FCA Annuities Thematic Review and Impending Market Study

Summary

On 14 February, the Financial Conduct Authority (FCA) published the results of a detailed thematic review into the annuities and related markets. The review involved a review of consumer research, a detailed analysis of FCA data, and questionnaires to 25 firms representing 98% of the sector.

- **Most consumers seem to have limited self-confidence** in dealing with annuities, and are therefore more likely to settle with default choices.
- **60% of consumers are staying** with their existing pension provider. 80% of these consumers could be getting a better deal elsewhere via the open market.
- **£115–230 million detriment:** in the rough estimate of additional pension savings lost as a result of this.
- **Pension providers 70% retention rates:** from exploiting the well-known consumer behavioural trait of inertia, and evidently to their customer’s disadvantage.
- **Financial Services Consumer Panel research** published last month into non-advised sales suggest that customers who do shop around seem to fall victim to another scandal of firms offering straight-through services culminating in a less than optimal product for a fee higher than what many advisers charge.
- **Consumers with limited pots:** people with less than about £5,000 (about a quarter of people currently retiring) would not benefit from shopping around even if they wanted to. This problem will worsen as a result of auto-enrolment.

Next steps: in-depth annuities/income drawdown market study

- **FCA market study** looking with more depth into annuities and income drawdown.
- **Call for evidence** under way currently, closing on 14 March.
- It will then publish an interim report in the summer, followed by a final report around February 2015.

Background

On 14 February, the Financial Conduct Authority (FCA) published the results of a thematic review by the regulator since January 2013 into the annuities and related markets. The review set out to:

- assess whether and by how much consumers would be better off buying an annuity from the open market rather than their existing pension provider;
- consider the drivers of provider behaviour, including assessing, at a high level, the profitability expected from their annuity business; and

The Chartered Insurance Institute
• review existing research about consumer behaviour and engagement to better understand how this affects shopping around and the choice of annuity. This project was led by Jackie Wells (who is also on the CII Professional Standards Board).

Public policy implications on saving for retirement

Although the retirement savings has dominated the Government/regulatory public policy debate, and problems in the decumulation market could undermine the efforts of the last two successive Governments to encourage savings to improve welfare in retirement.

• Auto-enrolment will bring another 11 million or so people into this process, and it is these people that may experience the biggest and most complex problems in buying annuities.

• This is not the first time the government has been concerned about the promotion of an open market in annuity sales. The FSA has had rules to improve information that pension firms provide to their customers to facilitate use of the open market. More recently, both the ABI and The Pensions Regulator have published Codes of Conduct on Retirement Choices.

Other public policy implications

Other seemingly unconnected public policy and regulatory decisions will also have an impact:

• Retail Distribution Review: annuities and other decumulation-related products are retail investments, and therefore the RDR will impact the availability and quality of retail investment financial advice as well as the attractiveness of non-advised processes.

• EU Gender Directive: the Gender Directive prohibiting insurers from discriminating on the basis of gender has affected the rates offered on the basis of average life expectancy. While that may be theoretically advantageous to women, it may have resulted in an overall disadvantage to both genders as insurers raised rates to compensate.¹

• Solvency II: annuities are long-term investment products offered by insurers based on estimates of life expectancy and other factors, and therefore impact an insurer’s chosen prudential risk-based capital model.

• Policies and regulation around the use of property equity in retirement: solutions are available to supplement provide household liquidity in retirement using property equity. There is a small private equity release market, but more importantly the Government is trying to make universally available the possibility of using home equity as a way of offsetting residential care costs.

Thematic Review Findings²

Design of the study

The review involved the FCA collecting a combination of 2012/2013 annuity sales data (using regulatory returns) and a collection of quotes from 25 firms (representing about 98% of the annuity sales market by volume). The FCA also commissioned a desk study of existing consumer research into the annuity market, pulling together a range of sources, plus twelve major projects from seven key UK organisations.

¹ See for example, David Trenner FCII, APFS, Chartered Financial Planner, Banned! Underwriting Annuities by Gender: Where Do We Go From Here? CII Thinkpiece no.53 (March 2011).

² Financial Conduct Authority, TR14/2 Thematic Review of Annuities, February 2014; see also FCA Press Release 14 February 2014.
Consumers in the annuity market

The overall findings of the consumer research suggest that consumers are overwhelmed by the complexity of decumulation and therefore are likely not to shop around:3

**Complexity:** decumulating wealth at retirement, in the form of either arranging an income drawdown facility or buying an annuity (or some sort of sequenced combination of both), is a major decision customers face at retirement.

- This decision is complex with multiple courses involving different providers, products and rates;
- This decision will have a huge impact on the customer's overall financial wealth over the rest of retirement;
- With retirement lasting upwards of 30 years-plus, and characterised by changes in circumstances such as declining health and invariable partner loss, the decision could be far-reaching; and
- The decision may also not be reversible without considerable effort, financial loss and stress.

**Awareness:** most consumers seem to be aware that they can shop around for an annuity, and they claim they shop around, but end of settling with their existing pension provider:

- 90% say they are aware of the open market option; but
- 63% say they shop around but this can mean a range of things.

**Engagement:** consumers find it difficult to select and buy an annuity, and many struggle to assess risk, uncertainty and retirement options. Auto-enrolment, while improving pension savings by reducing the need to actively engage in the process, might actually worsen the situation because they will suddenly need to become very active in difficult decisions when they retire.

**Inertia:** there is a significant body of evidence suggesting that consumers tend to opt for the easiest, most straightforward and least active option, especially in financial services. Unless there is a clear and obvious benefit to taking action, most consumers will settle for the default choice.

**Confidence in their existing provider compared to wider market:** a consistent finding from several projects into consumer trust and confidence suggest that even though consumers have limited overall trust in the sector, they are more likely to trust their own financial institution. This is especially the case in annuities.

Benefits of shopping around

Given this understanding of how most consumers approach annuities, the FCA’s market data on how consumers actually interact should come as no surprise:

- 60% of annuities were purchased through the customer’s existing pension provider, either directly or through a third party.
- 80% of those purchasing an annuity from their existing provider would benefit from either shopping around or switching. This rises to up to 91% for those considering enhanced annuities.
- On average, the benefit of switching is equivalent to having an extra £1,500 saved into a pension just prior to retirement.
- This equates to about £115–230 million of additional pension savings across all consumers who do not shop around. The range reflects the theoretical nature of this benefit: for example significant increases in shopping around would impact rates.

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Exception: consumers with smaller pots

The FCA findings also observe that consumers with smaller pension pots (less than about £5,000) are less able to shop around even if they wanted to.

- 27% of annuities were for less than £5,000.
- Around half of these customers are getting the best rate, and the remainder would only benefit by less than 5%, and therefore would not really benefit from shopping around.
- The consumer research suggests that this limited choice could affect people with as much as £10,000, which would affect about half the currently retiring population.
- The proportions of those affected will get larger as auto-enrolment works through, unless the Government is able to resolve the complex pot consolidation dilemma.

Proportion by which consumers could increase their annual income by shopping around and switching (FCA chart, Thematic Review report, p.16):

![Proportion by which consumers could increase their annual income by shopping around and switching](chart)

Annuity market products and providers

The extent to which consumers shop around for an annuity depends on a number of factors including consumer attitudes and behaviour, but provider activity plays a significant role. The FCA gathered various data on the number of providers active in annuity market in 2012, and focused on 25 providers representing 98% of the market by volume.

Market share is very concentrated and skewed towards the existing customer proposition: 13 providers only sell annuities to existing pension customers; 6 sell annuities on the open market only. This is very concentrated, whereby just 3 firms enjoy 97% of the market share (57%, 21% and 19% respectively).

The FCA will be examining more closely the following issues:

- **Profitability**: the FCA will be looking at this in more detail in its market study. Tentatively it expects that standard annuities to existing customers were expected to be significantly more profitable.
- **Retention rates**: these range by provider from about 70% to less than 10%. Firms on the high end have active retention strategies that may increase customer loyalty and reduce the propensity to shop around.
- **Customer interaction**: those providers that enjoy high retention rates tend to all follow a similar pattern in the way they deal with customers at or just before retirement. The customer is normally sent a statement at an appropriate time before the preferred retirement date and is then contacted by telephone. While the option to
shop around on the open market is set out, the customer is also offered a much easier option to simply stay with the provider.

Financial Services Consumer Panel Research

While the FCA have observed market shortcomings in how consumers are not shopping around sufficiently, a parallel piece of work published by the Financial Services Consumer Panel in December 2013 highlighted problems with those consumers who do shop around:

- **Confusing distribution market**: consumers seem to be attracted down a profitable non-advised route by firms offering “straight through” services leading to an annuity purchase. Firms offering non-advised services are able to avoid RDR regulations on conduct of business, and therefore negative practices such as cold-calling and cold-emailing are common.

- **Potentially exploitative practices**: such as rollover pricing sent by defined contribution providers to their customers approaching retirement, combined with exit penalties in contracts, embedded or opaque charges and regulatory arbitrage that impede informed choices.

- **Increasingly complex annuity products many offering poor value for money**: consumers are made to believe that they are saving money going for a non-advised route when in fact they are paying more. There is emerging concern that insurers are making excessive profits from annuities, brining into question the value for money.

The Consumer Panel recommended the following steps:

- **FCA market study**: should be undertaken looking at exploitative pricing practices described above and to undertake remedial action to promote effective competition. It should also strengthen the OMO operation, recommending that exit penalties be banned, excluding tied annuity sales from the OMO definition. The FCA appear to have done this as a result of their thematic research;

- **Improved Money Advice Service propositions for annuity advisers**: these should be better developed along with associated guidance, and they should undertake a targeted educational campaign; and

- **Government efforts to address structural weaknesses in the annuities market**: including reforms to the tax system to prevent people with small pension pots from taking a lump sum. Another major recommendation would be to create a NEST-type service for annuities.

Implications and next steps

It is clear from this thematic review and the FSCP research that the annuity market is not working sufficiently for consumers.

- Most consumers have limited self-confidence in dealing with annuities, and are therefore more likely to settle with default choices.

- As a result, the majority of consumers are staying with their existing pension provider, even though the vast majority could be getting a better deal elsewhere via the open market.

- In an effort to maintain higher retention rates, some providers are exploiting the well-known consumer behavioural trait of inertia, and evidently to their customer’s disadvantage.

- Many of those customers who do explore the open market option seem to be victim to another problem: paying exorbitant fees to firms offering non-advised straight-through services culminating in a less than optimal product.

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• There is also a problem for consumers with limited pots: people with less than about £5,000 (about a quarter of people currently retiring) would not benefit from shopping around even if they wanted to. This problem will worsen as a result of auto-enrolment.

**Competition Market Study**

The FCA have decided to undertake a more detailed competition market study into retirement income (annuities and income drawdown). This will assess how well competition works for consumers in these markets with a view to exploring whether any remedies are required to drive competition and improve consumer outcomes in this area. In particular, the study will:

• seek to identify ways of improving consumer engagement to prompt shopping around;
• look at market dynamics (for example, patterns of market entry and exit) to understand what drives the high levels of concentration observed in parts of these markets; and
• look at how these markets are likely to develop in the future in response to changing retirement patterns and needs.

The market study will include a supervisory element looking at pension providers’ sales of annuities to their existing customers. If they find poor sales practices, they will ask firms to make changes immediately, and may require further action following the final report on the market study.

As some of these findings raise wider issues for Government policy, such as the choice available to customers with small pension funds, they have worked with HM Treasury and DWP to feed into the wider work they are doing in this area.

**Next steps:**

• The regulator is conducting a call for evidence for this Market Study that closes on 14 March.
• An interim report will be published in the summer.
• The final report is expected around February 2015.

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