Institute and Faculty of Actuaries

FCA annuities market study

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FCA retirement income market study

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Contents

A. Is FCA market study still relevant?

Why is the FCA conducting a market study?

- The FCA has a statutory objective to promote effective competition in the interests of consumers
- FCA been looking at annuities market since 2013:
  - A one-off purchase, potentially significant, irreversible decision
  - Large market: annuity purchases around £14bn in 2012
  - Lack of switching – 60% of consumers purchase from existing pension provider despite benefits of switching
  - Price comparison websites may be misleading
  - Behaviour of pension providers unfairly to retain annuity customers
- FCA initial thematic review concluded that further work required

The Budget– is the market study still relevant?

"In light of the Budget changes we will also look to understand how consumers, providers, and distributors are likely to behave in the new market landscape in order to assess potential competition risks and vulnerabilities (e.g. complex and opaque product innovation)."

"Although the true impact of the Government's reforms is likely only to be known after some years, many of the features of the market we are concerned about may persist. There are also new issues that we will need to consider."

FCA Retirement Income Market Study, Revised Terms of Reference, 9 June 2014

B. Scope and issues

Market study - Scope

- **Geographical scope** – products available to UK customers (international comparisons sometimes useful)
- **Consumers** – consumers using funds from their pension schemes to purchase an income product at retirement
- **Focal products** – annuity and income drawdown products – terms of reference wider than just annuities
- **Related products and markets** – also looking at interaction with other products (defined benefit pensions, State pension, savings/cash ISA/NS&I products, stock market-based investments, investment bonds from a life company, own/family business, equity release products)
- **Types of firms** – insurance companies (large and small), intermediaries (e.g. advisers and brokers) and providers of SIPPSs

Issue 1. Competitive conditions in current market landscape

- FCA examine whether features of current market where competition may not be working effectively in the interests of consumers that might carry through into the new retirement landscape:
  - Product distribution
  - Role of advice and guidance
  - Consumer decision-making
  - Effectiveness of the open market option.
- Undertake further consumer research

Issue 1. Competitive conditions in current market landscape (2)

- The level of concentration in the annuities market
  - Six firms offering standard annuities on the open market in (2012); top three accounted for 63% of standard annuities. FCA also said "*concentration is increasing over time*"
  - Level of concentration even higher for customers with smaller pension pots
- The impact of changes in the retirement income landscape (e.g. auto-enrolment) on the structure of the market
- The impact of existing regulations that are in place (Solvency II Directive, PRA Rules etc.)

Issue 2. The new market landscape

- New products and business models are likely to arise in response to the March 2014 Budget
- FCA to understand how the market is likely to develop
- Identify potential competition risks and vulnerabilities to consumers in the new landscape

Issue 3. Value for money of retirement income products

- FCA will assess the *value for money* associated with consumers adopting different at-retirement strategies in the future landscape
- Using VFM, FCA to determine the most important factors to consumers when choosing retirement income products
- Analysis aims to provide a baseline for consumers to assess the value for money of product innovations that we expect to see in the new landscape
- Analysis to play a role in new guidance?

Issue 4. Behaviour in the new market landscape

- Consumer inertia
  - Leads to a ‘default’ annuity purchase with the existing pension provider
  - More complex as the number of options increases
- FCA working with Government to develop the *impartial guidance guarantee*
- Market study will identify
  - Issues to address in final guidance guarantee
  - Wider consumer protection issues for FCA to address
- Comparative analysis of international approaches in countries where annuitisation is not compulsory

Issue 4: Consumer behaviour and role of behavioural economics

- The FCA is looking to ‘nudge’ people into doing what’s best for themselves (by changing behaviour)
- Notable “biases” in the market for annuities that potentially lead consumers to sub-optimal outcomes:
  - Lack of *financial literacy*, knowledge of the product, knowledge of the options
  - ‘*Fear of the unknown*” - transfer past relationship of trust with pension provider to future purchases?
  - Buying an annuity is a large one-shot decision with no learning and no method of recourse if it goes wrong – leads to *risk aversion*
  - Consumers unable adequately to consider the trade-off between the *present and the future*

Issue 4: Behaviour of firms

- Sales practices and tactics to retain customers/win customers on the open market
- Type, range and comparability of information provided to consumers regarding their options
- Differential pricing and profitability
  - Retained customers vs open market customers
  - Customers with smaller pension pots
- Role of advisory services offered by firms
- Specific sales conduct - separate thematic review

C. Process, powers and remedies

Market study process - what to expect

Launch
(announce study and indicate scope; engage with stakeholders)

Research
(collect data/information; market research; roundtables etc.)

Analysis & Interim Reports
(assess evidence; interim report outlines draft analysis & preliminary conclusions – may consider proposed solutions)

Final Report
(analysis, conclusions and where relevant, proposed remedies)

Remedies
(rule-making, enforcement powers, guidance; may consult on proposed remedy)

6-12 months

Study "re-launched" in June 2014

FCA expects to produce Interim Report later 2014

Parallel processes

Market study powers

Information gathering:

- Questionnaires to firms, desk research, surveys, mystery shopping, other regulators (e.g. PRA) etc.
- FSMA powers to require regulated firms to provide information/ data
- Internal FCA data analysis (i.e. profitability)
- Complaints and submissions
  - industry participants
  - consumer associations

Remedies:

- Policy and regulatory changes (recommendations to PRA)
- Changes to existing rules
- Firm specific enforcement powers
- Publishing guidance
- Proposals for enhanced industry self-regulation
  - market investigation reference to the CMA from April 2015
  - CMA potentially impose draconian behavioural measures as well as structural remedies

Market study remedies

	OFT Market Studies
Completed (since Dec 2002)	53
No further action	4 (8%) (Equity underwriting, Online consumer contracts, Misleading advertising and pricing of goods and services, and Isle of Wight ferry services)
Referred to the CC	15 (28%)
Others (e.g. undertakings, voluntary changes, policy recommendations to Govt.)	34 (64%)
	CC Market Investigations
Completed (since Dec 2002)	13
The vast majority of which were subject to an AEC finding	12 (92%)
No further action	1 (Pay TV)

Very rare that market studies result in no action at all

Changing regulatory/commercial context

Regulatory context

- Solvency II
  - Pressure on capital (e.g. matching adjustment)
  - Diversification benefit
- Conflicting roles of PRA and FCA (solvency vs. consumer interest)
- ABI Code of Conduct on Retirement Choices
  - Emphasises importance of shopping around (OMO)
  - Suitability of Code post-April 2015?

Regulatory context (2)

- FSCS CP21/14, open until 6 January 2015, proposes 100% compensation for annuities, so the comparative strength of particular annuity providers could diminish in the eyes of consumers

Commercial context of HM Government reforms

- Decline in annuity sales
- Sales opportunity for annuity providers with big investment funds operations
  - INSPRU prohibition against non-insurance activities
  - FSMA confines UK insurance activities to authorised insurers
- Annuities providing for extraction of lump sums (if provided for at inception)
  - An opportunity for a non-insurance investment product
  - Pricing: tension between need for insurer to be able to use current pricing to recalculate annuity and consumers being already locked-in (akin to pre-reform annuitisation market?)
- DB schemes: transfers out do not currently reflect longevity/dependant status etc, so there is a risk that least costly members will transfer out to a personal pension: an unintended consequence?

Possible outcomes

Possible outcomes

- Behavioural remedies
  - Industry undertakings
  - For example, prohibiting differential pricing for annuities?
  - This would not extend to non-insurance products, like a group's investment products, because there is no perceived competition issue there (yet)

Possible outcomes (2)

- FCA rule-making powers
  - FCA could seek to control differential pricing
  - FCA could introduce rules to limit incumbency advantage in relation to annuity sales (see FCA's conclusions on insurance add-ons and PPI prohibition against sale of insurance at the same time as finance)
  - FCA could impose some form of advice requirement where annuity (or another product?) is sold by incumbent pension provider
  - FCA could take enforcement action against a particular firm e.g. in relation to product literature, to encourage better disclosure/suitability (see for example Yorkshire Building Society/Credit Suisse case): this may be a way to limit the risk of group companies using incumbency advantage to sell bad value non-insurance investment products to be bought with pension proceeds

Possible outcomes (3)

- Structural remedies (unlikely without CMA reference):
  - Split pensions businesses from annuities businesses? Less likely now, given (a) reduction in annuity sales and (b) increase in FSCS cover?
  - Split pensions businesses from investment businesses? This could avoid the biggest groups replacing profitable roll-over into annuities with roll-over into bad value investment products

    BUT FCA/CMA would first want to see strong evidence of harm before proposing such radical measures

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Possible outcomes (4)

- Annuity terms reform
  - Should annuities be allowed to be more flexible, given the impending draw-down rights for personal pensions?
- Common criteria by which to compare annuities – simplification on a website operated by an impartial body (e.g. the Pensions Advisory Service) – information remedy unlikely to be effective in isolation though
- Information remedies: sufficient?
  - "Guidance", but focus will not be on selection of annuity provider
  - Links between provider of pension product and investment product to be made clear? However, would this help protect consumers from the usual inertia?

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Guidance

Birth of Guidance Regime

- HM Government: “the guidance service is intended to equip and empower people to make confident and informed choices on how they put their pension savings to best use”
- HM Treasury “will hold overall responsibility for the service design and implementation until the guidance service reaches maturity”
- Initial providers are to be the Citizens Advice Bureau (CAB) and the Pensions Advisory Service (TPAS): a reflection of the withering of the mid-tier FA market and (apparently) mistrust of product provider advice

Birth of Guidance Regime (2)

- Possibility of other “trusted consumer-facing organisations” such as Age UK becoming involved
- Pension Schemes Bill 2014/15

Role of the FCA

- HM Government has proposed that the FCA “as the expert conduct regulator” should set standards and monitor compliance
- HM Treasury will designate organisations as providers of guidance but authorisation by the FCA is not required
- Apparently, this approach “will help prevent unscrupulous firms passing themselves off as providers of guaranteed guidance”
- HM Treasury will be responsible for ensuring that guidance providers take “remedial action” (for non-compliance) “on the basis of any recommendations about their conduct from the FCA”

Position of the FCA

- Uncomfortable position for the FCA?
- Who will be blamed if the guidance service is not operational in good time for April 2015?
- … and what about public examples of bad practice or non-compliance with the standards?

FCA July Consultation (CP14/11)

- Distinction between guidance and advice: consumers are expected to make “informed and confident decisions” by virtue of the guidance
- Legislation will “clarify” that guidance providers will not need authorisation under FSMA
- FCA’s role will be limited to monitoring compliance with the new standards regime: it will have no enforcement rights

Guidance standards

- Final standards and rules are to be published in a policy statement in late Autumn
- FCA proposals cover three areas: guidance standards; industry levy; and handbook changes for insurers

Draft Guidance Standards

- HM Treasury to hold “overall responsibility for the service, design and implementation” of the guidance service
- FCA’s objective is for guidance to be “tailored”, but not to give product/provider recommendations (IFA territory)
- Guidance providers must deliver the guidance “with due skill, care and diligence” and ensure that individuals are competent
- Communications to consumers must be “clear, fair and not misleading”

Position of Insurers

- COBS 19.4 is proposed to be amended so that consumers receive a “retirement option statement” covering the value of the pension, any guarantees and any other “special features” such as MVRs, together with “a clear and prominent statement” about the guidance service
- Insurers must provide the statement between four and six months before intended retirement date, subject to the next point

Position of Insurers (2)

- Such statement must be provided along with a retirement quotation, if requested more than four months before the intended retirement date (unless the statement has been provided in the previous 12 months)
- At least six weeks before the intended retirement date, insurers must remind pension clients about the statement
- Insurers must not “actively discourage” use of the guidance service, including by leading consumers to believe the service is unnecessary (TCF)

Position of Insurers (3)

- "Signposting": on top of the above, FCA has proposed a wide obligation on insurers to refer to the availability of the guidance service when it communicates with customers about retirement options – seemingly, on every occasion
- When insurers receive an application to access funds within a personal pension/annuity, they must provide a "description of the tax implications of doing so"

Levy

- FCA proposes that only those firms that could benefit from the provision of retirement guidance should pay for the service
- The proposed categories of levy payers would be:
  - Deposit acceptors (banks etc)
  - Insurers – life
  - Portfolio managers
  - Investment fund managers and operators of collective investment schemes or pension schemes
  - Advisory arrangers, dealers or brokers

Levy (2)

- Query allocation methodology: specific consultation imminent