lesser degree - although some commented that the effect was skewed towards wealthier consumers or those with larger pots. One described *"… starting to see a small group of people shopping around quite heavily. It's difficult for us to quantify how many people are – and that's playing advisers and non-advisers off against each other."*

Others felt that the new code created an "*information overload*" for consumers - with thick and complex packs arriving at 2 months, 6 weeks and 2 weeks prior to retirement – resulting in an increase, rather than decrease, in inertia.

One respondent commented that it may be too soon to judge the full effect as those consumers who have received information under the ABI Code would only just be coming to the market.

Many respondents also commented that whilst the ABI Code made consumers aware of the need to shop around, it was not creating an understanding of the range of services available to help them or where to find them. One respondent commented, "*I think that the missing bit … is the signposts on the wake-up packs, that sends you to MAS*[6] *or Unbiased*[7] *or something like that. It's not anything they are familiar with*." Another said, "*…there is evidence that there have been more [consumers] going on the web looking for something and that is where they found the non-advised. The customers have not gone looking for non-advised, they have gone looking for someone to help them. And [they're] the only people open for new customers].*"

Fears were also expressed by the variety of offers thrown up by web searches – some of which were reputable brokers and advisers and other unregulated lead generation sites – some believed to be off-shore. A number of respondents mentioned an industry development to provide consumers with a list of annuity purchasing services complying with minimum standards, through the trade body PICA[8], to signpost consumers to reputable businesses.

A number of respondents reported what they saw as significant changes in the providers' activity, such as outbound sales calls to retiring consumers. These were put in place prior to the implementation of the Code to improve their strategies to retain customers once the Code was implemented. One commented*, "… many of the ceding providers saw it coming - of course they did, they were part of the process - and have spent time and effort making the ABI code work for them."*

Some respondents characterised these strategies as in three tiers, as set out in the diagram below, with the offer moving on the next tier if the previous tier was unsuccessful in retaining the customer's funds. One commented *"… the big insurers … will eventually have their own non-advised annuity desks that will be whole of market but people will have been first given the option to buy an existing annuity or a partner annuity … I think it's all about stakeholder management whilst trying to preserve as much of the margins as they can."*

[6] MAS is the Money Advice Service

[7] This is a reference to the website unbiased.co.uk that provides a service for consumers to search for a professional adviser

[8] PICA is the Pensions Income Choice Association.

Another commented that provider retention activity was strongest with the bigger pots: *"So that's the way their retention models work, they look at big cases first - funds under management - and then target those. If you look at it, it's a U-curve in terms of the proportion retained. Obviously they retain the small cases, because there is nowhere to go. But in terms of the number of cases that find their way into the open market, many of the larger cases are retained."*

Another respondent questioned whether the current practice of offering significantly inferior annuity rates to existing customers would be sustainable under the regulatory principle of Treating Customers Fairly and would risk future retrospective regulatory action.

Broader Policy

Most respondents expressed a view that wider public and regulatory policy was focused on the annuity as the best and safe option to secure a retirement income.

Some felt that this was sensible, practical and appropriate for the majority of consumers. As one respondent said *"actually, for most of our client base, annuities look like a pretty good option."* This policy position was also felt to be supportive of the further development of non-advised models.

Others felt that this position was storing up potential business and political risk for the future by underplaying the risks arising from the irrevocable nature of annuity purchase – particularly for 'healthy rate' consumers. Risks cited were:

- purchase timing risk – current rates are historically low and could rise again as the economy strengthens
- personal circumstances risk – future changes to health or family circumstances
- inflation risk – for the overwhelming majority of annuity purchasers not selecting an indexed or escalating income, the risk of diminishing purchasing power with significant price inflation.

As one respondent summarised, *"…I think FCA and TPR are quite good at working together to implement a common policy agreement but I don't think TPR and FCA have got to the point that buying an annuity is a risky thing."*

Another comment made by some respondents was that the current arrangements for trivial commutation were too restrictive and should be liberalised as consumers were being forced into uneconomic annuity contracts.

Gender Equalisation

A number of respondents reported distortions in the market caused by a rush of male consumers seeking to buy annuities prior to the implementation of gender equalisation in January 2013[9]. One respondent commented that this 'closing down' sale had created a situation where excess demand had pushed male rates up to post-equalisation rates and even beyond.

More strategically, some respondents commented that gender equalisation had created an external factor to force strategic reviews of underwriting practice in conventional annuity providers – either to exit the market (and re-brand another provider's annuities for existing customers), move to different underwriting criteria (such as life styling via postcode rating) or compete directly with the enhanced providers. One respondent

[9] The EU Gender directive required that insurers no longer used gender as an underwriting factor in annuity pricing.

commented, *"I think the gender directive's given it a shove down that slippery slope towards individual underwriting for everybody."*

5.3 Changes in Annuity Distribution

The next part of the interview sought more views on how sales in the market were segmenting, the speed and direction of change and the likely impact on the suppliers in the market.

The general reaction by respondents was that the market was in a considerable state of flux. There appeared general agreement that the shift to non-advised sales for those exercising OMOs in the mass market was now in place and was irreversible. As one respondent summarised, *"…trading as non-advised is a lot cheaper and a lot less risky and that was really where all the competition was going. So we felt we needed to …"*

Some were of the view that this was the new equilibrium and that the market would settle out to adjust over the rest of the year. But others argued that there was significantly more change to come over the next 2-3 years, for example *"...people trying to do things differently would probably have taken them 3 or 4 months to decide what it is and then 3 and 4 months to try and implement so I think you're just starting to see the people who are trying to change the way they do business as a result of RDR and various other initiatives."*

One summarised by saying *"in my 20 year career, this is the most interesting period I've been through - all the indicators are all over the place."*

A number of drivers were mentioned in interviews including:

- The existing providers were still reacting to changes in the wider market arising from the RDR and the consequent impact on administration and systems. Changes in the annuity market had been of lower strategic priority to those in investment and pensions but the impact of the recent market developments discussed above was now forcing them to change. Further changes from RDR are still to come with the implementation of changes from the FSA's review of investment platforms. All this suggested to respondents that existing providers would create significant strategic change programmes to compete in the new market, to protect their existing books of business moving into the 'at-retirement' phase. As one respondent put it, *"…the fund management industry can't continue to allow its customer base to bleed and die and drop off."*
- More product development was expected in reaction to the rise of the enhanced annuity providers and respondents predicted the demise of the 'standard' rate annuity. This could include not just conventional annuities but also temporary and convertible annuities, investment linked annuities, income drawdown, equity release and potentially products for the long-term care market: "*I think [industry] people are starting to have a holistic view of retirement now - where they're looking at it not as there are five different products, its what's the income I need and how do I structure a set of products that give you that income need. So I think that's one of the areas the market will develop [at] the top end, the larger more affluent market"*
- Further legislative and regulatory measures were expected by respondents to increase the proportion of retirees exercising their OMO. Participants mentioned the comments by the Pensions Minister indicating his appetite to find ways of making the OMO the default choice and also potential outcomes from the FCA's current thematic review of annuities.
- Respondents commented on recent significant new investment into annuity distribution (such as Phoenix's investment in Key Retirement Solutions) and the entry or planned entry of big retail and consumer brands into the annuity distribution market
- Another view expressed was that generalist financial advisory businesses were still adjusting their strategies and operations to fee-based operations and other RDR requirements. Annuities generally formed a small proportion of their business and so may have been neglected, especially following the

'closing down sale' caused by gender equalisation. The argument was that generalist IFAs would refocus on the annuity market and rebuild their activity or look for referral opportunities to a non-advisory partner for customers no longer economic to serve on an advised fee basis. But another view was *"the vast majority [of generalist advisers] sell a handful of annuities a year. I suspect in their cases they're clients that they've got longer term relationships with where I don't think they see a need to change their business model"*

- A number of respondents pointed to the increasingly vital IT systems required to operate effectively in the more complex market. New developments were in train to make systems available to speed up the process of securing guaranteed quotations from multiple providers, increase accuracy of proposal submission and completion of purchases.
- It was noted, and evidenced within the businesses interviewed, that a number of non-advised distributors were adding in-house advisory services to broaden their offer

Overall, those who argued that more change was to come pointed to the fact that the market was still very fragmented. The leading brokers were reported as writing around 5,000 annuities a year from an estimated market of 200,000 OMOs – market shares of around 2.5%. Many concluded that the increasing need for process and marketing efficiency would drive consolidation in the market over the next 2-3 years.

5.4 Consumer Outcomes following RDR

The next series of questions asked respondents to evaluate the benefits and dis-benefits for consumer and to review the quality of outcomes from the various post-RDR distribution models.

Most respondents expressed the view that the RDR improved the clarity of services on offer to consumers and, as noted above, had stimulated the development of both more non-advised services and better non-advised models.

However, many also felt that it had created an unhelpful commission/fee division in the market and that it had stimulated competition for distribution amongst providers that was driving up the levels of commission that may not be reflected in better rates or outcomes for consumers.

In trying to evaluate whether there were better overall outcomes for consumers in the current market, many respondents talked about a balance between:

- more consumers having access to better annuity rates than offered by their existing pension provider and
- consumers not getting the best possible rate available or the best product or annuity 'shape' for their circumstances

Most expressed the view that the largest step to better overall outcomes was to get the 50% or so[10] of consumers who don't get an annuity rate from other providers to shop around. As one respondent argued, "*where's the really egregious market failing? It's the 50 to 60% of people that don't shop around at all."*

Another respondent estimated *"[of the] 400,000 people [who] bought annuities, roughly half stick with their ceding company - which probably agrees with what you think from the market. You've got 122,000 who opt for a standard annuity, 76,000 non-standard and 35,000 go down a kind of drawdown or something else."*

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[10] This was a reference to the ABI's Retirement Choices research published in May 2013 that found that 50% of annuity purchasers did not approach other providers.
See
https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/Retirement%20Choices%20research%20May%202013.ashx.

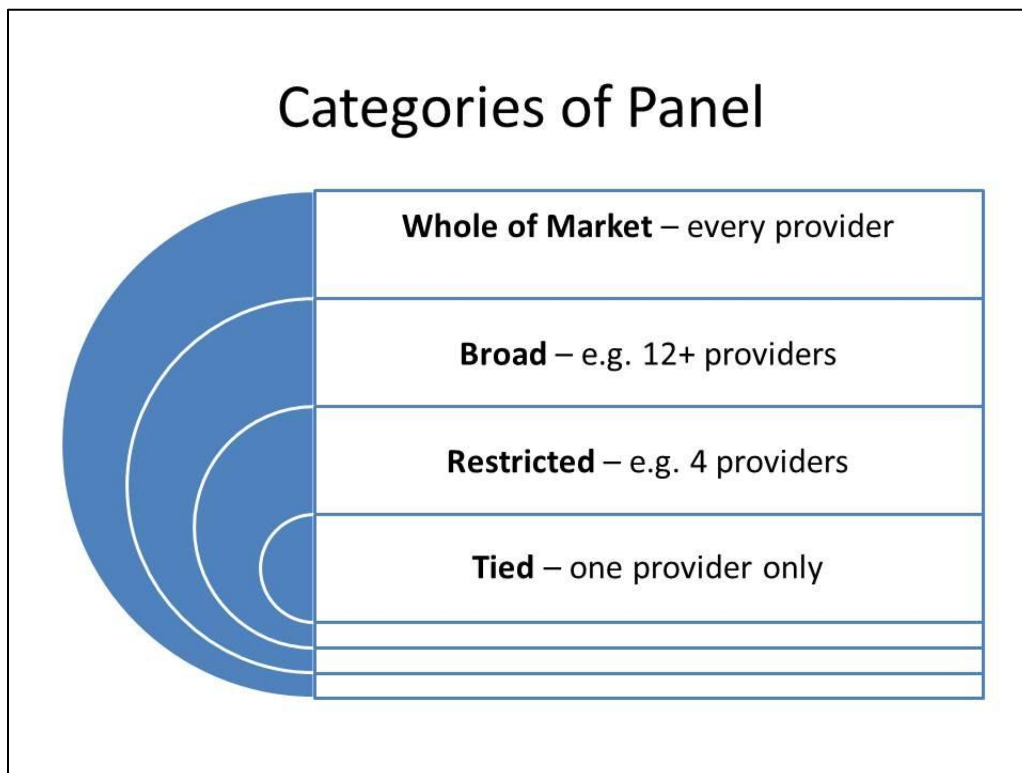
One respondent quantified the rate improvements for customers taking an OMO rather than staying with their existing provider, quoting their experience that the improvement for *"…enhanceds is over 40% on average, [conventionals] was about 18% the last time I looked."*

Some commented that for some of the50% currently staying with their existing provider, the best rate could still be with that existing provider. Examples quoted were if the pot was small, because of guarantees build into the existing contract, or because the provider was active in the standard market and was quoting competitive rates. So whilst many more consumers should exercise their OMO than do, not all should. One respondent observed *"what we find is about 6% of our clients cede with their existing provider and everybody else does either an enhanced annuity or a conventional annuity."*

However, many respondents commented that those taking the effort to shop around may still not achieve the best rate if they arrive at a non-advised service that:

- is tied to one provider or uses a limited panel or
- carries out simple screening of lifestyle and medical information to generate enhanced quotes – a practice referred to as 'shallow' underwriting - rather than obtaining detailed information – for example on medication – that could access more favourable rate in 'deep' underwriting

A number of respondents divided tied/panel arrangements into four categories:



1. **Tied** to one annuity provider only – typical situations were 'introducers' (described further in section 5.6) and providers not wishing to offer annuities themselves to their existing pensions customers,
2. **Restricted panels:** covering, say, 4 providers including perhaps only 1 enhanced provider. Critics suggested this might give the impression to consumers that the service would be providing some 'shopping around' but was still effectively tied for the 50-60% of customer able to access enhanced rates. This was seen as particularly disadvantageous when coupled with 'shallow' underwriting.

3. **Broad** panels: covering, say, 12 or more providers, including at least 3 or more enhanced providers and/or accessing an estimated 80% of the market. These were seen by many as providing a practical route to access the best rates for most, if not all, customers.
4. **Whole of market**: where rates were searched from all providers in the OMO market – some argued that this was the only way to ensure a genuine 'best rate' offer, whereas others argued that the additional costs of this search outweighed any benefits of securing marginally better rates for a minority of customers.

Non-advised services with limited panels and/or shallow underwriting were seen by some to have real commercial advantages as they would have lower process costs and the ability to secure higher commission rates from providers by providing higher volumes of business. They could then use this advantage to spend more on marketing to attract more customers away from existing providers and build the share of the OMO market and their own share within it.

Others felt that these advantages would be short lived as consumers and the consumer media would soon become aware of the services that were not achieving the best rates. This would damage their reputation and brand and consumers would go elsewhere. As one respondent put it, *"if I were setting up one of these businesses, I wouldn't take the risk of a small panel or a simpler process and a few quid from one or two providers, because I think the downside is just too big."*

Another risk raised by respondents was where non-advised services were not pro-active in ensuring that consumers had considered and understood the implications of the 'shape'[11] of the annuity selected and that no valuable guarantees were being given up by leaving their existing provider.

One view expressed was that the commoditised view of General Insurance created by comparison websites had been transferred to annuities. So consumers would just follow the process and not ask questions about the wider suitability of the annuity offered or shape they are guided to: *"it's not a discussion point any more … they don't discuss it in the pub."* A respondent quoted a statistic that "60% select single lives, even if they have a spouse".

Another stated that "*…70% of people buying annuities without any advice or guidance will make at least one material error which with the benefit of some education or support or advice they wouldn't have done* …", whilst another commented *"… from our experience one in seven customers has something in [the]small print, it's not just guaranteed annuity rates, it could be protected tax free cash … it could be a terminal bonus that's due in three months' time if you wait … life cover potentially attached to the policy that dies when you transfer it away - so not necessarily the smartest thing to lose if you're in ill health…"*.

A few respondents also felt that the growth of non-advised and the introduction of fees was driving other advised sales out of the middle market to the detriment of the consumers who would benefit from more than just an annuity. As one summarised "*getting the best rate may just making the best of a bad job… if you analyse it logically, [most] consumers need to strike a balance between an income for life insurance and an investment in real assets to protect against inflation. The question is to what extent are customers prepared to share risk with an insurance company for the potential upside?"*

So in many cases, the discussion was characterised as a debate about whether we should celebrate the good – represented by the significant efforts to widen the OMO market – or criticise services that weren't the best – with the risk of scaring away consumers from the OMO market and leaving them to buy an annuity from their existing providers.

[11] By 'shape' respondents meant the choice of features such as guaranteed minimum periods of payment, spouse's pensions and escalating or inflation linked payments.

One respondent summarised their view as *"don't let the perfect get in the way of the good."* And another as *"It's a market force question for me … will retiring people genuinely shop around or will their provider just do enough to stop them shopping around?"*

5.5 Non-Advised – Best Practice

We then asked respondents to set out what they regarded as best practice in a non-advised service. The following section is a synthesis of their responses.

Taking the responses together, the characteristics of a good non-advised service identified were:

- **A culture of putting the interests of the consumer first**: *" …if I'm a Tesco or a Saga or a Post Office, if I can acquire customers for next-to-nothing, I shouldn't then be encouraged by greed … I should see it all in terms of customer outcomes, conversion, repeat business, brands."*

- **Service choices set out clearly for consumers upfront**: *"… clarity about what the service costs, clarity about what the service actually does and importantly what it doesn't do is obviously vital."*

- **Comprehensive range of engaging and effective information and guidance:** "... provides the customer with all the information they need to make an informed choice and has processes in place to assess that understanding."

- **Great customer 'experience' :** *"it feels friendly and it feels nice and it feels engaging and it feels in your interest"*

- **No customers turned away:** *"… we have no minimum requirement of size of pot … [we] take pots right down below £1,000"*

- **Searching the market widely[12]:** "*… our benchmark … is to say … [they] should be offering a minimum of 80% market coverage of rates."*

- **Deep underwriting**: "*… we will just ask you ten questions rather than the full medical underwriting and you think great, haven't I done well? I have got an enhanced annuity. What you don't realise is that if you had spent another three minutes answering a few more questions you have got an extra 5% income"*

- **Effective use of technology:** *"… quickly that transformed into an online acquisition and marketing with an online quotes tool which was then picked up by a telephone based non-advice specialist ... with straight-through submission to providers"*

- **Appropriate and effective checks and safety nets**: "…we recognise that despite putting information in documents that are plain English accredited, despite making them as simple and as easy to understand as is possible that people do not absorb and take on the detail and do not always make the smart choice … "
- **Interaction with a skilled facilitator**: "... one of the things that we're very keen on is that everyone has a 15 minute conversation … once you've made the decision, very difficult to get out of it short of dying…"

[12] As noted above, some respondents argued strongly that best practice would be to search on a 'whole of market' basis

- **Allowing time for consumer to make choices: "***New school is all about selling annuities and not worrying about the detail – just make the sale"*

As mentioned above, a number of respondents felt that there is a need for a set of standards to encourage or enforce best practice in the non-advised market. This would ensure that those consumers made aware of the need to shop around could be guided to services that operated to these standards and hence obtain good outcomes.

This was seen as particularly important as relatively few people were going to go through a full non-advised process more than once when looking to purchase an annuity. But a view was also expressed that there may too few businesses currently with the capacity to operate at these higher standards.

5.6 The Role of Introducers

Consumer brands

The next section covers the role of introducers – businesses which have existing consumer brands/franchises to generate customer enquiries but then pass the enquiries generated to a financial services business to service – and asked about the part they are likely to play in the market and how they may affect the way the market operates.

The was a general view that traditionally introducers had played a very small part in the annuity market as the existing pension providers were the dominant source of annuity business. But this was now changing with the changes in the market already described.

With the growth of the DC funds and the need to shop around for the best deal, big brands were seen to be testing the water to see if they could offer annuity propositions to their customers. Examples mentioned by respondents included:

- Supermarket brands – such as Tesco
- Retirement brands – such as Age UK
- Comparison sites – such as Confused.com and
- Consumer champion brands – such as Virgin.

Views varied as to the likely success they would have in the market. Some saw their brand and marketing strength placing them in a strong position to take a significant share of the OMO market as consumers looked for a trusted source of help to navigate an unfamiliar market. They also saw their commercial strength as key to driving hard bargains with annuity providers and distributors.

One respondent commented, *"I think there's a real opportunity for them … I think they're genuinely going into it with the best intentions. I guess it's whether they can marry up those intentions with the delivery against them"* and another *"…the annuity market hasn't really taken off on things like Compare the Market … .I think it is ripe for going on something like that because … it does lend itself to a rate-driven [product] like annuities."*

Some respondents reported a number of providers as very active in seeking out new partnerships with introducers to secure distribution in the OMO market. Offering annuities through a non-advised model could be seen as low risk and providers could offer 'white labelled' products and processes with enhanced levels of commission to reflect the volumes of business delivered and the tight control over process.

A number of respondents expressed concern that some introducer arrangements might lead to a *"race to the bottom"*, using a narrow panel or tied approach to offer a 'better than existing provider' proposition with competitive 'standard' or 'shallow' underwritten annuities and suggested negotiated levels of commission may be as high as twice the level paid to other distributors. One respondent voiced it in this way*: "… they can*

afford a big advertising budget because they're not providing as good a service but the customer doesn't know any of this and if all of this was apparent to the customer then they would obviously choose a better service …" and another *"they are coming in with limited panels they are offering a fairly watered down solution …it is about cutting margins, we will offer you a little bit better than you might have got from your existing provider but not as good, you could get."*

Other respondents were more sanguine and noted that previous attempts by introducers to secure market share in the packaged investment products market had been unsuccessful and that consumers would prefer to deal with specialist financial brands when purchasing complex financial products. One respondent said "I think [new introducers] are finding it harder than they think it will be". In effect, their judgement was that introducers would not be able to commoditise the annuity market – especially one that was becoming more, rather than less, complex.

Employers as Introducers

A few respondents looked more widely at this question and flagged the growing importance of employers and DC scheme trustees as a different kind of introducer. As noted above, this workplace market was felt to be lagging developments in the retail market but a number of respondents noted increased awareness of employers and trustees of the potential for better outcomes for scheme members if they were enabled to shop around.

Those closer to this market felt that the employers' advisers (typically Employee Benefit Consultants (EBCs) or specialist corporate Independent Financial Advisers) had tended to focus on the accumulation stage and were themselves slow to realise the needs and opportunities at retirement. One *said "the [workplace] pensions industry has been slow to recognise that (a) it needs to do something but (b) it also could be commercially advantageous to do something; it's not just an irritation."*

But the ABI Code has directly affected those schemes administered by insurers and its messages were now resonating across the wider workplace market. So those with connections with the workplace market were seeing more progressive EBC firms look at how they could provide better solutions, either themselves or in partnership with the new specialist firms. One respondent described a substantial programme of activity that was securing large employer schemes as clients for their existing service. Another commented, *"One of the trends we've definitely seen over the last 6 months is trustees of DC schemes keen to put in open market panels. Whereas historically they just had a default annuity with a provider we're now seeing … many more trustees interested in open market options."*

The flows of business were still seen as much smaller than those in the retail market in 2013 but were expected to grow fast in the next 5 years and to a position where it would outstrip the retail market. One respondent commented, *"…the amount of money per annum going into DC is significantly increasing and over the next 5 to 6 years the pot sizes will rapidly increase so companies are starting to see that at the moment it's an issue that they know they haven't covered off. But there's a handful of people retiring each year with relatively small pots - in five years' time those numbers will be much bigger" and another "2.5m DC [workplace pension] scheme members are material".*

5.7 Distribution Economics

The final section of the interview invited respondents to share what they could of the underlying economics of annuity purchase business post-RDR. As this conversation was commercially sensitive, some respondents were prepared to more open than others. It is also worth noting that these are all opinions expressed as part of research interviews.

COMMISSIONS AND FEES

As discussed above, non-advised sales fall outside of the new RDR regulations and can still be on a commission basis. In interviews, respondents considered the use of commission in the retail market as near universal.

Typical commission rates for standard annuities reported as 1% - 1.5% and for enhanced annuities 2.5% - 3%. Some respondents were able to quote average commission rates for their business, for example *"broadly the margins would be, at the most, on an enhanced 3.25%, on average on conventional annuity is about 1.5% commission … enhanced is typically nearer 2.5%*".

However, many indicated that higher levels of commission were available for volume distributors – a 1% uplift being considered typical. Some also commented that they believed much higher commission rates (5% or even more) were being offered by providers to secure tied or restricted panel agreements.

Only one respondent talked about having a minimum charge for non-advised services in the retail market (£300) that was rebated from the commission generated combined with a cap on the commission taken for large annuities. However, fee-based non-advised services were much more common in the workplace market, with the employer or trustee usually paying the fee. Typical fee levels were £300 - £400 and reflected the lower costs without the need for retail marketing/advertising costs and higher conversion rates prompted by the employer's endorsement.

Fees for retail advisory services were also typically charged on a percentage of purchase price basis. 2.5% was quoted as a typical level but levels less than 2% were also quoted that seemed to reflect those with more automated processes (e.g. on-line self-completion fact finds) and telephone-based advice. One respondent mentioned additional fees when advising on more than one pension pot (£250 per additional pot).

Fees for other retirement income products – such as with-profit or investment annuities or income drawdown – were typically at the same level as other investment products at 3% of the investment + 0.5% annually charged against the fund value. Fees could also be charged for periodic reviews.

Again in the workplace market, flat fees were seen as more common but combinations of minimum fees (e.g. £750 or £1,000) and percentages were also quoted. One respondent also quoted different fee rates for standard and enhanced annuity advised purchases (1.5% and 3% respectively). Some respondents commented about the wider scope of advised sales that would include features such as investment switching (sometime referred to as fund immunisation[13]) prior to annuitisation, advice on investment of tax-free cash and review of existing contracts for guarantees[14].

PROCESS COSTS

Most respondents had a view on the costs of non-advised processes but these could vary depending on:

- the degree of automation of customer interaction and administration and
- the cost of customer acquisition through advertising, direct mail, web marketing and referral arrangements.

Typical costs quoted by respondents were £350 - £400 for a non-advised sale and £550-£600 as the starting point for advised sales. As noted above, for advised sales, there were additional costs for dealing with multiple pots.

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[13] Invested funds are switched into (typically 75%/25%) gilts and cash with the aim of minimising the risk of movements in asset values changing the expected annuity income and lump sum – gilts are selected as these are the backing asset for annuities and so gilt values are likely to move in line with annuity rates.

[14] One non-advised service also specifically mentioned that it included a review of the existing contract for guarantees as part of their standard checks before transacting

Automation was seen as key to efficient processes and lower costs in a number of ways:

- providing engaging information and guidance to allow consumers to understand the options available to them and the consequences of their potential choices
- gathering personal and underwriting data quickly and accurately from the customer and without labour costs – and allowing the customer to break and return without losing data already entered
- guiding consumers only to those underwriting questions that are relevant for their lifestyle and health
- securing on-line guaranteed personalised quotations for real time comparison by the consumer and/or adviser/facilitator
- allowing consumers to explore trade-offs between 'shape' and 'rate' interactively and with personalised rates
- monitoring consumer's exploratory activity on the service's website to gauge the degree to which they may be making an informed decision
- recording all activity (on-line, by telephone and correspondence) to keep a complete record of the purchase for secure legal and regulatory compliance – and also for the consumer to refer to later
- ensuring error free proposals are submitted to providers to secure quoted annuity rates within the guarantee period and to bargain for higher commission rates from providers
- to automate the process of obtaining and chasing existing providers for fund values, annuity quotations and to process OMOs

The interviews suggested strongly that there were significant differences in the degree of automation in the market. Non-advised services were generally more automated - but there were still significant variations in the levels of automation and different approaches in the IT deployed.

One respondent commented*, "one thing we have noticed is the people who have gone into non-advised in a determined way, have spent a lot of time getting their systems working very efficiently, so the integration with providers is high, it's a very clean, slick process."* They also commented *"what the non-advised specialists have done well is they map the value journey to the work journey so that … you're not doing a lot of work before you've emotionally locked someone in."*

Some had invested heavily in integrated proprietary systems and were capable of supporting an entirely on-line sale if the customer chose. Others used a combination of web, telephone and bureau services. In particular, the TOMAS system[15] was widely used to 'power' non-advised services – providing detailed information packs with illustrative rates and a quotation engine for many other services. The TOMAS business also provided an end-to-end non-advised referral service, on a whole of market basis, for advisory businesses to pass on cases considered not economic to advise.

As noted before, advisory businesses were seen to lag behind non-advised businesses in addressing the changing annuity market. This was particularly apparent in their use of technology and in interview there were descriptions of largely manual quotation processes with separate submissions of quotation information by email using a paper-based Common Quotation Form (QCF) to secure quotes from providers and iterative re-quotations to secure keener rates from provider's sales teams. As one respondent summarised *"the solutions that are in place at the moment, from my point of view, just seem to be a few years behind where we really ought to be."*

It was not clear whether these manual processes were securing the same, better or worse rates than through on-line systems although, as advised cases, the pots were generally larger and hence rates more likely to be negotiable with providers on a case-by-case basis. Respondents referred to new IT services becoming

[15] TOMAS (The Open Market Annuity Service) was acquired in October2010 by Just Retirement, one of the leading enhanced annuity providers.

available[16] to automate annuity quotations for advisers but concerns were expressed at the level of costs for using these services for advisors without high volumes of annuity business.

PROFITABILITY

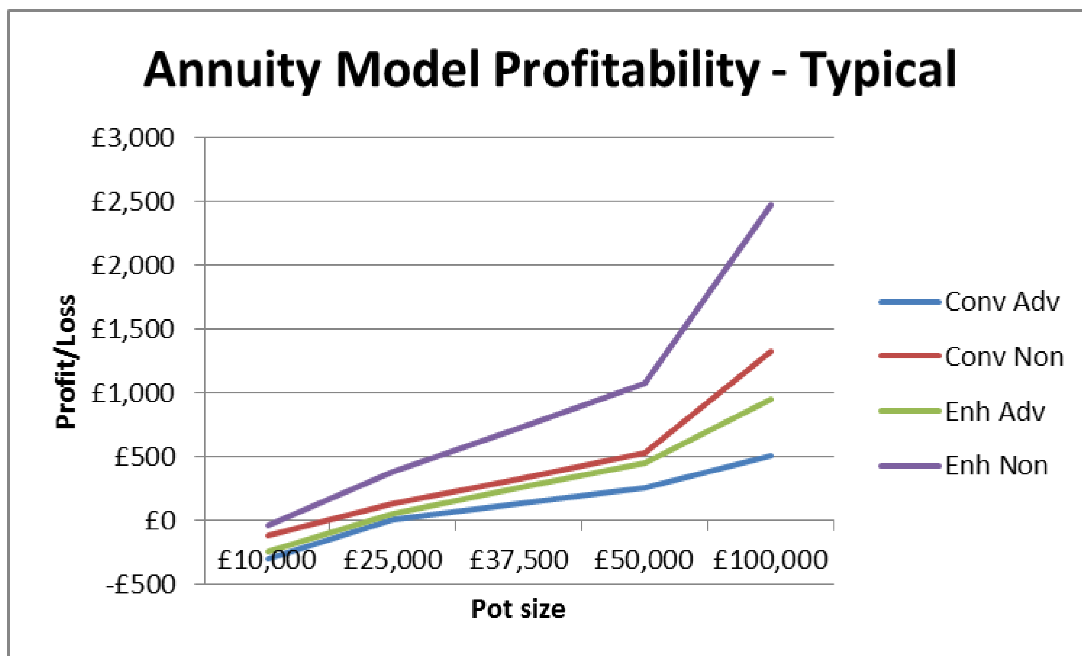
This topic was probably the most commercially sensitive and so most comments were circumspect. But there appeared a general view that the non-advised model was more profitable than advised. The advised model only won out where advice was broader in scope than just an annuity – either because it involved more complex products and/or covered other aspects such as investment of a lump sum.

Those who had developed non-advised models, however, pointed out that there was considerable investment required in systems and marketing to establish the business and deliver this lower cost base and that this had to be recouped.

COST AND REVENUE MODEL

One participant shared a simple model they had developed to compare the relative economics of the advised and non-advised model and the impact of technology investment in response to our topic guide. The data provided is attached in Appendix 3. They stated that this model was based on their own experience as a distributor modified by informal conversations with other distributors.

This respondent's model supports others' views that the non-advised model is significantly more profitable than the advised model, as is shown in the graph below. This plots the profitability for different pots sizes of advised (Adv) and non-advised (Non) sales and of conventional (Conv) and enhanced (Enh) annuities using typical current processes.



It is worth noting that in this model, non-advised costs quoted are at the low end of the range of costs quoted by respondents and also that the level of fees for advised sales used is around 1.7% for conventional and 2.1% for enhanced annuities, below the 2.5% level quoted by some other respondents.

[16] Such as AVELO EXCHANGE's Annuity Plus

The model also suggests that most non-advised sales will be profitable and that all sales are profitable at the model's quoted average case size of £37,500. This would tend to support comments that the non-advised businesses are able to operate at these levels because of significant investment in marketing and technology.

Another key point is the significantly higher levels of profitability of enhanced annuities over conventional annuities. This suggests that the costs of obtaining and handling the additional underwriting data to secure enhanced annuity rates are more than outweighed by the higher levels of commission/fees secured.

It would also tend to suggest that the middle market described previously can still be served profitably on an advised basis but that the higher returns and lower risk of non-advised sales will mean that this model is more attractive to the distributor. As another respondent put it *"… for the £100,000 pot I could do advice for £2,500 - cheap as chips - I could earn [up to] £4,000 on a non-advised basis."*

A further version of the model indicates costs and revenues that might be achieved with a fully automated process in place and higher revenues arising from the resultant efficiencies for providers being passed back in enhanced commission levels.

It is worth noting that whilst these data would suggest that the market will still offer advised and non-advised services to most annuity purchasers, an effect of RDR, noted above, has been a retreat from advised sales of annuities by generalist advisers towards higher value pots.

As noted above, a number of non-advised specialists are adding advised services to broaden their service and could fill this gap. But there was a view that they are unlikely to promote advised sales at the expense of non-advised sales: if middle market consumers will willingly accept a non-advised service, it is generally seen by the distributor as both more profitable and having lower risk.

There is therefore an open question as to how much advised sales will be a feature of the middle market for annuity purchase post-RDR in the absence of strong consumer demand for advice (and hence appetite to pay fees) in preference over non-advised services.

6. Conclusions

The Panel expressed particular interest in a number of topics for which conclusions, based on the research findings, are drawn below. The author has also suggested some other conclusions from the research that the Panel may also wish to consider.

6.1 Trend Towards Non-advice

The research tends to support the Panel's view that, post-RDR, a significant number of advisers are focusing on non-advised services using a commission remuneration model.

Evidence suggests significant development of marketing and systems platforms to expand capacity and increase efficiency amongst specialist annuity brokers and, potentially, from new consumer brands and existing pension providers.

The evidence also suggests that similar development has not been yet been taking place in the advised space, or were, at least, lagging non-advised developments.

However, the research also suggested two other relevant findings:

- A significant drop in advised sales reported for 2013. It was unclear whether this was due to one-off market distortions (such as the gender directive, temporary diversion of advisers effort with RDR) or

heralded a withdrawal from annuity advice by generalist regulated advisers in favour of referral to specialist and, potentially, non-advised services
- A number of specialist annuity brokerage firms are adding in-house advised offerings to broaden their offer to consumers

It is also worth noting again that around 50% of annuity sales are by providers to their existing customers – so called 'retained annuities' – and that almost all of these remain, post-RDR, on a non-advised basis.

6.2 Best Practice for Non-advised

The research suggested, as summarised in section 5.5, that best practice for non-advised should cover:

- A culture of putting the interests of the consumer first
- Service choices set out clearly for consumers upfront
- Comprehensive range of engaging and effective information and guidance
- Great customer 'experience'
- No customers turned away
- Searching the market widely
- Deep underwriting
- Effective use of technology
- Appropriate and effective checks and safety nets
- Interaction with a skilled facilitator
- Allowing time for consumer to make choices

6.3 Distribution Economics

The main findings from the interviews about attitudes to commissions and fees were that:

- Charging fees was seen by firms as a barrier to consumer engagement
- The commission model tended to focus consumers' minds on value in the form of annuity rates rather than service costs
- Fees were commonly being structured on a percentage rather than flat basis in the retail market - at a level above commission for conventional annuities but around or below that for enhanced annuities
- The division of the market between commission and fees post–RDR had been a significant stimulus to the growth of non-advised sales but avoidance of compliance with regulatory suitability obligations was a more fundamental driver

Analysis of the cost and revenue data supplied concluded that:

- Typical commission rates for standard annuities were reported as 1% - 1.5% and for enhanced annuities 2.5% - 3%. Higher levels of commission were available for volume distributors – a 1% uplift being considered typical although higher levels were believed to be offered to secure tied or

restricted panel agreements by providers. Fees levels reported for advised services were commonly in the range 1.7% – 2.5% of the purchase price.

- The non-advised business model is significantly more profitable for distributors than the advised – although the non-advised model typically benefits from efficiencies resulting from substantial IT investments.

Based on detailed data provided by one respondent, typical non-advised sales are profitable down to below £20,000 and all sales are profitable at the average OMO market pot size quoted of around £37,500 – advised or non-advised. Break-even for advised sales could be around £25,000.There is, however, a question as to the future levels of advised sales of annuities in the absence of strong consumer demand for advice (and hence appetite to pay fees) over non-advised services.

6.4 Advantages and Disadvantages for Consumers of Non-advised Services

The advantages for consumers of non-advised services cited were:

- Ready accessibility of non-advised services and competitive quotes via the web
- Ability to assess easily the impact on retirement income of different annuity shapes using on-line tools or packs produced by comparison services such as TOMAS
- Ability to compare rates between different sites or providers on a like-for-like basis
- Access to helpful information, education and guidance on many reputable sites
- Inexpensive service provided for those with small or even very small pots
- The ability to check understanding with an expert over the phone
- The ability to access advice services should the client feel unable to make an informed choice unaided
- Opportunity for faster completion using straight-through processing to providers

The disadvantages cited were:

- The focus tends to be of achieving the best-rate for a single pension pot rather than the most suitable income solution for the consumer's needs
- The difficulty of designing effective interventions to nudge the consumer into considering the longer-term risks or wider consequences of their choices
- Little or no access to other retirement income products/solutions apart from conventional annuities
- Higher chances of unintentionally forgoing valuable guarantees in existing contracts
- Higher chances of overlooking or even concealing medical conditions that would qualify for enhanced rates
- Most importantly, no recourse for the consumer should the product purchased subsequently prove unsuitable for their needs

6.5 Views on Consumers' Awareness, Knowledge and Understanding of about the Benefits and Limitations of Purchasing Annuities via Non-advised

The main conclusion to be drawn is that whilst consumers are becoming more aware of the need to shop around for the best annuity rate, especially if they are in poor health, consumers are still unaware of how best to act on this information.

The evidence suggests that non-advised services (either from their existing provider or an annuity broker) are chosen by consumers on the basis of convenience, simplicity and perceived lower costs and without understanding of the wider considerations listed above.

Only a small minority were reported as searching the market more widely or actively negotiating for better terms of business and that these were generally consumers from higher income groups with larger pension pots.

This could be a significant risk in a fast changing market as consumer demand may not act to widen best practice or ensure fair commissions/fees through the action of effective competition.

6.6 Importance of Introducers

The conclusion drawn is that that a number of high-profile consumer brands are planning to test the market over the next 1-2 years with a variety of propositions. This may cause continued turbulence in the market as consumers try to navigate the changing and competing offers and services.

The importance of introducers seems to lie in their ability (or otherwise) to bridge the gap in consumer awareness described above. With public and regulatory policy designed to drive more consumers into the OMO market, the open question is whether consumer brands can attract these consumers to services more economically than financial providers, advisers and specialist brokers and provide acceptable consumer outcomes without undermining their brands' values.

At this point the views of experts appear widely spread.

6.7 Other Conclusions

The author would also highlight the following conclusions which may be interest to the Panel when considering outcomes for consumers securing income in retirement:

Changes in the Annuity Product

Experts reported fundamental changes in the annuity product, driven by the growth of the enhanced annuity. The consequences for consumers, particularly those in full health at retirement, would appear profound as the existing annuity pool is broken up by more and more sophisticated underwriting and rating. The Panel may wish to do more to understand the possible scenarios resulting and the implications for consumers.

Responses of Ceding Providers

A COMMON VIEW WAS THAT CEDING PROVIDERS WERE BEING FORCED TO ADOPT NEW STRATEGIES IN RESPONSE TO WIDER CONSUMER AWARENESS OF THE OMO, STRONGER REQUIREMENTS OF PROVIDERS TO INFORM CONSUMERS OF THEIR CHOICES AT RETIREMENT AS WELL AS GREATER PUBLIC TRANSPARENCY OVER PROVIDERS' ANNUITY RATES FOR EXISTING CUSTOMERS. THE CONCLUSION IS THAT SIGNIFICANT CHANGE IS IN TRAIN AND WILL REMAIN SO FOR 2-3 AS PROVIDERS LOOK TO IMPROVE THEIR OFFERS IN THE 'AT-RETIREMENT' MARKET AND YET RETAIN MARGINS. THE PANEL MAY WISH TO CONTINUE TO MONITOR THESE DEVELOPMENTS TO SEE HOW THEY IMPACT OUTCOMES FOR CONSUMERS.THE IMPORTANCE OF TECHNOLOGY

Another key finding was the importance of technology in enabling efficient annuity purchase services. The impact of the significant investment required appears likely to change the structure of the market, forcing concentration in what is currently a very fragmented market for OMOs, and possibly raising barriers to entry. It is also possible that a limited number of technology providers may have very significant influence over the scope, quality and cost of services in the market. The Panel may wish to explore this further to assess the risks to consumers.

Workplace Markets

A final finding was the predicted growth in importance of the workplace market and the effects that changes in the retail market were now having on this market. The Panel may wish to consider consumer outcomes more specifically in this market and whether these will differ from significantly those in the retail market.

Nick Hurman

October 2013

Appendix 1: Author profile

NICK HURMAN

Nick is an independent industry professional who has been directly involved commercially in the 'at – retirement' market and more recently in the RDR access debate.

Whilst Managing Director of London Life, he lead the launch of an annuity consolidation service for existing policyholders coupled with a new with-profit annuity offer. As Director of SAGA's personal finance arm[17], he developed their annuity proposition offering both non-advised and advised services to customers using a combination of in-house and outsourced provision of annuity broking and financial planning solutions. He also has experience of the provision of other retirement solutions, whilst at NPI, where he launched a new range of drawdown products and as Chief Executive of NPI Membership Services was responsible for the division providing regulated advice to existing policyholders seeking financial advice around their retirement needs.

In his work with AEGON, he researched how consumers would design access to products and advice if given a clean sheet of paper[18] and formed the basis of a series of engagement activities and events with stakeholders such as the FSA, FSCP, HMT, Which? and the ABI. He has also acted as research director for the Resolution Foundation developing the case and business model for a national generic advice service subsequently taken forward in the Thoresen review. Recent published work includes research on savings incentives and consumers' motivations for savings for the CII in March 2011[19], on defining straightforward outcome products for the FSCP in June 2011[20] and, with Ian Costain, on researching the advice gap for the FSCP in March 2012[21].

In 30 years' experience in retail financial services, Nick has worked both as an industry executive and consultant with organisations such as Legal & General, Price Waterhouse, NPI, London Life, SAGA, AEGON UK and RGA (UK). As an independent consultant, he has also worked in the research and public policy arena with the DWP, FSA, PHSO, NEST, the Money Advice Service, the CII, the Equity Release Council, the Resolution Foundation and other research and actuarial consultancies.

Nick holds an MBA from City (now CASS) business school in addition to his BSc from University College, Durham and is an FCII and Chartered Insurer.

[17] Then called SAGA Investment Direct, now SAGA Personal Finance

[18] http://www.cii.co.uk/knowledge/resources/articles/cii-thinkpiece-6-the-future-of-financial-distribution-and-advice-listening-to-consumers/10051

[19] http://www.knowledge.cii.co.uk/system/files/TP52_Hurman_Effective_Incentives_for_Saving_16Mar2011_0.pdf

[20] http://www.fs-cp.org.uk/publications/pdf/straightforward_outcome.pdf

[21] www.fs-cp.org.uk/publications/pdf/**advice-gap**.pdf

Appendix 2: List of Interviews

Organisation	Interviewee(s)	Job Title
Age Partnership	James Dean Dan Baines	Head of Retirement Options Sales and Marketing Director
Age UK Enterprises	Dennis Barrett	Commercial Relationship Insurance Manager
Annuity Direct	Alan Higham	Chairman
Annuity Line	Billy Burrows	Head of Business Development
AVIVA	Nick Johnson	Head of Annuity Sales
Creative Benefits	Joe Kennedy	Wealth Management Consultant
Hargreaves Lansdown	Tom McPhail Ruth Richards	Head of Pension Research Head of Annuities
Just Retirement	David Cooper Peter Ellis	Group Marketing and Distribution Director Director of Retirement Income
Key Retirement Solutions	Paul Wilson*	Managing Director
Lighthouse Group	Roger Sanders Lee Barnard Mark Wilson	Managing Director, Employee Benefits Managing Director, Lighthouse Financial Advice Head of Pension Service
Lloyds Bank	Richard Anderson	Head of Wealth Planning and Retail Distribution

(* =Telephone Interview)

The author and the FSCP are grateful to individuals who gave up their time to participate in this research.

The author would also like to thank Lola Bello from the FSCP's secretariat for her support and input to this project.

Appendix 3: Cost and Revenue Model *(provided as evidence by one respondent)*

Typical Costs

Costs	Annuity Type	Advised	Non Advised
Introduction/Acquisition	Conventional	100	100
	Enhanced	100	100
	Investment	150	150
Advice/Selection	Conventional	150	50
	Enhanced	150	50
	Investment	300	150
Underwriting/Completion	Conventional	50	50
	Enhanced	100	100
	Investment	50	50
Overheads/Other	Conventional	200	75
	Enhanced	200	75
	Investment	250	75
Total Conventional		500	275
Total Enhanced		550	325
Total Investment		750	425

Typical Revenues

				P&L (Typical)	
Case Size	Annuity Type	Advised	Non Advised	Adv	Non
£10,000	Conventional	£200	£160	-£300	-£115
	Enhanced	£300	£280	-£250	-£45
	Investment	£400	£350	-£350	-£75
£25,000	Conventional	£500	£400	£0	£125
	Enhanced	£600	£700	£50	£375
	Investment	£850	£875	£100	£450
£50,000	Conventional	£750	£800	£250	£525
	Enhanced	£1,000	£1,400	£450	£1,075
	Investment	£1,250	£1,750	£500	£1,325
£100,000	Conventional	£1,000	£1,600	£500	£1,325
	Enhanced	£1,500	£2,800	£950	£2,475
	Investment	£2,500	£3,500	£1,750	£3,075
£37,500 (avg size)	Conventional	£625.00	£600.00	£125.00	£325.00
	Enhanced	£800.00	£1,050.00	£250.00	£725.00
	Investment	£1,050.00	£1,312.50	£300.00	£887.50

We also explore the art of the possible:

Optimised Cost Model

Costs	Annuity Type	Advised	Non Advised
Introduction/Acquisition	Conventional	75	75
	Enhanced	75	75
	Investment	150	150
Advice/Selection	Conventional	150	50
	Enhanced	150	50
	Investment	300	150
Underwriting/Completion	Conventional	25	25
	Enhanced	50	50
	Investment	25	25
Overheads/Other	Conventional	150	50
	Enhanced	150	50
	Investment	175	50
Total Conventional		400	200
Total Enhanced		425	225
Total Investment		650	375

Volume e-enabled Service

				Optimised P&L	
Case Size	Annuity Type	Advised	Non Advised*	Adv	Non
£10,000	Conventional	£200	£200	-£200	£0
	Enhanced	£300	£325	-£125	£100
	Investment	£400	N/A	-£250	N/A
£25,000	Conventional	£500	£500	£100	£300
	Enhanced	£600	£813	£175	£588
	Investment	£850	N/A	£200	N/A
£50,000	Conventional	£750	£1,000	£350	£800
	Enhanced	£1,000	£1,625	£575	£1,400
	Investment	£1,250	N/A	£600	N/A
£100,000	Conventional	£1,000	£2,000	£600	£1,800
	Enhanced	£1,500	£3,250	£1,075	£3,025
	Investment	£2,500	N/A	£1,850	N/A
£37,500 (avg size)	Conventional	£625.00	£750.00	£225.00	£550
	Enhanced	£800.00	£1,218.75	£375.00	£994
	Investment	£1,050.00	N/A	£400.00	N/A
Overall Profit/Loss	Conventional		£550.00		
	Enhanced		£993.75		
	Investment		N/A		
Difference	**Conventional**			**£100.00**	**£225.00**
	Enhanced			**£125.00**	**£268.75**
	Investment			**£100.00**	**N/A**

* Not Appropriate for Investment Annuity