Original Article

Is failure imminent for the United Kingdom's annuity market?

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ABSTRACT This article is based on Dr Harrison's February 2012 report, 'Treating DC members fairly in retirement?', published jointly by the National Association of Pensions Funds and the Pensions Institute at Cass Business School. The report addresses concerns about the sub-optimal outcomes members of defined contribution (DC) schemes in the United Kingdom's private sector suffer when they buy their annuities. It suggests that although the market has the capacity to deliver better outcomes, currently it fails thousands of members, especially those with smaller funds. The report's conclusion is that unless corporate advisers, providers and regulators take action, the government will be forced to intervene. An explicit market failure will become evident when the auto-enrolment system for the private sector is phased in from October 2012, which will bring 6–8 million additional savers into the DC pensions market, most of whom will be lower earners and 'serial default members'.

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OVERVIEW OF THE PRIVATE SECTOR DC MARKET

The future security in retirement of private sector employees will depend on the success of defined contribution (DC) schemes.¹ For future cohorts of retirees, DC will deliver much lower incomes than were achieved under defined benefit (DB) schemes. What's more, DC cannot be 'fixed' by higher contributions alone. Nor will improvements in asset management strategies and lower member charges help if members continue to purchase annuities that are inappropriate for their circumstances and uncompetitive in terms of

pricing. Although it is true that consumer detriment can be found in almost any financial markets, arguably the DC auto-enrolment market is different because it will form the key delivery vehicle for the government's private sector retirement welfare policy and it is compulsory for employers to pay contributions, although for the time being employees will be able to opt out.

The report investigated the operation of the annuity market for members of contract- and trust-based DC schemes in the private sector workplace. The United Kingdom has the largest annuity market in Europe, currently worth about £12 billion per annum and expected to increase to about £23 billion by 2014–2015. The Pensions Regulator (TPR) states that, at present, there are 2.5 million members in DC trust-based

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schemes and 3 million in contract-based schemes. The government expects 6–8 million additional employees to join these schemes under auto-enrolment, which will be phased in from autumn 2012. Most current DC members – 80–90 per cent – are in the default fund for the accumulation phase – the same fund that is expected to be used by auto-enrolled members. Indeed, the whole success of auto-enrolment is predicated on member inertia – once auto-enrolled into a scheme they will stay put.

The objective of the research was to identify the existing practices in the annuity market that lead to member detriment. This detriment has been well documented and in the report is quantified as an aggregate annual loss of between £500 million and £1 billion in terms of the annuitants' lifetime income. Without change, the scale of detriment will increase, as DC schemes mature and auto-enrolment is implemented. For the success of DC auto-enrolment, therefore, the need to recognise and address these problems is very urgent.

The primary focus of the report was the low-to-median earner, towards whom the workplace pension reforms are targeted and for whom the success of the DC pension system, in the form of an annuity, will provide financial security in retirement and independence from means-tested benefits. In the United Kingdom, an annuity is the *only* financial services product that provides a guaranteed income for life, irrespective of both market conditions and how long the annuitant lives. The fact that interest rates are low and that longevity is increasing does not change members' need for a guaranteed lifetime income. The report deliberately did not enter the debate about whether annuities are the right product for decumulation, but instead questioned the ways in which the scheme member is expected to interact with the market that sells the product. In particular, it questioned whether scheme providers that sell directly to internal clients deliver fair outcomes. In the medium term – the next 5–10 years – the funds of defaulters are likely to be worth less than £100 000, and for about 80 per cent, they will be worth less than £50 000. As the switch from DB to DC in the

private sector continues, cohorts of savers increasingly will rely on DC for their private pensions – there will be no DB component.

Furthermore, changes implemented in January 2013 under the Retail Distribution Review (RDR) are expected to limit the number of independent advisers that offer a whole-of-market annuity service for DC members with funds worth less than £50 000 – that is, the majority. Under RDR, advisers will provide independent advice (whole of market), restricted advice (where the adviser is tied to the products of one or more providers), or generic advice (where the adviser offers support on the website and/or phone, but the decision is the customer's). Sales commission will be abolished for regulated and restricted advice – where the adviser makes the decision – but will still be permitted on products sold via generic advice, where sales are designated 'execution-only'. This is the model used by annuity websites. Firms that offer an execution-only service and receive sales commission have to demonstrate that the customer has made all the decisions, which means that in theory they can only deal with DC members who are financially literate and well informed. In practice, there is no way to assess if this is the case, unless outcomes are evaluated, which they are not.

The assumption of the Financial Services Authority (FSA), which the report argues is fundamentally flawed, is that the DC member will understand the difference between the various types of advice, identify the services for which they are paying – in the form of a fee or commission – and know when they are taking responsibility for the outcome. The report provides evidence that consumers do not understand the current system of advice regulation and will not understand the new one. So unless employers, trustees and scheme providers step in to fill the member-support gap – by making a robust open market option (OMO) process the DC scheme default – members will continue to suffer detriment.

An understated feature of the annuity market at present is that there is a clear 'default' option, for contract-based DC members in particular, which exploits member inertia in a similar way

to auto-enrolment, but with potentially detrimental results. About six providers dominate both the scheme and annuity markets. Their retention of DC customers at retirement, who take the internal annuity offered, varies considerably. One major provider, which the report could not name, has a retention rate of 86 per cent, which, coincidentally, is the about the same percentage of members that use the default accumulation fund.

The impact of a strong brand name and customer loyalty in relation to these retention rates cannot be overstated. Unpublished consumer research, to which the report's author had access, assessed the responses of different control groups to the type of messages used by insurance company call centres. Participants in one control group were told that the scheme provider was not the best annuity provider. They were so impressed by the provider's 'honesty' that they decided to stay put out of loyalty. As behavioural economics theory notes, when it comes to financial services, consumers are not rational and nor should we expect them to be so when financial services organisations play the loyalty card so successfully. 'Fear of regret' on the part of consumers who move away from the default is a behavioural trait easily exploited.

The research was extensive: more than 90 organisations took part, including 80 per cent of the major scheme and annuity providers, and the same proportion of the specialist annuity advisers and the corporate advisers. The government, the regulators, consumer groups, academics, analysts, independent trustees, and the main trade organisations that represent insurers and asset managers also contributed, as did a broad cross-sample of DC schemes.

Although there was clear evidence of good governance in certain parts of the DC scheme annuity market, there was overwhelming evidence of structural problems in terms of lack of internal rate transparency, conflicts of interest, advice gaps, pricing anomalies and poor governance practices, which combine to create a formidable barrier to successful member outcomes.

THE INTERRUPTED JOURNEY FROM ACCUMULATION TO DECUMULATION

For most employees, membership of a workplace DC pension scheme represents an illogical and uncoordinated journey. It begins with an institutional asset management model, which is designed primarily for the serial default member (also described by the Pensions Institute as the 'reluctant investor'), who passively accepts the designated default fund choice of the employer (contract-based DC) or trustees (trust-based DC).² Employers and trustees, in turn, tend to rely on their adviser or provider to choose the default fund.

The member's journey concludes at retirement with the requirement to select and buy an individual long-term retail insurance product (the annuity) – a process that demands an above-average level of literacy and numeracy. For the defaulter there is no learning curve derived from the experience of accumulation and, in most cases, the annuity decision is one-off and irreversible; it sets in stone the lifetime income for the member and often for his or her partner or spouse. DC schemes' annuity selection and purchase processes vary from the excellent to a state of affairs that arguably is negligent, albeit stopping short of a breach of regulations. Where annuity support is weak or absent, members are likely to buy an inappropriate product for their circumstances, frequently at the wrong price. By chance, some will actually secure a good price for the wrong type of annuity; many more will lose out on both counts. Auto-enrolment exacerbates this problem, bringing 6–8 million serial defaulters into the market. Unless the market reforms, they will join the thousands of existing members who are stranded without practical support when they make their annuity selection and purchase.

The current situation, in terms of consumer detriment, is stark:

- Each annual cohort of pensioners loses in total around £500 million – £1 billion in lifetime income. This will treble as schemes mature and auto-enrolment is phased in.

- The figure represents 5–10 per cent of the annual amount consumers spend on annuities.
- An estimated 20 per cent of this loss is transferred to the government and the taxpayer through reduced tax revenues and the increased demand for means-tested retirement benefits.

BARRIERS TO AN EFFICIENT ANNUITY MARKET

This detriment is the result of explicit and implicit barriers in the supply chain. These include:

The exploitation of the behavioural profile of serial defaulters

Serial defaulters lack financial capability, and auto-enrolment assumes that this situation will not change. Yet members are both blamed for their lack of engagement with the annuity market and at the same time exploited. ‘Inertia’ and ‘lack of engagement’ are not neutral terms when they are applied to DC members at retirement: they serve to stigmatise the member who is not capable of making an informed choice. A common perception among experts interviewed for the research was that members ‘must’ become engaged and that if they ‘won’t’ they are responsible for the poor outcome. This does not sit comfortably with the FSA’s Treating Customers Fairly (TCF) principles, which recognise the power the knowledge community (advisers and providers) have over individuals who do not have the technical expertise to make complex financial decisions.³

Yet, at present, there is a disconnection between the DC accumulation stage, which is designed for the 80–90 per cent of scheme members classed as ‘defaulters’, and the annuity purchase stage (decumulation), which is designed for well-informed, literate and numerate investors, with strong conceptual and problem-solving capabilities (10–20 per cent). Whereas the first stage assumes most members *cannot* make effective investment decisions, the second assumes they *can* make informed choices that require an understanding of inflation and interest rates, and also morbidity and mortality trends in relation to their own life and the life of their spouse or

partner, where relevant. Moreover, the member’s experience of buying life assurance – the main product they are likely to have encountered where the underwriting takes account of morbidity and mortality assumptions – will have given them the impression that ‘being in poor shape’ is a negative rather than positive factor in pricing, and thus any knowledge they have acquired will be counterintuitive for the annuity purchase.

The inappropriate transfer of risk to the member

The sudden transfer of risk and responsibility at the point of retirement, from the knowledge community (advisers and providers, employers and trustees) to the consumer, is inappropriate and a DC governance failing. The result is an estimated annual loss of £500 million – £1 billion per annum in terms of each retiring cohort’s lifetime income.

Industry perceptions and stigmatised descriptions of default members highlight a further systemic failure in DC governance and are indicative of an inappropriate transfer of risk and responsibility from employers and trustees, who benefit from professional advice, to individual members, most of whom are conditioned by accumulation default processes to accept the decisions ‘experts’ make on their behalf, even if this is only an insurance company’s helpline, which is dedicated to selling internal annuities.

Overall, this means that the present system is deeply flawed, because of the ease with which the ‘knowledge community’ can transfer inappropriate responsibility and risk to the member – and which appears to be comfortable in so doing – although this is changing.

The problem of member ‘inertia’ is partly concealed by industry statistics on ‘shopping around’. While the Association of British Insurers’ (ABI) research indicates that more DC customers are shopping around, it is very likely that the trend relates to activity in the individual personal pension market, where individuals ‘buy’ a pension product, usually through an adviser, rather than in workplace DC, where employees ‘join the company pension scheme’.⁴ The blurring of

market data – the ABI does not distinguish between individual personal pensions and group arrangements – is unhelpful, given the differences in the retail and workplace environments. In the former, the consumer makes an active decision; in the latter, membership under auto-enrolment will be passive. Moreover, the term ‘shopping around’ is very poorly defined and is not evaluated. Until baseline measures are established, it is very misleading to equate shopping around with making informed choices that lead to appropriate outcomes.

Not all members need full advice – far from it – but they do need support. Opinions vary on member capability. Some equate the proportion of members in the default fund with the proportion that needs help at retirement. One relevant piece of research cited in the report identified DC member capability in relation to the OMO as follows:

- Fifteen per cent are confident and able to make an informed decision on an execution-only basis. Even here, the system needs to ‘sanity-check’ decisions and intervene if they look inappropriate, for example if it appears that the customer has a health or lifestyle condition that indicates a better rate could be obtained through individual underwriting.
- Forty-five per cent of members need help of a generic kind to ensure they are making appropriate choices.
- Forty per cent need a full advisory service.

This is a more thoughtful analysis of the member’s capability, although the conclusion remains the same, that the accumulation defaulter is likely to be a decumulation defaulter – that, 85 per cent of members need help, whether this is generic (45 per cent), where the member makes the decision, or fully regulated (40 per cent), where the responsibility for the decision lies with the adviser.

The regulatory requirement for member support is weak

The provision of support to members annuitising their DC funds is entirely optional on the part of

employers, trustees and providers. Under the Finance Act 2004, all schemes providing DC benefits must offer the OMO to members, but the only regulatory requirement is that they provide basic generic information about annuities and the OMO. They can discharge this duty simply by giving members a leaflet written by the FSA or TPR.

DC schemes that do help tend to offer a two-tier service

Where schemes do offer annuity support, frequently this is discriminatory – a point noted by TPR, which said it was poor governance to implement a ‘two-tiered annuity broking service that provides an enhanced service for members with large funds and limited services for members with small funds’.⁵ TPR said that ‘members with small fund balances are just as likely (if not more so) to benefit from smoker/enhanced rates if access to such rates is offered’, and that ‘if the fund balance is small, it is just as important for a member to get best value from the proceeds of their retirement fund’.

The assumption that members with smaller pots do not need help appears to be prevalent among advisers and providers, which argue that an increase of, say, 5 per cent for a member with a smaller pot is not material; that an extra £10–£20 per month is not relevant. The two most common arguments used to defend this view are, first, that it is not economic to secure modest increases for smaller pots, and second, that these members will be so disappointed with their annuity income that a few extra pounds a month is neither here nor there.

Access to specialist annuity advisers is an impenetrable maze

For DC members who try to use the OMO, it is virtually impossible to find the top advisers in the market. Moreover, the message ‘shop around’ is meaningless if most ‘shops’ are closed to those with smaller funds – because there is no money in it for the advisers. (This is not a criticism but a statement of fact.) Currently, only about 10 firms of independent advisers appear to have

the systems and scale to provide DC schemes with a cost-effective annuity service that includes a service for members with smaller funds. The government and regulators know the identity of the specialist firms, as do trustees, Employee Benefits Consultants (EBCs) and scheme providers. The only stakeholders in the DC market left in the dark are the scheme members. Postcode search engines, such as those used by unbiased.co.uk and the Personal Finance Society's findanadvisor.org (the first two organisations listed in the FSA and TPR annuity and OMO leaflets), do not help. Nevertheless, most DC members pay commission when they annuitise, whether they receive advice or not. This is because major annuity providers factor the cost of commission into their prices, so it is paid to the owners of annuity websites where members self-select and where they take responsibility for their decisions.

Pricing practices in the annuity market lack transparency

It is impossible to investigate formally the internal annuity rates that insurance companies offer to their DC scheme members (the 'roll-over market'), but there is considerable anecdotal information to suggest that pricing can be poor. Annuity advisers said that where the provider participates in the open market, there can be a differential between its internal and OMO rate of up to 20 per cent.

There is evidence of rate 'adjustments' and cliff-edge rates bands

Annuity advisers said they are aware of rate 'manipulation', whereby a scheme provider adjusts downwards the internal rate (and corresponding OMO rate, where applicable) in anticipation of a substantial tranche of internal DC member funds reaching maturity.

Furthermore, where individuals shop around on a self-select (execution-only) basis, they will not be aware of the impact of a provider's rate bands, which apply outside of the most commonly quotes rates of £50 000 and £100 000. This means customers miss out on the opportunity to improve

their overall rate, for example by targeting a specific band through the retention of part of their tax-free cash allowance or by aggregating or splitting their DC pots.

Enhanced rates lack transparency and benchmarking

Some providers do not offer enhanced rates, which is a particular concern for those who buy the internal annuity. Even where they do offer enhanced rates, this might be little more than an extra £1 per month, and the rate can be significantly lower than the top *standard* rate on the open market. Moreover, enhanced rates secured through execution-only OMO websites are likely to be 'underwriting-light', which means that members secure only a percentage of the potential uplift. This is due to the fact that the enhancement is based on a simplified questionnaire rather than on full medical underwriting. The enhanced market, which is comparatively new, requires close scrutiny, particularly in relation to the underwriting assumptions and financial strength of providers. We also need to see benchmark percentage uplifts published on the relevant websites run by the FSA, the Pensions Advisory Service (TPAS) and the Money Advice Service (MAS).

Providers in both the scheme and annuity market benefit from retention rates of 80–90 per cent

Providers in both markets have little incentive to encourage customers to transfer funds to competitors. Why would they? Competition might improve under the ABI's new code of conduct, which requires insurance companies to make the OMO more explicit to members of DC schemes. However, the fact remains that the lack of transparency in internal annuity rates will continue to facilitate high retention levels.

Providers of contract-based schemes wield an inappropriate degree of power

For contract-based schemes, in particular, there are significant barriers to good governance that

relate to 'ownership' issues. The regulators' perception of what constitutes good governance under contract-based DC has changed significantly since group personal pensions and stakeholder schemes were first introduced in the private sector. It is an anachronism, therefore, to persist in treating group contract-based DC members as a series of individual retail customers. Nevertheless, this remains the case.

Under a trust-based scheme, the trustees are the effective owners of the member data and assets. This confers the ability to implement close supervision of annuity processes. It also enables trustees to manage the accumulation stage efficiently. For example, they can transfer member assets automatically to a new asset manager appointed to improve returns and to reduce charges and risk. In contract-based DC schemes, the owner of both the member data and the assets is the provider and there is no obligation on providers to share member data with the employer or with the employer's adviser. This means the provider has the primary relationship with the member and can drive the annuity decision: it does not have to inform the employer or its adviser when it sends important information to members.

Recently, TPR has encouraged employers with contract-based schemes to establish governance or management committees and many have done so. However, these committees have no regulatory teeth and member representation is considered to be weak. Employers say that it is difficult to find members who are willing to participate and that there is no formal process to ensure that they develop the necessary knowledge and understanding. This creates a disconnection between the member, who is the primary stakeholder, and the scheme. TPR recognises the importance of member trustee training through its trustee services and Trustee Toolkit, but there is no equivalent system for contract-based DC.

THE REPORT'S RECOMMENDATIONS

The headline recommendations that follow on from these findings fall into four categories.

Recommendation 1: Improve transparency and governance for all DC members

- *Transparency must be improved to increase competition and establish trust in the market.* The lack of transparency in annuity providers' pricing practices is detrimental to consumers who do not have access to a specialist adviser that understands the complex underwriting system. The government, the FSA and the ABI should collectively drive transparency in annuity pricing and commission factors. The ABI's code of practice begins this process but does not go far enough.
- *Improving sponsor governance at retirement is essential.* Employers and trustees should be able to support members at retirement without fear of regulatory reprisals. The government should support TPR's work on principles for DC by endorsing a simple and single set of rules for non-regulated advice in the workplace. The government should also consider whether it is necessary to introduce safe harbour rules to protect employers and trustees who have complied with the rules.

Recommendation 2: Clarify the meaning of the OMO and make it the default

- The default OMO has a clear and simple meaning and should be used across the industry.
 - It is predicated on an agreement between the employer, trustees or the provider, with an annuity adviser that has the expertise and capacity to provide advice and the OMO service for all fund sizes above the trivial commutation level.
 - It is presented to the member as an integral part of the scheme and member data are passed automatically by the provider or scheme to the adviser; the member has the right to opt out of this arrangement.
 - It requires the adviser to initiate contact with the member and actively drive the process through to the annuity purchase.

The research identified clear examples of this model in both contract- and trust-based schemes across a wide range of sectors, including the ‘tough end’ of the market where members are low-to-median earners with lower levels of financial literacy, and where employers cannot afford to pay for member advice. Therefore it is available and also affordable, provided members are not overcharged.⁶

- A critical first step towards the implementation of this model across the industry is to establish a register of specialist annuity brokers. The second step is to encourage, and if necessary, *require* employers, trustees and providers to automate the default OMO as outlined above.

Recommendation 3: Define what is meant by a successful member outcome; establish processes to monitor and evaluate the outcome

- The current evidence and statistics on ‘shopping around’ and the use of the OMO are unsatisfactory, as is the understanding of the level of financial capability and literacy that members require to use the services. The government, through its working party on the OMO, should establish clear baseline measures and implement processes for monitoring and evaluating outcomes actually achieved in relation to member circumstances and the systems used.

Recommendation 4: In the event of market failure, the government should introduce a national annuity support and brokerage service

- Arguably, it would be inaccurate to say that there is an explicit market failure at present. In theory, all the component parts are present to deliver a service that secures a good member outcome across the whole private sector DC market. In practice, it is not clear whether the organisations with the power to deliver this service are willing to do so, particularly in relation to members with smaller pots and where

the employer is not engaged, as will increasingly be the case under auto-enrolment.

- The government should consider the example it has set in the accumulation market through the National Employment Savings Trust – which is purpose-built to correct market failure in relation to lower earners – and replicate it in the annuity market. Such intervention would be well aligned with the government’s proposals to facilitate transfers and consolidate ‘orphan’ pots during the accumulation stage. A national annuity service would have the scale to deliver member support and the full OMO brokerage process within the current commission costs factored in to annuity pricing. This could build on existing support services, including TPAS, the MAS and the Pension Tracing Service, and draw on the large-scale advice and brokerage services already provided by advisers and third-party administrators, among others.

CONCLUSION

Although there are barriers to change, there are strong incentives for reform. It is in the employer’s best interests to ensure that company pension contributions are well spent and do the job for which they are designed. Unless the DC scheme delivers adequate pensions, employers might be forced to pay financial incentives to maintain control of retirement policy if employees cannot afford to go. It is in the best interests of the government to balance the cost of tax relief on contributions with the tax revenue from annuity incomes. At present, it loses about 20 per cent of the estimated member detriment at retirement, which is worth £100 million – £200 million a year in tax revenue, a figure that will rise as the DC retirement market grows exponentially. Above all, it is in the industry’s best interests to increase consumer trust and confidence and to avoid the requirement for government intervention if the market cannot self-reform. The recommendations in the report are achievable, affordable and, importantly, readily-available – but the government, regulators and, in particular, the practitioners need to make them work.

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