Institute
and Faculty
of Actuaries

CP16/12: Secondary Annuity Market – proposed rules and guidance

IFoA response to the Financial Conduct Authority

24 June 2016

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The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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James Ridgwell and Philip Diamond
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Financial Conduct Authority
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24 June 2016

Dear James/Philip

IFoA response to CP16/12: Secondary Annuity Market – proposed rules and guidance

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA's consultation on the proposed rules and guidance for the secondary annuity market. Members of the IFoA's Life Standards and Consultations sub-Committee and Life Board have been involved in the drafting of this response. Members of this Committee and Board work for insurers active in the annuity and wider post retirement markets.

2. The actuarial profession has extensive experience in the valuation and wider risk management of annuities and other post retirement products. Accordingly, we believe the profession has an important role to play in the ongoing development of a secondary annuity market, and we would be pleased to discuss our response with the FCA.

3. The IFoA commissioned research in April 2016 on both the appetite amongst annuitants for the secondary annuity market, and also on lessons to be learned from other secondary markets. We refer to this research where relevant in the paragraphs below; a link to a summary of this research can be found here: IFoA Secondary Annuity Research.

General Comments

4. Access to adequate financial advice or guidance will be key to annuitants understanding the pros and cons of, and the inherent risks relating to, the choices they face. We therefore welcome the FCA's consultation on its proposed rules and guidance for the secondary annuity market. It is important that an appropriate advice/guidance infrastructure and consumer protection framework is in place before any secondary annuity market is opened, particularly if there is significant interest from potential sellers when the market first opens.

5. A robust consumer protection framework is also essential to avoid the potential risk of secondary annuity mis-selling. As noted in the consultation paper, many annuitants will likely be amongst the most vulnerable in society, particularly in older age. Robust consumer safeguards, both in terms of advice/guidance and regulation of annuity buyers' sales processes, will therefore be necessary to protect against mis-selling.

6. Although the freedom to decide how and when to use their retirement assets will be attractive to some pensioners, giving up a guaranteed income could increase the risk of inadequate income in later retirement. If an individual underestimates their future life expectancy and plans the remainder of the retirement income accordingly without a guaranteed pension income, they are likely to run out of savings before they die.

7. The IFoA therefore agrees that products which offer a guaranteed income for life will continue to play an important role for many pensioners. For most annuitants, keeping their annuity is likely to be the right decision for them. We encourage the FCA to ensure that the benefits of annuities and the risks associated with assigning are widely and clearly communicated as part of the secondary annuity advice and guidance framework.

8. The research we commissioned in March 2016 included opinion polling of existing annuitants in the UK, aged over 55. Although 66% of those polled said they were aware of the proposals for a secondary annuity market, only 18% claimed they were likely to sell their annuity income. Those polled were also more likely to say that the proposals were a good idea in principle, rather than a good idea for their circumstances.

9. In the sections that follow, we have limited our response to those consultation questions where we believe the IFoA's expertise can add value.

Response to Consultation Questions

Q1: Do you agree with our proposal to require specific risk warnings to be given to consumers at first contact? Would you suggest any changes to the format and content of the risk warnings?

10. The IFoA supports the principle that the generic risks of a secondary annuity market should be flagged to annuitants, not only when they first show interest in the market, but also as they proceed through any sale process. This is essential to help the individual (and their dependants) understand the implications of exchanging their annuity income for a lump sum.

11. As mentioned above, we believe that for most annuitants keeping their annuity policy will be most appropriate for their circumstances. A key risk with selling an annuity is the loss of guaranteed income for life, and we agree that the risk of running out of money in retirement should be particularly prominent in the risk warnings.

12. The other risks included in the table of warnings are also key factors for annuitants to consider, in deciding what is most appropriate for their circumstances. However, the general risk of mis-selling should also be prominent, but could be referred to alongside the recommendation/ requirement to take advice or guidance.

13. We also agree that firms should consider the needs and preferences of the relevant consumer when issuing risk warnings. Although there is scope to use an online process, this will not be appropriate for all consumers, particularly the elderly.

Q2: Do you agree:

- **that at first contact all sellers should be:**
  - **informed about the compulsory advice requirement;**
  - **given a recommendation to take advice and/or Pension Wise guidance**
  - **given a recommendation to shop around; and**

- **that annuity providers should check that legally required ‘appropriate advice’ has been taken, by receiving confirmation in a durable medium, prior to proceeding with annuity income sale?**

14. As mentioned above, access to adequate financial advice or guidance will be key to annuitants in understanding the pros and cons of the secondary annuity market, and whether it is appropriate for their circumstances. For many annuitants, it will be a difficult decision to know whether or not it is appropriate to assign their annuity.

15. The IFoA agrees that when annuitants first show interest in the secondary annuity market, they should be:

    - informed of the compulsory requirement to take financial advice requirement (with it being clear when advice is compulsory)
    - recommended to take financial advice otherwise, or guidance from Pension Wise and
    - recommended to shop around.

16. Access to tailored guidance from a public body such as Pension Wise will be critical where financial advice is not taken. Annuitants with smaller pensions may have a particular need for robust guidance, especially if they have limited alternative retirement benefits.

17. In our opinion polling of annuitants, the appetite for independent financial advice if selling the annuity was mixed: 45% indicated that they would not or did not know whether they would take advice. Furthermore, those who claimed they would seek advice indicated they would pay an average of £162 for it. This figure is likely to fall short of the cost of advice in most cases, and so some consideration should be given to how the cost of advice could be paid for. Payment from the annuity lump sum is clearly feasible only where the sale of annuity income takes place.

18. Any advice and guidance should consider not just whether it is appropriate to exchange annuity income for a lump sum, but also how the corresponding lump sum should then be invested. Our opinion polling also suggested there was significant uncertainty amongst annuitants over what they would do with proceeds of the sale; 55% of those polled did not know whether they would then buy a different retirement product such as income drawdown.

19. It is clearly in the best interests of the annuitant that they should shop around for the best price for their annuity income. It is likely that the level of interest from buyers will fall with declining annuity size; it is plausible that for the smallest annuities, interest in buying the annuity may be restricted to buy-back from the existing annuity provider (if at all).

Q3: Do you agree with our proposals that at first contact all sellers should be informed about the possible need for contingent beneficiary consent, and that FCA should make rules in relation to contingent beneficiary consent?

20. We agree that when annuitants first show interest in the secondary annuity market, they should be informed of the potential need to obtain contingent beneficiary consent. A wide range of beneficiaries could be impacted by changes to the annuity policy, including joint lives, spouses, civil partners and minors. We also support the general principle that such contingent beneficiaries should be involved in the decision-making process at an early stage.

21. It is important that insurers/ annuity providers recognise the rights of these wider beneficiaries when considering re-assignment of annuity benefits. Therefore we support the principle of FCA’s

a legal requirement that annuity providers check that they have received the consent of contingent beneficiaries before re-assignment/ buyback.

Q4: Do you agree that, at first contact, all sellers should be informed about:

- **the ancillary costs the relevant firm reasonably believes it may charge for**
- **the possibility that the relevant annuity provider may cover its costs, directly or indirectly, from the seller?**

22. We agree that the relevant range of ancillary costs – estimated or otherwise – should be disclosed to annuitants, together with any corresponding lump sum offered net of such costs. Disclosure of costs and the lump sum on a net basis will help annuitants understand the initial transactional implications of selling their annuity income.

Q5: Do you agree with our proposals on panel disclosure rules?

23. The IFoA supports the FCA's proposals on panel disclosure. Access to a wider range of potential annuity buyers may help annuitants achieve a better price for their annuity income. Transparency over the size of a given broker's range, and of any relationships between them and the potential buyers should help annuitants make an informed choice (including, where relevant, between different brokers).

24. As mentioned above, the range of potential buyers may be limited where the annuity size is small; it may also be limited in the earlier stages of a secondary annuity market if a relatively small number of participants are offering to buy annuity income.

Q6: Do you agree that firms providing quotes should be required to:

- **present quotes for annuity income in certain prescribed ways; and**
- **provide the price comparator alongside their quotes for annuity income?**

25. Requiring secondary annuity market quotes from different brokers/ providers to be comparable will make it easier for annuitants to choose between different quotes, and we agree that some degree of prescription over the format of the quotes is desirable.

26. As noted in the consultation paper, most annuitants are likely to struggle to place a value on their annuity income. Many may also have unrealistic expectations of the lump sum they could receive on the secondary annuity market; in our opinion polling, over 40% of annuitants would expect to receive a lump sum in excess of 100% of the future annuity payments.

27. It is important that indicative quotes highlight the risk that subsequent guaranteed quotes may be substantially different to indicative figures; this is particularly likely where any underwriting process subsequently reduces the lump sum available.

28. We note the proposal that quotes be on a uniform single lump sum/ sterling basis. One potential difficulty with using a single lump sum is that some buyers may offer lump sums in instalments, with future lump sums contingent on survival (as a guard against anti-selection). In such cases, the indicative lump sum may not subsequently be paid in full, if the former annuitant does not live long enough to receive each instalment. This would require additional disclosure.

29. Showing quotes in descending order may also help annuitants identify the best offer, although it is possible that the highest offer need not be most appropriate for the annuitant's circumstances – again, if lump sums were paid in instalments, for example.

30. We also agree - on the grounds of transparency - that quotes should not be contingent on other events, such as sellers committing to invest the proceeds in a specific product. However, we do not see any difficulty in the buyer offering preferential terms on other products should the annuity sale go ahead.

31. The IFoA agrees that some form of price comparator is very important in letting annuitants understand the value of their annuity income. In our poll of annuitants, we found that while a general explanation of the factors to consider and tailored information from a body such as Pension Wise would both generally be useful, a statement of the value of the annuity was considered to be most useful*. The suggestion in our poll was based on the annuitant provider's reporting value, so differed in detail from the proposal in this consultation.*

32. The proposed use of the open market cost of buying a replacement annuity is one way to provide a price comparator. However, the open market cost may require further explanation. As noted in the consultation paper, it would typically include an allowance for the annuity provider's policy 'set-up' costs, including (potentially) some degree of underwriting. Including these 'set-up' costs by using an open market cost would increase the indicative current value of the annuity income, thus widening the gap with any quote on the secondary market. Explaining this factor in the quote, and the likely range of such 'set-up' costs may address this issue to an extent, but adds to the complexity of such disclosure.

33. The consultation paper also explains that the open market cost of the annuity should consider the same medical details as the secondary annuity quote. We agree that consistency of medical details is important. However, it is likely that the secondary annuity quote will use a detailed underwriting process to mitigate the risk of anti-selection. The underwriting criteria in the (primary) annuity market are unlikely to mirror that developed for the secondary market, as the risk of anti-selection is generally lower on the primary market. There may therefore be some difficulties in replicating primary market costs on non-standard medical terms.

Q7: Do you agree that the 14 day stop period requirement should be extended to all secondary annuity market interactions?

34. Given the potential range of parties involved (including annuitant, annuity provider, broker and buyer), we believe the proposal for a 14 day 'stop period' is sensible.

Q8: Do you agree with our proposals on broker incentives and charging?

35. We agree that a conflict of interest could arise if a broker operating in the secondary annuity market were to receive commissions set by buyers operating in this market. As such, we agree with the FCA's proposals on broker incentives and charging.

Q9: Do you agree that the FCA should make rules requiring that an annuity provider can only cover reasonable costs when charging to help facilitate or execute an annuity income sale?

36. Annuity providers will incur costs in a secondary annuity market, and we agree that they should be able to recover 'reasonable' costs. As noted in the consultation paper, costs are likely to be incurred in making any checks required by legislation and in underwriting in the case of annuity buyback.

37. However, annuity providers are also likely to incur future costs in relation to notification of death. Keeping track of whether annuitants are still alive once payments have been re-directed is likely to be a key challenge in the secondary annuity market, and there could be an increased risk that

annuity payments continue after the death of the annuitant, which would give rise to losses for insurers. The writers of the original annuity will need to consider the impact of such uncertainty and additional costs, although such costs would generally be incurred sometime after re-assignment.

38. The IFoA agrees that annuity providers should not place unreasonable barriers in the way of consumers seeking to sell their annuity income. However, we do not think it would be appropriate for the FCA to propose fixed levels of ‘reasonable’ costs as different annuity providers will have different expense bases.

Q10: Do you agree with our proposals to continue to provide access to the ombudsman service in relation to the sale of annuity income on the secondary market?

39. Given the potential risk of mis-selling in the secondary annuity market, we agree that sellers of annuities and contingent beneficiaries should continue to have recourse to the ombudsman service.

40. The consultation paper explains that the annuity provider should take reasonable steps to: check that the relevant financial advisor met the requirements of the relevant legislation; obtain the consent of contingent beneficiaries. It would be helpful if the FCA could give guidance on its expectations on what are ‘reasonable’ steps for the parties required to make these checks.

Q13: Do you agree that we should provide guidance reminding firms active in this market about their existing legal responsibilities in respect of sellers who may lack full mental capacity?

41. As we mention earlier, many annuitants will likely be amongst the most vulnerable in society, particularly the very elderly; for example, where they are open to undue influence from relatives or others (such as carers in a nursing home). We also agree that there is a higher incidence of mental capacity problems amongst the elderly. We therefore support the FCA’s proposal to issue guidance reminding participants in the secondary annuity market of their legal responsibilities in respect of sellers who may lack full mental capacity.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager at Steven.Graham@actuaries.org.uk or on 020 7632 2146 in the first instance.

Yours sincerely,

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President, Institute and Faculty of Actuaries