Financial Conduct Authority

Market Study MS14/3.2

Retirement income market study: Interim Report

Provisional findings and proposed remedies

December 2014

We are asking for comments on this report by 30 January 2015.

You can send them to us using the form on our website at:
www.fca.org.uk/your-fca/documents/market-studies/ms14-03-response-form.

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We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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Abbreviations used in this document

ABI	Association of British Insurers
AMC	Annual Management Charge
APE	Annual Premium Equivalent
AUM	Assets Under Management
AVC	Additional Voluntary Contributions
CDC	Collective Defined Contribution
CII	Chartered Insurance Institute
CAB	Citizens Advice Bureau
CMA	Competition and Markets Authority
COBS	Conduct of Business Sourcebook
D2C	Direct to Consumer
DA	Defined Ambition
DB	Defined Benefit
DC	Defined Contribution
DWP	Department for Work and Pensions
FCA	Financial Conduct Authority
FSCP	Financial Services Consumer Panel
FSMA	Financial Services and Markets Act 2000
GAD	Government Actuary’s Department
HHI	Herfindahl-Hirschman Index
IDR	Implied Discount Rate
IFA	Independent Financial Adviser

IFS	Institute for Fiscal Studies
IRR	Internal Rate of Return
ISA	Individual Savings Account
MAS	Money Advice Service
NAPF	National Association of Pension Funds
NS&I	National Savings & Investments
OMO	Open Market Option
ONS	Office for National Statistics
PICA	Pension Income Choice Association
PRA	Prudential Regulation Authority
RDR	Retail Distribution Review
SERPS	State Earnings Related Pension Scheme
SIPP	Self-Invested Personal Pension
SRD	Selected Retirement Date
S2P/SSP	State Second Pension
TPAS	The Pensions Advisory Service
TPR	The Pensions Regulator
UFPLS	Uncrystallised Fund Pension Lump Sum
VNB	Value of New Business

1.
Executive summary

Introduction

In 2013 there were approximately 8 million members of personal and stakeholder pension plans in the UK. As people come up to retirement, they will be faced with the decision of what to do with their pension savings. Until now that decision has, for most people, consisted of purchasing an annuity, which is typically a one-off, irreversible decision.

In February 2014, we launched a market study to assess whether competition in the retirement income market is working well for consumers – and if not, to understand why, and what changes could be made to drive better outcomes. This report presents our provisional findings and our proposed remedies for consultation.

This market study follows a thematic review of annuities we completed earlier this year. Choosing an annuity has historically been one of the most important decisions a consumer will make in their lifetime as, once that decision is made, the consumer is locked into that annuity type and rate for the rest of their lives. The thematic review found that 60% of consumers were not switching providers when they bought an annuity, despite the fact that around 80% of these consumers could get a higher income on the open market, many significantly so. For enhanced annuities the proportion of consumers who could get a better deal rises to 91%. Therefore, we concluded that many consumers were failing to get a good deal at retirement and that further work was needed to identify the root causes of these issues.

Context

From April 2015, in what is the biggest reform of the retirement system in a generation, consumers will be given much greater freedom over how to generate a retirement income from their pension savings. The reforms open up a range of choices, especially for those savers with smaller pension pots and those with other sources of retirement income.

The Government's reforms mean that the landscape is on the brink of major change. To support consumers facing increased choice, the Government also announced a guidance guarantee, which entitles everyone with a defined contribution pension to access free, impartial pensions guidance when they retire. We have worked closely with the Government to develop standards for this guidance. These were published on 27 November 2014, and take into account the findings in this report.

Following the announcement of the reforms, we amended the Terms of Reference for the market study. While the overarching objective of the market study remained to get competition working more effectively for consumers, we shifted our emphasis away from current market dynamics and looked at how market conditions might evolve after April 2015. We have identified some developments we very much want to see as the market evolves, but have also identified some future risks.

We were aware, in starting this work, of potential issues with both consumer and firm behaviour in this market. Alongside this market study, we undertook a second thematic review, this time specifically into annuity sales practices since the introduction of the ABI Code in 2013. This is published alongside our market study.

This thematic review considered whether firms' sales practices have contributed to consumers not shopping around and switching, and indeed found some evidence of this. It identified particular concerns in the enhanced annuities market. This means consumers may be missing out on a potentially higher income in retirement as a result. Following our thematic review, we are asking the majority of firms to do further work, to determine if our findings in relation to enhanced annuities are indicative of a more widespread problem. Although we consider that many of the principles underlying the ABI Code are good, the evidence we have gathered suggests it has not always been observed by firms in practice. Therefore, we are considering how we might replace the ABI Code with FCA regulation to ensure it is fit for purpose in the new landscape.

Our approach

We examined products purchased by UK consumers with their accumulated defined contribution pension pots that provide an income during retirement – specifically, annuities and income drawdown.

We undertook two public calls for evidence and engaged with a wide range of industry stakeholders, consumer organisations and other Government departments. We analysed a range of information from firms, including strategy documents, contracts, product literature, consumer research and communications, data relating to sales, pricing and profitability. We also gathered information from a variety of industry participants and other stakeholders both prior and subsequent to the 2014 Budget, which has helped inform our early views on how the market might evolve.

We commissioned both quantitative and qualitative consumer research and conducted a framing experiment to explore how consumers react when choices are presented in different ways. We commissioned an international comparative analysis of ten countries that have experience relevant to the UK. We also undertook an economic analysis of the value for money of annuities, both over time and compared to other retirement income strategies.

Our provisional findings

This market study found that competition in the retirement income market is not working well for consumers. Consistent with previous findings of the thematic review of annuities in February 2014, many consumers are missing out on a higher income by not shopping around for an annuity, and some do not purchase the best annuity for their circumstances. We found a common perception among consumers that annuities offer poor value, as reflected in media coverage. This is despite the fact that our economic analysis (published in our Occasional Paper 5 alongside this market study) has shown that for people with average-sized pension pots, the right annuity purchased on the open market offers good value for money relative to alternative drawdown strategies and may therefore be a good option for those with low risk appetites.

We found a number of reasons for consumers not exercising their open market option. On the positive side, some consumers are fully aware of their right to switch, consider alternatives and make a conscious decision to stick with their current provider. On the negative side, however, one in five of those who purchase an annuity with their existing pension provider are unaware that they have the option to switch, while others are deterred from engaging with their options by the length and complexity of the 'wake-up packs' sent out by providers,[1] or because they do not believe that the sums involved make it worthwhile. Our thematic review findings suggest that providers' verbal communications with their customers do not go as far as they should to encourage shopping around.

Consumers' tendency to buy from their existing pension provider weakens competitive discipline. Not only do incumbent providers feel less pressure to offer competitive vesting rates, but challengers find it difficult to attract a critical mass of consumers. As a result there has been limited new entry into the decumulation market in recent years.

Our research confirmed that pension savers display well-known biases, such as a tendency to under-estimate longevity, inflation and investment risk. We also found that the choices savers make are highly sensitive to how the options are presented (framing effects), which means that consumers may make different decisions, even when the underlying choice remains the same, depending on the way the information is provided.

Looking forward, we expect to see more "hybrid" products emerge, combining annuity and drawdown features. Our consumer research clearly suggests that many savers will welcome the increased flexibility that such products offer. However, there is a risk that greater choice and more complex products will reduce consumers' confidence and appetite to shop around and thus weaken competitive pressure to offer good value in this market. In addition, the behavioural factors noted above make savers vulnerable to being sold products which do not best meet their needs.

Savers reaching retirement will face a landscape that is more complex, and will need more support in making the right choices. The Government's guidance guarantee will perform a vital role here, but this is just one part of the picture. It is equally important that firms' own communications with customers support decision making, and more broadly, that the market works well: that firms design and sell retirement products that meet genuine consumer needs, and that healthy competition on the open market drives good value. At the end of the day, people should get the income in retirement that they have saved for.

We have identified some developments that we very much want to see, for example new tools and business models to support consumer decision-making, and the emergence of more flexible retirement products. It is important that these are designed to support mass market consumer choice. However, we have also identified a number of future risks. While it is too early to say exactly how the market will evolve, we note the following.

- In future, converting accumulated pension savings into retirement income need not be a one-off, irreversible step as has been the case for consumers purchasing lifetime annuities. Savers will welcome the increased flexibility, including the ability to change course over time. However, without a clear moment in time to make a decision, it may be harder to prompt savers to shop around or switch.

1 The information sent to members of contract-based and trust-based pension schemes before they make a decision regarding taking benefits from their pension savings.

- If more hybrid products appear, savers should be better able to find a product that meets their particular needs. This may be especially true for the many savers who have other sources of retirement income and must choose how to draw down their defined contribution pension pot alongside decisions about their defined benefit pension, other savings and property. However, more complex products are likely to be less directly comparable which could make shopping around more difficult for consumers.
- While charges for lifetime annuities are effectively captured in the headline rate, the same is not true for products with a drawdown element. Complex or opaque charging structures make comparisons harder and weaken competitive pressure on value. We do not want to see such features in the new landscape.
- Previously, drawdown products were sold primarily with full advice to people with significant pots to invest. Going forward, the industry will need to develop appropriate mass market distribution and guidance arrangements for products with a drawdown element. Higher risk products must be sold responsibly.

Our proposed remedies, recommendations and actions

This report sets out a number of proposed remedies that we believe will go some way to addressing the concerns identified in our provisional findings, with a particular focus on stopping things getting in the way of consumer choice, and improving the clarity and simplicity of communication between firms and their customers.

It is important to note that this market study is part of a wider package of FCA work that directly or indirectly impacts on the retirement income market. We will also monitor the market and if consumers appear not to be getting the support or products they need, and/or competition is failing to drive good value, we will consider what intervention is appropriate.

We are consulting on proposed remedies, recommendations and actions, and at this stage we are minded to pursue the following.

1. **We propose to require firms to make it clear to consumers how their quote compares relative to other providers' on the open market.** This information could be provided, for example, by using the Money Advice Service (MAS) annuity comparison website to generate alternative quotes for a particular consumer from other providers operating on the open market, based on certain characteristics (age, pot size and some specific health conditions). In addition to the ranking information that the firm provides, it could also state the additional annual income that could be achieved by the consumer should they choose the highest quote. We note that the MAS website illustrates differences in income on a monthly, yearly, and ten-yearly basis.
2. **We recommend to both the pension guidance service and to firms to take into account framing effects and other biases when designing tools to support consumer decision-making.** How options are presented has a strong impact on outcomes. For firms, this means options should be presented in a way that supports good decision-making rather than driving sales of particular products. In the longer term, we recommend that as the Government's work on continual improvement of the guidance service progresses, consideration should be given to appropriate framing, including use of behavioural triggers such as a rule of thumb to use when withdrawing funds through strategies such as Uncrystallised Fund Pension Lump Sums and income drawdown. This would create a simple guideline for consumers and counter known biases around risk appetite and longevity.

3. **We will work with Government to develop an alternative to the current wake-up pack. This should be behaviourally trialled to assess the impact on consumers' awareness of their right to shop around, and the proportion of people who switch.** Our research has shown that consumers find wake-up packs too long, difficult to navigate and full of jargon.

   We consider that changes are needed to the existing at-retirement communications in order to ensure clarity and simplicity for consumers, allowing them to exercise choice effectively. As part of this, new at-retirement communications should be behaviourally trialled in order to make them as effective as possible in terms of prompting shopping around and signposting impartial guidance. As stated in our Policy Statement about retirement reforms and the guidance guarantee in November 2014, we will undertake in 2015 a thorough review of our rules in the pensions and retirement area, including at-retirement communications. We also propose to consult on replacing the ABI Code of Conduct with our own rules. This work will build on the standardisation work being undertaken with the Treasury and industry.

4. **In the longer term, we recommend the development of a 'Pensions Dashboard' which would enable consumers to view all their lifetime pension savings (including their state pension) in one place.** It should set out individuals' entitlements including all of their accumulated DC pension savings, and allow consumers to view all of their other sources of retirement income (such as defined benefit and state pension entitlements) in one place. We are aware that this idea has been raised in the past and we recognise the challenges in implementation and cost for such a project. However it has been successful in other countries, and we believe that the case for introducing it in the UK is getting stronger. As people increasingly have multiple pension pots and other sources of retirement income, there is a greater need for this tool.

5. **We will continue to monitor the market as it evolves using a combination of consumer research, market data and ongoing sector supervision.** We may take further steps if we see competition weakening (for example, due to consumer inertia), or if we see inappropriate products, distribution arrangements, or charging structures emerging. We are also aware that certain consumer segments are potentially vulnerable to scams, including investment scams and pension liberation scams. We are currently running a national consumer campaign on investment scams,[2] and will continue to take enforcement action against such activity. We will remain on high alert for scams targeting consumers at retirement.

Next steps

We invite comments on our provisional findings and proposed remedies by **30 January 2015**. We look forward to working with industry, consumer groups, Government and other interested stakeholders during this period.

Once we have considered the consultation responses, we will produce our final report in 2015. To the extent that any remedies we ultimately decide to implement require changes to the FCA rules, these will be subject to a separate formal consultation and cost benefit analysis later in 2015.

2 http://scamsmart.fca.org.uk/

2.
Introduction

This chapter explains the background to the market study, what we set out to do, what we are publishing, and next steps.

To date the retirement income market has been mainly served by annuities. Buying an annuity – thereby converting accumulated pension savings into a guaranteed (stream) of retirement income - is one of the most significant financial decisions consumers ever have to make, all the more so because it is for most a one-off, irreversible decision.

The ongoing shift towards defined contribution (DC) pensions, the introduction of auto-enrolment, and the possible introduction of collective pension schemes, all increase the importance of this market working well.

Our thematic review of annuities in February 2014 indicated that many consumers purchase an annuity from their existing provider, despite the fact that shopping around on the open market and switching provider would more often give them a higher income in retirement.

In its 2014 Budget, the Government announced that it will introduce greater flexibility for consumers at retirement, removing the effective requirement to buy an annuity. To support this increased flexibility, the Government also announced the guidance guarantee, which entitles everyone with a DC pension to access a free impartial pensions guidance service when they retire.

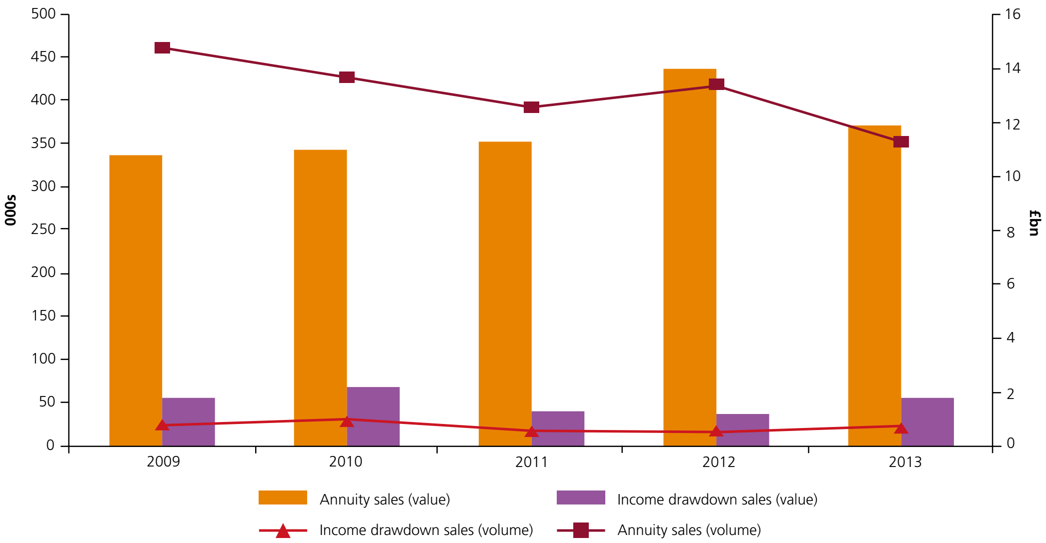
The purpose of the market study is to understand what underlies the lack of shopping around in this market at present. In light of the Budget changes, we have also sought to understand how consumers and firms are likely to behave in the new market landscape. We have looked to assess whether further steps are needed to support consumer decision-making in this market, to boost shopping around and switching, and ultimately to drive value for pension savers in this market, ensuring that people get the retirement income they have saved for.

Why retirement income?

Retirement income is an important market for many people. Recent research by the Office for National Statistics shows that prior to automatic enrolment 55% of UK males and 51% of UK females have some form of private pension savings (either through currently saving for a pension or through entitlements to a previous pension).[3] As automatic enrolment is phased in between now and 2018, these figures are expected to increase, making it all the more important that the retirement income market delivers good outcomes for consumers.

The retirement income market is an important sector of the UK financial services industry and the wider UK economy. In 2013 there were approximately 8 million members of personal and stakeholder pensions in the UK, with annual pension contributions totalling approximately £19bn.[4] In 2013, there were 353,000 sales of annuities with a total value of £11.9bn.[5] In contrast income drawdown sales totalled 22,000 in 2013 with a value of £1.2bn.[6]

Figure 1 Sales of annuities and income drawdown by value and volume, 2009-2013



Source: ABI Industry data

Encouraging consumers to save adequately for retirement (accumulation) and generate a good income in retirement (decumulation) is also a wider public policy issue of increasing relevance in light of the ageing population. Some of the key policy developments in the pensions landscape include the following.

- **Auto-enrolment** – a legal requirement that every employer must automatically enrol its workers into a qualifying pension scheme if they are aged between 22 and state pension age, earn more than £10,000[7] a year and work in the UK. Employers will gradually enrol all eligible workers into qualifying pension schemes between 2012 and 2018.
- **Collective pension schemes –** a new Pension Schemes Bill introduced to Parliament in June 2014 includes measures that will enable workplace and personal pension schemes to provide 'collective benefits'.[8] These allow schemes to share risks among members by pooling their assets. This means that when a member retires, they can receive an income from the shared assets of the scheme.

3 ONS (2014), available at: http://ons.gov.uk/ons/rel/pensions/pensions-short-stories/characteristics-of-people-and-households-without-a-private-pension/info-pension.html.
4 Moneyfacts Treasury Reports (July 2014); based on HMRC data.
5 ABI subscription data.
6 ABI subscription data.
7 Earnings trigger for 2014/15 tax year.
8 Pension Schemes Bill (HC Bill 12) http://www.publications.parliament.uk/pa/bills/cbill/2014-2015/0012/cbill_2014-20150012_en_1.htm.

- **2014 Budget –** the 2014 Budget announced fundamental changes to the options consumers will have for accessing their defined contribution[9] (DC) pension savings at retirement.[10] These changes are explained in more detail below.

The 2014 Budget

As noted above, the 2014 Budget announced fundamental changes to the options open to individuals accessing their DC pension savings at retirement. The proposed changes will be effective from April 2015. From the age of 55, DC pension holders will be able to:

- take their pension savings as cash[11] (in one lump sum or in smaller amounts over time[12] subject to income tax at the marginal rate)[13]
- buy an annuity or other income-generating guaranteed product
- use an income drawdown strategy, absent any limits, and/or
- use a combination of the three options listed above.

To support this increased flexibility the Government announced a 'guidance guarantee' which entitles everyone with a DC pension fund to access free (at the point of delivery) impartial guidance, including the option of a face-to-face conversation about their options when accessing their pension savings.[14] The Government announced in July 2014 that this would be a centralised pensions guidance service. The objective of the pensions guidance service is 'to help empower consumers to make informed and confident decisions on how they use their pension savings in retirement'.[15] It will not be mandatory for people to take this guidance to access their pension savings, but they will be signposted to the pensions guidance service before they take any benefits. We encourage consumers to seek appropriate guidance or advice to understand their choices at retirement.

In July 2014, we consulted on the rule changes needed to bring in this signpost for contract-based schemes, as well as rule changes needed to take account of the pension reforms more

9 Also known as 'money purchase schemes'. The benefits paid to an individual member of a DC pension scheme are calculated by reference to contributions paid into the scheme in respect of that member and (increased) by the investment return received. At retirement the member's pension is currently typically secured by purchasing an annuity or scheme pension. An individual retirement income is therefore dependant on the level of pension contributions, investment return and (for most) the prevailing annuity rate at retirement. DC schemes differ from defined benefit (DB) schemes, which promise scheme members a level of benefit on death or retirement (most DB schemes are also 'final salary pension schemes', providing an income based on how much an individual earns close to retirement). defined ambition (DA) schemes combine the features of DC and DB schemes.

10 *'Greater freedom and choice at retirement'*, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293759/37630_Budget_2014_Web_Accessible.pdf. This will only apply to people who take a decision regarding generating an income from their DC pension pot post-April 2015 and will not affect those who have already made a decision.

11 Consumers who choose to take some form of cash may choose to take their entire pension savings as a lump sum at one point in time, or they may draw down their cash intermittently to generate an income for retirement. If UFPLS (see footnote below) is used as a vehicle from which to draw an income, consumers may draw down as and when they want or need to.

12 This is termed as 'uncrystallised pension fund lump sum', or 'UFPLS' within the Taxation of Pensions Bill.

13 The amount of tax payable on retirement income is determined by the value of an individual's pension savings. The amount of tax paid on each band of the pension pot is set out in the table "Income Tax rates and taxable bands for the 2 tax years from 2013 to 2015". For example, if the pension pot is sufficiently large so as to push an individual into the 40% income tax bracket then an individual will pay 40% tax on balances over £31,866 (up to £150,000) and the corresponding 20% rate for balances below that figure. Guidance on Rates and allowances: Income Tax https://www.gov.uk/government/publications/rates-and-allowances-income-tax/rates-and-allowances-income-tax.

14 Although the pensions guidance service will be free, consumers may decide following access to it that they wish to obtain further advice or guidance which incurs a cost, such as using an independent financial advisor or a broker.

15 HMT, Freedom and choice in pensions: Government response to consultation, 2014 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332714/pensions_response_online.pdf.

generally. In addition, the DWP will be amending its existing regulations on the information trustees and schemes must provide to their members, to ensure members are signposted to the pensions guidance service as they approach retirement.

The guidance does not replace financial advice given by regulated advisers, communication programmes run by trustees for their members, or contract-based pension providers' communications with their own customers. We expect that many people will continue to consult a financial adviser. Indeed it is intended that 'the guidance will signpost people to additional specialist help where appropriate, including, for example, regulated financial advice or debt advice'.[16]

The Treasury has strategic responsibility for the implementation and service design of the pensions guidance service, designating the guidance providers and setting the overall level of funding that is required to deliver the guidance. On 17 October 2014, the Chancellor of the Exchequer announced that the guidance will be delivered by The Pensions Advisory Service (TPAS) and Citizens Advice Bureau (CAB). The intention is for the guidance service to be a single service with a single brand and the designated guidance providers will work together and with Treasury to deliver different elements of the service. The Government will lead on the digital delivery, TPAS on telephone services and CAB on the face-to-face element.

To ensure the conduct of the designated guidance providers is subject to appropriate controls, the Government has brought forward legislation in the Pension Schemes Bill ('the Bill') to establish a separate FCA standards regime.[17] This gives the FCA duties and powers to set standards and to monitor the compliance by designated guidance providers with those standards. The FCA's role in relation to the pensions guidance service is to set the standards that the designated guidance providers must adhere to and monitor their compliance with the standards.

Our Policy Statement published on 27 November 2014 sets out 'near final' standards for the designated guidance providers delivering the Government's guidance guarantee and 'near final' rules for firms.[18] As the service develops, we will review how the standards are operating in practice. The Bill sets out a levy on regulated financial services firms which will be collected by the FCA on behalf of the Treasury to fund the pensions guidance service.

The standards aim to:

- ensure that the guidance is impartial, consistent, of good quality and engaging across the range of delivery channels
- create consumer trust and confidence in the designated guidance providers and content of the guidance so that consumers actively use the service
- ensure that the framework works for both contract-based and trust-based pension schemes, and
- deliver helpful guidance for consumers that considers their retirement options and refers them to specialist advice or information where appropriate.[19]

16 CP14/11 – Retirement reforms and the Guidance Guarantee http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-11.

17 Pensions Schemes Bill 2014-15 http://services.parliament.uk/bills/2014-15/pensionschemes.html.

18 We anticipate formally making the standards and rules published as near final in our Policy Statement PS14/17 as soon as possible if the Pensions Schemes Bill 2014 is passed in its current form. Royal Assent is currently expected in the new year before the end of this Parliamentary session.

19 The content of the guidance session is set out in paragraph 20 of Standards for Designated Guidance Providers Instrument 2014, see appendix 1 of Policy Statement on Retirement Reforms and the guidance guarantee available at http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-17

Our concerns

In February 2014, we published the results of our thematic review of annuities ('our previous thematic review').[20] That review found that some parts of the annuities sector were not working well for consumers. In particular, we found that eight out of ten consumers who purchase their annuity from their existing provider could get a better deal on the open market. Two groups of consumers were identified as being particularly at risk of not getting a good deal.

- Consumers with smaller pension funds are generally offered lower annuity rates than those with larger funds and have less choice of providers on the open market. The concern identified related to how these consumers were served by the market rather than the extent to which those consumers shopped around.

- Consumers who are eligible for an enhanced annuity but do not explore this option stood to gain the most from shopping around, but also needed to be aware of and understand their potential eligibility for an enhanced annuity.[21]

Based on the findings of the previous thematic review, we considered it appropriate to launch a market study into retirement income. This enables us to look more broadly at the retirement income market as a whole (wider than just annuities) with a view to analysing how competition is working, and how it might develop. Following the significant changes to the retirement income landscape announced in the 2014 Budget, we reassessed the scope of our market study (see Figure 2 for key facts about the scope of the market study).[22] In doing so, we reflected that many of the features of the market we were originally concerned about might persist in the new landscape, but there were also new issues to consider, and how consumers and firms are likely to behave in the new market landscape.

Figure 2 The scope of the market study into retirement income

Key facts about scope

Geographical scope: products available to UK consumers by providers active in the UK.

Consumers: consumers using funds from their personal pension plans and/or their defined contribution occupational pension schemes to purchase an income product at retirement. This includes occupational trust based schemes insofar as consumers use their accumulated funds to purchase a product from the open market to deliver income for their retirement.

Focal products: all annuity and income drawdown products. Bulk annuity purchases are outside the scope of this market study.

Related products and markets:[23] defined benefit pensions, state pension, savings account/cash ISA/NS&I products, stock market-based investments, investment bonds from a life company, own/family business; and equity release products.[24]

Types of firms: insurance companies (large and small), intermediaries (such as advisers and brokers) and providers of self-invested personal pensions (SIPPs).

20 Thematic review of Annuities TR14/2 http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02

21 The review identified that only 5% of annuities sold by providers to their existing pension customers were enhanced compared to 50% of annuities sold on the open market. http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02. The latest thematic review of annuity sales practices found individual examples of customers disclosing medical conditions to their provider that were not covered by the firm's enhanced underwriting criteria, but were not informed that these medical conditions may be covered elsewhere.

22 Our revised terms of reference, published in June 2014, can be found on the FCA website at: http://www.fca.org.uk/your-fca/documents/market-studies/retirement-income-market-study-revised-terms-of-reference.

23 These have been considered when forming our view on focal products, but have not been directly included in the scope of this market study.

24 While a related product, equity release products are not directly within the scope of this market study. However, in the future the FCA may wish to undertake further work in this area, as noted in our 2014 Risk Outlook: http://www.fca.org.uk/news/risk-outlook-2014.

The rest of this report is structured as follows.

- Chapter 3 describes the market landscape for retirement income products.
- Chapter 4 sets out our analysis of consumers in this market.
- Chapter 5 sets out our analysis of the supply and distribution of retirement income products.
- Chapter 6 sets out the indicators of competition in the retirement income market.
- Chapter 7 sets out the findings of our international comparative research of other national retirement income markets.
- Chapter 8 sets out our current view of innovation in the retirement income market.
- Chapter 9 sets out our proposed remedies.
- Chapter 10 sets out our next steps.

Alongside this interim market study report, we are also publishing the following.

- A report conducted by Ignition House on behalf of the FCA setting out the findings of qualitative consumer research of circa 100 participants.
- A report conducted by GfK on behalf of the FCA setting out the findings of quantitative consumer research of circa 1,000 respondents.
- A report conducted by Oxera on behalf of the FCA presenting the findings of our international comparative research of 10 other national retirement income markets.
- An FCA report on the findings of a framing experiment conducted by YouGov on behalf of the FCA of circa 900 respondents.
- An FCA Occasional Paper presenting our analysis of the value for money of annuities and other retirement income strategies, and a report that describes the mortality assumptions used in our analysis.

3. Market overview

This chapter provides factual context for the analysis contained in the subsequent chapters. It sets out key facts about the market today, including the regulatory framework, and an overview of the forthcoming changes.

Currently, consumers can use their DC pension pot to purchase an annuity or, subject to some constraints, an income drawdown product. Historically annuities have been the most widely-purchased retirement income product. Many savers will have other sources of income or wealth to consider alongside their DC pension pot, including a DB pension, the state pension, and property.

The consumer journey into retirement is changing, with fewer people approaching it as a moment in time transition and more opting for a phased approach. This has implications for how and when consumers engage with the question of what to do with their DC pension pot.

The retirement income value chain can be broadly split into three elements - product providers, advisers and other intermediaries, and reinsurers.

- **Product providers** can be distinguished between those who only operate on the open market, those who only serve their existing customers, and those who offer both services. The market is only moderately concentrated – the biggest six providers account for about 60% of the market.
- **Intermediaries** provide a range of services to consumers during their retirement journey, from basic price comparisons through to full financial advice. The regulatory framework distinguishes between services that provide a personal recommendation, and services that do not, and the consumer redress available in the event that a product is unsuitable reflects this.
- **Reinsurers** offer specialist underwriting expertise to annuity providers, allowing them to insure against the longevity risk they take on when selling products to consumers. The ability to share risk, for a price, is relevant for new entrants among others.

We summarise the impact of the Government's reforms which have increased the range of options available to consumers in terms of generating their retirement income, and means the market is poised to undergo significant change.

We also summarise other relevant aspects of the regulatory framework, notably the Retail Distribution Review and Solvency II.

In this chapter we set out the relevant market and regulatory context within which our market study has been conducted. First, we describe the products, the value chain and the consumer journey. Then, we set out the key aspects of the regulatory context of this market, namely the reforms to the retirement landscape set out in the 2014 Budget, the FCA's Retail Distribution Review and Solvency II.

Retirement income products

Annuities

An annuity is a product that allows a consumer to convert their pension savings into a regular income that will last for the rest of their life. Although compulsion to purchase an annuity by age 75 was abolished in 2011, annuities have remained the most-widely chosen solution for 75% of UK retirees with DC pension funds.[25] There are a number of different types of annuity available and these are set out in Figure 3.

Figure 3 Summary of the different types of annuity products currently available

Annuity type	Key features
Single life annuity	All of the guaranteed income is paid to one individual and payments stop when that individual dies.
Joint life annuity	Some or all of the guaranteed income continues to be paid to an individual's spouse or partner after they die.[26]
Level annuity	Provides the same level of guaranteed income each year, meaning that their real value is eroded over time by inflation. The initial rate offered to the consumer will be higher than an escalating annuity as there is no protection against inflation.
Escalating annuity	The guaranteed income increases each year by an agreed fixed amount, for example by a fixed percentage or in line with any increases in inflation. The initial rate offered to the consumer will be lower than a level annuity to cover the costs of the guarantee.
Enhanced/impaired annuity	The guaranteed income from the annuity is higher (because the annuity provider expects to provide the income for a shorter period of time) for annuitants whose life expectancy is affected by their lifestyle choices, such as smoking (enhanced annuity) or certain medical conditions, such as cancer (impaired annuity).[27]
Investment-linked (or 'with-profits') annuity	The individual's pension savings are cashed in and moved into an annuity which is linked to the investment performance of the funds selected, with the potential for higher income. Investment-linked annuities can be exposed to explicit charges in terms of annual management charges (AMC), or transactional charges (such as a fee to switch the fund that is invested in).
Fixed-term annuity	The individual is paid a guaranteed income for a fixed period, at the end of which the individual is paid a lump sum.

25 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/301563/Pensions_fact_sheet_v8.pdf.

26 From April 2015, beneficiaries of individuals who die under the age of 75 with a joint life or guaranteed term annuity will be able to receive any future payments from such policies tax free. The tax rules will also be changed to allow joint life annuities to be passed on to any beneficiary. These changes mean that people will no longer have to worry about their pension savings being taxed at 55% on death. See page 57 of Autumn Statement 2014. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382327/44695_Accessible.pdf.

27 Throughout the report 'enhanced annuity' will have the meaning of both enhanced and impaired annuities.

It is also possible for consumers to purchase combinations of these products. For example, a 'joint escalating' annuity combines features of a joint life annuity and an escalating annuity.

In 2013 annuity sales fell by 15.3% in value terms, from £11.9bn to £10.1bn. As a result of the increased flexibility that will be available to retiring consumers from April 2015, market research estimates that the annuities market will fall in value terms to £6bn this year, and then grow to around £7bn by 2019.[28]

Income drawdown

Income drawdown is currently the most common alternative to buying an annuity. It allows a consumer to leave their pension fund invested while drawing an income from it by using income withdrawals or by purchasing a 'short-term annuity'. Currently, income withdrawals are made through a capped or flexible drawdown pension arrangement. The key features are described in Figure 4 below.

Figure 4 Summary of the different types of income drawdown currently available

Drawdown type	Key features
Flexible drawdown	Flexible drawdown products are currently only available to those people who have a minimum amount of secured income (£12,000) in a tax year from another pension scheme.[29] Individuals do not have to show that they qualify for all future years and for those that do qualify, they may take as much as they like from their pension pot.
Capped income drawdown	Capped drawdown is in principle available to everyone, although some providers will not offer capped drawdown to consumers with smaller pots. The amount that can be taken from the pension pot each year is limited by tax rules and must be reviewed by the product provider (every 3 years for those under 75, and annually for those over 75).

Unlike annuities which offer a guaranteed income for life,[30] the income generated from drawdown is subject to investment and market fluctuations. An individual's retirement income may go up or down depending on the performance of the underlying funds and the performance of bond yields used by the Government Actuary's Department (GAD) to set the maximum permitted withdrawal level. Further, income drawdown does not provide insurance against longevity, so a long-lived individual, or one who draws down a disproportionately large amount of their total savings each year, is at risk of running out of money in their lifetime.[31]

To date, the majority of income drawdown contracts have been offered to UK consumers with advice, which means individuals must pay an advice fee. In addition, providers of income drawdown also usually charge a fixed annual fee for managing the funds (an annual management charge, AMC) and there may be additional administration charges.

As set out in Chapter 2, in 2013, income drawdown sales rose by 47.6% in value terms, from £1.2bn to £1.8bn. 88.2% of those sales were with independent advice, 9.2% with restricted

28 Source: ABI/MINTEL – MINTEL Annuities – UK August 2014, page 8.

29 The additional yearly income required to qualify for flexible drawdown is £12,000. This was reduced from £20,000 on 27 March 2014 as a result of changes announced in Budget 2014.

30 It should be noted, however, that with investment-linked and flexible annuities the pensioner is taking some degree of investment risk. While these products typically offer a guaranteed minimum income, the income beyond that can go down as well as up.

31 Recent research from Cazalet consulting (cited in the Daily Telegraph) shows what would have happened in a range of withdrawal scenarios, had a £100,000 pot been invested in 2000 in the FTSE 100 index. It found that drawing a fixed income increasing yearly by 2.5%, irrespective of the value left in the remaining pot, might drain the fund very quickly indeed. If income of £10,000 was taken, the pot would have run dry sometime around 2008. Even the modest-seeming £5,000 annual withdrawal would leave only £40,000 at the end of 2014. This is mainly due to the effect that regular, fixed withdrawals can have if they are made after markets have fallen. This phenomenon has been labelled 'pound cost ravaging'.

advice, and 2.6% on an execution only basis (these terms are defined below).[32] Market research suggests that income drawdown sales are likely to continue to grow if annuity rates remain at current levels and consumers take a more risk-tolerant approach to their pensions once they have more control over their options from April 2015.[33]

Other related/alternative products

In addition to annuities and income drawdown there are a number of other related products that consumers can currently use to generate additional or alternative retirement income.

Figure 5 Alternative products and sources of retirement income

Product	Key features
State pension	Currently the basic state pension pays retirees a maximum amount of £113.10 per week. This can be topped up if certain criteria are met. The Additional State Pension and Pension Credit will also be available to some retirees. For people reaching state pension age after 6 April 2016, the new state pension will apply.[34] The new state pension will be a single-tier pension with an individual entitlement worth at least £148.40 per week. Pension credit, which currently provides a boost to the basic state pension for those on low income, will cease to exist.
Defined benefit (DB) pension schemes	Pays out an income based on an individual's earnings. The amount the consumer receives at retirement (or ill-health or death) is defined and is paid directly to the individual. Unlike with DC schemes, there is no 'pension pot' to be used to buy an annuity or enter into income drawdown.
Defined ambition (DA) pension schemes	Defined ambition is a new type of workplace pension proposed by the Government. A DA pension seeks to give greater certainty for members than a DC pension about the final value of their pension pot and less cost volatility for employers than a DB pension. Defined ambition pensions are still very much being thought about and discussed.[35]
Collective defined contribution (CDC) pension schemes	The Government has also proposed the introduction of Collective Defined Contribution plans, where the employer pays a fixed rate of contributions and risk is shared between the members. An expected benefit is calculated, but not promised – the actual pension benefit to be paid is based on the funding level of the scheme – so the pension in retirement is not certain. The extent of this uncertainty varies between schemes.[36]
Equity release products	Allow a consumer to access the equity they have acquired in their property. Typically equity release products will either be lifetime mortgages, which allow an individual to borrow a proportion of their home value, or home reversion, where an individual sells a share of their property, but retains a right to continue living in the property.[37]

32 Percentage of income drawdown sales by volume in 2013.

33 Source: ABI/MINTEL – MINTEL Annuities-UK August 2014, page 31.

34 These new arrangements will apply for men born on or after 6 April 1951 and women born on or after 6 April 1953. People born before these dates will continue to receive the basic state pension and, depending on their circumstances, the additional state pension https://www.gov.uk/new-state-pension/overview.

35 The Government has been consulting on the possibility of encouraging the development of 'defined ambition' (DA) pension schemes. In particular, it has looked at how collective defined contribution schemes might work in the UK. The Government's proposed model for this would have a fixed contribution rate for employers, a target pension income for employees (with provision for this to be adjusted if the scheme becomes under-funded); and pooling of scheme assets (rather than individual funds for each member), with an income paid from this pool at retirement http://www.parliament.uk/business/publications/research/briefing-papers/SN06902/defined-ambition-pension-schemes.

36 http://www.parliament.uk/business/publications/research/briefing-papers/SN06902/defined-ambition-pension-schemes.

37 See footnote 24.

Product	Key features
Buy-to-let investments	Consumers may decide to purchase property specifically for letting purposes and with a view to generating income. This may be done through purchasing property with their savings, or through a buy-to-let mortgage.
Other investments	Consumers may have a range of other financial products which they use to generate retirement income, for example savings accounts, cash ISAs, National Savings & Investments (NS&I) products, stock-market-based investments and investment bonds.

Consumers of retirement income products

Consumers go through a lengthy journey prior to the point at which they decide to purchase a retirement income product with their pension pot. Currently, the consumer journey to retirement (illustrated in Figure 6 below) can be summarised as follows.

- Consumers save into a pension pot during their working career in order to create a pension pot (the accumulation stage). At some point during this time they will also select their selected retirement date (SRD).[38] Typically, 5 to 10 years before a consumer's SRD, the pension provider will adjust their 'lifestyling' strategy to invest in lower risk assets such as cash or fixed interest. This reduces the volatility of investment returns and makes retirement income more predictable. Lifestyling schedules are likely to change in the future as fewer people default into an annuity purchase.[39]

- Four to six months prior to the SRD, consumers will receive a 'wake-up pack' from the provider with whom they have their accumulation savings.[40] These communications from the provider are required by FCA regulation.[41]

- At this stage, the consumer will either make a decision to purchase a retirement income product or defer their retirement income decision. If the consumer decides to defer, the provider will contact the consumer again after a defined period of time, usually 12 months.

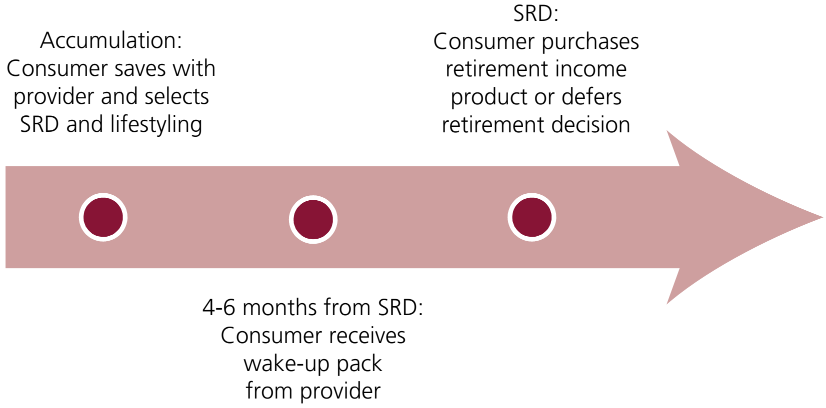
38 For defined contribution trust-based schemes, an individual's SRD is set by the scheme upon joining.

39 Lifestyling is designed to 'lock in' accumulated investment growth in an individual's pension pot as they approach retirement. Lifestyling involves investing in riskier assets when an individual is a long way out from retirement and switching to less risky assets as they approach retirement. Lifestyling is likely to be suitable where a consumer purchases an annuity as it provides a more predictable income. Lifestyling is less suitable for consumers wishing to use income drawdown to generate an income in retirement as moving the pension fund to lower risk assets is likely to reduce the investment returns.

40 For members of trust-based occupational schemes the wake-up pack will be sent at least six months prior to their SRD.

41 See Conduct of Business Sourcebook (COBS) 19, relating to supplementary pension provisions: http://fshandbook.info/FS/html/FCA/COBS/19

Figure 6 Today's typical consumer journey to making a retirement income decision



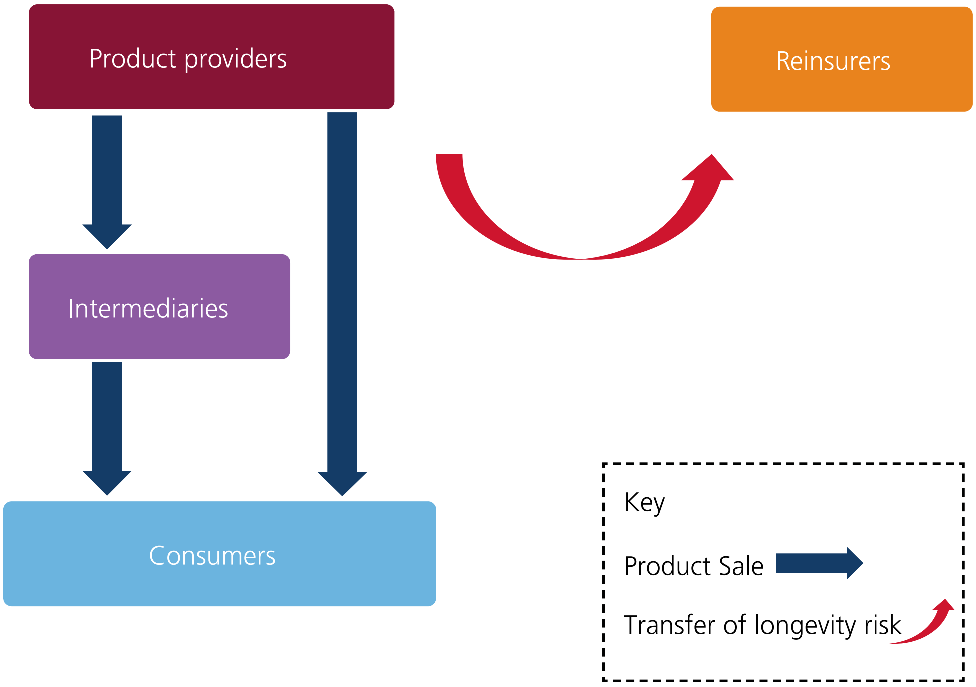
However, it is important to recognise that for many consumers, the retirement journey will be more complex than this. Many people now follow a phased retirement process, for example by continuing to work part-time into retirement. These consumers are moving away from the traditional retirement journey with a 'single decision point' in time. Further, many consumers will have more than one DC pot, maturing at different times, and/or DB benefits. These additional sources of income may or may not be linked to their DC savings.

The decision around the purchase of a retirement income product is not the only complex decision which needs to be taken during the consumer journey. Several decisions taken during the accumulation phase (such as the option to lifestyle, as described above) have an impact on the size of the pot from which retirement income will be generated. This market study mainly focuses on the decumulation stage, which starts from the choice consumers make at retirement.

The retirement income value chain

The retirement income value chain can be broadly split into three elements: product providers, intermediaries and reinsurers. Their relationship in the value chain and to consumers is illustrated in Figure 7 below:

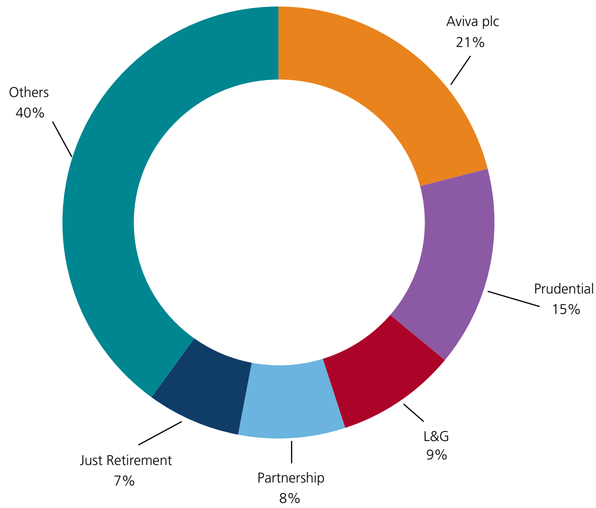
Figure 7 Overview of the retirement income value chain



Providers of annuities

There are a number of product providers in the UK who offer annuities.[42] See Figure 8 below.

Figure 8 Annuity provider market shares (by new APE premiums),[43] 2012



Source – Standard & Poor's Synthesis Life/MINTEL: MINTEL Annuities-UK, August 2014, page 54.

42 The make-up of firms who provide income drawdown products is somewhat different; products are offered by a broader range of firms, including traditional insurers, platforms and SIPP operators.

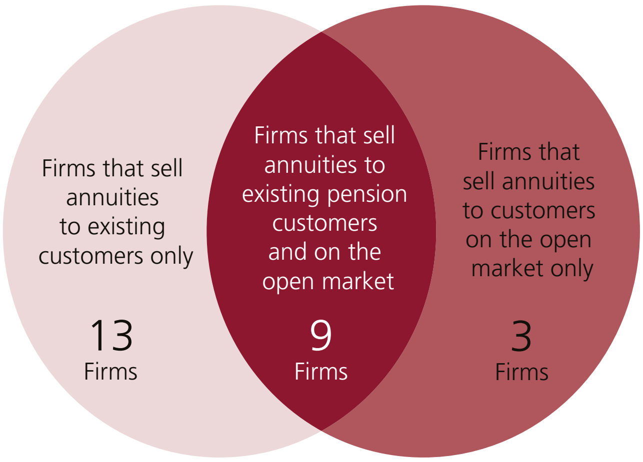
43 APE premiums: Annual premium equivalent is a sales metric used by insurers by which sales are estimated by taking 100% of regular premiums plus 10% of new single premiums for the financial year.

These providers can be broadly categorised into four groups, as set out below.

- Providers who compete for both open market consumers and their existing consumers.
- Providers who only compete for consumers on the open market (that is, they have no internally vesting customer base).
- Providers who do not compete for consumers on the open market.
- Providers who do not offer individual annuities to consumers, but instead provide bulk annuity solutions for workplace pension funds.[44]

In our previous thematic review of annuities,[45] we gathered information from 25 firms, representing 98% of all active pension annuity providers by volume of sales in 2012. We identified that of those 25 firms, 13 sold annuities to their existing pension customers only and the remainder operated in the open market.

Figure 9 Firms selling annuities to retail customers, 2013



Source: FCA Thematic Review of Annuities, 2014

Measures of market concentration for the standard and enhanced annuity product sector are plotted in Figure 10 below.[46]

This shows that the level of concentration has stayed relatively low and stable at 1000 HHI points. Variations in the measure could be explained by new entry to this sector. However, fluctuations in market share and the resulting concentration ratios are likely attributable to existing providers gaining market share by entering the open market to sell enhanced annuities.[47]

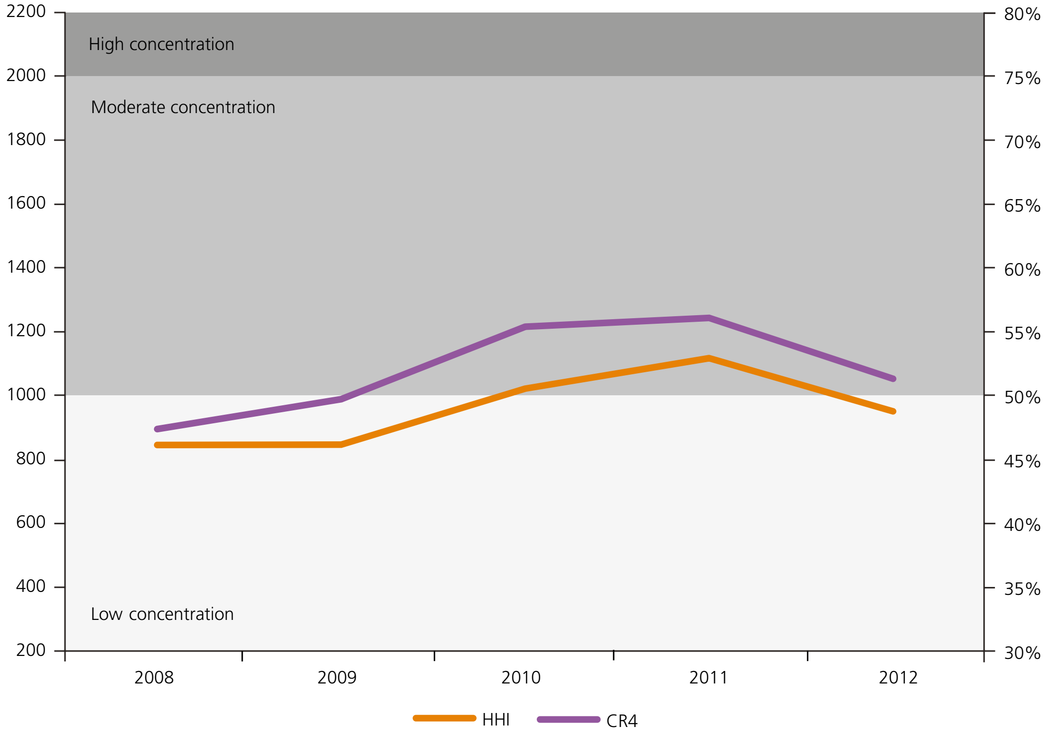
44 However, bulk annuities are not within the scope of this market study, and have therefore been excluded from the calculation of market shares.

45 Thematic review of Annuities TR14/2 http://www.fca.org.uk/static/documents/thematic-reviews/tr14-02.pdf.

46 The four-firm Concentration Ratio (CR4) measures the market share of the four largest firms in a market, whilst the Herfindahl-Hirschman Index (HHI) calculates the sum of the squares of the market shares of all firms in the market in order to obtain an overall figure that indicates the level of concentration in a market accounting for the relative size of the firms. We have estimated the CR4 and the HHI indices based on data submitted by ten firms on new business premiums based on APE premiums for standard and enhanced annuities and ABI data on overall market size (for standard and enhanced annuities) per year. Residual market shares have been split equally into fifteen, assuming that the rest of market is characterised by fifteen equally sized players.

47 As noted at the time of publication of our previous thematic review of annuities (page 21) in February 2014: '…more providers are entering the open market to sell enhanced annuities. At the time of this report there are 10 providers with the expectation that two more will be entering the market soon.' Thematic review of Annuities TR14/2 http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02.

Figure 10 CR4 and HHI analysis, 2008-2012[48]



Source: FCA own calculations

The concentration measures that we have calculated do not distinguish between the open market and internally vesting market. We have not been able to calculate this with the data available to us.[49]

Providers of income drawdown

Income drawdown sales have historically been significantly lower than sales of annuities, with one drawdown sale for every 16 annuity sales in 2013. Prior to the landscape changes announced in the Budget, income drawdown has overwhelmingly been sold through a personal recommendation (over 95% of sales in 2013) and typically to higher net-worth consumers.[50] In the new landscape, we are aware that more simplified drawdown products may be brought to the market, potentially being sold to consumers through sales channels that do not involve a personal recommendation (such as execution only). Chapter 8 of this report discusses this and other potential innovations in the market in further detail.

Many life insurers offering annuities in the retirement income market also offer income drawdown. In March 2014, approximately half of the firms that were included in our market study sample of 14 firms offered some form of drawdown product in addition to annuities.

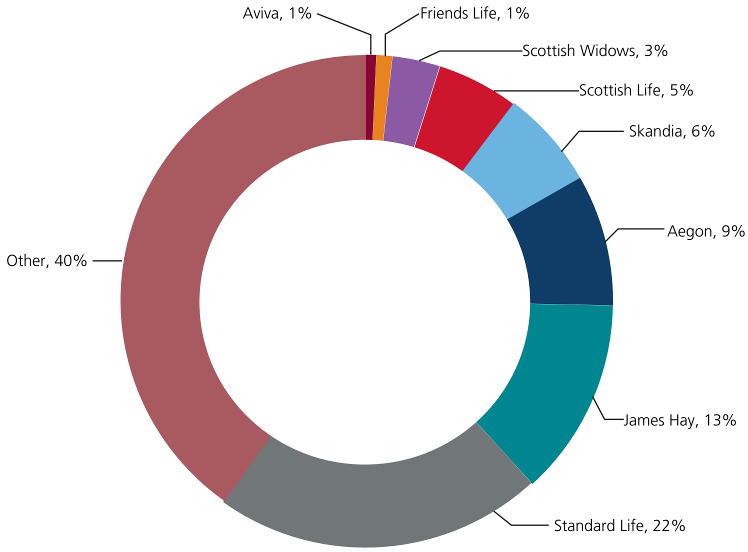
48 Thresholds used in this figure are taken from the OFT CC Merger guidelines. This is an indicative analysis based on the annuity sector only (given its dominance to date) in order to provide a sense of the competitive positions of the main current players in the retirement income market.

49 Our previous thematic review presented market shares in the OMO market for the year 2012. From the data submitted by firms, we do not have the necessary level of detail to estimate concentration in the internally vesting and OMO segments across the years. Thematic review of Annuities TR14/2 http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02.

50 Source: ABI/MINTEL – MINTEL Annuities-UK, August 2014, page 33.

Based on the assets under management (AUM) figures reported by Canaccord, the main providers of income drawdown products in 2012 were Standard Life (with a market share of approximately 22% of the income drawdown market), followed by James Hay (approximately 13% market share), and Aegon and Skandia (both with a market share below 10%).[51] Market shares by AUM are shown in the chart below.

Figure 11 Income drawdown market shares by AUM, 2012



Source: Canaccord Genuity, October 2014

Going forward, it is anticipated that there will be an increased role for income drawdown products and significant changes to the way income drawdown products are sold to consumers. This is discussed in more detail in Chapters 5 and 8 of this report.

Distributors and other intermediaries

For those consumers purchasing a product at retirement, there are two broad service channels open to them.[52]

- A sale with a personal recommendation (for example, a sale following the receipt of simplified, focussed or full financial advice).
- A sale without a personal recommendation (for example, a sale following the provision of information only, or execution-only services).[53]

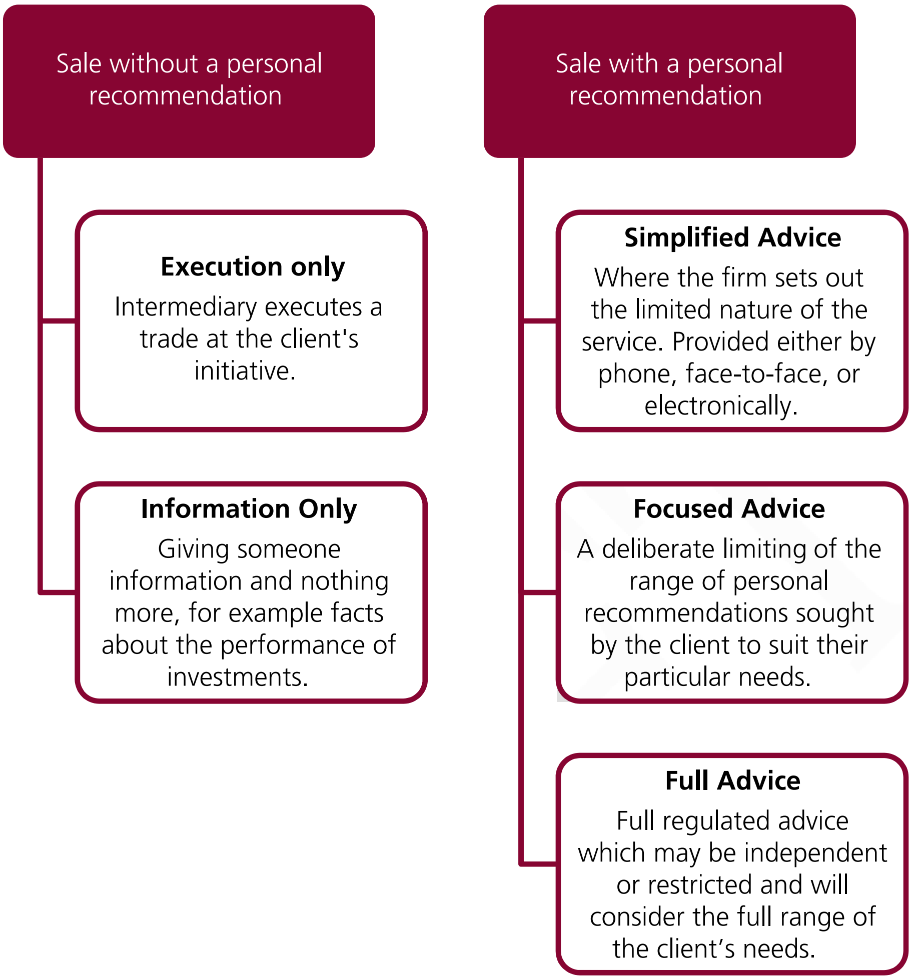
Retail investment advice services in this market can be provided by pension providers, financial advisers and other intermediaries such as brokers. There are also other types of intermediary in the supply chain who introduce consumers to sources of retail investment advice. These firms are typically known as introducers, many of whom operate in this market as websites which offer an annuity comparison service. The development of the retail investment advice market and the role of introducers is discussed in more detail in Chapter 5 of this report.

51 Canaccord Genuity Report: Life Insurance UK, 15 October 2014.

52 Some trustee-based DC occupational schemes offer members additional information and pre-retirement training sessions for groups of individuals approaching retirement http://www.thepensionsregulator.gov.uk/guidance/guidance-dc-schemes.aspx#s11011.

53 GC14/3 Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development http://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf.

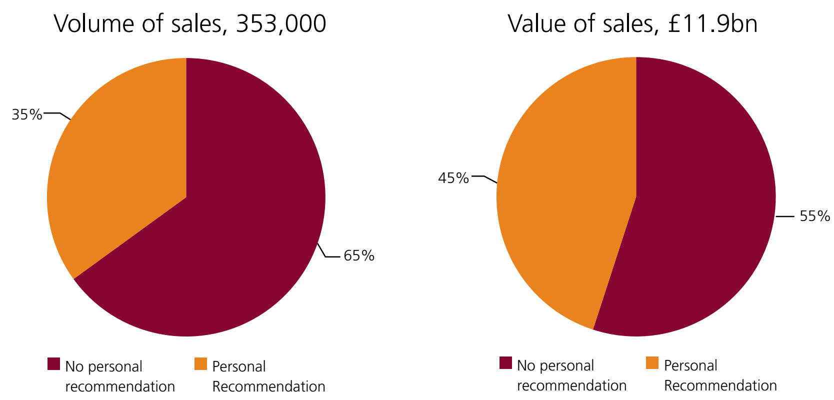
Figure 12 Defining the boundaries of retail investment advice



Source: Retail investment advice: Clarifying the boundaries and exploring the barriers to market development.

Sales data and recent market research indicates that 55% of annuity sales by value in 2013 were sold without a personal recommendation (accounting for 65% of the total volume of annuity sales). This data also indicates that annuity product sales involving a personal recommendation were higher value sales. This is illustrated in Figure 13 below.

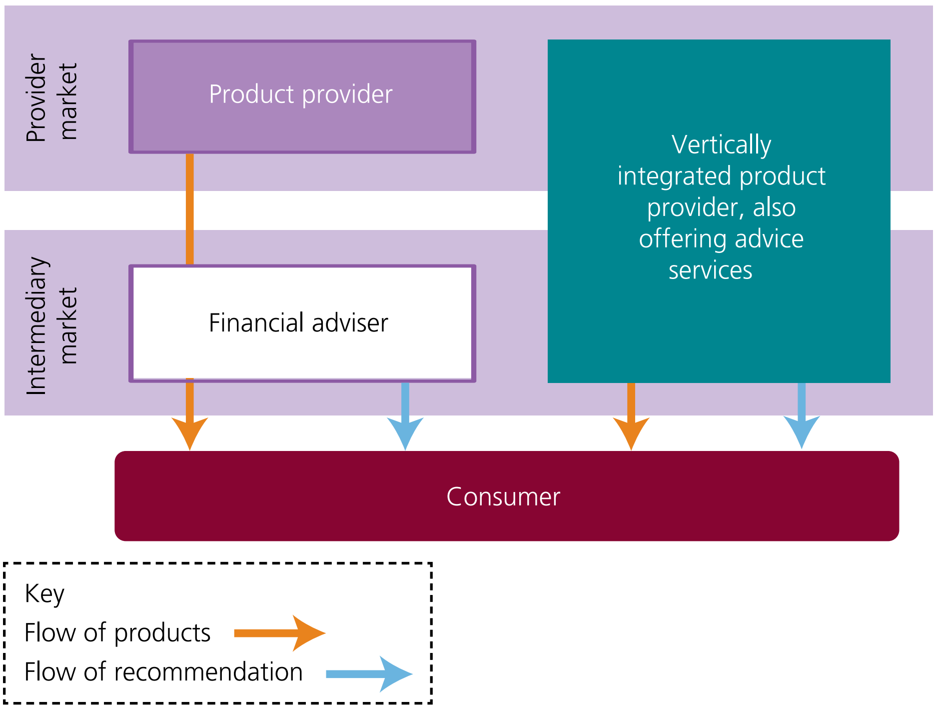
Figure 13 Proportion of annuity sales by service channel (value and volume, 2013)



Source – ABI/MINTEL: MINTEL Annuities-UK, August 2014, page 54.

Where product providers offer consumers a personal recommendation they typically do so through a vertically integrated subsidiary, as illustrated in Figure 14 below.

Figure 14 Overview of vertically integrated advice services



Vertical integration can provide efficiency gains to companies through a reduction in distribution and delivery costs (as a result of having an integrated supply chain).

Reinsurers

As illustrated in our overview of the retirement income value chain, annuity providers typically insure a proportion of the longevity risk they assume when selling annuities to consumers. To do so they use a reinsurer because they bring specialist underwriting expertise to the transaction that providers may not possess. Reinsurers in the UK market include Swiss Re, Hanover Re, Munich Re, Pacific Life Re and Reinsurance Group of America (RGA).

Reinsurers have been key to the development of enhanced annuities. In particular, many enhanced annuity providers have agreements in place for quota share liability insurance. This means that the primary insurer (the enhanced annuity provider) and the reinsurer share the amounts of insurance, policy premium, and losses on a fixed percentage basis.

Typically annuity providers reinsure between 40-80% of the longevity risk assumed. Reinsurance is also available for the longevity risk associated with sales of standard annuities, but it is much less common.

The process of reinsuring a provider's mortality risk will involve an underwriting assessment of the consumer, conducted by the reinsurer. To carry out this assessment the reinsurer will often obtain medical details of the consumer from the provider, including hospital notes where appropriate. In some cases, the reinsurer may require the provider's customer to see a GP.

Having collected this information, and using other data on the consumer (such as educational achievements and postcode), the reinsurer will produce its own individual mortality projection. At this point, the reinsurer will provide a quote to the provider for its reinsurance services, which is usually guaranteed for a period of between ten days and three months.

The price of the reinsurance services will take account of factors such as the level of services provided, any licensing fees incurred for the use of the reinsurer's underwriting systems, costs and profit margin.

Regulatory context

Impact of the 2014 Budget reforms

Before the 2014 Budget

Prior to the 2014 Budget announcement, the regulatory framework for accessing defined contribution savings allowed consumers to pursue the following options (see Figure 15 below).[54]

First, consumers had the option to withdraw up to 25% of their defined contribution (DC) pension pot as a tax-free cash lump sum. With the remainder, they had five options:[55]

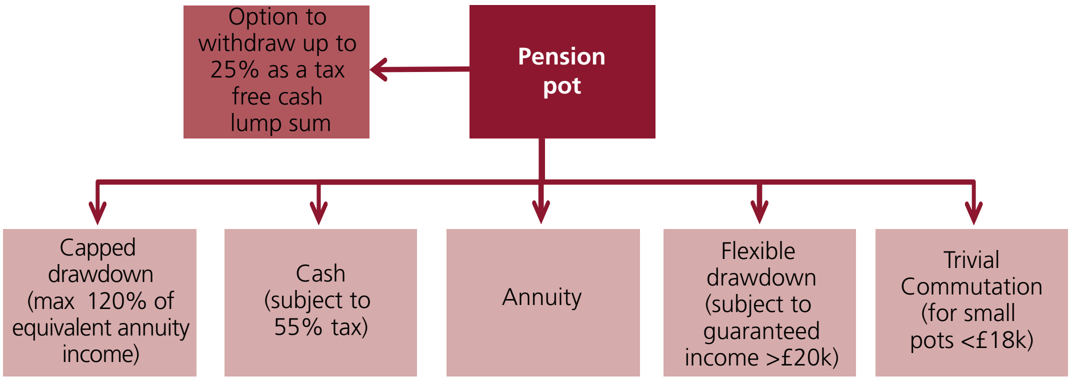
- consumers could purchase an annuity
- consumers could enter into a 'capped drawdown' arrangement, which allowed them to take income from their pension, up to a maximum amount of 120% of an equivalent annuity income
- consumers could enter into 'flexible drawdown', with no limits on the amount they could draw from their pension savings, subject to having a guaranteed pension income of over £20,000 per year in retirement from elsewhere

54 The exception may be for people holding DC Additional Voluntary Contributions attached to a DB scheme, who may be able to take their whole AVC savings as tax-free cash when the 25% limit is applied to the DB and AVC scheme jointly.

55 Note, individuals are under no obligation to take any fraction of their DC pension pot as tax-free cash before they make a product decision.

- consumers could access cash from their pension subject to a tax penalty,[56] and
- consumers aged 60 or over with overall pension savings of up to £18,000 (before the 25% tax free cash entitlement is subtracted) could take all of their savings in one lump sum (known as trivial commutation). Further, small pots of £2,000 or less could be taken as a lump sum (regardless of total pension wealth).

Figure 15 Options for consumers pre-Budget 2014



Interim changes up to April 2015

As a first step towards the Budget 2014 reforms, the Government announced a number of changes to the pension rules that came into effect from 27 March 2014:

- the amount of guaranteed income people need in retirement to enter into flexible drawdown was reduced, from £20,000 to £12,000 per year
- the amount of total pension savings that can be taken as a lump sum was increased, from £18,000 to £30,000
- the capped drawdown withdrawal limit was increased from 120% to 150% of an equivalent annuity
- the maximum size of a small pension pot which can be taken as a lump sum (regardless of total pension wealth) was increased from £2,000 to £10,000, and
- the number of personal pots that can be taken under these rules was increased from two to three.

Changes from April 2015

As a second step the Government has set out a suite of changes that will be effective from April 2015. From the age of 55, DC pension holders will be able to (see Figure 16 below):[57]

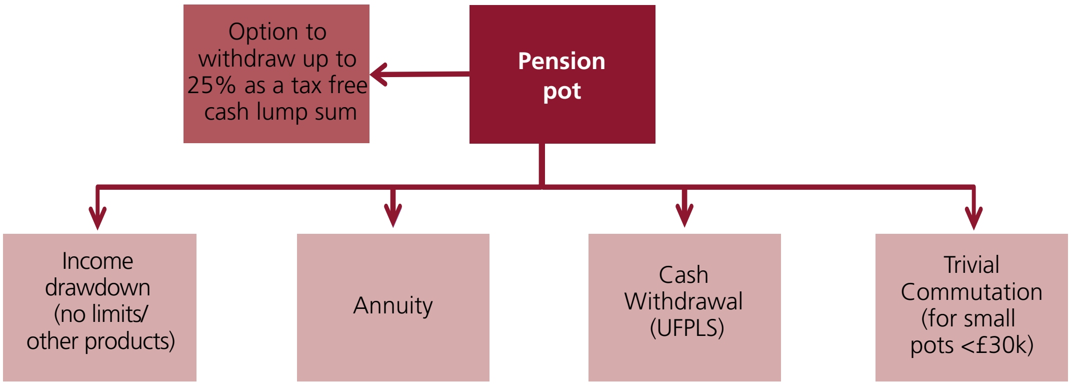
- enter into income drawdown, absent any upper limit
- purchase an annuity or other income-generating guaranteed product, and/or

56 Technically this applies to any cash amount taken above the 25% tax-free entitlement and is an unauthorised payment attracting a tax penalty (of 55%).

57 This is correct at the time of writing.

- take one or a series of lump sums from an uncrystallised pension fund (that is without the need for entering into a 'decumulation product' such as income drawdown). This is known as uncrystallised fund pension lump sum, or UFPLS.

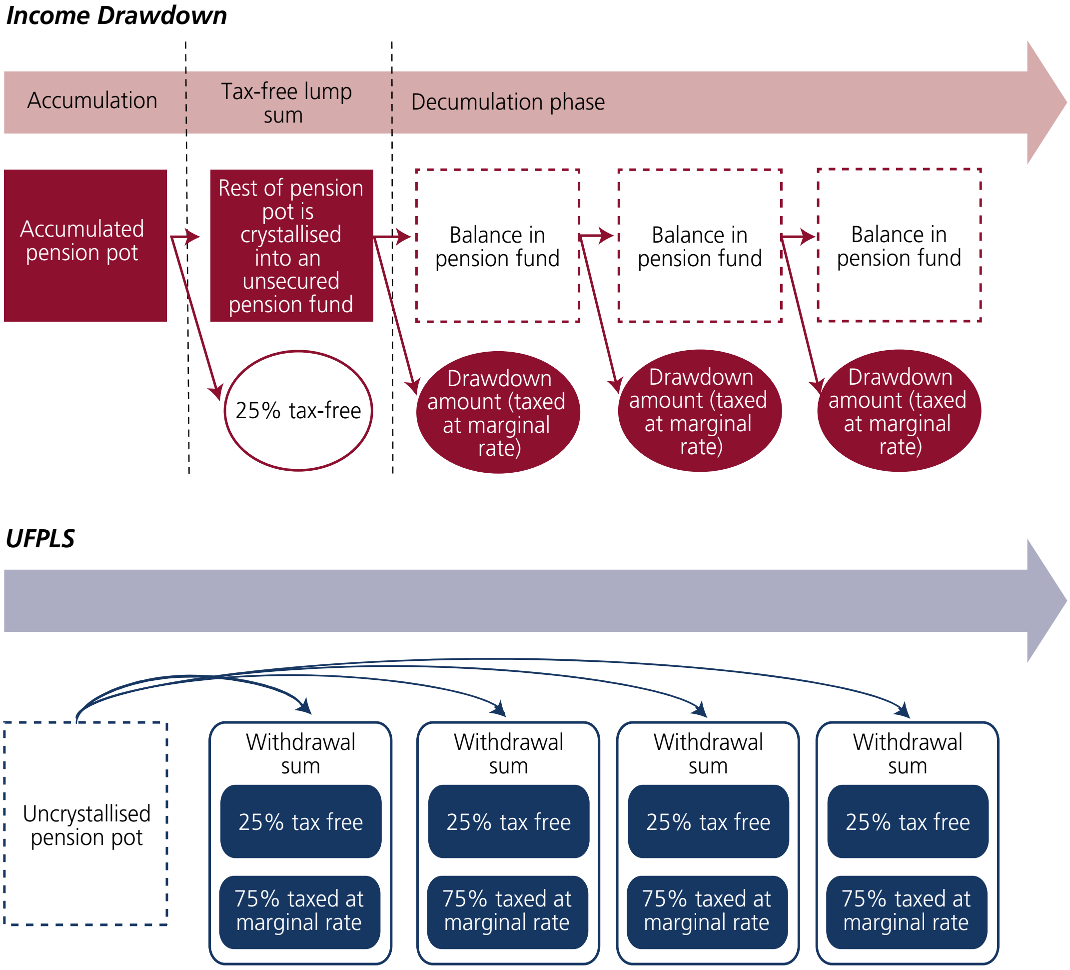
Figure 16 Options for consumers from April 2015[58]



The option to use UFPLS has some important differences compared with income drawdown in terms of tax treatment. This is illustrated in Figure 17 below. In particular, if a retiree decides to enter into an income drawdown contract they will have the option to withdraw 25% of their pension fund as tax-free cash before transferring into a 'crystallised' decumulation fund. Any sums withdrawn from the crystallised fund will be taxed at the individual's marginal rate of income tax. A retiree wishing to use UFPLS to draw an income at retirement will keep their pension savings in an 'uncrystallised' fund from which they are able to draw down any amount as income. Of the amount withdrawn, 25% will be tax-free and 75% will be taxed at the individual's marginal rate of income tax.

58 It should be noted that the proposals set out in Budget 2014 are permissive rather than prescriptive; pension schemes and providers have discretion over the options that they offer. See Chapter 8 for more detail on permissive override.

Figure 17: Tax implications of Income Drawdown and UFPLS



Source: FCA

To support the increased flexibility the reforms will bring, the Government announced the 'guidance guarantee' which entitles everyone with a DC pension fund to access a free (at the point of delivery) impartial pensions guidance service, including the option of a face-to-face conversation about their options when accessing their pension savings.[59] It will not be mandatory for people to take this guidance to access their pension savings, but they will be signposted to the guidance service before they take any benefits, through a 'signpost letter'. The pensions guidance service will also provide an indication of the tax they would pay when taking a lump sum.

The Budget reforms will have a profound impact on the life insurance market; in particular the supply of annuities is expected to shrink. The most material immediate impact has been on share prices and market sentiment. For firms whose business strategies are almost entirely based on the sale of retail annuities, market commentary has been mixed as to whether their business models will remain viable. Nevertheless, we are aware that firms are considering two ways to maintain volume: either by launching new retail products (such as more flexible annuities, or income drawdown options), or by expanding into wholesale 'bulk purchase' products. Product innovation has been considered in more depth in Chapter 8 of this report.

59 That is, the guidance service will be free, but consumers may decide following access to the guidance service that they wish to obtain further advice or guidance which incurs a cost, such as using an independent financial advisor or a broker.

Retail Distribution Review (RDR)

The RDR was announced in June 2006 with the specific aim of identifying and addressing the root causes of problems that continued to emerge in the retail investment market. The RDR had a number of objectives, in particular:

- to maintain an industry that engages with consumers in a way that delivers more clarity for them on products and services
- to enhance a market which will allow more consumers to have their needs and wants addressed
- to provide remuneration arrangements that allow competitive forces to work in favour of consumers
- to maintain standards of professionalism that will inspire consumer confidence and build trust
- to build an industry where firms are sufficiently viable to deliver on their longer-term commitments and where they treat their customers fairly, and
- to develop a regulatory framework that can support the delivery of these objectives and does not inhibit future innovation that benefits consumers.

The RDR proposals included:[60]

- new standards for independence that required firms providing independent advice to make recommendations based on a comprehensive and fair analysis of the relevant market, and to provide unbiased and unrestricted advice
- changes to adviser charging which meant that firms should be paid by charges that they have set out upfront and agreed with their clients, rather than commissions set by product providers, and
- raising professional standards.

These proposals came into effect on 31 December 2012. The first part of our Post-Implementation Review of the RDR, looking at the RDR's impact to date, is currently being undertaken.

In addition, we have carried out a three-cycle thematic review into how firms have implemented key RDR changes regarding the disclosure and delivery of adviser charging and service models. The most recent, third cycle of the review has also focused on the ongoing services firms provide to clients in return for the ongoing adviser charge and how firms are delivering these ongoing services in practice. The output from the Post-Implementation and thematic reviews is due to be communicated shortly.

60 http://www.fca.org.uk/firms/firm-types/sole-advisers/rdr

Solvency II

Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry.[61] It aims to establish a set of EU-wide capital requirements and risk management standards with the aim of increasing protection for policyholders. Solvency II will be adopted by all 28 European Union Member States and three of the European Economic Area countries on 1 January 2016.

The intention of the new regime is to protect policyholders' interests more effectively by making firm failure less likely, and by reducing the probability of consumer loss or market disruption. The more consistent requirements of the regime should also make it easier for firms to do business across the EU. The new regime will apply to all insurance firms with gross premium income exceeding €5m or gross technical provisions in excess of €25m.

Solvency II will direct insurers to ensure that they have enough capital set aside to provide reserve funds to cover all insurance claims that they are likely to receive. All insurance companies operating in the EU will be required to comply with the Directive when it comes into force. In summary, the Directive sets standards for insurance companies covering three main areas.

- **Valuation of assets, liabilities and capital requirements:** the Directive covers how insurers value their liabilities (such as claim payments) and assets (such as Government bonds, share and property) that they hold. This area of the Solvency II rules also covers the funds insurers must hold in reserve to ensure they can meet policyholder claims.

- **Governance and risk management:** Solvency II also relates to how the structure and management of insurance businesses are governed. This will enable insurers to identify, measure, monitor, manage and report risks to which they are exposed, and ensure their businesses are managed to a high standard.

- **Reporting and disclosure:** the rules set out the information that insurers must report on their business and how it is reported. Some of these reporting mechanisms will be publicly available, while others will be privately reported to the relevant regulator. The intention of this aspect of Solvency II is to provide the public and regulators with more information to allow them to understand more about the businesses that provide insurance to individuals and institutions.

The prudential regulation of insurance firms is the responsibility of the Prudential Regulation Authority (PRA). The PRA's guidance on its approach to insurance supervision provides further details on its work to prepare for the implementation of Solvency II. This includes the interim approach the PRA is taking to allow insurers to use their Solvency II work to meet, as far as possible, the current regulatory requirements under the Individual Capital Adequacy Standards.[62]

Consumer redress mechanisms and finance protection

Our rules on dispute resolution set a framework for how firms should deal with complaints and seek to ensure that consumers are treated fairly and that firms have sufficient flexibility to deal with each case individually. If a firm has done something wrong – and the consumer has suffered financial loss, distress or inconvenience as a result – we would expect the firm to return the consumer back to the position they would have been in had the act or omission not occurred.

61 Directive 2014/51/EU ("Omnibus II"): http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0051&from=EN

62 See, for example, *The Prudential Regulation Authority's approach to insurance supervision* (June 2014), page 16. Available at: http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf

In the event that consumers receive an unsuitable personal recommendation in relation to a retirement income product, they can do the following.

a. Complain to the firm – under the rules[63] firms have up to eight weeks to deal with complaints.

b. If the consumer is not happy with the response that they receive from the firm, they can refer their complaint to the Financial Ombudsman Service ('ombudsman service').[64], and

c. If a consumer does not want to accept a decision by the ombudsman service, as a last resort they may be able to take their case to court.

In addition, the Financial Service Compensation Scheme (FSCS) can pay compensation to customers of authorised financial services firms if the firm is no longer trading and is unable to pay the claims against it. The FSCS covers deposits, insurance business, investment business, and mortgage advice and arranging and there are no limits to the compensation it can pay.[65]

Conclusion

The retirement income market has traditionally been characterised by a consumer journey that involved a one-off, 'moment in time' decision to move into retirement. Historically, of the options available to consumers, the most common decision has been to purchase an annuity (or, for consumers with smaller pension pots, to take trivial commutation).[66]

The Government's reforms have created a wider range of options for consumers in terms of generating their retirement income and the consumer journey to retirement is also changing, with more consumers opting for phased retirement. Chapter 8 sets out our early views of possible market developments in the UK, based on work undertaken as part of our ongoing supervisory responsibilities. The next chapter considers the consumers of retirement income products to understand what underlies the lack of shopping around and switching in this market.

63 FCA Handbook, section on Dispute resolution: complaints http://fshandbook.info/FS/html/FCA/DISP.

64 The ombudsman service was set up under the Financial Services and Markets Act 2000 to sort out individual complaints that consumers and financial businesses aren't able to resolve themselves http://www.financial-ombudsman.org.uk/default.htm.

65 http://www.fscs.org.uk/. The PRA is currently consulting on proposed changes to the PRA's rules for insurance policyholder protection. These proposed changes include increased limits for compensation for certain insurance products to reflect the significance to policyholders of the risk insured and the consequences of cover being withdrawn. For more information, see Consultation Paper http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp2114.aspx.

66 See Chapter 3 for a definition of trivial commutation.

4.
The consumers of retirement income products

This chapter summarises our research into consumer behaviour and attitudes to retirement. We sought to investigate what underlies the lack of engagement and shopping around, to understand the key behavioural biases at play in this market and to explore how consumers might behave in the new landscape.

- Our research shows that 60% of consumers who purchased an annuity, bought from a different provider. Of the 40% of consumers who stayed with their existing pension provider for an annuity, the majority (80%) were aware of their option to shop around. However, of those who did not switch, one half did no shopping around. This suggests that even when consumers are aware of their option to shop around, not all are clear on how to do this in practice. Some consumers made an active choice to stay with their existing provider out of brand loyalty and trust. Others, however, believe shopping around is not worth it.

- Consumers described the information they receive from providers as difficult to navigate, primarily due to unfamiliar terminology and jargon. Nearly one quarter of consumers in our survey put off retirement planning because it is complex, and approximately a further quarter do so out of fear of making a wrong and irreversible decision. This indicates that consumers need better quality information about their right to switch and more support to do so.

- Our research confirms that consumers exhibit a range of behaviours such as present bias, overconfidence and loss aversion. A number of factors mean these biases are strongly present, including the complexity and one-off nature of the decision; the trade-off involved between the present and the future; and the need to assess the risk and uncertainty associated with different options. The fact that these biases are strongly at play in this market has important implications for the design of the pensions guidance service and firms' own approach to communicating with their customers.

- We are also conscious that savers in this market can be vulnerable to scams.

The findings of our consumer research have informed our thinking on our proposed remedies, set out in Chapter 9 of this report.

Background

The pension landscape in the UK has undergone significant change and will continue to shift as DB schemes lose their dominance in the private occupational pension system and are replaced by DC schemes. The Government's latest consultation on DA[67] pensions that combine features of DB and DC and the potential for new forms of DC pensions, in particular collective DC (CDC), if implemented, could further change the pension landscape over the medium to longer term. Changes to the pension landscape have also included the replacement of the State Earnings-Related Pension Scheme (SERPS) with the additional state pension (the state second pension) for employees in 2002.

Further, increases to the state pension age are being phased in and the new state pension will apply to anyone retiring after April 2016. The automatic enrolment of employees aged between 22 and the state pension age earning over £10,000 a year introduced in 2012 is expected to result in between 6 and 9 million people newly saving or saving more into workplace pension schemes.[68] Under this initiative, employees will automatically save for a private pension unless they actively opt out. This is designed to lead to a rise in DC pension pot sizes over time. Although the relative immaturity of many DC schemes means that pension assets will likely remain low for some time to come, the trend toward larger DC pension savings is already underway; average funds used for annuity purchases in 2013 were around 30% larger than in 2006.[69]

As highlighted by the FCA's consumer research undertaken as part of this market study (published alongside this report) and recent analysis by the Institute for Fiscal Studies (IFS), the current generation of retirees usually do not rely solely on DC arrangements for income.[70] They are also more likely than future cohorts to have some secure inflation-proofed income from DB schemes (schemes are required to link pension payments to inflation) and SERPS. It also means that currently pension pot size is not necessarily a good reflection of financial wellbeing in retirement; over four-fifths of current retirees[71] use sources of income beyond their DC pension scheme in retirement.[72]

Looking forward, however, the importance of DC pots in providing an income in retirement is likely to grow and ensuring future cohorts of consumers are well equipped to make an informed decision about what to do with their DC pension pots at retirement will become even more critical.

What we know about consumers of retirement income products

Pension pot sizes

In 2013, 353,000 annuities were sold, two thirds of which were standard annuities. This

67 The Government has been consulting on the possibility of encouraging the development of DA pension schemes, the aim of which would be to create greater certainty for members than is provided by a pure DC pension, but at lower cost volatility for employers than current DB pensions. In particular, it has looked at how CDC schemes might work in the UK. The Government's proposed model for this would have a fixed contribution rate for employers, a target pension income for employees (with provision for this to be adjusted if the scheme is under-funded); and pooling of scheme assets (rather than individual funds for each member), with an income paid from this pool at retirement.
http://www.parliament.uk/business/publications/research/briefing-papers/SN06902/defined-ambition-pension-schemes.

68 Enabling and encouraging saving: the evidence around pension reform and saving
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223061/enabling_and_en`couraging_saving.pdf.

69 FCA calculation based on ABI "quarterly and annual long-term business" data.

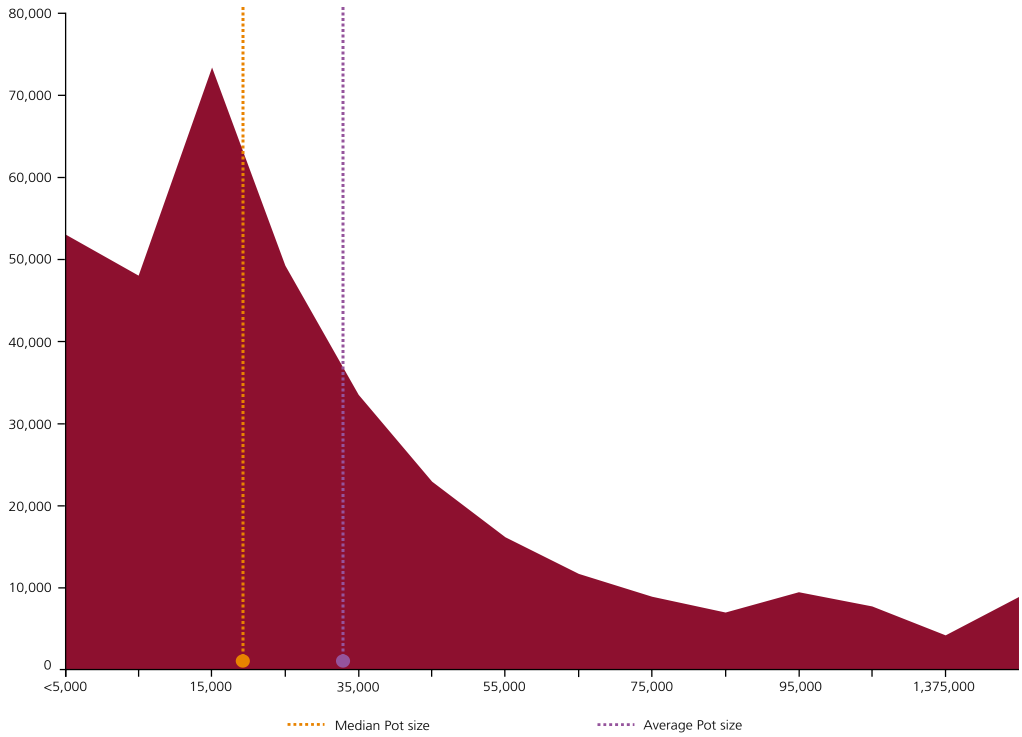
70 Retirement sorted? The adequacy and optimality of wealth among the near-retired IFS Working Paper W14/23
http://www.ifs.org.uk/uploads/publications/wps/WP201423.pdf.

71 Defined as: people over 55 years old who have either started drawing down from/accessing their pension savings or have made a decision to 'defer' i.e. put off accessing such pension savings since March 2014. This includes people who may still be in full-time or part-time employment and plan to make a decision about their pension in the next 12 months.

72 At Retirement Consumer Research – exploring changes in the retirement landscape,
www.fca.org.uk/your-fca/documents/at-retirement-consumer-research-exploring-changes-in-the-retirement-landscape. Please note, in this chapter when referencing our quantitative consumer research where base sizes are low, this is clearly stipulated.

compares to 22,000 new income drawdown contracts over the same period. The average (mean) annuity in 2013 was purchased with a pension pot of £33,670. The median value was less than £20,000, meaning that half of all annuity purchases in 2013 were made with pots of less than £20,000.[73] The average pension pot used for income drawdown purchases in 2013 was almost 2.5 times larger than for annuities, at £80,700.[74] Annuity sales by fund size are given in Figure 18 below.

Figure 18 Annuity sales by fund size, 2013



Source: ABI Quarterly Pension Annuities by age of annuitant and by fund size

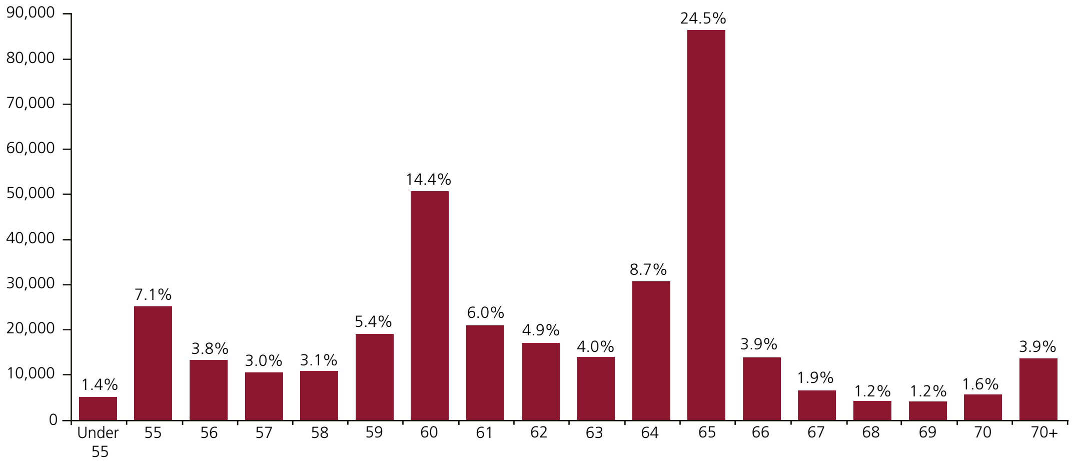
Age of annuitants

ABI data suggests that the most popular age at which to purchase an annuity is 65, but there is also a clear spike in sales at age 60 (see Figure 19). A very small proportion of annuities are currently purchased by individuals over the age of 70. Our qualitative consumer research indicates that consumers tend to view pensions as a product with a 'maturity date', which is normally the selected retirement date (SRD) of the individual recorded by the pension scheme at the time the pension was set up. This date is usually based on the state pension age which might explain the sales peaks seen below. Few consumers in our qualitative research were aware that they could access their DC pot any time from 55 onwards, or indeed that they could choose to leave their pension invested beyond this date.

73 Based on ABI subscription data and publicly available industry data (publicly available industry data can be accessed at https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Pensions/The%20UK%20Annuity%20market%20Facts%20and%20Figures.ashx.

74 Source: ABI/MINTEL – MINTEL Annuities – UK August 2014, page 31. Note, the data does not include income drawdown sales made on platforms. The data may include switches made between drawdown products, which could overstate the average figure.

Figure 19 Annuity sales by age, 2013



Source: ABI Quarterly Pension Annuities by age of annuitant and by fund size

Our qualitative research indicates that the changes announced in the Budget have raised consumers' awareness of their ability to take pension income 'as and when they need it', suggesting that purchasing decisions are much less likely to be the one-off events that they have historically been.

Respondents in our qualitative consumer research described a variety of situations where they may be earning, paying into a pension, deferring decisions on outstanding pots, and taking annuity income all at the same time. Indeed, figures published in the latest Labour Force Survey by the European Commission[75] showed that the average Briton accesses their pension earlier than retirees in most other European countries, and yet a comparatively larger proportion of the population (nearly one fifth) remain in work until age 65 and beyond.[76] Both pieces of research point to a new approach of 'phased retirement' for current and future cohorts of retirees.[77]

Further, life expectancies in the UK are steadily rising and are projected to continue to increase well into the future.[78] A 65 year old male annuitant with a £10,000 pension pot in 2006 could expect to live another 20 years, while the same individual in 2014 could expect to live another 22 years. Women and those with larger pension pots have on average marginally better life expectancies.[79]

75 Labour Force Survey Statistics – transition from work to retirement September 2014 http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Labour_force_survey_statistics_-_transition_from_work_to_retirement

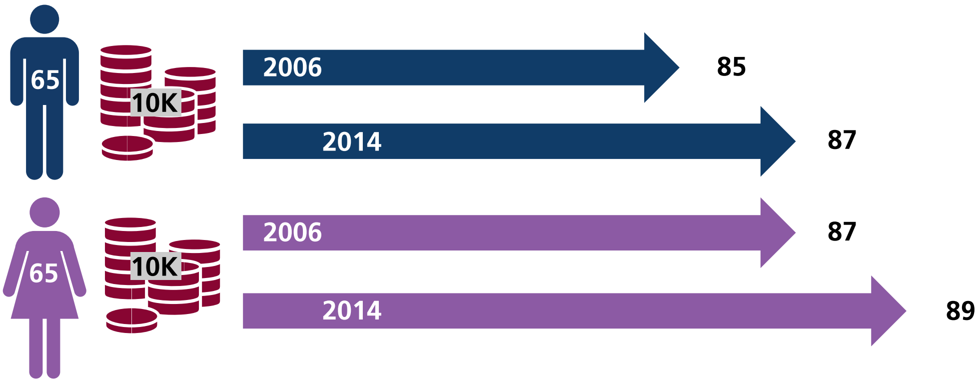
76 Labour Force Survey Statistics – transition from work to retirement September 2014 http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Labour_force_survey_statistics_-_transition_from_work_to_retirement.

77 http://www.ons.gov.uk/ons/guide-method/compendiums/compendium-of-uk-statistics/population-and-migration/index.html

78 ONS Historic and projected mortality data from the Period and Cohort life tables, 2012 http://www.ons.gov.uk/ons/dcp171778_345078.pdf.

79 Occasional Paper No.5 - The value for money of annuities and other retirement income strategies in the UK, www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-5

Figure 20 Life expectancy - 65 year old, £10,000 pension pot in 2006 and 2014



Rising life expectancies mean that higher pension assets will in the future be required to maintain a reasonable standard of living for longer. Further, improved health of those in older age will likely place greater demand on pension assets as retirees enjoy a more active retirement, particularly in earlier years. There was an expectation from the participants in our qualitative research that income needs will drop in later life as their health fails and they become less active, but people in general did not want to think beyond that to consider the costs of long term care. Only one in five respondents in our quantitative research think their income needs in retirement will go up over time.

The trend toward phased retirement, increasing life expectancy, and a greater awareness of more flexible retirement income options means that age profiles of consumers in this market could look very different in the future.

Impediments to a well-functioning market

Consumer engagement and shopping around

Our previous thematic review of annuities raised the concern that too many consumers purchase an annuity from their existing pension provider without considering what would be available to them on the open market (by shopping around). Specifically, 80% of consumers who purchased their annuity from their existing provider could get a better deal in the open market. For enhanced annuities this figure is 91%.[80,81]

As research by the Financial Services Consumer Panel highlighted, there is a broad spectrum of 'shopping around', and the description was found to embrace a wide range of behaviour and outcomes.[82] For some consumers, 'shopping around' involved briefly looking for information about annuity rates in the press or online, but these consumers stopped short of obtaining

80 Financial Conduct Authority, Thematic Review of Annuities, Thematic Review TR14/2, February 2014, http://www.fca.org.uk/news/tr14-02-thematic-review-of-annuities, page 10.

81 In some cases, pension contracts include a provision called a guaranteed annuity rate (GAR). This can significantly increase (and sometimes double) the income the customer receives in retirement for a given pot compared to the current market rate. For these consumers, shopping around is unlikely to lead to a higher retirement income. Some with-profits pensions can apply market value reductions (MVRs). The timing of withdrawal from these pension funds can affect the fund value and ultimately the retirement income generated. The annuity sales practices thematic review sets out some good and poor firm practice with regard to GARs and MVRs. To clarify the information on GARs and MVRs required to be provided by firms, the FCA will make the rule amendments to COBS 19.4.1, as set out in Appendix 1 of our Policy Statement on retirement reforms and the guidance guarantee.

82 The Annuity Purchasing Process http://www.fs-cp.org.uk/publications/pdf/optimisa_annuities_final_20130708.pdf.

actual quotes from alternative providers.[83] Others who 'shopped around' attempted to obtain comparative quotes, or went straight to one alternative provider with a strong brand reputation. We consider shopping around to be defined as set out in Figure 21 below.

Figure 21 Definition of shopping around and switching

Shopping around vs switching

- There is an important difference between shopping around and switching, and shopping around does not necessarily lead to switching.
- Shopping around is usually measured through consumer research whilst switching is a quantitative measure based on actual purchases from a different provider.
- An individual may have switched without shopping around (for example, purchasing from another provider, perhaps as a response to a direct offer financial promotion, which does not constitute, in our view, true shopping around).
- MAS promotes a four-step plan to shopping around for annuities:
  - Step 1 - Decide on type of annuity you want
  - Step 2 - Check what your pension provider is offering
  - Step 3 - Use the MAS annuity comparison table
  - Step 4 - Discuss your findings with a retirement income expert
- The MAS guide is equally applicable to other retirement income products as it is to annuities, though we recognise that Step 3 - the comparison of products - is more difficult for alternatives such as income drawdown where 'products' vary according to much more than just the headline price.
- We expect that an 'expert' source, as described in Step 4 will be easier for consumers to access with the introduction of the pensions guidance service.

Source: FCA's thematic review of annuities 2013 and Money Advice Service website

Our own consumer research revealed that consumers find comparison sites very useful to see best buy rankings, but respondents were aware that there may be some bias in the results.[84] Many were also wary of entering their details into comparison websites to obtain quotes as they were aware from past experiences with motor and home insurance that this could generate sales calls or emails, indeed a couple of respondents reported being 'inundated' as a result. Our quantitative research shows that where consumers used comparison websites, a quarter did not enter their details, and of those that did, around half reported receiving calls, emails or mailings from companies they

83 46% of those who purchased an annuity from their existing provider said they stuck with their existing provider as they offered one of the best rates available, which would suggest they had done some looking around. At Retirement Consumer Research – exploring changes in the retirement landscape, www.fca.org.uk/your-fca/documents/at-retirement-consumer-research-exploring-changes-in-the-retirement-landscape.

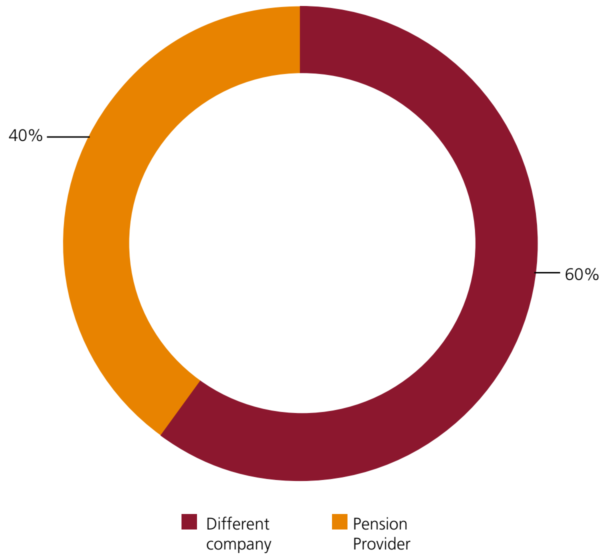
84 12% of the retired used price comparison websites for information, guidance or advice about what to do with their pension pot.

did not recognise.[85] We undertook a thematic review of the use of annuity comparison websites and consequently published guidance in June 2014,[86] setting out our expectations of firms when creating and operating annuity comparison websites (more detail is provided in Chapter 5).

The research commissioned for the market study shows that 60% of consumers who purchased an annuity switched provider.[87] Of the remaining consumers, 80% were aware of their option to shop around but decided not to do so or to actively stay with their provider.[88, 89]

Of the 40% of people who stayed with their provider, one half did not engage in any shopping around. This suggests that some consumers may not know how to shop around in practice, or they may decide to stay with their existing provider out of brand loyalty or trust. Some consumers believe shopping around is not worth it. This is in part driven by the perception that switching will only make a limited difference to their overall income and indicates that consumers may not appreciate the total financial benefits when considered over a lifetime.

Figure 22 Proportion of annuity sales purchased through the internally vesting market (pension provider) and the open market (different company)[90]



Source: Research conducted for the FCA by GFK based on 132 annuity purchasers.

The previous thematic review of annuities estimated the extent to which consumers would be better off purchasing their annuity on the open market and found that failing to purchase the best value annuity can lead to substantial reductions in consumers' income in retirement. This review found that, on average, those who purchase a standard annuity from their existing pension provider could increase their income by £67 per year by purchasing an annuity on the

85 Although we cannot say how positively or otherwise these phone calls were regarded.

86 Finalised guidance 14/6 Annuity comparison websites http://www.fca.org.uk/static/documents/finalised-guidance/fg14-06.pdf.

87 We are aware that other sources of research provide slightly different estimates (including our previous thematic review), with a higher proportion of consumers not shopping around. This difference may be explained by the fact that GfK's research also includes consumers buying annuities through a panel or a tied provider; hence GFK's finding (that 60% of consumers buy an annuity from a different provider) does not necessarily reflect the proportion of people that shop around and switch provider, by our definition.

88 It should be noted that high switching levels are neither a necessary nor a sufficient condition for markets not working well for consumers, especially as consideration needs to be given to consumers who might switch to a poorer deal, the different reasons why consumers might not switch (including whether that involves an active decision to switch or not, following shopping around); and the impact that levels and type of switching have on suppliers offerings

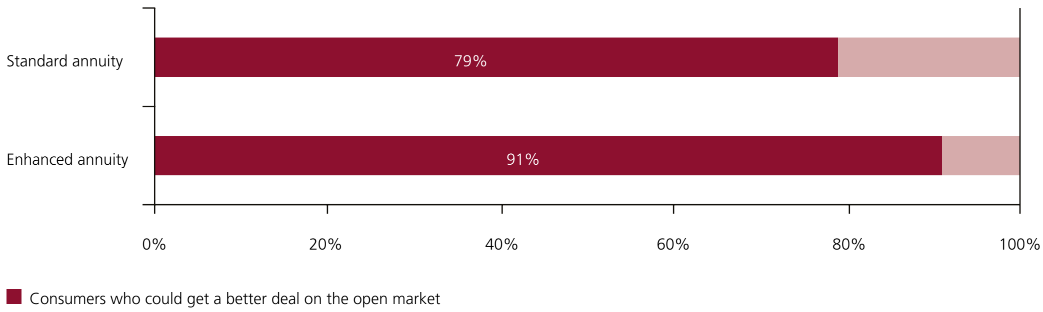
89 Base: 132 annuity purchasers.

90 Propensity to stay with the existing pension provider is even greater for purchases of income drawdown; almost two-thirds of income drawdown contracts in our consumer survey are with a consumer's existing provider. Source: GfK research.

open market.[91] Our previous thematic review into annuities estimated that consumers who would be eligible for an enhanced annuity (either from their pension provider or using the open market), but who purchased a standard annuity from their pension provider would, on average, benefit from shopping around and switching by £110 to £175 annually. However, the true range of additional income to the individual will depend on the nature of the individual's health and lifestyle factors. Our quantitative consumer research has found that almost one half (43%) of people in bad health[92] were not aware that annuity income varies with life expectancy. If firms do not support these consumers to get good outcomes, they could be missing out on a significant income in retirement as a result.

There is also a risk that consumers who save with pension providers who are not active in the open market for decumulation products, may find shopping around more difficult. For these consumers, comparison tables or websites will not display their existing provider's offer, for which they will have to contact the firm directly.

Figure 23 Proportion of consumers who could get a better deal on the open market



Source – The FCA Thematic Review of Annuities

Consumer awareness and confidence

Our quantitative consumer research shows that only 45% of retirees recall receiving information from their existing pension provider about their option to shop around when purchasing a retirement income product. Of those who purchased an annuity with their existing pension provider, one in five said they were unaware of their option to shop around. 40% said that they had always received a good service from their provider and, related to this, 31% said it is important to choose a brand that they trust. 46% of consumers who stayed with their provider said that the annuity offered one of the best rates available, suggesting they had done at least some shopping around.[93]

This research also showed that 23% of those who retired between September 2013 and February 2014 (and 14% of those who retired since March) draw a monthly income from their pension pot but are unsure what income-generating product they bought. There is room for improvement in the level of consumers' awareness and confidence in their at-retirement decision making. The pensions guidance service is likely to play a role in this.

91 The previous thematic review of annuities estimated that each annual cohort of consumers annuitising would need to have saved between £115m to £230m extra into their pensions to make up for the income lost by not shopping around and switching provider, although we recognise this may not be realisable, as changes in switching behaviour may result in changes to the market. FCA, Thematic Review of annuities 2013, http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02.

92 Base: 78 consumers. At a total sample level, 38% of consumes did not know that smokers or those in poor health could get a higher income (base size 1000).

93 Base: 55 consumers.

Barriers to shopping around and switching

Once consumers have identified a provider for their retirement income product, it appears that it is relatively straightforward to purchase the product, even when they are using multiple pots (either individually or consolidated). Consumers that have reached their selected retirement age can easily switch their pension pots to their chosen provider. This process can take some time, typically a few weeks but should not materially affect consumers' decision-making.

Perceived barriers to shopping around facing consumers purchasing retirement income products include:[94]

- difficulty in understanding where to start with the process or how to go about finding out about it (particularly those with limited confidence using the internet)
- a reluctance to commit to the time/effort involved. This is particularly true for consumers whose DC pension pot accounts for a relatively small proportion of their overall retirement income
- unfamiliar terminology puts people off and adds to the complexity of decision making - pensions are described as 'jargon-filled'
- an unwillingness to provide detailed personal information, particularly online where they had not heard of a site or used it before
- trust in 'experts' to do it for them. If employers were involved in the process, consumers typically had more limited knowledge of their options and did not shop around. This is usually because the consumer trusts the person they speak to who they treat as an 'expert' and feel little need to carry out any follow-up research. The same is true for those who delegate their decision to an IFA, and
- major life events which result in an urgent need to turn their pension into income (for example ill health, redundancy). For these consumers, time is the key factor in decision making.

Some consumers make an active decision to stay with their existing pension provider rather than shop around and (potentially) switch. These motivations are often (subtly) different to the barriers to shopping around, and may include:

- loyalty to the existing provider with whom they have saved for many years. Of those choosing to stay with their existing provider, one third of retirees quoted this as a reason for staying put[95]
- a belief that the likely uplift to their annuity would not justify the effort of shopping around; consumers rarely consider the impact on their lifetime income (see the example given below in 'perceived search costs'), and
- value placed on a trusted brand when purchasing a lifetime product.

Perceived shopping around costs

A consumer's decision whether to stay with their existing provider or to switch to an alternative provider for their decumulation product will depend on the actual and perceived costs and

94 Evidence from FSCP consumer research and FCA consumer research.

95 Base: all retired who took out an annuity (132), all retired who took an annuity with existing provider (55). At Retirement Consumer Research – exploring changes in the retirement landscape, www.fca.org.uk/your-fca/documents/at-retirement-consumer-research-exploring-changes-in-the-retirement-landscape

benefits of switching. Consumers that purchase from their existing provider will face few switching and search costs. Indeed, our market study has found evidence of a firm emphasising the simplicity of buying their own product in the information they send to internally vesting customers, suggesting there is no need for them to look any further. Meanwhile, consumers receive little information on the alternatives, except that they do have the option to switch to other providers through the open market option.

Consumers who do little or no shopping around may be acting reasonably if they do not believe that they can make better choices on the open market or if the costs involved do not outweigh the benefits of any additional income. However consumers may not have a good perception of these costs or of their own capacity to assess benefits. Often consumers have only considered the impact shopping around has on income in the short term and not over their lifetime. If consumers are presented with a saving of £1.28 per week, they may not feel that it is worth shopping around and switching for. However, that £1.28 amounts to £67 a year which, for the average annuitant means around £1,500 over their lifetime. Different messaging around the lifetime value of the extra pounds a week may help people to understand the opportunity cost of staying with their own provider and help to put search costs in context (see Occasional Paper No.5 – The value for money of annuities and other retirement income strategies in the UK).

Even for those consumers who are aware of their option to 'shop around' for a retirement income product, how to do this in practice may not be clear. To search effectively consumers need to approach both brokers and providers directly. Many brokers do not make it clear to consumers which companies they have arrangements with and therefore provide quotes for.

This complicates the searching process and increases the cost of finding the best rate. These features of the market and consumers' lack of confidence in shopping around will increase the perceived costs of making mistakes and choosing the wrong product increasing the likelihood of defaulting to their existing provider. Almost one quarter of consumers in our survey who said they keep putting off retirement planning do so because it is complex, and 21% do so through fear of making the wrong decision.

Product choice

Consumers do not always make choices in a rational way based on all the available information.[96] Factors such as complexity often lead consumers to make intuitive decisions rather than deliberative ones.

There are a number of factors which might explain the prominence of certain behaviours (or 'biases') in the market for retirement income products, including:

- the complexity of the retirement income decision,
- the one-off nature of the decision (at least historically) which does not allow for learning from past mistakes,[97] and
- a pertinent trade-off between present and future.

Annuities, which have historically been the default option for UK retirees who wish to generate an income from their DC pension pot, provide a guaranteed income for life. Annuities act as a commitment device for consumers, preventing over- or under-spending of retirement savings.

96 Please refer to our Occasional Paper No.1, 'Applying behavioural economics at the Financial Conduct Authority' for fuller explanations of the terms and economic concepts used in this chapter. http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-1.pdf.

97 Though this may be possible for consumers with multiple pension pots.

We expect to see more people entering into arrangements which provide greater flexibility in the future (such as income drawdown) and the risks arising from behaviours such as present bias, overconfidence and loss aversion, are potentially great absent a robust guidance offering by Government and appropriate communication from industry.

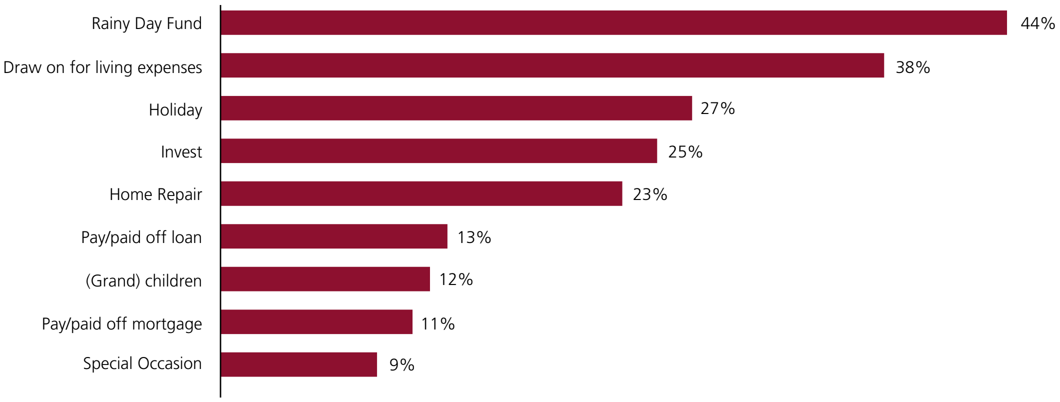
Firms play a crucial role in shaping consumer choices and in doing so take into consideration their understanding of consumer behaviour. Firms might exploit consumer biases, designing products and services that benefit from consumers not overcoming mistakes, or they may actively use insights about individuals' behaviour to help consumers to engage with financial services and make better choices by designing products that are easier to relate to.

Present bias

When it comes to making a decision about what to do with their accumulated DC pension savings, most people choose to take their full 25% tax-free lump sum entitlement. The preference for tax free cash might be explained by heavy discounting of future incomes and a lack of consideration of the impact on future consumption capability (or, present bias).

However, empirical evidence suggests that motivations for taking cash lump sums may be more rational and less driven by consumers' short-sightedness than theory might imply. The top two uses for cash lump sums reported by consumers in our quantitative survey are 'saving for a rainy day' and 'drawing on for living expenses' (chosen by 44% and 38% of consumers respectively). Experiences of other countries where consumers are allowed to withdraw cash lump sums show that the money is often used to repay debt or for home improvements (as in Australia), whilst tax incentives likely explain the popularity of cash sums in Ireland (and the UK).

Figure 24 Nominated expenditure from a lump sum



Source: Research conducted for the FCA by GfK, based on 498 consumers who have or will take a lump sum.

Having made their choice of whether to take tax-free cash, consumers must select their preferred vehicle to deliver an income in retirement. This choice is likely to be affected by present bias; consumers must assess the trade-offs associated with the different options available to them. For consumers purchasing annuities, these trade-offs have typically included accepting:

- a lower initial payment for an annuity which protects against increases in the overall level of prices (inflation),
- a lower monthly payment for a joint-life annuity for insurance against the death of one spouse, and
- a lower monthly payment for an annuity which is guaranteed (pays out with certainty) for a set period of time.

Our qualitative consumer research shows that although there is a high awareness of the risk that inflation can *'eat away'* at income, the majority of retirees are unwilling to pay the price today (in the form of lower initial payments) to inflation proof their income for tomorrow. When asked to estimate what impact this would have on initial income from an annuity purchased with a £100,000 pot, consumers heavily under-estimate the costs involved, or even think that the initial payment will be higher than the income that would be generated through purchasing a level annuity. Joint-life contracts and guarantee periods work in a very similar way; when faced with the trade-off above, a preference or need for more money today prevails.

Overconfidence

Overconfidence is observed in consumers of retirement income products; consumers tend to be overconfident that their income will cover them in retirement. This stems from consumers underestimating longevity, as we found in our qualitative consumer research. Despite consumers reporting in our survey that they take into account a broad range of factors when making a decision about their retirement income[98] (including income required and longevity) they are likely to over-estimate how many people will on average die between 65 and 70, and under-estimate how many will live beyond 80 on average.[99] For example, consumers estimated that 50% of the individuals who retire at 65 in good health will live to 80. In reality, data shows that 80% of men and 85% of women retiring at 65 in good health will reach the age of 80.[100]

Loss aversion

Insights from studies of consumer behaviour tell us that people strongly prefer avoiding losses to acquiring gains: the fear of losing something in one's possession is much greater than the gain felt by acquiring something new.

Cannon and Tonks[101] speculate that individuals may be loss averse when the relevant 'reference point' is their lump sum pension pot (as with an annuity purchase). The choice presented to consumers at retirement which compares a (relatively large) lump sum with a future income stream extending for an uncertain time is a very hard one for consumers to contemplate fairly. A key motivation coming out of our qualitative research for consumers coming up to retirement choosing drawdown over annuities is the fear of dying early (which is linked to overconfidence bias, above) and losing their pension pot to the provider.

Framing effects

All of us are susceptible to the way that information is presented. Depending on the way information is presented by providers, consumers assessing their retirement income options may make different decisions, even though the underlying choice remains the same.

Presenting annuities and other drawdown strategies in different frames can significantly alter an individual's relative preferences for these products. In the annex to this report we discuss the findings of a quantitative experiment commissioned by the FCA involving 900 UK consumers (aged 55-75). The study found that, faced with a choice between the annuity and alternative strategies,[102] consumers prefer the annuity under the consumption frame, while they prefer the alternative product under the investment frame.[103] The reason for this is that under the investment

98 At Retirement Consumer Research – exploring changes in the retirement landscape, www.fca.org.uk/your-fca/documents/at-retirement-consumer-research-exploring-changes-in-the-retirement-landscape

99 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape: www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape

100 In their report, "Expectations and experience of retirement in Defined Contribution pensions: a study of older people in England" the IFS found that men aged 50-60 underestimate their life expectancy on average by around two years, and women by four years. http://www.ifs.org.uk/comms/r73.pdf.

101 http://www.bristol.ac.uk/cmpo/publications/other/annuitypricing.pdf

102 Including simple drawdown from a savings account.

103 Examples of the two frames can be found in chapter 7.

frame, the annuity is viewed as a poor investment choice: the potential losses are more important than the potential gains from the annuity. That is, the income gained from living a long time does not outweigh the risk of getting nothing back, should the consumer die tomorrow (related to loss aversion discussed above). Meanwhile under the consumption frame, consumers are focussed on the insurance element of the annuity product in protecting them against running out of funds through living a long time, rather than the intermediate investment return. Consumers therefore appreciate the feature of a guaranteed income for life under the consumption frame. Further, just introducing the term 'annuity' changes the choices consumers make and significantly reduces the proportion of consumers opting for an annuity,[104] meaning that the bad reputation associated to annuities is likely to heavily affect the consumers' choice.

The future of the retirement income market

Under the proposed new legislation (detailed in Chapter 3 of this report), from April 2015 consumers will have much more freedom when it comes to making their retirement income decision. The changes announced resonate well with consumers who have lost faith in financial providers, believe that annuities offer poor value for money, and want to have more control over their money.[105]

As discussed in the previous section of this chapter, the trend toward phased retirement is likely to continue to gain momentum. While triggers for people to start thinking about their pension have typically included paying off their mortgage or their partner retiring,[106] decisions are less likely to be one-off and driven by specific events in the future, particularly with the introduction of UFPLS (see Chapter 3) and other flexible options which require little or no action on behalf of the consumer to begin taking pension benefits.

There has already been a significant shift in behaviour since the Budget. Consumers who do not need an immediate stream of income have chosen to take a cash lump sum (up to the 25% tax-free allowance) and defer the rest rather than purchase a lifetime annuity.[107] There is no reason to suggest that consumers' treatment of the tax-free cash allowance will change post-April 2015; consumers are likely to continue to compartmentalise this money and remove it from considerations about the remainder of their pension pot. Decisions about the remaining pension pot will become much more complex and many consumers, aware that there will be a plethora of options available, are unsure exactly what they will do.[108] Consumers will be encouraged to take guidance before they access any of their pension pot, and it is intended that the guidance experience will aid consumers to take decisions in the context of their total pension wealth, including the tax-free cash lump sum.

Consumers in our research show a tendency to move away from annuity purchases in the future, preferring some form of flexible drawdown option (38% of people retiring within the next five years stated that they will choose income drawdown compared with just 15% of those who retired within the last year).[109] Our qualitative research suggests that this trend seems to be driven by an inherent dislike for annuities. Mintel's prediction is for a fall of around 50% in the value of the annuities market in 2014, followed by a slow return to growth over the next five years.[110]

104 Introducing the term annuity reduced consumers' preference for the annuity compared with the alternative income strategy by 16 percentage points.

105 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape

106 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape

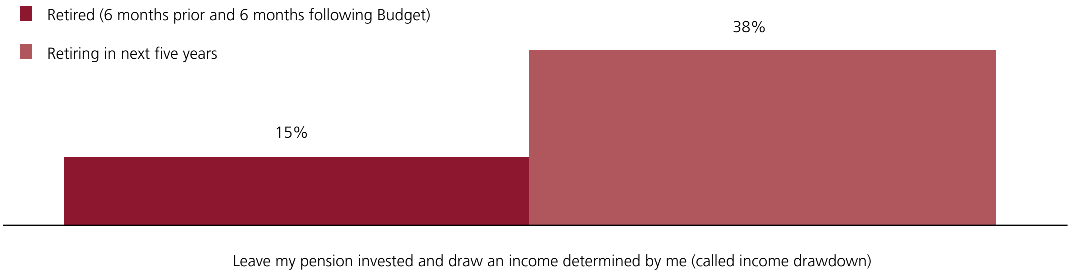
107 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape

108 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape

109 At Retirement Consumer Research – exploring changes in the retirement landscape, www.fca.org.uk/your-fca/documents/at-retirement-consumer-research-exploring-changes-in-the-retirement-landscape

110 Source: ABI/MINTEL – MINTEL Annuities-UK, August 2014, page 8.

Figure 25 Take up of income drawdown as projected by consumers



Source: Research conducted by GfK on behalf of FCA, based on 318 retired and 682 pre-retired consumers with DC pensions.

Consumers opting for flexible drawdown say that they plan to draw down their money in stages, or leave it invested until they need it (which may come later than typical annuity purchases today as the trend to phased retirement strengthens).[111] There is little evidence to suggest that consumers will take out their entire pension pot and spend it; respondents generally feel that they will act responsibly with their pension for which they have saved for many years. This has broadly been the experience of other countries (see Chapter 7 for more details of our international research).[112]

The main reasons provided for wanting some form of flexible drawdown are a:

- dislike of losing their pot on death and the inflexibility of annuities,
- desire to adapt to changing circumstances,
- desire to have more control over their money, and
- mistrust of providers.

Recent Ipsos MORI research showed that 23% of consumers with a DC pension do not know how much their pot is worth.[113] Consumers who need to make a decision regarding their DC pension pot in the new, post-April 2015, landscape are likely to require more support in their retirement income journey than is currently available. The lack of effective shopping around (as described earlier in this chapter) is likely to remain a problem in the future; this may be exacerbated by a combination of behavioural responses to a more complex market, and firms' activities aimed at retaining customers.

The Government's guidance guarantee will have an important role to play in presenting information and options to consumers clearly, to help them navigate their retirement choices.[114] Around one half of consumers coming up to retirement are aware of the guidance guarantee,

111 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape

112 The retirement income market (Comparative international research), www.fca.org.uk/your-fca/documents/the-retirement-income-market

113 Ipsos MORI research on behalf of Hargreaves Lansdown, available at https://www.ipsos-mori.com/Assets/Docs/Polls/omnibus-hargreaves-lansdown-pensions-2014-tables.pdf . GfK research published alongside this report finds a lower proportion of respondents that are not able to work out their pot size. This might be due to both the framing of the questions (GfK gave respondents six different pot bands to choose from, while Ipsos MORI only three bands), and the the sample selection criteria. Indeed, all participants to the GfK survey hold a DC pot (this was one of the screening criteria), while the Ipsos sample is all adults aged 45-65 in the UK. Therefore, respondents with very small pots, and also those who do not know their pot size, may have screened themselves out of the GfK survey because that pot was not at the top of their mind.

114 In addition to the pensions guidance service, DWP has launched a set of initiatives to raise consumer awareness of pensions reforms due to come out in April 2015. The initiatives will include: a major advertising campaign, themed 'Your Pension, Your Future'; a YouTube channel; and a radio soapbox tour. This is likely to increase consumer engagement during the consumer journey, and may also have an impact on consumers' propensity to shop around.

and views of it are largely positive. TPAS and CAB have been announced as designated guidance providers of the guidance guarantee.[115] Further, firms are likely to develop tools to help consumers to navigate their options. While we welcome these, we recognise the risk that the problem of consumer inertia may get worse if proper steps are not taken to address this.

Potential risks to consumers in the future landscape

The FCA is alert to the risks posed by firms' involvement in promoting to consumers the opportunity to transfer their pensions to get 'better returns'. Many of the firms involved are unauthorised and are operating illegally. These firms typically seek to attract consumers by offering a 'free pension review', which suggests to consumers they will get free professional advice. In reality, professional advice on pensions is not free.

The outcomes of these 'reviews' tend to range from very poor advice to fraud, typically involving consumers being encouraged to move their existing pension savings into high risk unregulated investments, often based overseas. Even where the investments are not outright scams, they tend to be speculative, illiquid, niche schemes that are unsuitable for the investment of pension savings.

To address these issues, we are working with TPR and others on a multi-agency initiative looking at aspects of pension liberation and scams.[116] Where we find firms have breached Financial Services and Markets Act 2000 (FSMA) rules and/or have acted fraudulently we will take appropriate action including working with the relevant authorities, where required. As stated in our Policy Statement,[117] we will be alert to scams in the new pensions and retirement income market, building on the focus we already have on pensions liberation and associated investment scams.

In addition to these initiatives the FCA has issued consumer alerts, adviser alerts and industry guidance.

In January 2013,[118] we issued an adviser alert outlining our concerns that consumers were being encouraged to transfer their pension savings from work and personal pension schemes into self-invested personal pensions (SIPPs), with a view to investing in unregulated products or high risk investments.

The FCA had identified business models whereby advisers were restricting their advice to the suitability of the SIPP wrapper which would hold the underlying investment rather than advising on the suitability of the underlying investment itself.

Furthermore these business models tended to concentrate specifically on the switching of mainstream regulated funds into SIPPs with underlying unregulated high risk assets, whilst giving little or no consideration to other possible pension planning arrangements. Similarly there was frequently little consideration given to consumers' needs and personal circumstances.

Our supervisory work identified serious and ongoing failings by firms operating this business model, which placed a substantial number of consumers at risk from scams and pensions fraud. In April of this year[119] we issued a further alert to advisers outlining our findings and stating that firms who did not provide advice on the underlying investment or on the transfer to a SIPP or SSAS (small self-administered scheme) fell short of their obligations under the FCA's Principles for Business and Conduct of Business Rules.

115 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/366791/pension-schemes-bill-2014-to-2015-new_flexibilities.pdf

116 http://www.pensionsadvisoryservice.org.uk/publications-files/uploads/pension-scam-booklet_7_page.pdf

117 http://www.fca.org.uk/static/documents/policy-statements/ps14-17.pdf

118 FCA alert to advisers re. SIPPs, January 2013: https://www.fca.org.uk/static/documents/alert-pension-transfers.pdf

119 FCA adviser alert, 28 April 2014: http://www.fca.org.uk/news/sipps-further-alert

At the same time, we issued an alert to consumers warning of the risks of accepting 'free' pension reviews and moving their pension savings into unregulated investments.[120] In August 2014, we updated this alert and produced a factsheet[121] for advisers and pension product providers to issue to consumers if they felt they were at risk. In October 2014, the FCA launched a national consumer awareness campaign 'ScamSmart' informing people about investment scams, the types of tactics used by fraudsters and tips on how to avoid scams.[122]

Alongside this, we published our concerns that people are being encouraged to use their work pension to buy shares in Emmit Plc via a SIPP, risking significant financial loss. The scheme targets inexperienced investors who may not understand fully the implications of the scheme or the tax implications.[123]

The FCA's supervisory and enforcement work in this area is continuing. We consider these issues present potential risks to consumers who will be faced with greater choices in how they hold their pensions and in their ability to withdraw their pension savings from 1 April 2015.

120 FCA consumer alert: Protect Your Pension Pot, 28 April 2014: http://www.fca.org.uk/consumers/financial-services-products/pensions/protect

121 FCA factsheet/alert, 26 August 2014: http://www.fca.org.uk/your-fca/documents/protect-your-pension-pot

122 http://scamsmart.fca.org.uk/

123 FCA Press Release, 31 October 2014: http://www.fca.org.uk/news/statement-re-promotion-of-shares-in-emmit-plc

5.
The supply and distribution of retirement income products

This chapter sets out our analysis of the supply and distribution of retirement income products. It focuses on those characteristics of the supply side that can have the potential to prevent or distort competition in this market.

Distribution arrangements
We reviewed a range of distribution arrangements and strategies for annuities, in particular tied or panel arrangements between providers, and marketing arrangements between providers and intermediaries. We do not have competition concerns with the majority of these, however, there are some specific arrangements that we want to understand better. To date, income drawdown plans have almost entirely been sold to consumers following advice. In the new landscape, drawdown products are expected to be directed at mass-market consumers on a predominantly execution only basis through direct to consumer distribution channels.

Advice
Barriers to take-up and development of services involving a personal recommendation exist in the retirement income market. On the demand side, these include the perceived or real costs of advice and on the supply side, a lack of clarity by firms of the boundary between sales involving personal recommendations and those that do not.

Retail investment advice will need to evolve to support the new retirement income landscape. Good quality retail investment advice with a personal recommendation need not necessarily involve full advice - it can also be delivered through more cost effective means, such as simplified or focused advice models. We have made it clear that the regulatory framework permits firms to develop such models in our guidance consultation on retail investment advice.[124]

124 GC14/3 Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development http://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf.

Barriers to entry
The annuities sector has seen limited new entry in recent years.[125] The most significant factor contributing to the lack of new entry appears to be gaining access to the customers of incumbent pension providers. We have considered the impact of regulatory barriers (specifically, capital requirements) but consider these as having minimal impact at this time. We will keep this under review.

Adverse selection
Economic literature suggests that a system in which annuities are purchased on a voluntary basis (as will be the case in the new landscape) could lead to selection problems, where only the healthiest people purchase annuities. However, we have seen limited empirical evidence, including from overseas, to suggest that this is a significant problem in practice. The move toward fully underwritten annuities is also likely to address any imbalance of information between consumers and firms.

Distribution arrangements

Arrangements in the annuities sector
We discussed general supply side features of the retirement income market in chapter 3, where we present information on the value chain and the providers, distributors and reinsurers operating in the market. In this chapter we focus our attention on arrangements we identified that could potentially cause or contribute to poor competition outcomes in the retirement income market.

The market for annuities is characterised by a number of different types of distribution arrangements, including:

- preferred provider agreements (or referral arrangements)
- restricted panel arrangements, and
- vertical distribution agreements.

Preferred provider/referral arrangements
A preferred provider arrangement, as shown in Figure 26 below, is an arrangement between a pension provider (product provider A, in the figure below) and an annuity provider (product provider B below) where provider B has an agreement to provide annuities for all or a subset of provider A's existing pension customers. Such an arrangement might exist where the pension provider does not offer a decumulation product, or does not offer a particular type of annuity, such as enhanced annuities. The pension provider referring the consumer will typically receive a commission from the provider offering the (alternative) decumulation product if a sale is generated as a result of the arrangement.

In some cases, these referral arrangements will be on a single tie basis, that is, the referral agreement is exclusive. The exclusivity of these arrangements does not affect the consumer's ability to shop around on the open market outside of the arrangement. The exclusivity of these arrangements may consist of:

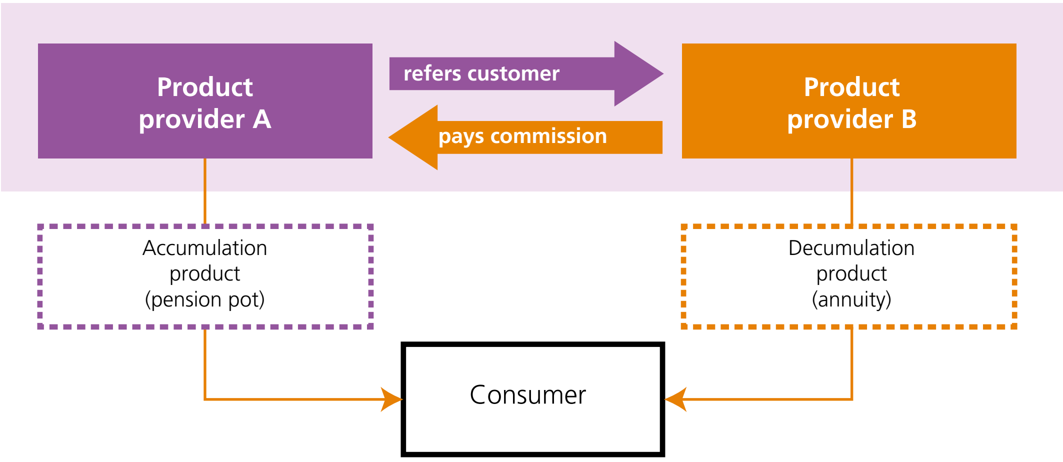
125 See Chapter 3 of this report.

- an agreement by provider A (the accumulation provider) not to refer its customers to any provider other than provider B for an annuity, and/or

- an agreement by provider B (the product provider) not to enter into an (tied) arrangement with any other provider (in addition to provider A).

Although both types of agreement are possible (and both may apply at the same time), the first appears, from the evidence collected, more common in the retirement income market.

Figure 26 Illustration of referral arrangements



We reviewed a number of these referral arrangements as part of our assessment of competitive conditions in the current landscape (see Chapter 2 for details on the scope of our study). In general, these types of arrangements could give rise to the following concerns.

- They can raise barriers to entry to the annuities market by anti-competitively foreclosing access to customers for those firms who compete (only) on the open market – the degree of market foreclosure will be more significant if annuity providers with sizeable market presence have a network of exclusive long-term distribution agreements with decumulation providers.

- They might also facilitate collusion, particularly when they require frequent interactions at different levels between firms. This may lead to the exchange of commercially sensitive information which may be carried out without appropriate safeguards or may not be essential for the fulfilment of parties' obligations under the agreements.

- From a consumer perspective, these arrangements potentially discourage consumers from shopping around to maximise the value for money of their annuity purchase on the open market. This can be particularly concerning in a market with a high degree of consumer inertia such as this one and where, as uncovered by our thematic review (published alongside this report), some customers are not made aware of the open market option. If, in the absence of a referral arrangement, a significant number of consumers would likely have considered the open market, that could raise concerns.

However, in some situations these arrangements may create potential benefits for consumers, particularly for consumers who do not shop around.

Our consumer research (see Chapter 4) identified that a significant percentage of consumers reaching retirement do not shop around on the open market and do not choose the most competitive product available to them. Our previous thematic review of annuities and our money's worth analysis have also identified that annuity rates from existing providers are usually lower than on the open market.

However, some of the referral arrangements we have seen make provision for the rate offered to the consumer to be benchmarked against open market rates. Therefore, consumers buying annuities through these arrangements who otherwise would have chosen their existing provider's product may obtain a better rate or a product that better meets their needs. In these circumstances, those aspects of the arrangements which lead to consumers getting a better rate or more suitable product could be beneficial.

Restricted panel arrangements

These arrangements typically involve one pension provider selecting a number of annuity providers to offer quotes to their pension customers. They are widely used by providers in the market for retirement income products more generally.

Restricted panel arrangements offer consumers the opportunity to compare the products and prices of a selection of retirement income providers' annuity products. The market coverage of restricted panels varies from panel to panel, meaning the customer choosing from a panel may buy an annuity from a portion of the open market but not the full open market.

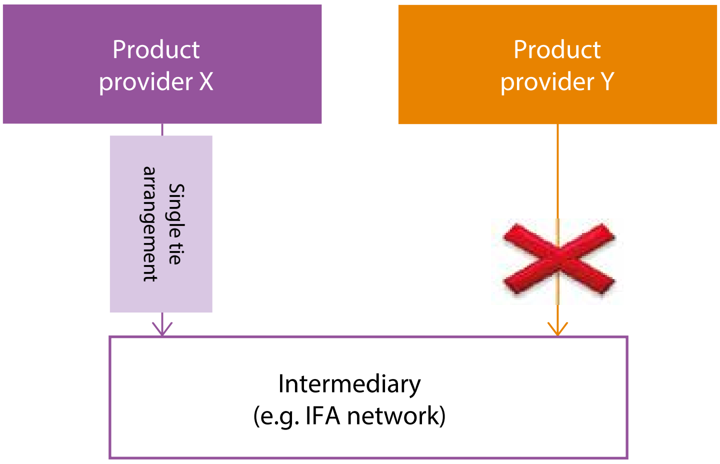
Although restricted panel arrangements give the consumer more choice than is available through a tied arrangement, we have some concerns about the coverage and transparency of such arrangements. It may not always be clear to consumers that the range of providers or products being presented to them through the panel arrangement is restricted, or what this means in terms of the market coverage of the panel. This was also reflected in the findings of the thematic review of annuity sales practices, which found examples where disclosure was not sufficiently clear to consumers that the panel service provides access to a restricted portion of the open market and that the consumer may still receive a higher income in retirement from shopping around on the full open market outside of the panel arrangement.

It has been suggested to us by one industry stakeholder that the FCA should prohibit the use of referral arrangements and panels, and require firms who cannot service their customers' needs to direct those customers to the whole of the open market. We do not consider this to be a proportionate action at this time because, although these arrangements have the potential to hinder competition, the extent to which this is the case will depend on a number of factors (e.g. type of the agreement, market structure, and the share of the parties). On balance, we consider that the impact of these arrangements on competition in this market is limited. Moreover, we would need to balance this against any efficiencies and whether these are passed on to consumers (and whether they can only be achieved in this manner).

Vertical distribution arrangements

Product providers and intermediaries use vertical distribution arrangements widely to market annuities. Some of these agreements may include an exclusivity clause, preventing the intermediary from marketing other providers' products. The operation of these arrangements is illustrated in Figure 27 below.

Figure 27 Illustration of exclusive vertical arrangements



Vertical agreements (agreements between firms at different levels of the supply chain) are often used by firms across the UK economy to achieve efficiencies in the supply chain (for example in respect of production, distribution, service and marketing), without incurring the costs of vertical integration.

Given the potential efficiency gains, competition law is generally more concerned with vertical agreements that restrict competition where the parties have significant market power and the restrictions of competition result in outcomes such as market-partitioning, resale price maintenance and foreclosure of the market to competitors.

We have not reviewed specific vertical exclusive agreements as part of this market study. However, we have reviewed firm business strategy documents, and whilst these do not generally raise competition concerns, we will need to consider in more detail the impact on competition of those arrangements that appear to operate in a similar way to single branding agreements.[126]

Conclusion on arrangements to market annuities

There are a number of distribution arrangements in place in this market and all firms using them should ensure that they comply with competition law. Whether a particular distribution arrangement breaches competition law will depend on its impact on competition.

We have reviewed a range of distribution arrangements and have no competition concerns with the majority of these. However, there are some specific arrangements that we want to understand better and we will be engaging with the relevant firms in due course to obtain further information in parallel with the consultation on our proposed market study remedies.

Arrangements to market income drawdown

In contrast to annuities, the majority of income drawdown plans are sold externally, with approximately one-third of sales made with the existing pension provider.[127] To date, income drawdown plans have almost entirely been sold to consumers with advice. In 2013, 97.4% of new income drawdown plans were sold through independent or restricted advice services.

126 In general terms, single branding agreements can give rise to competition concerns in a number of ways, such as: foreclosing the market to competing and potential suppliers, facilitating collusion, and reducing inter-brand competition

127 Source: ABI/MINTEL – MINTEL Annuities-UK, August 2014, page 31.

The importance of independent and restricted advice in the distribution of income drawdown is likely to have been influenced by the type of consumer purchasing income drawdown. Typically, these will have been consumers with significant pension pots to invest who were more able to afford the cost of using an independent financial advisor. Providers would typically set a minimum pot size in order to qualify for income drawdown, meaning that income drawdown was not always an option for the 'average' consumer who has a pension pot of around £34,000 (as shown in Chapter 4 of this report).

In order to obtain financial advice, consumers must pay a fixed fee. In addition to the one-off fee for advice, providers of income drawdown typically charge a fixed annual management charge (AMC) for managing the funds and there may be additional administration charges.

As set out in chapter 8, we expect the distribution arrangements for drawdown to evolve significantly in the new landscape with the development of more direct to consumer business models with a significant digital/online element. Given the complexity and choice of products we anticipate being developed, consumers are likely to find comparison of products more difficult and will need adequate and appropriate support through the retirement journey. Complex or opaque charging structures would also make comparisons harder and weaken competitive pressure on value.

The advice market

As discussed in Chapter 3 providers of retirement income products offer their products with different levels of retail investment advice. Though not all firms will offer each service, the services available are set out in Figure 12 in Chapter 3 of this report.

Developments in the advice market

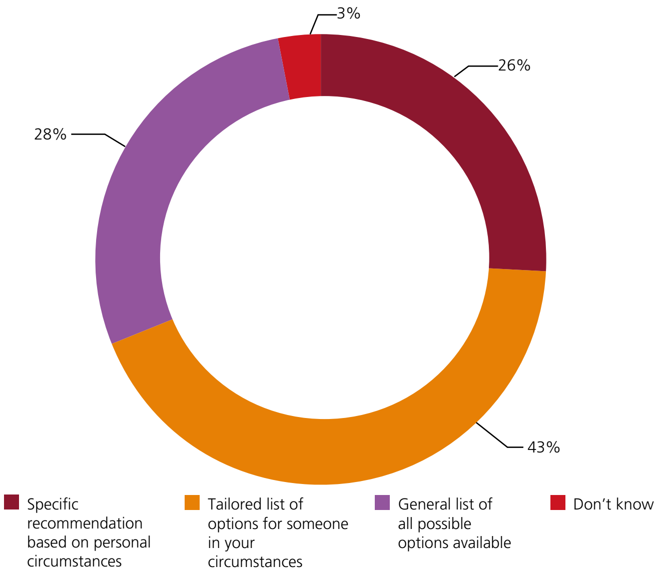
Although consumers will be entitled to a pensions guidance service conversation before they take benefits from their pension from April next year, we expect many firms to develop their own support services. In November, our Policy Statement on the guidance guarantee made it clear that any behaviour by firms to undermine the pension guidance service would be considered to be likely to contravene the client's best interests rule under COBS 2.1 and Principle 6, treating customers fairly.[128]

As illustrated by consumer research published by the CII in October 2014 (see Figure 28) 69% of the consumers sampled expect the pensions guidance service to provide either a specific recommendation based on personal circumstances, or a tailored list of options based on the individual's circumstances. This is indicative of a demand for services above and beyond that which the pensions guidance will provide.[129]

128 See Policy Statement http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-17.

129 The Government has said that the guidance service is intended to be critical first step for consumers considering their retirement options, and will equip them with the information they need to go on and seek regulated financial advice where appropriate.

Figure 28 Consumer expectations of the pensions guidance[130]



Source: CII research, 2014

Despite the apparent consumer need for services that appear more likely to involve a personal recommendation (at least 26%), it appears that barriers to take-up exist. These are set out below and will need to be considered by firms developing retail investment advice models in the future.

- **The costs (real and perceived) associated with services which provide a personal recommendation.**

Our consumer research has shown that consumers want access to good quality advice, but consider the costs of full advice[131] to be prohibitive when they were informed that this could amount to approximately £1000.[132] However, we also note that in certain circumstances, the costs of purchasing a product on an execution only basis could potentially be equivalent to purchasing through a full advice service where an annuity rate that firms offer on an execution only basis is lower (because it incorporates the broker commission). According to research by the Financial Services Consumer Panel[133] and evidence that we have seen during the course of our study, commission rates for a standard annuity are 1-1.5% and 2.5-3% for enhanced annuities. For the average size of pot used to purchase an annuity (around £34,000) this is equivalent to £330 -£990. This is on the assumption that the annuity rate offered on an execution only basis incorporates the broker commission. However, consumers using such services should be aware of the specific costs involved, as firms are already required to provide this information under existing COBS rules.[134]

130 In response to the question "Which of the following would you need the guidance to provide in order for it to be of value to you?" Page 12, Guaranteed Guidance for retirement: What consumers want http://www.cii.co.uk/media/5638950/cii_what_consumers_want_gg_web_7oct2014.pdf.

131 References in the remainder of this chapter to full advice, simplified advice and focused advice should be read as sales involving a personal recommendation. Similarly execution-only should be read as sales without a personal recommendation. Both are defined in Figure 12.

132 Exploring Consumer Decision Making and Behaviour in the At-Retirement Landscape, www.fca.org.uk/your-fca/documents/exploring-consumer-decision-making-and-behaviour-in-the-at-retirement-landscape. Also see chapter 5 of this report.

133 See http://www.fs-cp.org.uk/newsroom/2013/244.shtml.

134 Specifically, COBS 2.2.1R(1), which relates to information disclosure before providing services; and COBS 4.2.1R and 4.5.2R, which obliges firms to ensure the information they provide is fair, clear and not misleading, accurate, balanced and sufficient.

We recognise that full advice may not be affordable or justified for certain consumers, particularly those with small pots. However, good quality retail investment advice need not necessarily involve full advice, and can be delivered to certain consumers through more cost effective means, such as simplified advice. There are benefits to well-designed, lower cost methods of meeting customers' straightforward needs. During the course of our call for evidence, one stakeholder suggested that there was scope to provide a simplified advice service for around £500.

- **Firms' lack of clarity on the boundary between services that involve giving a personal recommendation and those that do not.**

Our boundary consultation paper *Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development,*[135] highlighted that the uncertainty for industry on the boundary between sales involving personal recommendations and those that do not was having a significant influence on the design of some firms' customer interfaces. The paper made clear that we want firms to understand the options for them that sit between execution-only and full advice and our regulatory framework supports the provision of these services. Our work in this area has sought to help firms understand the regulatory requirements in order to allow them to develop different delivery mechanisms for a broad range of consumers. The finalised guidance will be published next year.

The role of introducers

Introducers are an important part of the retirement income market, acting as intermediaries between consumers and providers.[136] Price comparison websites are a common example of introducers and are generally regarded as helping to provide choice for consumers by enabling them to compare products in a simple and accessible way.

Price comparison websites were perceived by consumers in our qualitative consumer research to be very useful, empowering them to take the next step (be that talking to a provider or looking for an IFA). However, respondents to our research were also often reluctant to enter their personal details into these sites for fear of being 'bombarded' with sales calls, referencing their experiences purchasing general insurance products. This concern has also been raised by the Financial Services Consumer Panel (FSCP),[137] who carried out their own research in 2013 and found cases of consumers being 'hassled' and 'bombarded' with calls as a result of entering their details onto annuity comparison sites.[138]

Our thematic review of the use of annuity comparison websites considered whether the information on these websites was fair, clear and not misleading, as required by COBS 4.2.1R and supporting rules and guidance in COBS 4, as well as in line with Principle 7 of our Principles for Businesses. This review identified risks that annuity comparison websites may not provide appropriate information to allow consumers to make informed decisions, and to make clear their role and the nature of the service they provide. In June 2014 we published guidance setting out our expectations of firms when creating and operating annuity comparison websites.[139]

135 GC14/3 Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development http://www.fca.org.uk/news/guidance-consultations/gc14-03.

136 Introducers more generally have also been the subject of FCA scrutiny in relation to "pension liberation" and pension scams, as discussed in Chapter 5 of this report.

137 http://www.fs-cp.org.uk/newsroom/2014/247.shtml.

138 http://www.fs-cp.org.uk/publications/pdf/optimisa_annuities_final_20130708.pdf.

139 Finalised guidance 14/6 Annuity comparison websites http://www.fca.org.uk/static/documents/finalised-guidance/fg14-06.pdf.

Barriers to entry and expansion

Competition in a market can be limited by barriers to entry and expansion for firms. These barriers can make it more difficult for a firm to enter a market or to grow, lowering the incentive for existing firms to offer cheaper and/or better quality goods or services.

We have considered the following potential barriers to entry and expansion to the retirement income market.

- **Incumbency advantages and brand loyalty:** building a good reputation and brand within the retirement income market requires considerable expenditure in terms of building expertise (for example, in underwriting) and establishing quality of service and marketing reliability. These elements are not easily replicated as they require significant sunk costs. Consumer research we have undertaken indicates that brand loyalty and existing relationships with 'well-known' providers are significant drivers in consumers' decision-making.

  As we have seen, consumers in this market are inert and many do not shop around and/or switch away from their existing annuity provider. Consumer inertia is exacerbated by provider sales practices and creates a default advantage for incumbent providers with pension customers. This may be a barrier to expansion for existing firms who only operate on the open market, and a barrier to entry for potential new entrants.

  Looking forward, the development of UFPLS could increase the existing provider default advantage. If existing pension providers develop UFPLS functionality on all pension schemes and products, and present this as a way for customers to access cash at retirement without making a decision, there is a risk that customers will be dissuaded from shopping around and/or using the guidance guarantee. This could effectively prevent challenger retirement income providers from being able to compete for a large segment of consumers.

- **Access to back books:**[140] existing providers may retain or acquire back books as part of their strategy to grow or consolidate market share, or to achieve economies of scale through combining large portfolios and streamlining processes. It is also possible for newer entrants to acquire back books in a similar way, as illustrated by the recent bulk annuity purchases by such firms. Whilst in theory, back book business could be a barrier to entry for non-insurance operators (as they are less likely to have the capabilities required for policy management and evaluating risks), we have not seen any evidence of this during the course of this market study.

- **Access to and costs of reinsurance:** there are a number of benefits to accessing reinsurance and if the costs of reinsurance are prohibitively high for new entrants, it may present a barrier to entry. First, it enables a provider firm to use its distribution system at full capacity without disturbing financial ratios, second, it reduces the concentration of risks, and third, it allows a firm to access the underwriting expertise of the reinsurer. Reinsurance can therefore help new entry, as it allows firms entering the market to do so without relying on their own underwriting capabilities. However, we have not seen evidence of reinsurance acting as a barrier to entry during the course of this market study.

- **Regulatory requirements:** regulatory requirements can impose costs on firms which have the effect of chilling competition. However, this is less of a concern where the costs imposed are variable and affect all firms proportionately. In this market, certain stakeholders have

140 Back books consist of policies that are no longer sold but which remain on insurers' books as premium paying policies. For example, annuities sold years ago and which are still being paid as an income to the retiree.

argued that capital requirements may be more constraining on new entrants and single product line providers (such as an annuity-only provider) than firms who are able to diversify their risk[141] because they have other classes of business (such as an insurance provider that writes annuity business but also has general insurance and investment product lines).

There are two forms of capital requirement that insurance firms can be subject to.[142]

- **Pillar 1 capital requirements**, which set out the capital requirements for firms based on European Directives, known collectively as 'Solvency I'. These requirements were augmented by the FSA for the risks posed by with-profits products.

- **Pillar 2 capital requirements**, where firms' senior management carry out their own assessment of economic capital given their business model and risk appetite. The PRA provides high-level guidance about the overall approach and, following its own assessment, can recommend a capital add-on for an insurer to ensure its capital levels reach a standard of being able to meet losses over a one-year horizon to a 99.5% level of confidence. Pillar 2 requirements are designed to be more risk sensitive than those under Pillar 1. Depending on the firm's business model, either Pillar 1 or Pillar 2 might be the binding regulatory constraint. In January 2016, Solvency II will replace the UK's current prudential regime. Under Solvency II insurers will calculate capital requirements using a Standard Formula, or an Internal Model approved by the regulator. Solvency II prescribes that capital requirements correspond to a one-year value at risk, calibrated to a 99.5% degree of confidence, covering all quantifiable risks. It also prescribes limited circumstances where a regulator may set a capital add-on, for example where internal models are no longer fit for purpose and need to be amended, or where governance deficiencies have been identified. In these cases the capital add-on must be removed where the firm has addressed the underlying deficiency. Capital add-ons must also be reviewed at least annually.

Taking into account the views of stakeholders and following discussions with the PRA, we do not consider that capital requirements represent a material barrier to new entrants to the retirement income market for the following reasons:

- looking forward, it is by no means clear that capital requirements under Solvency II will present a barrier to entry. Solvency II is calibrated at the equivalent of a "BBB" credit rating. This is a lower rating than many firms typically already seek to achieve from rating agencies to meet the requirements of third party brokers and analysts. Further, the effect of the Long Term Guarantee package (LTG package) agreed in November 2013, was to mitigate the increase in financial resources previously anticipated for annuity business under Solvency II

- the capital requirements under Pillar 2 and Solvency II are applied proportionately and correspond to the levels of risk underwritten by the firms, reflecting the diversification of risk

141 Assets with appropriate characteristics of safety, yield and marketability and which are diversified and adequately spread must be held to match insurers' liabilities so that the liabilities incurred in writing insurance policies are matched with assets of an appropriate nature and term. The Prudential Regulation Authority's approach to insurance supervision, June 2014, page 28: http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.

142 The FCA also has prudential regulation responsibilities for certain firms, and has recently put in place measures to raise the capital requirements for SIPP operators (see PS14/12: *A new capital framework for Self-Invested Personal Pension (SIPP) operators* (August 2014)). These provisions will come into force on 1 September 2016. We considered that at the current level of capital requirement there is a real risk that when a SIPP operator exits the market pension schemes could be left without a functioning administrator, creating potential adverse effects for the consumer. By prescribing a minimum level of capital it makes it more likely that firms can afford to enter and exit the market without risks to consumers.

- firms have the option to write other classes of business with a view to diversifying their risk, seeking regulatory approval where necessary, or they could choose to reinsure, (albeit with the associated costs), to benefit from the diversification achieved by the reinsurer, and

- to the extent that capital add-ons are used under Solvency II, we do not consider that they would represent a material barrier to entry. Typically, capital add-ons would be imposed on a firm *after* it had entered the market, as add-ons would usually be imposed in the context of a change of circumstances that meant that the firm no longer met Solvency II requirements.

Additionally, we also do not consider that capital requirements represent a material barrier to expansion for the following reasons.

- First, as noted above, capital requirements are applied proportionately and correspond to the levels of risk underwritten by firms, reflecting diversification of risk. Firms have the option to write other classes of business with a view to diversifying their risk, using reinsurance where necessary.

- Second, we are aware that many firms (including less diversified firms) are already seeking to write other classes of business in light of the new landscape changes. In chapter 8 of this report we outline the product innovations we expect to see in the new landscape, for example hybrid products which incorporate elements of annuities and income drawdown. We are also aware that firms have cited the lower capital requirements associated with these products as a driver for diversification.

Conclusions on barriers to entry and expansion

In relation to annuities, we consider that the potential barriers to entry set out above are not significant with the exception of the impact of incumbency advantage and brand loyalty which may prevent access to a sufficiently large group of contestable consumers in the open market. Given that a significant number of people in the retirement income market have a tendency to buy from their existing pension provider, we are concerned that incumbent providers feel less pressure to offer competitive vesting rates and that challengers find it difficult to attract a critical mass of customers. This could explain why there has been limited new entry in recent years.

For income drawdown, the barriers would appear to be less material, as evidenced by the larger proportion of drawdown sales that are made through external providers, discussed earlier in this chapter. However, these barriers may become more acute as the distribution chain for income drawdown changes, with new drawdown products expected to be directed at mass-market customers on a predominantly execution only (or guidance and information) basis through firms' direct to consumer distribution channels. Therefore, sales of drawdown products through existing providers could well increase from their current levels.

It is not clear how the changes to the landscape will impact on the severity of these barriers. On the one hand, the new flexibility open to consumers from April 2015, combined with the pensions guidance service and development of additional information tools and more affordable advice models could help to improve consumer engagement and demand for innovative products. The increased scope for firms other than incumbent annuity providers to develop new products could also increase the potential for new entry into the retirement income market. On the other hand, depending on how the market develops, the existing provider's default advantage could be reinforced. In chapter 9 of this report we have set out proposed remedies and recommendations to help drive competition between firms for open market customers.

Although we do not consider that regulatory requirements relating to capital represent an undue barrier to entry and expansion in this market, the FCA and the PRA will continue to work together in respect of monitoring the authorisation of entrant firms going forward.

Information problems and firm behaviour

Adverse selection is an issue often associated with insurance markets. It arises where an individual's demand for insurance is positively correlated with the individual's risk of loss, and the insurer is unable to reflect this in the price of insurance. This means consumers who are of greater risk of loss are more likely to purchase insurance and the cost of insurance rises for all consumers.

Consumers may hold private information (such as the longevity of other family members) which allows them (theoretically) to better predict their mortality than the insurer. Assuming that this is the case, it is possible that consumers who actively decide to purchase an annuity are more likely to be healthier and longer-lived than the average population. To the extent there exists information asymmetry between consumers and firms, firms could be expected to raise prices (by reducing annuity rates) to consumers. In these circumstances annuities may be less attractive to consumers.

However, we do not consider the risk of adverse selection to be a key concern for the following reasons.

- First, our international research (See Chapter 7) has found that demand for annuities has not been severely affected by adverse selection issues.
- Second, in practice we consider it unlikely that consumers are able to exploit information advantages such as life expectancy. Our consumer research, for example, has found that consumers significantly underestimate the life expectancy of the average population, even where they have family members who have lived significantly beyond the average life expectancy (as shown in Chapter 4).
- Third, even if consumers hold more information about their own circumstances and health, the information gap between providers and annuitants is closing as annuity provider's move to a fully personalised, individual method of underwriting for annuities, and away from the traditional pooling philosophy of insurance.[143]

143 This was a development that annuity providers informed us of prior to the Budget announcements of March 2014. The definition of full underwriting will vary from provider to provider, but typically involves the completion of a medical questionnaire (such as the industry standard common quote form), and in some cases a medical examination.

6.
Indicators of competition in the retirement income market

This chapter examines some key indicators of competition and value in the retirement income market.

Parameters of competition
Competition on price is straightforward for annuities, as headline rates are easily comparable. For drawdown, charges are less visible. Brand is important in these markets, with some consumers forsaking higher income to stay with a brand they trust. More choice is available to consumers who exercise their open market option.

Profitability
Our profitability analysis is consistent with the findings of the earlier thematic review, which found some differences in profitability in different parts of the market but did not find clear evidence of excessive profits overall. However, given the limitations in the data available, we place limited reliance on this finding.

Money's worth of annuities
We examined the money's worth of annuities (amount paid out vs amount paid in – comparable to the claims ratio in the general insurance market). A 65 year-old male purchasing a standard annuity with a £50,000 pension pot in the open market can expect to receive as much as 94% of this money back.

Our analysis shows that increasing longevity and interest rate movements have caused annuity rates to fall in recent years, but that money's worth has been relatively constant over time. Money's worth is lower on the vesting than on the open market. This reinforces the findings of our previous thematic review on annuities on the importance of shopping around and the use of the Open Market Option.

Value for money of other retirement income strategies
Our analysis shows that consumers with a low appetite for investment risk could generate a higher income from an annuity than the alternative strategies compared. The exception to this is if a consumer was to withdraw a constant nominal amount from their pot each year until the age of 85 – however, this strategy has a 65% chance of the consumer running out of money.

Indicators of a competitive market

A competitive market for retirement income would ideally have the following features:

- provider sales practices that are clear, transparent and allow consumers to purchase the retirement income product that best meets their perceived needs
- retirement income products which offer good value for money
- clear and transparent charging structures
- well informed consumers who are aware of the risks and benefits of different types of retirement income generating strategies through the pensions guidance service and other support services, and
- consumers who are aware of their option to shop around and exercise this option to get the best deal based on their personal circumstances.

We have explored the following indicators of competition to identify whether the market is working well for consumers:

- parameters of competition
- profitability of annuities, and
- value for money of retirement income products and indent.

Parameters of Competition

The typical parameters on which firms compete in any market are price, quality, range and service. In this section we summarise how these parameters apply in the retirement income market.

Price

The price on which annuity providers compete is the headline rate, which is determined by a number of factors: the size of the premium used to purchase the annuity, interest rates, the type of annuity purchased, the insurer's mark-up and information on the consumer's life expectancy. For income drawdown, the price reflects charges for ancillary services such as annual management, dealing and administration. These are less visible and comparable, and thus may be subject to less competitive pressure.

Quality

Consumers are not able to directly measure the quality associated with different retirement income products offered by the different providers. As a result, consumers use indirect proxies of quality such as brand when comparing providers. According to our research, over one half (55%) of retirees prefer to stick with a brand they know well for their retirement income and almost one third (31%) of those who stay with their existing provider say it is important to choose a brand they trust for a long-term product. While there is an incentive for providers to compete on brand, the competitive pressure on providers to improve the quality of their products is, therefore limited.

Range
There is a wide range of products and not all products are offered by every provider. Much more choice is available on the open market as some providers only operate in the vesting market and only offer standard annuities.

Service
The type of service provided to a customer varies according to sales channel and provider. Consumers may attain a service with or without a personal recommendation which can be provided by their existing pension provider, by an alternative provider, or by an intermediary. The channels of provision open to consumers will vary between providers. This is discussed in more detail in Chapter 3 of this report.

Profitability of annuities

Our previous thematic review undertook a high level analysis of annuity providers' profitability[144] to understand to what extent pension providers benefit from customers who do not shop around for an annuity. We have considered the issue in further detail, looking at two different indicators.

- Using the Value of New Business (VNB)[145] as a metric, profitability rates tend to be higher in the open market as compared to the internally vesting and enhanced sector.
- Under the Internal Rate of Return (IRR) less Implied Discount Rate (IDR)[146] metric, profitability rates for enhanced annuity sales are fairly similar, whilst internally vesting annuities show the highest profitability, on average more than two percentage points higher than the open market over the relevant period.

Our profitability analysis is consistent with the findings of our previous thematic review, which found some differences in profitability in different parts of the market but did not find clear evidence of excessive profits overall. However, there were limitations in the data available so we place limited reliance on this finding.

Money's worth of annuities

Historically, and mainly for regulatory reasons, the market for retirement income products has been dominated by annuities. In recent years, particularly following the financial crisis, a number of stakeholders have suggested that the annuities market was not working well and that annuities did not represent good value for money for consumers. As part of our market study we have measured the money's worth of annuity products. Money's worth has been measured as: the proportion of the premium that a consumer purchasing an annuity will get back, taking into account expected mortality and investment returns.

144 As the 'actual' profitability of annuity business will not be known for many years in the future, the FCA's profitability analysis considers 'expected' profitability, that is the value of profits that providers expect to make in the future from the annuity business written in a particular period.

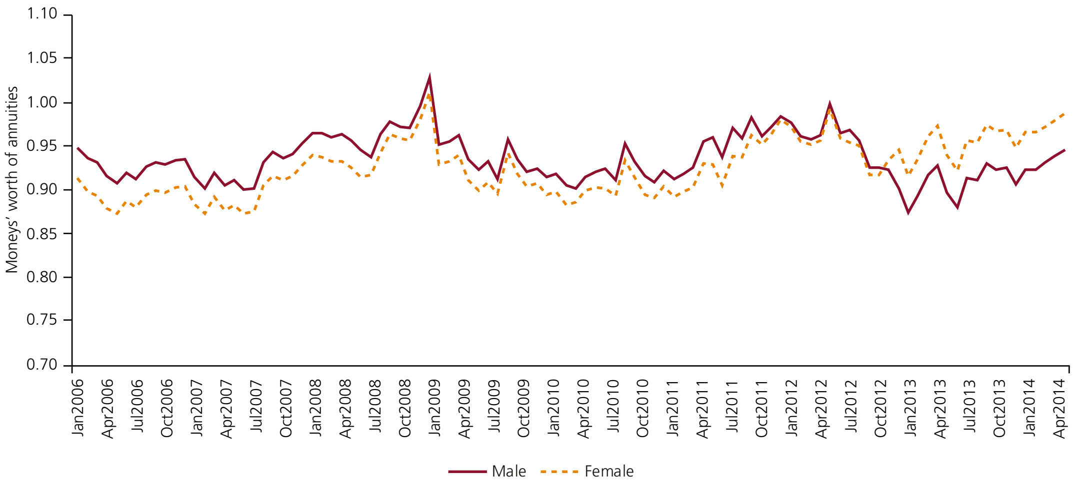
145 VNB is the value attributed to the relevant block of business written in the reporting period in question, valued using an embedded value approach. For annuity business the VNB is calculated either on an annual premium equivalent basis or present value of new business premium basis.

146 IRR is the discount rate that, when applied to the projected real world distributable earnings, produces a nil present value at the point of sale. It gives an indication of the expected return on the capital invested. IDR is a single discount rate that, when applied to the projected real world distributable earnings, produces the market consistent value at the valuation date/point of sale. IDRs measure the theoretical minimum required return to capital providers given the risks inherent in a block of business.

The findings of our analysis are summarised below, and the full report has been published alongside this report as a separate Occasional Paper.

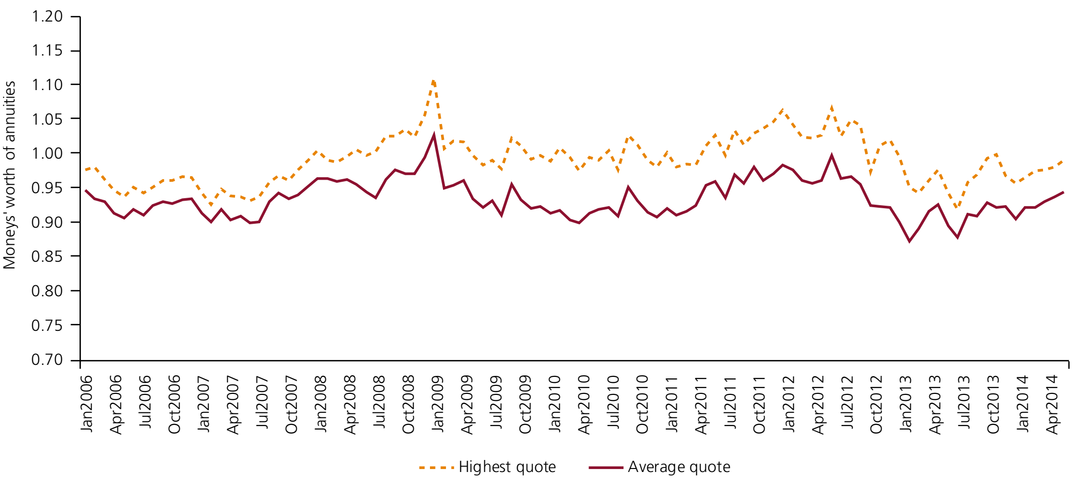
Our analysis shows that a 65 year-old male purchasing a standard annuity with a £50,000 pension pot in the open market can expect to receive back as much as 94% of the premium paid. This suggests that annuities can represent good value for money, particularly if consumers shop around effectively on the open market. Our analysis shows that obtaining the best quote (as opposed to the average quote) on the open market can significantly improve the money's worth of an annuity. These findings are illustrated in Figure 29 and Figure 30 below.

Figure 29 Money's worth of annuities for a 65 year-old with a £50,000 pot



Source: FCA's Occasional Paper, 'The value for money of annuities and other retirement income strategies in the UK'

Figure 30 Money's worth of annuities – average versus best quotes in the market



Source: FCA's Occasional Paper, 'The value for money of annuities and other retirement income strategies in the UK'

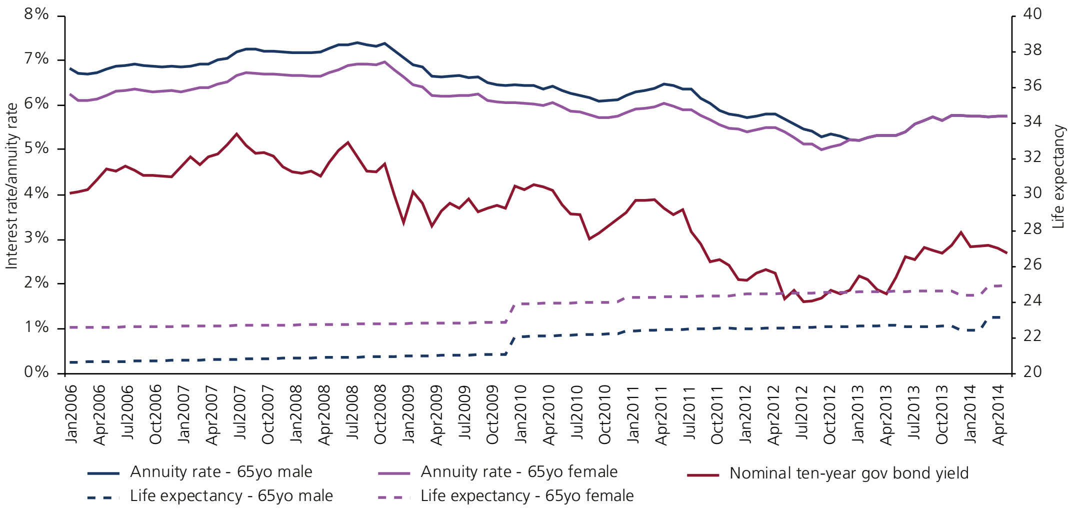
The annuity payments consumers receive depend heavily on two factors: interest rates and mortality assumptions. In order to understand how money's worth has changed over time and whether that indicates the extent to which the market is working well for consumers, we analysed the payments that would be available today if mortality assumptions and interest rates from 2006 were used to calculate the annuity rate.

- If consumers today have the same life expectancy as consumers in January 2006, they would receive around £200 more annual income than they actually get today.
- If interest rates in June 2014 were equal to rates in January 2006, annual income from the annuity would be £300 higher.

These results illustrate that increasing longevity of the UK population and interest rate movements have significantly impacted on annuity rates. Interest rates are currently very low and life expectancy has increased, and these have both pushed annuity rates down, contributing to the perception that annuities represent poor value for money. The relationship between life expectancy, interest rates (Government bond yields are used as a proxy) and annuity rates is plotted in Figure 31.

Falling annuity rates (illustrated by the blue and purple solid lines) in the past few years (specifically, since 2008) reflect the combined effect of increases in life expectancy (dotted lines) on the one hand and interest rates falling (red line) on the other hand.

Figure 31 Annuity rates (for a 65 year-old male and female), Life expectancy (for a 65 year-old male and female), and Government bond yields (2006-2014)



Source: FCA's Occasional Paper, 'The value for money of annuities and other retirement income strategies in the UK'

We analysed separately the impact of interest rates and mortality assumptions on an annuity available in the open market in June 2014 for a 65 year old male annuitant. First, if life expectancy for a 65 year old in June 2014 was equal to life expectancy in January 2006, providers in 2014 would offer on average around 7% more income per year. As annuitants are expected to live longer than in 2006, annuity providers have compensated for having to pay income for longer by reducing the income offered to new annuitants.

Second, if interest rates in June 2014 were equal to interest rates in January 2006, providers in 2014 would on average offer around 11% more income per annum. This means that recent low interest rates have significantly impacted on annuity rates and more so than the impact of improved longevity. The comparison stands out even more if we take as a reference point the interest rates in January 2000, when interest rates were higher than in 2006. Variations in interest rates contribute to the perception that the value of annuities has declined.

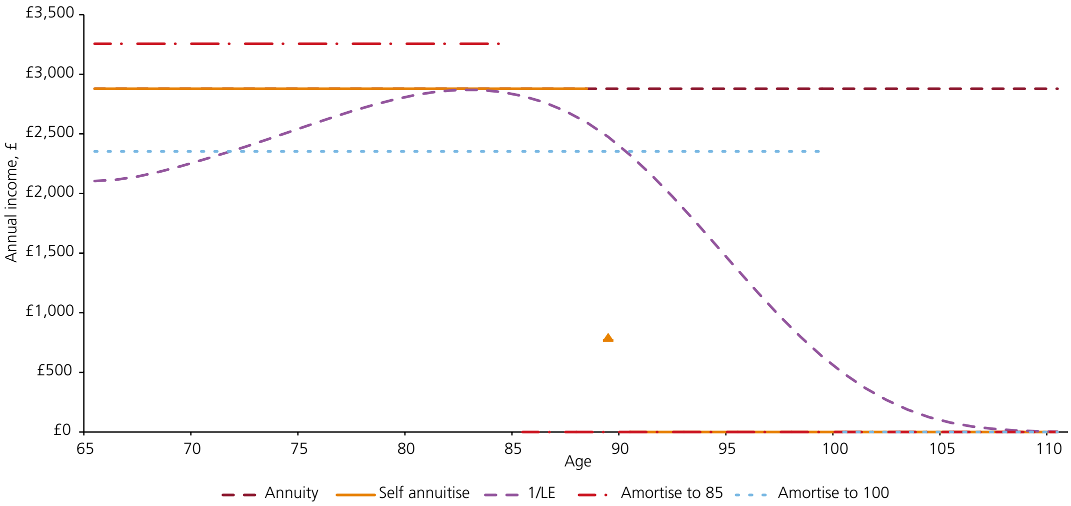
Alternative retirement income strategies

We also considered as part of our analysis the alternative strategies that could be pursued by consumers to generate a retirement income, in order to evaluate whether alternative income generating strategies offer consumers better outcomes than an annuity in terms of money's worth. To do this, we compare the value for money of an annuity with four alternative strategies.

- **Amortise to 85 years old**: take a constant nominal income each year until 85 years old, at which point funds are exhausted; hereafter 'amortise to 85'.
- **Amortise to 100 years old:** take a constant nominal income each year until 100 years old, at which point funds are exhausted; hereafter 'amortise to 100'.
- **Self-annuitisation:** take the same yearly income as the average open market quote for a level annuity.
- **Drawdown strategy based on life expectancy ($^1/_{LE}$):** consume each year a fraction of the retirement pot depending on life expectancy at that time. For example, if life expectancy is assumed to be 20 years from the date at which the drawdown of pension benefits commences, consumption is 1/20 of the pot in that year.

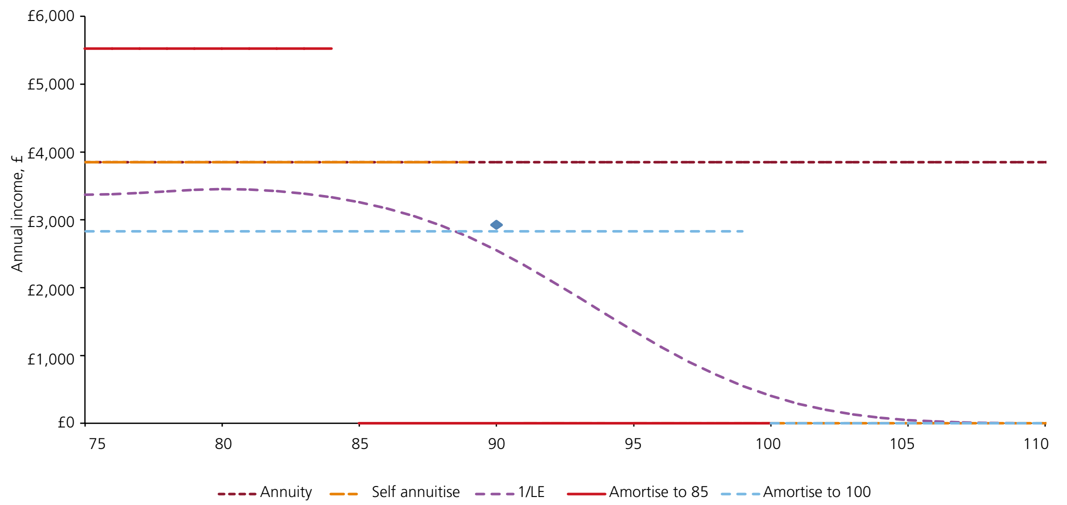
The results of our analysis show that, where consumers invest in very low risk Government bonds, they could generate on average a higher income from an annuity compared to the alternative strategies. The exception to this is the strategy of amortising to 85, but adopting that strategy also presents consumers with a 65% chance that they will run out of money (a risk that an annuity protects against). The results of alternative strategies are presented in Figure 32 and Figure 33 below.

Figure 32 Income profile of alternative strategies for a 65 year-old male with pension savings of £50,000 retiring in June 2014



Source: FCA's Occasional Paper, 'The value for money of annuities and other retirement income strategies in the UK'

Figure 33: Income profile of alternative strategies for a 75 year-old male with pension savings of £50,000 retiring in June 2014



Source: FCA's Occasional Paper, 'The value for money of annuities and other retirement income strategies in the UK'

There is scope for consumers with relatively higher appetite for investment risk to obtain an income equivalent to that provided by an annuity without running out of money and potentially being in a position to leave an inheritance. However, taking on investment risk in this way leaves the consumer open to volatility in investment returns and falls in the value of their fund that they are unable to recover. Poor investment performance could just as easily lead consumers to run out of money. Our analysis indicates that for a 65 year-old male using the 'self-annuitise' strategy, investing in UK equities, (and assuming no management fee), there is a 65% chance of the pot being larger than the original £50,000 after 20 years, as they may well live beyond the age of 85. There is also a 10% chance that someone using this strategy runs out of money by the age of 85. Where fees are taken into account, the risk of the consumer exhausting the pot increases.

In conclusion, our findings show that despite the poor perceived value, the right annuity, when purchased on the open market, may still represent the most appropriate retirement income product for some consumers. The value for money of the product they choose will highly depend on whether the consumer has shopped around so as to compare the annuity rates offered by the existing provider to other available rates in the open market, and switch in case other providers offer better rates. However, we note that many consumers will value the flexibility of annuitising only part of their pot to maintain a certain level of income and may wish to gain higher returns on the remainder of their pot. For some consumers who do not rely on their pension pot to fund their retirement, annuitisation may not be the best option.

7.
International comparisons

This chapter summarises the key findings of a review of the retirement income markets in ten countries that have experience relevant to the UK.

Key findings include the following.

- There is little evidence of consumers running out of money in retirement in countries where consumers have freedom to withdraw lump sums (this includes all countries in our sample with the exception of Chile, Singapore and the Netherlands). Often the use of lump sums is 'rational', for instance, to pay off debt or for home improvements.

- Countries which place a high degree of responsibility on individual savers tend to be more innovative; this is particularly true for the USA.

- There are concerns about low consumer shopping around (New Zealand, USA) and high fees and charges (Chile, Singapore), as well as about 'bad' consumer choices and mis-selling (Australia, USA).

- Academic research suggests that annuities can provide reasonable value in most countries. However, without tax or regulatory incentives, demand for them tends to be low.

In terms of useful lessons to be learned from other national markets:

- Consumers in saver-led markets (such as the UK) typically have a greater need for financial advice and guidance. There are examples of initiatives to improve financial literacy and tools to support consumer decision-making.

- The framing of products can have a significant impact in the product choices consumers make. This may explain differences in purchasing decisions between Switzerland and the USA, for instance.

- There are examples of initiatives to improve consumer shopping around and outcomes. These range in their level of regulatory intervention from information initiatives (such as consumer awareness programmes) to structural initiatives (such as state-run product comparison platforms).

These findings have informed our thinking on our proposed remedies, which are set out in Chapter 9.

Background

To understand the possible implications of the impending changes on the UK landscape for retirement income, we commissioned Oxera to analyse the retirement income markets in the following ten countries: Australia, Canada, Chile, Denmark, Ireland, Netherlands, New Zealand, Singapore, Switzerland, and USA. These countries have been chosen on the basis that they have experience relevant to the UK in terms of consumers making decisions at retirement regarding retirement income products. The full report has been published alongside this document. The focus of the report is on the competitive dynamics of retirement income markets (including providers, types of products, consumer behaviour and decision-making, and regulation). Although none of the countries examined has undergone the level of change that the UK is about to experience through its reforms to the retirement income market, we commissioned a piece of research to see what we could learn from other countries which have been either wholly liberalised (USA, Australia, New Zealand) or partly liberalised (Denmark, Canada), in terms of the supply structure and the decisions that consumers make under those regimes.

Figure 34 Scope of commissioned international research

Key lessons for the UK

1. **There are examples of initiatives to improve financial literacy and tools to support consumer decision-making.**

Our international research has found that consumers in saver-led markets (such as the UK) typically have a greater need for financial advice and guidance. The research has identified examples of initiatives to improve consumer financial literacy and access to information. In Denmark, advice and information websites run by the Government and by pension companies provide simple and comprehensive material on pensions, and offer advice on how best to manage pension funds. Their success is reflected in a high customer satisfaction rate with the information available to them (around 70%) and financial literacy rates. Similarly, the pensions 'dashboard' in the Netherlands, developed and run by the pension federation, together with the Dutch funds and the social security bank (SVB), informs every individual about all pension entitlements they have built up with different pension funds over their lifetime (including their state pension entitlement). This has encouraged consumer engagement with pensions by making them more tangible and visible. Some indication of the success of the dashboard is provided by self-reported measures of financial awareness.

In light of the fact that 43% of respondents in our quantitative study were unable to provide an estimate of the size of their pension savings without prompting, lessons could be learned from the other countries to help consumers in the UK prepare for retirement and their pensions guidance conversations.

A further initiative is the use of a '4% withdrawal rule' in the USA, which is used as a benchmark for guiding consumers in their income drawdown strategies.[147] In the UK, a general dislike for annuities has led some of those coming up to retirement to consider phased drawdown (where money is withdrawn in stages or simply left invested until it is needed). However, some consumers also display limited understanding of these products and will need support to make good decisions in the future.[148] The Government has said it will have the guidance service up and running for April 2015 and that it will seek to iterate to continually improve it based on the new product choices and developing market distribution arrangements. As this work progresses, consideration should be given to appropriate framing, including use of behavioural triggers such as the rule of thumb (developed by an impartial body with sufficient expertise, such as the Government Actuary's Department) to best ensure that consumers properly understand and engage with important decisions such as managing longevity risk.

Figure 35 Dutch Pensions Dashboard

Consumers in the UK will have more information and support in their decision making at retirement with the introduction of the pensions guidance service. However, the pensions guidance service will be one element of the information consumers need, and consumers will

147 The 4% withdrawal rule was devised by William Bengen in the USA. Based on simulations, he determined an annual drawdown rate of 4% of the original balance, inflated over time in line with general prices, to be consistent with not outliving one's assets. It became popular in the 1990s and is still in people's minds, even though its assumptions on investment returns may no longer hold.

148 See our consumer research, discussed in Chapter 5 of this report and published alongside this report.

also require sufficient information about their retirement savings in order to make the guidance conversation as useful as possible. We are also aware of ongoing initiatives such as 'pot follow member' and standardising pension pot information which seek to address some of the issues around pot fragmentation, which we welcome.

2. The framing of products can have a significant impact on consumer decision-making.
Evidence from other countries shows that the framing of products can have a significant impact on the product choices consumers make. Consumers are susceptible to the way that information is presented and may make different decisions, even though the underlying choice remains the same, depending on the way information is provided. For instance, products may be framed in terms of future consumption or in terms of investment returns. An illustrative example is provided for the case of an annuity purchase in Figure 36.

Figure 36 An annuity product framed as a consumption and investment decision

Consumption Frame	Investment Frame
A retiree can spend £500 each month for as long as he lives in addition to state pension. When he dies there will be no more payments	A retiree invests £100,000 in an account which earns £500 each month for as long as he lives. He can only withdraw the earnings he receives, not the invested money. When he dies, the payments will stop and the investment will not pass to his estate.

Framing may explain differences in purchasing decisions in countries such as Switzerland (where until recently pension schemes framed their benefits as annuities so that many people were largely unaware of their accumulated wealth) versus the US (where options are presented in terms of the pot size and investment returns, which make lifetime annuities look like a relatively poor deal).

The concept of framing is explored in more detail in the annex to this report. The evidence from the international research and our framing experiment strongly suggests that consumers entering the retirement journey in a certain frame are likely to be biased towards certain decisions. Specifically, we found that consumers are more likely to purchase an annuity when presented in a consumption frame than when presented in an investment frame.

We consider that there is an important role for the pensions guidance service in providing information to retirees in different frames (see Chapter 9). In doing so, consumers are less likely to be biased toward one option over another because of the way in which the option has been framed.

3. Consumers are likely to get a better deal if they shop around for their retirement income products. There are examples of initiatives to improve consumer outcomes through, for example, consumer education programmes.
Examples of initiatives include Chile, where the Government operates an electronic quotations system designed to facilitate comparison of pension products. The platform connects pension fund administrators and life insurance companies to provide individuals a complete and comparable picture of their retirement options. In the USA, employers have a fiduciary duty to invite advisors from different companies to inform their employees coming up to retirement about the products they offer. This induces consumers to shop around before deciding where to put their retirement money. In Australia, enhanced transparency of product fees has been used to improve comparability of charges and drive competition in the retirement income market.

Indeed, our qualitative consumer research has identified that one of the key barriers to further shopping around is consumers' difficulty in effectively assessing and comparing products and the complexity of the information they are provided in wake-up packs.[149] In addition, our thematic review of annuities sales practices (published alongside this report) identified that although the documentation signposted other retirement options, such as drawdown, the majority of firms' telephone calls with customers focus on annuities alone, rather than on all the options at retirement. The quality of conversations between firms and their customers about their wider retirement income options will be even more significant in the new retirement landscape. There are some firms which require significant improvements to their documentation.[150]

4. Cultural characteristics can influence product innovation

There is evidence that cultural characteristics can influence product innovation. For example, in Singapore a very strong bequest culture has led to the development of an annuity which offers a lower rate than a lifetime annuity, but provides for a bequest to beneficiaries. Interestingly, one plan which consisted of the highest monthly income but coupled with zero bequests, dropped from the system completely. This had been unpopular, chosen by only 3% of members, illustrating the clear influence that the cultural preferences of consumers (in this case, the desire to leave money behind for their beneficiaries) can have on a market.

The changes to the retirement income market are likely to lead to innovation by firms in this market (see Chapter 8), including new products such as combinations of features of annuities and income drawdown, and 'simplified' drawdown products. Our research has highlighted that framing can be used to guide consumers to particular products, even if they do not meet their risk appetite and capacity.

Overview of retirement income markets

The main DC pension systems vary considerably across the ten countries, resulting in a wide range of outcomes regarding the three broad categories of retirement income products considered (lifetime annuities, income drawdown products and lump sums). These variations are summarised in Figure 37 below.

149 The ABI Code of Conduct was developed by the ABI and its members to ensure that pension providers' communications to customers approaching retirement help every consumer to make an informed decision. Amongst other requirements, according the Code, wake-up packs must be jargon free and clear.

150 TR14/20 Annuities Sales Practices, http://www.fca.org.uk/news/thematic-reviews/tr1420-annuities-sales-practice

Figure 37 Summary of retirement income markets by product

Country	Lifetime annuities	Income drawdown products	Lump sums
Australia	Allowed, but very little demand	Allowed. Main options are account-based income streams	Allowed and relatively common
New Zealand	Allowed, but there are no annuity providers in New Zealand	Allowed	Allowed and relatively common
USA	Allowed, but demand is weak. 9% of retirees have significant annuity income	Allowed	Allowed
Canada	Allowed, with significant demand	Allowed, although with restrictions in some cases	Limited for DC pension schemes
Ireland	Required, unless income can be shown to be above threshold to qualify for income drawdown	Allowed given sufficient income	Restricted to 25% or 1.5 times income as tax-free lump sum (taken by most people)
Switzerland	Default option, and subsidised	Not allowed	Allowed, but discouraged
Denmark	Unlimited deferred annuities	Restricted amounts can be allocated to term annuities	Allowed
Netherlands	Mandatory	Not allowed	Not allowed*
Singapore	Mandatory	Not allowed	Not allowed
Chile	Default option	Restricted to 'programmed withdrawals'	Not allowed
UK	Formerly primary option. Allowed	Currently restricted to 'capped drawdown' and 'flexible drawdown' products but will be 'Allowed' (for all) post-April 2015	25% tax-free, taken by most people. Expected policy is for whole pot to be available, taxed at marginal income tax rates after 25% tax-free allowance

*Note: * Except for very small pots which would provide an annuity income of less than €417 (£330)[151] per year (a fund of around €12,000 (£9,600).[152]*
Source: Summary of the data and sources presented in the individual country sections of Oxera's report, www.fca.org.uk/your-fca/documents/the-retirement-income-market

The consumer journey

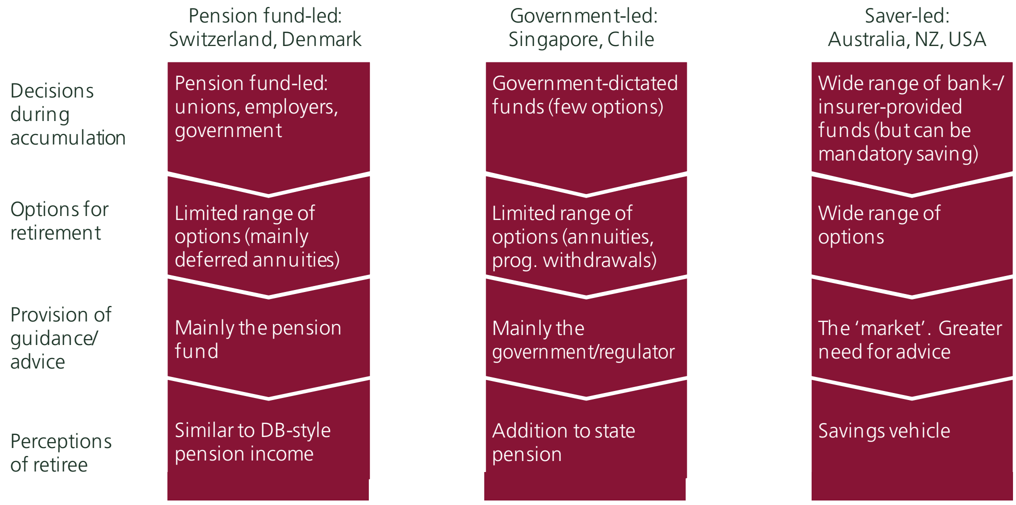
Where consumers can make choices at retirement, the process falls under one of three broad categories.

- Pension fund-led (Switzerland, Denmark and the Netherlands).
- Government-led (Chile, Singapore).
- Saver-led (Australia, USA, New Zealand and the UK).

151 See Dutch Association of Industry-wide Pension Funds, 'The Dutch Pension System: an overview of the key aspects', section 6.2 (http://www.pensioenfederatie.nl/Document/Publicaties/English%20publications/Nederlandse_pensioensysteem_Engelstalige_versie.pdf).
152 On the basis of an index-linked annuity rate of 3.5%.

The key aspects of these three different consumer journeys are illustrated in Figure 38 below, and are a useful indicator of how key features of the saver-led consumer journey in the UK will evolve.

Figure 38 Simplified illustration of consumer journeys in different countries



Consumers' decisions about retirement income products are framed by the structure of regulation and taxation in each pension system, and also by the relative importance of their DC pension funds and any alternative sources of income that they have. Evidence from all the countries in our research indicates that advice and consumer preferences, perceptions and behaviour all play a role in determining the outcomes of the customer journey. In particular, the key findings of our research on the consumer journey are as follows.

- **Role of regulation**

In some systems, the customer journey is tightly controlled by regulation, with consumers having relatively few choices to make whilst in other systems consumers have much broader scope to make decisions and, indeed, sometimes total flexibility.

- **Decisions and outcomes**

Consumer decisions and outcomes depend on the size of the consumer's DC pension fund, their particular circumstances and the other sources of retirement income they expect to receive (for example state pension, DC pensions and DB pensions).

- **Role of advice and guidance**

Bespoke financial advice is typically only obtained by higher net-worth individuals. Regulators in many countries are concerned about the quality and cost of advice and guidance that consumers receive and have restricted commission payments (Australia) and capped charges (Chile) in response to concerns about payments influencing the quality and type of advice provided. Limited accessibility to advice and concern over high fees or excessive risk may result in consumers preferring mainstream 'default' options.

- **Consumer preferences**

Consumers prefer assets at certain points during retirement, and these preferences vary across countries due to differences in cultural trends. For example, in Australia there is demand for initial lump sums to pay for housing expenses (such as remaining mortgage liability).[153] In Singapore, there is demand for assets to provide a bequest to beneficiaries. In the USA, there is a perceived need for flexibility in case of unexpected medical expenses.

- **Perceptions of value for money**

Consumer perceptions of the value for money of different retirement income products also vary between countries. Academic research tends to show the value for money of annuities is reasonable in most countries, but that there can be significant variation between providers and products (highlighting the need for consumers to shop around). Perceptions of value for money are affected by regulation and taxation (for example, the regulated annuity rate in Switzerland). The framing of outcomes in terms of future consumption (Switzerland) or of investment returns (USA and Australia) also affects perceptions.

- **Consumer behaviours**

Important behavioural aspects that affect decision-making include the impact of default options (such as annuities in Switzerland). Consumer biases (discussed in Chapter 4) such as loss aversion and present bias can also affect decisions, but behaviour that appear to reflect these biases may reflect more rational consumer preferences. For example, demand for short-term annuities in Denmark may reflect present bias, but also more rational needs for resources early in retirement.

Drivers of product provision and consumer decision-making

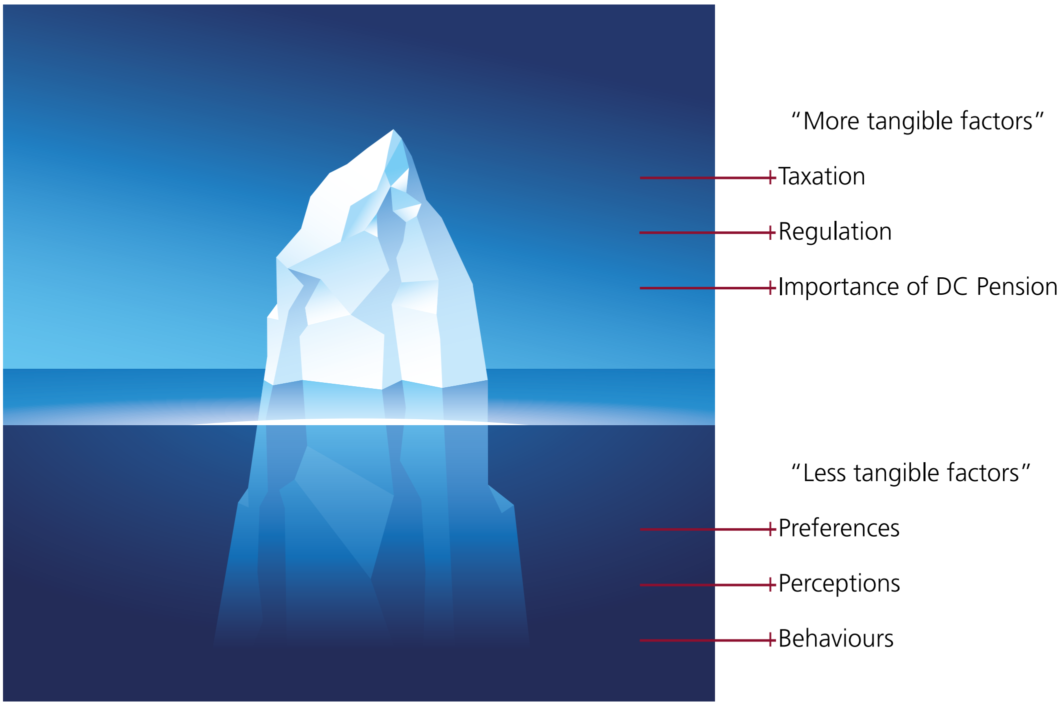
The provision of retirement income products in the ten countries analysed reflects the respective regulation and taxation structures, as well as consumer demand. In relation to annuities, other issues, such as adverse selection (discussed in Chapter 5) or a shortage of assets to match liabilities, do not appear to have been a severe constraint on consumer take-up.

In terms of product availability reflecting regulatory structures, there is evidence from our research of innovation in less restrictive markets, such as the USA. Low rates of take-up in other countries are likely to be due in part to greater regulatory restrictions or lack of demand. For example, countries with strong demand for lifetime annuities have clear regulatory or tax incentives for choosing annuities over other products, while countries that do not incentivise annuities have low levels of take-up (for example Australia and the USA).

Lack of demand is an important factor in determining the availability of retirement income products, including the take-up of annuities. In terms of the factors that affect consumer demand, our research shows that these can be classified into 'more tangible' and less 'tangible' factors, as set out in Figure 39 below.

153 Anecdotal evidence from the Australian equivalent of the UK's National Association of Pension Funds (NAPF) suggests people with smaller pension pots favour cash lump sums, whilst those with larger pots favour retirement income products.

Figure 39 Factors driving consumer decision-making



Many of the broad trends in demand for retirement income products can largely be accounted for by relatively tangible factors. As explained above, regulation, taxation and benefit structures and the relative importance of DC pensions go a long way to explaining demand for lifetime annuities, income drawdown products and lump sums. However, variation in demand patterns across countries can be linked to some less tangible factors, such as:

- the lack of lifetime annuity products which also provide features desired by consumers (such as up-front capital)
- perceptions about value for money, specifically in relation to annuities, and
- the use of default options.

The role of regulation

The regulatory debate in most of our sample countries continues to focus primarily on the accumulation phase, particularly with regard to encouraging consumers to participate and increase their contributions, while minimising costs. In the more mature systems (such as Denmark and Switzerland) the decumulation phase is rising to the top of the agenda. As all of the systems continue to mature, the focus of discussion will increasingly shift to the decumulation phase. Our research has identified the issues set out in figure 40 as the key elements of the regulatory debate around decumulation.

Figure 40 Role of regulation – key issues

Addressing low levels of consumer engagement with, and understanding of, financial products in general, and retirement products in particular (New Zealand and Denmark).

Helping people to find the best deals, for example by constructing price comparison websites (Chile and New Zealand) or ensuring comparability of charges of products (Australia).

Addressing low-quality or misleading guidance and advice, and cases of mis-selling (Storm Financial in Australia).

Ensuring that people will have an income for life, so that they do not become overly reliant on the state for support (Singapore).

Ensuring also that people choose appropriate products in terms of risk appetite and capacity (Switzerland).

BEST CHOICE

Capping charges in some cases (Chile), but more often **taking action to increase price competition** (such as, by encouraging shopping around).

Regulation can also seek to achieve desired outcomes by taking account of consumer preferences, perceptions and behaviour. Evidence from our research suggests that 'nudges' can be quite effective, for example:

- using default options, which appear to have a significant impact on outcomes—for example in Switzerland, where annuities provided by the accumulation phase service providers are the default option (indeed, Switzerland is the only country in this study where annuitisation is the prescribed default)
- ensuring that products have the features that consumers desire—such as the regulated products in Chile and Singapore (allowing for bequests to beneficiaries), and
- framing perceptions of retirement income products in terms of future consumption, rather than investment returns, which may explain at least some of the differences in attitudes in countries such as Switzerland versus the USA (discussed above).[154]

Conclusion

In conclusion, many of the issues that we have identified in relation to the retirement income market in the UK are present in other national markets, such as consumer engagement, initiatives to increase shopping around, product choices and the role of advice and guidance for consumers. Our international research has helped inform some of our proposed remedies designed to increase the effectiveness of consumer communications to help address consumer inertia, encourage shopping around and, if appropriate, switching.

154 Though our framing experiment illustrates a strong correlation between framing and product choices, it is also possible that causation runs in the opposite direction such that demand for products influences the framing of retirement income options by providers.

8.
Innovation in the retirement income market

This chapter sets out early views on possible innovation in the retirement income market in the new landscape recognising that it is still very early to tell how the market will evolve.

Our early view on product innovation is that it may be focused in the following areas:

- individual underwriting of lifetime annuities (for both internally vesting customers and those exercising their OMO)
- managed drawdown products which offer a limited selection of funds while managing investment and volatility risk
- hybrid guaranteed products which offer varying degrees of guarantees on capital and income including unit-linked, variable and fixed term annuities
- cash based products offering cash on platforms and structured deposits
- UFPLS – providing the ability to stay in accumulation pot while drawing income, and
- blended solutions such as combinations of the above products

In terms of distribution we expect to see:

- direct to consumer (D2C) business models - utilising platforms and telephony sales staff to engage directly with consumers
- digital customer engagement – more engagement via digital channels to consumer throughout the pension lifecycle, and
- retirement advice – direct advice services from providers as well as growth of financial advisers and wealth managers

Such innovation is likely to be welcomed by consumers. However, it may also pose risks to consumers and/or weaken competitive pressure on value.

- In future, converting accumulated pension savings into retirement income need not be a one-off, irreversible step that it historically has been for savers purchasing a lifetime annuity. Savers will welcome the increased flexibility, including the ability to change course over time. However, without a clear moment in time to make a decision, it may be harder to prompt savers to shop around or switch.
- If consumers are no longer "locked in" to a product for the duration of their retirement, firms may need to work harder to retain customers through their retirement. We would not want to see firms introducing undue contractual or financial barriers to switching.
- If a greater range of products becomes available, savers should be better able to find one that meets their particular needs. This may be especially true for savers who have multiple sources of retirement income. However, faced with increased choice and complexity, consumers may find comparisons harder, and may become less confident to shop around or switch.
- Until now drawdown products were sold primarily with full advice to people with significant pots to invest. Going forward, the industry will need to develop appropriate mass-market distribution and guidance arrangements for products with a drawdown element. Without this, consumers may not properly understand the risks involved and risk may not be shared appropriately between consumers and suppliers.
- While charges for annuities are effectively captured in the headline rate, the same is not true for products with a drawdown element. Complex or opaque charging structures would make comparisons harder and weaken competitive pressure on value.

Innovation in the retirement income market

In this section we have considered the possible extent and form of product and supply chain innovation in the retirement income market in the new landscape, recognising it is at an early stage of development. Our analysis is based on information gathered from a variety of industry participants and other stakeholders both prior and subsequent to the 2014 Budget announcements.

Drivers of innovation

The key drivers of innovation in this market are the following.

- **Consumer demand**: our international research supports the view that one of the key drivers of innovation in the market is consumer demand. In this regard, the Government's reforms to the decumulation aspects of the landscape will provide consumers with increased flexibility, which in turn is likely to stimulate consumer demand for new products.

- **Regulatory context**: the regulatory environment is likely to be a driver of certain types of innovation. For example, the Budget reforms related to income and death tax changes enable existing products to be used in a different way or new products to be devised. Legislative and regulatory rule changes will see the requirement for trust based and contract based providers to signpost the pensions guidance service, which is driving change in how providers engage with customers throughout their pension lifecycle. Furthermore, Solvency II (discussed in Chapter 5 above) may encourage firms to develop products that require lower capital reserves, potentially shifting the risk sharing between the product provider and the consumer.

Product innovation in the new landscape

We consider that product innovation in the new landscape will *initially* be focused on the following areas.

- **Lifetime annuities**: we expect to see developments in underwriting, with more personalised underwriting for both internally vesting and OMO customers. While these developments were already happening in the market before the reforms were announced, this has now been accelerated as providers seek to manage adverse selection (explored in Chapter 5 of this report) as annuity sales contract. We also expect there will be modifications to existing lifetime annuity products on the market but that in the short term, these changes are likely to be driven by changes in tax rules (for example, income tax no longer applying to value protected annuities).

- **Managed drawdown**: given the increased flexibility that will be available to consumers in the new landscape and the findings of our consumer research (which indicate that consumers value flexibility, and the concept of drawdown is appealing), we expect take-up of income drawdown products to rise. Drawdown products offering a limited selection of funds to choose from (for example, three to five funds) are expected to be directed at mass-market customers on a predominantly execution only basis through direct to consumer distribution channels. Multi-asset and diversified growth funds are expected to be used to manage volatility and some investment risk for consumers in these 'managed drawdown' products.

- **Hybrid guaranteed products**: our consumer research has identified that in addition to flexibility, consumers will also value products that offer an element of guarantee. Hybrid products such as fixed term annuities, investment-linked annuities and variable annuities are expected to be re-branded or launched, with guarantees and the price attached to these being more modularised (that is, pick and choose guarantees). We expect these products to be targeted more towards mass-market customers, than they have typically been up until now.

- **Blended solutions**: advisers and providers are expected to use blended solutions which cover differing consumer needs and wants such as an annuity to cover living costs and drawdown exposing customers to investment growth and risk. We also expect providers to offer a number of products that can be used back to back, such as drawdown as a 'bridging product' while income needs are flexible, then in later life the purchase of a lifetime annuity for the security of a guarantee.

- **Cash based products:** given the expected large numbers of consumers who will draw down their pensions into cash, and the appeal of cash from a liquidity and security perspective, we anticipate this may lead to the development of cash based products in other markets such as platforms and banks.

- **UFPLS**: given the changes to the tax regime for UFPLS in the accumulation phase (see Chapter 3) we expect to see firms develop the capability to offer UFPLS functionality on existing pension schemes (both trust and contract based).

Supply chain innovation in the new landscape

In addition to the introduction of the pensions guidance service to the consumer retirement journey, we also expect innovation and development in the supply chain in the new landscape to be focused on the following areas.

- **Direct to consumer (D2C) business models**: we expect to see an increase of the use of this type of business model, particularly by insurers. We consider that these business models will involve interaction with potential customers in the run up to and throughout the retirement journey, and will have a significant digital/online element to them (see below). Though we also expect many providers to continue to offer telephony support on a non-advised basis.

- **Digital customer engagement**: many firms already offer online digital tools and guides for consumers. We expect firms to develop a more holistic digital proposition for consumers going forward, in an attempt to digitise the wider pension lifecycle and customer journey towards, at and through retirement. This will allow firms and consumers to interact at the different stages of the journey and potentially provide consumers with greater access to information and the ability to manage their retirement journey from an earlier stage.

- **Retirement advice**: as discussed in chapters 3 and 5 there are already some examples of different advice models, such as simplified advice. We expect some providers to offer direct advice services for customers who cannot service themselves through non-advised routes or simply wish to speak to an adviser. Financial advisers and wealth managers not employed by providers will continue to provide individual retirement and tax planning recommendations for their customers and may experience an increase in demand.

Risks to effective competition

In conclusion, we consider that the reforms to the retirement income landscape will lead to innovation in terms of new products, distribution and engagement services in the short to medium term. We welcome innovation that delivers products that better meet consumer needs through channels that support good decision-making. Our research has identified that consumers will welcome the new flexibility.

However, there are potential competition risks that will need to be monitored in the new landscape.

Consumer inertia

- **UFPLS:** If existing pension providers develop UFPLS functionality and present this as a way for customers to access cash at retirement without making a decision, there is a risk that customers will be dissuaded from shopping around and/or using the pensions guidance service. We note that providers will have a vested interest in retaining their customers, and that challengers will struggle to gain critical mass without a significant proportion of savers venturing onto the open market. We welcome the decision to provide a signpost to the pensions guidance service when someone plans to access their pot, even if not to crystallise it. We are working with the Government to ensure effective signposting to the guidance service.

Barriers to switching

- **Permissive override:** The Government has announced that a permissive statutory override will be introduced to ensure that all DC schemes are able to offer their members increased flexibility as a result of the changes in the 2014 Budget.[155] However, if existing pension providers experience high outflows from profitable legacy pension contracts they may choose not to provide permissive overrides to scheme rules which could consequently act as a barrier to a customer having freedom and choice in their DC pensions.

- **Terms, conditions and charges:** Providers may seek to use terms and conditions or charges as a barrier to customers switching.

Paradox of choice

- **Complexity and choice of products:** Innovation may result in complex products and a proliferation of choice making it difficult for customers (and advisers) to compare products and identify which align with their needs and circumstances.

In light of these potential risks, and as set out in more detail in Chapter 9, we will monitor the market to track developments to assess whether these risks arise and if so, the impact on consumer outcomes. This will allow us to develop a macro-level picture of the market and identify any further risks and issues early and consider what mitigation steps may be required.

155 See Freedom and choice in pensions (July 2014) page 14
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332718/Pension_artwork_print.pdf.

9.
Proposed remedies

This chapter sets out our proposed remedies and invites views. It also notes that this is part of a package of wider FCA work that impacts on the future of the retirement income market.

Our findings highlight a need for more to be done to help consumers in the retirement income market understand their options, make good decisions and act on those decisions. Even now, a significant number of consumers demonstrate a lack of awareness of their options and do not shop around or switch, missing out on additional income as a result. Lack of understanding of options or lack of confidence in shopping around could have even more severe consequences in the new landscape.

Our proposed remedies, recommendations and actions
The objective of the proposals set out below is to increase the effectiveness of customer communications to help address consumer inertia, encourage shopping around, and if appropriate, switching.

1. We propose to require firms to make it clear to consumers how their quote compares relative to the quotes of other providers operating on the open market.

2. We recommend to both the pensions guidance services and firms to take into account framing effects and other biases when designing tools to support consumer decision-making. For firms, this means options should be presented in a way that supports good decision-making rather than drives sales of particular products. We recommend that the pensions guidance service should also consider providing consumers seeking to generate a retirement income through UFPLS or income drawdown with a 'rule of thumb' to counter known biases around risk appetite and longevity.

3. We will work with Government in developing an alternative to the current 'wake-up pack'. This should be behaviourally trialled to assess the impact on consumer's awareness of their right to shop around, and the proportion of people who switch.

4. We recommend the development of a 'Pensions Dashboard' which would enable consumers to view all of their pension savings (including their state pension) in one place.

5. We will continue to monitor market developments. If consumers appear not to be getting the support or products they need, and/or competition is failing to drive good value, we will consider intervening further.

Related work

This market study is one part of a wider package of FCA work that directly or indirectly impacts on the retirement income market, in particular:

- the FCA's role in setting, and maintaining and monitoring compliance with, the standards of the pensions guidance service[156]

- the thematic review of annuity sales practices (published alongside this report) has found evidence indicating that firms' sales practices are contributing to consumers not shopping around and switching, and at times to consumers potentially buying the wrong type of annuity, in particular not purchasing an enhanced annuity when they may be eligible for one. This means consumers may be missing out on a potentially higher income in retirement as a result. (See TR14/20 Annuities Sales Practices)

- the FCA's finalised guidance on retail investment advice (referred to in Chapters 3 and 5 of this report).[157] This is one of the steps we are taking to ensure that the regulatory framework supports the development business models which work in the interests of consumers of financial products. Also relevant is our work on Smarter Disclosure,[158] and Project Innovate[159]

- our ScamSmart national consumer campaign is monitoring for, and mitigating the risk of, scams. Alongside this we continue to take enforcement action against scams and fraud. With consumers' ability to withdraw larger sums of money from their pension savings in the new landscape, there is an increased risk that a large cohort of consumers will be susceptible to scams. We will continue to raise consumer awareness of the scams they may face, the tactics fraudsters use, and provide tips on how to avoid these (See Chapter 4 of this report)

156 See Policy Statement http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-17.

157 GC14/3 Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development http://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf.

158 We want to improve disclosure and encourage firms and their advisers to consider how disclosures can be made as effective possible. We are particularly interested in stakeholders' research, experience and ideas for improving the effectiveness and delivery of information to consumers about products or services. We are inviting firms to work with us to test new ideas or techniques that could better support customer understanding of financial products and services and improve engagement, including ideas that take advantage of technological developments that are accessible and helpful for the intended consumers. Where an idea has strong potential for consumer outcomes to be improved, we may consider waiving or modifying certain disclosure rules if appropriate to allow testing. Firms that would like to talk to us about testing ideas can find more information here: http://www.fca.org.uk/firms/firm-types/project-innovate/test-ideas.

159 The Innovation Hub provides support for innovator businesses that are considering applying for authorisation or variation of permissions. It also helps innovators that do not need to be authorised but supply innovative products and services to regulated firms. For more information on the Innovation Hub, please contact InnovationHub@fca.org.uk.

- to commence in 2015, a wider policy review of the requirements on firms in relation to pensions and retirement products to ensure that they continue to be relevant and appropriate for the way in which firms and consumers' interact in the accumulation and decumulation landscape, and
- the ongoing supervision work that we undertake, including thematic and firm-specific supervision and sector research.

Our approach

The proposed remedies set out below specifically seek to address some of the issues identified in the retirement income market through our market study as set out earlier in this report.

We want to increase consumers' awareness of information and its relevance, enhance the quality of information that consumers receive so that they can properly assess it, and facilitate consumers acting on that information, by shopping around and, if appropriate, switching provider.

Given that the market is on the brink of major change, we are limiting proposed remedies to those issues that can achieve the most positive impact. In addition, we will monitor the market as it develops with a view to stepping in if consumers appear not to be getting the support or products they need, and/or if competition is failing to drive good value.

The Financial Services Act 2012 grants the FCA the power to refer a competition matter to the CMA for consideration. We may do this, for example, where we do not have the statutory powers to address the potential problem. We do not intend to use this power here as we have sufficient powers under FSMA to address the competition concerns that we have found.

We are inviting comments on our provisional findings and proposed remedies at this stage. To the extent that any final remedies we decide on require changes to FCA rules and/or guidance, these will be subject to a separate formal consultation and a consequent cost benefit analysis process.

In addition to our consultation process, we will continue to engage with the Treasury, the Department of Work and Pensions and the Pensions Regulator.

Summary of our provisional findings

Our provisional findings point to a retirement income market which is not working well for consumers. In particular, a significant number of consumers demonstrate a lack of awareness of their options when coming up to retirement and tend not to shop around for alternative products and providers or switch away from their existing pension provider.[160] The thematic review of annuities published in February 2014 highlighted the extent to which consumers might be foregoing income by not shopping around and/or switching provider. In this respect, we have identified a number of potential contributory factors:

160 See chapter 4 of this report, which sets out the findings of our consumer research, in particular: 22% of consumers who purchased an annuity from their existing provider were unaware of their open market option; and 40% of consumers surveyed purchased from their existing provider.

- Feedback from consumers on existing 'wake-up packs' is generally negative: there is too much information, they are difficult to navigate, and are full of jargon. The thematic review of annuity sales practices found that the quality of customer literature in this area varied. Some firms do not inform consumers in the letters that form part of their wake-up packs and reminder letters that they could shop around for enhanced annuities, for other firms this was the case for consumers of certain parts of the business. For consumers this means that they may buy an enhanced annuity from their current provider when they might have been able to receive a higher income in retirement from an enhanced annuity from another provider.

- The way information is presented to consumers has a real impact on consumer behaviours, with evidence from other countries and from our framing experiment showing that the framing of products can have a significant impact on product choices. Consumer research also shows that consumers do not consider the lifetime impact of a 'small' additional income each month to be gained from shopping around and switching provider. However, as set out in our previous thematic review of annuities, the lifetime impact of switching can be significant. That report estimated that to achieve the annual income available on the open market from their existing provider, a customer purchasing a standard annuity would require an additional £1,429 in their pension pot.[161]

- Consumers who are faced with greater choice in the new landscape will need more support in making decisions about their retirement income. Evidence from all 10 countries in our research shows that advice,[162] guidance and other support plays a role in determining outcomes and it is particularly important in saver-led markets, like the UK. There have been a number of international initiatives, such as the Pensions Dashboard in the Netherlands, which has encouraged consumer engagement and improved access to information.

Proposed remedies and recommendations

The objective of the proposed remedies is to increase the effectiveness of the information that is provided to consumers to help address consumer inertia, encourage shopping around, and if appropriate, switching. This does not mean providing more information, but rather better quality information that is clear, easily accessible and engaging. Through smarter disclosure by firms, delivery partners of the guidance guarantee, and Government, we hope to empower consumers to make better informed decisions at retirement and thus drive competition in the interest of consumers.

We consider that better information can be provided:

1. By pension providers, on their offer relative to other providers

2. Through the development of a virtual "Pensions Dashboard"

3. Within the content of pensions guidance service delivered by Citizens Advice Bureau (in respect of the face-to face delivery aspect) and The Pensions Advisory Service (in respect of the telephone elements of the delivery service)

4. Through an alternative form of information provision to wake-up packs, that engages consumers and prompts them to shop around, and if appropriate, switch provider.

161 See page 17 of our previous thematic review of annuities.

162 This refers to advice in a generic sense as it comes from an international context; it should not be treated as having the same definition of retail investment advice as used in earlier chapters.

We are also announcing our plan to monitor the retirement income market and are seeking views on whether there are any particular aspects that we should monitor.

1. **We propose to require firms to make it clear to consumers how their quote compares relative to other providers operating on the open market.**

We propose to require firms to tell their customers how the rate they offer on annuities compares to their competitors' quotes which are available on the open market. This information should be delivered:

- during telephone conversations with pension customers, and
- in written communications sent to customers setting out the provider's own quote.

The information provided could, for example, use the MAS annuity comparison website to provide quotes for a particular consumer (based on certain characteristics, such as age, pension pot size and some specific health conditions) from other providers operating on the open market. In doing so, consumers will be able to see the benefits of shopping around.

The provider could state, for example:

a. where its quote ranks and where there are alternative providers offering a higher rate on the open market if consumers wish to exercise their open market option,

b. the additional annual income that could be achieved by the customer should they choose the highest quote available (we note that the MAS annuity comparison site illustrates differences in income on a monthly, yearly, and ten-yearly basis), and/or

c. a lifetime estimate of additional income that could be achieved on the open market based on the average longevity of male and female consumers.

We consider that the oral aspect of this requirement could be provided by firms relatively easily and at a reasonably low cost, particularly if the MAS comparison website were to be used. Further, the MAS comparison site has recently been re-launched and provides information and quotes for a more extensive range of medical conditions and lifestyle choices. The website, provided by IRESS and Defaqto, provides real-time quotes which will provide more actionable quotes for people that use the service.

However, we also recognise that there may be some practical issues which will need to be considered. These could include the need for customer service staff to have access to the internet, and the willingness of consumers to share information over the phone (such as details of specific health problems), in order for accurate quotes to be offered. In addition, there may be issues around the timing of the quotes between written and oral communications and their duration. Nevertheless, we think that these potential issues could be overcome, and we would be keen to hear suggestions from firms as to how to design an effective solution.

In relation to the written communication aspect of this proposal, we consider that provider communications would benefit from being behaviourally trialled in order to ensure their effectiveness.

Please set out your views on:

1A: Whether the proposal could contribute to addressing the concerns we have identified?

1B: How could the proposal be best implemented, and/or how could practical issues be resolved?

1C: What information could be feasibly provided over the phone and in writing?

1D: How the proposal could be applied to other retirement income products, for example income drawdown?

2. **We recommend to both the pensions guidance service and firms to take into account framing effects and other biases when designing tools to support consumer decision-making.**

Our research confirms that how options are presented to consumers has a strong impact on outcomes.

For firms, the implication of this is that they should present options to consumers in a way that supports good decision-making, rather than one that drives sales of particular products, for example those with higher margins. A responsible approach to framing will be very important in helping consumers to make an informed decision on whether or not an annuity is the right option for their retirement income needs.

Our economic analysis of the money's worth of annuities compared to alternative methods of accessing pension savings (see Chapter 6 of this report) has shown that factors such as a consumer's risk appetite and life expectancy can have a significant impact on the returns consumers can make from retirement income products that do not provide guaranteed income, and also the risk of them running out of money in retirement. In the longer term, we therefore recommend that as the Government's work on continual improvement of the guidance service progresses, consideration should be given to appropriate framing, including use of behavioural triggers such as a rule of thumb to use when withdrawing funds from products such as UFPLS and income drawdown. This would help ensure that consumers properly understand and engage with important decisions such as managing longevity risk. The concept of a rule of thumb was identified in our international research as a successful initiative in the USA. We consider that any rule of thumb would need to be developed by an impartial, sufficiently qualified body, such as the Government's Actuary Department.

In addition, our Policy Statement has stated that we would expect advisers to take sustainability of income into account where they are advising clients to take uncrystallised (fund pension) lump sums (UFPLS) to ensure they are providing suitable advice.[163]

Please set out your views on:

2A: Whether the proposal could contribute to addressing the concerns we have identified?

2B: How the proposal could be best implemented, and/or how could practical issues be resolved?

163 Policy Statement PS14/17 http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-17.

2C: How the proposal could be applied to UFPLS or other products?

3. We will work with Government to develop an alternative to the current wake-up pack. Behavioural trialling of the wake-up pack would allow us to assess the impact on consumers' awareness of their right to shop around, and the number of people who exercise their open market option. We would like to hear from any firms that are interested in assisting us with this process.

Our consumer research (see Chapter 4) has highlighted that the current system of provider wake-up packs is not an effective way of providing consumers with the information they need to make informed decisions on their retirement income needs. There is too much information, they are difficult to navigate, and are full of jargon.

The thematic review of annuity sales practices published alongside the market study, found that the quality of customer literature in this area varied. Some firms do not inform consumers in the letters that form part of their wake-up packs and reminder letters that they could shop around for enhanced annuities, for other firms this was the case for certain parts of their business. For consumers this means that they may buy an enhanced annuity from their current provider when they might have been able to receive a higher income in retirement from an enhanced annuity from another provider.

There is some evidence that the complexity and inconsistency of information provided to consumers combined with barriers to accessing advice (whether real or perceived barriers) are driving consumers to default back to the least difficult option, that is, their existing provider.

On the basis of the above findings, we consider that changes are needed to the existing at-retirement communications in order to ensure clarity and simplicity for consumers, allowing them to exercise choice effectively. As part of this, we believe that any new at-retirement communications would benefit from being behaviourally trialled in order to make them as effective and informative as possible.

There is work underway led by the Treasury which we are closely involved in, which also has input from the DWP, TPR, the industry and occupational pension scheme representatives. We expect this work to lead to agreed standardised wording, templates and/or information factsheets that firms and trustees will agree to use for 'at retirement' communications. Further, as stated in our Policy Statement on the retirement reforms and the guidance guarantee in November 2014, we will be undertaking a thorough review in 2015 of our rules in the pensions and retirement area, including at-retirement communications. This work will build on the standardisation work being undertaken with the Treasury and industry. We also propose to consult on replacing the ABI Code of Conduct with our own rules. We consider that the potential benefits of replacing the ABI Code with FCA regulation would be to ensure that:

- those aspects of the ABI Code that we incorporate within our rules are fit for purpose in the new landscape, and
- that consumers receive information which informs them of their right to shop around and prompts them to exercise their open market option.

In addition, as set out in our Policy Statement on the guidance guarantee in November 2014, we consider the issues and risks of UFPLS to be broadly similar to those with income drawdown products. Therefore, our intended approach will be to treat these different retirement income options consistently in our regulation of income drawdown products, and to require at-retirement information to be provided to everyone before they take benefits from their pension savings. We will also be working with the DWP and TPR on the regulation of income drawdown and UFPLS as these may also become a feature of the occupational pensions landscape.

We will be contacting firms to take part in behavioural trials of new at-retirement communications, and invite industry participants to engage with us through the "Testing ideas for communicating with consumers" page on our website: http://www.fca.org.uk/firms/firm-types/project-innovate. We would like to hear from any firms that are interested in assisting us with this testing process. The results of this exercise will inform our review of our rules in the pensions and retirement area as outlined above.

Please set out your views on:

3A: What should the proposed content of future at-retirement communications be?

3B: Whether there is any other significant information that should be included in these communications? If so, please state the information required and why it should be included.

3C: Which aspects (if any) of the ABI Code we might consider incorporating into our rules in the pensions and retirement area? Please set out any additional measures that are not currently in the ABI Code that should be incorporated into our rules.

4. In the longer term, we recommend that a 'Pensions Dashboard' is created which:

- **can be accessed by UK consumers at any time through a personal log-in**
- **sets out an individual's entitlements including all of their accumulated DC pension savings, and**
- **could be developed over time to allow consumers to view all of their other sources of retirement (such as DB and state pension entitlements) in one place.**

In the longer term, we would like to see the development of a 'Pensions Dashboard' in the UK which would enable consumers to view all of their lifetime pensions savings, including their state pension, in one place.

Qualitative evidence indicates that the Pensions Dashboard in the Netherlands, which allows individuals to log in to view their total pension and non-pension assets, has encouraged consumer engagement with pensions by making them more tangible and visible to retirees. A Pensions Dashboard would allow consumers with several pension pots to have a clear understanding of their accumulated pension wealth. This is likely to benefit increasing numbers of people in the future with the introduction of automatic enrolment. Consumers with a better understanding of their accumulated pension wealth should make better informed decisions when taking their benefits.

We are aware that the idea of a Pensions Dashboard has been raised in the past and we recognise the challenge in implementation and cost for such a project. However, it has been successful in other countries, and we believe that the case for introducing it in the UK is getting stronger. Our provisional findings indicate that the quality of information provided to consumers could significantly improve their engagement with the market and subsequent outcomes. We consider that this initiative can make an important contribution in that respect.

Please set out your views on:

4A: Whether the proposal could contribute to addressing the concerns we have identified?

4B: Whether, beyond those we have identified, you foresee any difficulties implementing this proposal?

4C: How this proposal should be implemented and by whom?

Market monitoring activity

5. We will continue to monitor the market and are seeking views on whether there are any particular aspects (in addition to those set out below) that we should monitor.

Given the changes to the retirement income landscape and expected impact on market dynamics we propose a number of monitoring activities to track market developments and consumer outcomes, and spot any potential warning signs early. If consumers appear not to be getting the support or products they need, and/or competition is failing to drive good value, we will consider what intervention is appropriate.

We have identified the first wave of new products that firms are likely to bring to the market in 2015. While product innovation is welcome there are risks that we will need to monitor.

Understanding consumers' awareness, their understanding of products and the factors influencing their choices will be important as we move into the new landscape. Our consumer research has identified that consumers have a limited understanding of how to use more complex products, such as income drawdown, yet one third of the consumers in our sample intend to purchase income drawdown.

Consumers who are retired with money to invest are one of the groups identified as being particularly at risk of investment scams, so we have targeted our messaging at them in our recent ScamSmart national consumer campaign. In addition, we are aware of firms offering to release pensions before age 55 (known as early pension release or pension liberation), which may be a scam unless certain circumstances, such as ill health, apply. With the landscape changes to taxation giving consumers greater incentives to withdraw large sums of money from their pension savings, consumers are potentially more susceptible to or are a more attractive target for, investment scams. We remain vigilant for scams targeting consumers at retirement.

Monitoring market developments

In chapter 8 of this report, we set out our initial thinking on the possible extent and form of product and supply chain innovation in the new landscape. As part of that initial analysis, we identified the following competition issues that could potentially arise in the new landscape:

- consumer inertia
- barriers to switching, and
- a paradox of choice.

In light of these potential risks, commencing early 2015 we propose to monitor the retirement income market to develop a macro-level picture of how the market is developing. This will build on the work we currently undertake as part of our responsibilities and enable us to understand both changes in product development and features; and firm entry into, and exit from, the market in the new landscape. We will use the information we gather as an indicator of whether there are micro-level problems that require us to revisit the market at a later stage. Our supervision work will focus on the key conduct risks arising from the market changes.

Monitoring consumer behaviour and outcomes
In chapter 4 of this report we explored both current and potential future consumer behaviour in the retirement income market. We concluded that barriers to a well-functioning market already exist from a consumer perspective, and these could persist in the new landscape, in particular a lack of engagement, shopping around, and behavioural biases.

Therefore, we propose to monitor consumer behaviour and outcomes in this market through the use of regular consumer surveying to understand changes in consumer behaviour and awareness in the new landscape. This work will build on the quantitative survey of 1000 consumers conducted for this market study.

This monitoring, combined with our monitoring of market developments, will also provide us with high level indicators of any consumer inertia.

Please set out your views on:

5A: The proposed monitoring activities set out above.

5B: Any additional aspects that we should consider monitoring.

10. Next steps

This report set out the provisional findings of our retirement income market study and describes the proposed remedies we intend to take forward to make competition work well for consumers.

Before finalising our findings and deciding on a package of remedies we are consulting interested parties. In particular, in addition to the points set out in Chapter 9 above, we would welcome your views on the following questions.

i. Do you agree with the conclusions we have drawn from our analysis?

ii. Are there any reasons why our provisional findings should not become final?

iii. Are our proposed remedies likely to be effective in addressing the issues we have found?

iv. Are there any other remedies that we should consider?

The participants in this study, as well as any other interested parties, are invited to provide any views in writing, including relevant supporting evidence by 30 January 2015.

Once we have considered the consultation responses we will produce our final report in 2015.

To the extent that any final remedies we propose require changes to the FCA rules, these will be subject to a separate formal consultation and cost benefit analysis.

We look forward to working closely with industry, consumer groups, Government, and other interested stakeholders as part of this process.

Glossary of terms used in this document

The table below sets out key terms we use in this document and how we have defined them:

Term	Definition
ABI Code or ABI Code of Conduct on Retirement Choices	The ABI's compulsory Code of Conduct sets out how ABI members help their customers understand the choices they need to make at retirement, different ways to take income, and how to shop around. The Code came into force in March 2013 following a consultation period.
Accumulation	The phase during which a consumer saves into a pension pot during his/her working career to build up a pension pot for their retirement.
Adverse selection	Adverse selection arises where an individual's demand for insurance is positively correlated with his/her risk of loss and the insurer is unable to reflect this in the price of insurance.
Annual Management Charge (AMC)	Charges paid by consumers to firms in return for managing the client's investment fund.
Annuity	A product that allows a consumer to convert his/her pension savings into a regular guaranteed income that will last for the rest of his/her life.
Annuitant	A consumer who has bought an annuity.
Annuity rate	The yearly rate of return associated with a certain type of annuity expressed as a percentage of the premium that the consumer pays for the annuity. This may be fixed or variable depending upon the type of annuity purchased.
Assets under management (AUM)	The market value of assets that a firm manages on behalf of its investors.
Automatic enrolment	A legal requirement that every employer must automatically enrol its workers into a qualifying pension scheme if they are aged between 22 and state pension age, earn more than £10,000 a year and work in the UK. Employers will gradually enrol all eligible workers into qualifying pension schemes between 2012 and 2018.
Back-book business	Policies that are no longer sold but which remain on an insurer's books as premium-paying policies.
Bulk annuities	Sometimes referred to as a bulk purchase annuity, these are contracts between a defined benefit/workplace pension scheme and an insurance company to insure some or all of the liabilities of the pension scheme.
Buy-to-let investments	Consumers purchase property specifically for the purpose of letting, with the aim of generating an income.
Conduct of Business Rules (COBS)	The conduct of business requirements which apply to firms, with effect from 1 November 2007.
Consumption frame	In the context of this market study, a consumption frame describes the presentation of a retirement income product in a way which shows the amount the individual will be able to spend over a specific period of time.
Collective pension schemes	From 2016, employees will be able to pay into large workplace funds shared with other pension scheme members. Pension contributions paid into the fund will be pooled rather than segregated into individual pots.
Consumer inertia	In the context of this market, individuals base their purchasing decision on those that require the least effort.

Term	Definition
Consumer redress	A form of compensation paid out to consumers who have suffered financial losses, for example, as a result of firms' failure to comply with the FCA's Rules or Principles.
Collective defined contribution pension scheme (CDC)	A pension scheme whereby the employer pays a fixed rate of contributions and risk is shared between the members.
Decumulation stage	The process of converting pension savings into a retirement income.
Defined ambition pension schemes (DA)	A new type of workplace pension proposed by the Government which seeks to: • give greater certainty to members about the final value of their pension pot than a DC pension, and • provide less cost volatility for employers than a DB pension.
Defined Benefit pension (DB)	A scheme in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring, and the length of pensionable service. Also known as 'final salary' or 'salary-related' scheme.
Defined Contribution pension (DC)	A scheme in which a member's benefits are determined by the value of the pension fund at retirement. The fund, in turn, is determined by the contributions paid into it in respect of that member, and any investment returns. Also known as a 'money purchase' scheme.
Direct to Consumer (D2C)	Firms distribute their retirement income products directly to the consumer as opposed to through an intermediary.
Enhanced annuity	The annuity rate payable to the consumer is higher (because the annuity provider expects to provide the income for a shorter period of time) for individuals whose life expectancy is affected by their lifestyle choices of certain medical conditions.
Equity release products	Products that enable a consumer to access the equity acquired in his/her property. Typically equity release products will either be lifetime mortgages, which allow an individual to borrow a proportion of their home value, or home reversion, where an individual sells a share of their property, but retains a right to continue living in the property.
"Execution-only"	Sales whereby a consumer requests a specific product from a provider or intermediary and chooses not to receive full, simplified or focused advice at that time.
The Financial Services and Markets Act 200 (FSMA 2000)	The primary source of legislation governing financial services and markets in the UK.
Financial Services Act 2012	The Financial Services Act 2012 is an Act which implemented the new regulatory framework for the financial system and financial services in the UK. It replaced the Financial Services Authority (FSA) with the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) as the two UK financial services regulators. The Act sets out the regulators' statutory objectives and powers.
FCA Principles for Business	The fundamental obligations of all firms under the FCA's regulatory framework.
Guaranteed annuity rate (GAR)	In some cases, pension contracts include a provision which guarantees a minimum fixed rate at which a consumer can convert his/her pension fund into an annuity.
Guidance guarantee	The Government policy to provide everyone who has a DC pension fund access to a free (at point of delivery) and impartial pensions guidance service
Guidance standards	The standards set out by the FCA in its Policy Statement PS14/17 to monitor the designated guidance providers. These were published as 'near final' standards in November 2014 before the Pensions Schemes Bill 2014 is passed in its current form.
Hybrid products	Retirement income products which offer varying degrees of guarantees on capital and income including unit-linked, variable, and fixed-term annuities.
Income drawdown products	Products which allow individuals to take an income from their pension fund, while the remainder of the fund remains invested. Retirement income from income drawdown can increase or decrease according to the investment volatility of funds.
Incumbency advantage	The advantages enjoyed by firms already active in the retirement income market over other firms trying to enter into or expand within the market.
Internally vesting consumer	A consumer who purchases his/her retirement income product from the provider with whom he/she has placed their pension savings.

Term	Definition
Introducers	Introducers act as intermediaries between consumers and providers. An example of an introducer is a price comparison website.
Investment frame	In the context of this market study, an investment frame describes the presentation of a retirement income product from the point of view of the amount of income gained from investing a specific amount.
Lifestyling	An asset allocation strategy used mainly in defined contribution schemes whereby a member's investments are adjusted depending on age and length of time to retirement. Typically assets are switched gradually from equities to bonds and cash as retirement approaches.
Longevity risk	The risk of consumers outliving their projected life expectancy.
Loss aversion	An economic term which refers to a consumer's preference for avoiding losses, rather than for acquiring gains.
Market value reduction (MVR)	A deduction made by pension providers, for example on certain withdrawals or switches from or between with-profits funds.
Money's worth analysis	An analysis of the proportion of the premium that a consumer purchasing an annuity will get back, taking into account expected mortality and investment returns.
Mortality assumptions	Projections of expected death rates used by actuaries to estimate insurance premiums and pension obligations.
Open Market Option (OMO)	Introduced by the Finance Act 1975, the open market option allows an individual approaching retirement to shop around on the 'open market' for products to convert their pension savings into a retirement income product. That is, consumers do not need to secure their retirement income from their existing provider.
Pensions Dashboard	An interactive digital tool enabling people to view all their pension savings in one place.
Pensions guidance service	The pensions guidance service will be delivered from April 2015, as a result of the Government's guidance guarantee policy.
Pension liberation or early pension release.	The practice whereby firms offer to release a consumer's pensions before he/she reaches the age of 55 by conducting a "pension review". The reviews can result in the consumer receiving poor or fraudulent advice unless exceptional circumsatnces, such as ill health, apply.
Personal pension	An individual makes regular or lump sum payments to a pension provider.
Pillar I and Pillar II capital requirements	Types of capital requirements that insurance undertakings are required to hold under the regulatory framework.
Policy Statement	FCA issued Policy Statement 14/17 *Retirement Reforms and the Guidance Guarantee* on 27 November 2014.
Present bias	An economic term which refers to an individual's tendency to fail to consider the impact of their choices today on their future consumption capability.
Profitability (expected)	The value of profits that providers expect to make in the future from the annuity business written in a particular period.
Prudential Regulation Authority (PRA)	The PRA is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. In total the PRA regulates around 1700 firms.
Restricted panel arrangements	One pension provider selects a number of annuity providers to participate in a panel, which offers quotes to consumers. Panel arrangements are widely used by providers of retirement income products.
Retail Distribution Review (RDR)	A set of rules established by the FCA in 2013 aimed at ensuring fairness and transparency for consumers in the investment industry.
ScamSmart	The FCA's consumer awareness campaign which informs people about investment scams, the types of tactics used by fraudsters and tips on how to avoid scams.
Selected Retirement Date (SRD)	The date nominated by the consumer or pension provider at which the individual intends to retire and take benefits from his/her pension. This date is usually linked to the state pension age.

Term	Definition
Self-invested personal pensions (SIPP)	A pension 'wrapper' that holds investments until an individual retires and draws a retirement income. It allows individuals to make their own investment decisions from a range of investments approved by HM Revenue and Customs (HMRC).
Small Self-Administered Scheme (SSAS)	A workplace trust-based pension scheme usually established by directors of limited companies for specified employees of the company.
State Earnings-Related Pension Scheme (SERPS)	A Government arranged pension dependent on the amount an individual was paid whilst he/she was working. SERPS pensions were replaced in 2002 by the State Second Pension.
"Shopping around"	The process whereby consumers look for information on retirement income products they wish to buy. This may include looking in the press or online and obtaining actual quotes from alternative providers.
Solvency II	The European Solvency II Directive ("Solvency II") will be adopted by all 28 member states of the European Union and 3 of the countries in the European Economic Area by the end of 2016. The Solvency II Directive is the result of a comprehensive review of the capital adequacy regime for the European insurance industry.
Stakeholder pension	Payments made by an individual to a pension provider who invests the funds.
State pension	A regular income paid by the Government to individuals who have reached state pension age.
State Second Pension	The earnings- related element of the state pension scheme which has replaced the State Earnings Related Pension Scheme to enhance the basic state pension.
Switching	The process whereby consumers decide to end their contract with their pension provider and purchase an at-retirement product from another provider.
Thematic review of annuities ("our previous thematic review")	The FCA conducted a review and published its findings in TR14/2 Thematic Review of annuities, February 2014.
Thematic Review of Annuity Sales Practices	The FCA conducted a review and published its findings in TR14/20 Thematic Review of Annuities Sales Practices, December 2014.
Third-party arrangement	An arrangement between pension providers and annuity providers whereby one provider agrees to supply annuities for all or a subset of the other provider's existing pension customers.
Trivial commutation	Consumers are permitted to take smaller pension pots (less than £30,000) as a lump sum payment subject to conditions.
Uncrystallised Fund Pension Lump Sum (UFPLS)	An authorised lump sum, which can be paid on or after 6 April 2015 from uncrystallised funds under a money-purchase or DC arrangement to certain individuals aged 55 or over, without the requirement to buy a decumulation product.
Vesting provider	A provider with whom an individual has placed their retirement savings during their working life.
Wake-up pack	Information sent to consumers before they decide which retirement income products to purchase.

Financial Conduct Authority

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