Securing the future of pensions

FCA Retirement income market study: Interim Report

A response by the National Association of Pension Funds

January 2015

www.napf.co.uk

Contents

Overview

The NAPF welcomes the FCA's comprehensive analysis of the current retirement income market and consideration of the issues that arise from the changes introduced by the Freedom and Choice (F&C) agenda. Reforms are required to the procedures for helping pension savers get the most from their pension savings; both as a consequence of current market practices in the annuity market and in response to Freedom and Choice.

However, it is important that any reforms take account of pension savers from both trust-based and contract-based accumulation vehicles, since both will potentially engage with a range of FCA products at retirement and a wide range of alternative investments. **The NAPF is calling on the FCA, DWP and TPR to work together closely to ensure that regulation is fit both for a future where consumer choices will be more complex and for translating to the trust-based sector.**

While reforms are clearly necessary, there is a risk that the FCA's proposals concentrate too much on the historic flaws in the annuity market, with insufficient focus on the radical changes in the retirement income market, and on what savers need to do and too little on the outcomes they deserve to achieve. **The FCA, together with DWP and TPR, should be clear about what constitutes a 'good' outcome and regulate only where it drives progress towards 'good'. Clarity on outcomes will also help in the development of the right framing, heuristics and other behavioural techniques which we agree will be essential in helping savers as well as helping to shape good, new retirement income solutions.**

The new retirement income environment will expose pension savers to many new risks and challenges that regulators will need to be fleet of foot in addressing in order to prevent poor outcomes. Helping consumers avoid fraud or clearly poor outcomes will require a multi-agency approach with liaison between FCA, the Government, the Pension Regulator and the pension sector itself. I**n designing rules, the FCA will need to consider the emergence of new customer journeys into retirement and retirement income vehicles in such a way that it does not inhibit schemes from delivering good outcomes for their members.**

In any redesign of new rules and processes, consideration will also need to be given as to the additional costs of introducing this requirement and how that cost is to be borne by pension savers. In particular, **the FCA should consider the implications of the change for pension savers whose schemes and funds are subject to the charge cap being introduced in April 2015**. Creating additional costs that have to be borne by such savers could mean that they either have to bear the cost directly or, in some cases, that other services are sacrificed to keep under the charge cap.

The NAPF wishes to contribute further to this debate and the development of regulations for the new retirement income landscape. It will be important that the debate is carried out with reference to and an acknowledgement of the interaction other initiatives and regulations, in particular the latest proposals for automatic transfers and charge cap.

Introduction

1. The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector. We aim to help everyone get more out of their retirement savings. To do this we spread best practice among our members, challenge regulation where it adds more cost than benefit and promote policies that add value for savers.
2. The NAPF welcomes the FCA's comprehensive analysis of the current retirement income market and consideration of the issues that arise from the changes introduced by the Freedom and Choice (F&C) agenda. The NAPF also fully supports the view that reforms are required to the procedures for helping pension savers get the most from their pension savings; both as a consequence of current market practices and in response to Freedom and Choice.
3. The market that emerges in 2015 and 2016 will, most likely, begin to look less and less like that which exists today. Any reforms must work well to remedy past issues but, more importantly, must encourage and facilitate the development of good consumer outcomes.
4. There is a risk that the FCA's proposals concentrate too much on what savers need to do and too little on the outcomes they deserve to achieve. The FCA, together with DWP and TPR, should be clear about what constitutes a 'good' outcome and regulate only where it drives progress towards 'good'. Clarity on outcomes will also help in the development of the right framing, heuristics and other behavioural techniques which we agree will be essential in helping savers.
5. It is important that any reforms take account of pension savers from both trust-based and contract-based accumulation vehicles, since both will potentially engage with a range of FCA products at retirement (and, as noted in figure 5 in the report, a wide range of alternative investments). Moreover, if the FCA's lead on reforms of both the sales process and disclosure is later reflected in DWP / TPR regulation, it is critical that the views of trust-based schemes and the Pension Regulator are considered at an early stage. The NAPF is calling on the FCA, DWP and TPR to work together closely to ensure that regulation is fit both for a future where consumer choices will be more complex and for translating to the trust-based sector.
6. Summarised in the chapters below is the NAPF response to the following feedback questions:
    a. Do you agree with the conclusions we have drawn from our analysis?
    b. Are our proposed remedies likely to be effective in addressing the issues we found?
    c. Are there other remedies we should consider?
7. In addition to commentary on the findings relating to the FCA regulated parts of the pension market, we have added a number of observations about the important, and potentially growing, relationship between trust-based pensions and FCA regulated firms.

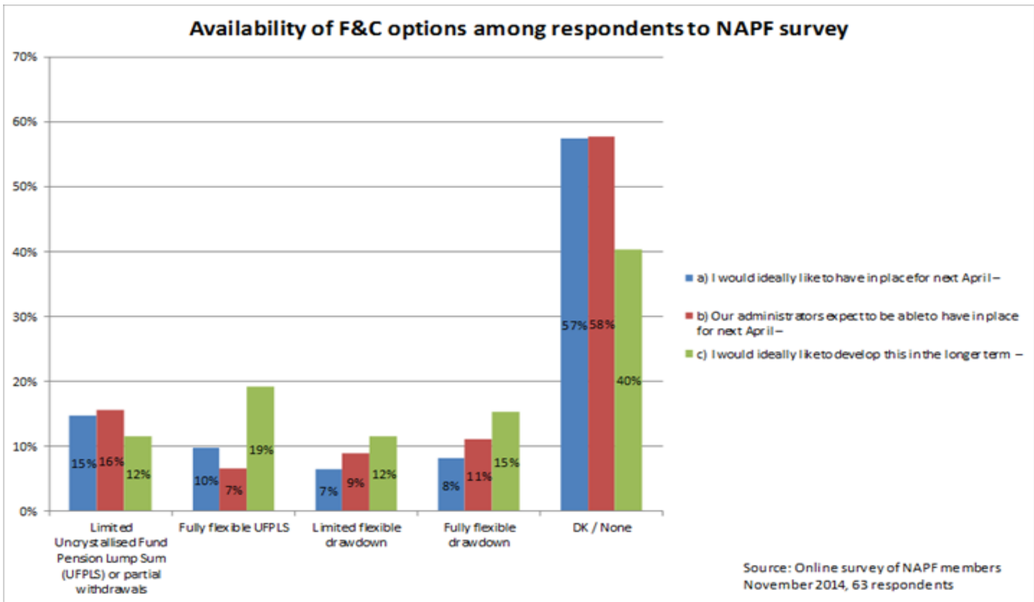
NAPF views on FCA analysis and conclusions

8. In our response to the FCA analysis and conclusions, we have considered the following set of issues (and in each have considered whether there are any peculiarities that relate to the trust-based market):
   - Analysis of current and prospective consumer behaviour
   - Analysis of the supply chain and supply chain behaviour
   - Analysis of the whether competition works in the retirement income market
   - Lessons from international comparisons
   - Innovation in the retirement income market
   - Overall conclusions

Consumer behaviour

9. The NAPF supports the findings from both the FCA's thematic review and subsequent research that demonstrate the extent to which consumers engage with or resist shopping around and switching. The reasons for not shopping around are complex and bound up not only with behavioural biases but also consumer experience of shopping around and advice in other financial markets. Perceptions about the complexity, cost and value of advice may be offset against the perception, and for some, the reality, that relatively small monthly or annual gains that can be made by shopping around.
10. We would agree that while there is a trend towards phased retirement, it remains the case that for the majority, retirement is a one-off event that takes place at either state pension age or the individual or scheme's selected or normal retirement age. In developing regulatory policy in this space, it will be important to reflect both the diversity of retirement patterns and the unpredictability of retirement for many. Factors such as individual and family health, employability, employer attitudes, economic conditions, investment returns all make the date at which an individual will need to or want to retire largely unknowable and certainly unpredictable.
11. For some time to come, it may also remain the case that many trust-based pension schemes will require savers to make a one-off decision to transfer their money to another vehicle that can provide the new flexibilities of drawdown and/or UFPLS or to purchase an annuity. A recent survey of NAPF pension fund members[1] suggested that more than half expect to have none of the flexibilities built into their schemes for April and a significant minority have no plans to develop in the longer term.

[1] NAPF survey of fund members, November 2014, 72 completed surveys, resulted unweighted



12. We agree that decisions for consumers will become more complex from April, not simply because of the new freedoms that the legislation will introduce but also because the market for retirement income products and the choices made available to pension savers through their own schemes will still be evolving. We share your concerns about the difficulties faced by pension savers and agree that, at least in the short-term, there is likely to be an increase in the take-up of new-style income drawdown and a fall in annuity sales. We have also seen evidence of an inherent contradiction between what savers say they want to achieve from their pension and their attitudes to different retirement income vehicles. In a recent consumer study, NAPF research highlighted that 82% of those aged 50-70 expressed a preference for a secure lifetime income over a more flexible but less certain option[2]. The preference for security is endorsed in qualitative research where, in the same breath, pension savers will state a preference for a lifetime income but reject annuities as a solution to their retirement income needs.
13. It remains to be seen whether it will become widely broadcast and known that generating a secure income through drawdown might mean taking a lower income than would be available through a lifetime annuity. This may yet change attitudes towards annuities and future behaviour. Another important factor in behavioural outcomes will be the solutions offered by existing providers (in the contract-based world) and trust-based schemes. **In addition to the Government's pension guidance service, both FCA regulated firms (whether managers of contract-based pensions, advisers or providers of retirement income products) and trustees of trust-based pension schemes should highlight the risks and benefits of the new options available to pension savers.**

2 NAPF consumer research, July 2014,

However, the regulations should fall short of an obligation to ensure that the consumer understands the risks and benefits.

14. We support the work of the FCA in reducing the scope for misleading offers of advice and guidance that could lead to fraud or speculative, high risk investment schemes. **Helping consumers avoid fraud or clearly poor outcomes will require a multi-agency approach with liaison between FCA, the Government, the Pension Regulator, consumer bodies and various parts of the pension and retirement income sector .**

Supply and distribution / Competition / Innovation

15. The NAPF recognises the different arrangements available in the annuity market. Many trust-based schemes currently tend to refer their members to the open market, through the services of an adviser or broker, if they wish to purchase an annuity. However, some have their own special arrangements whereby they have negotiated improved rates for their members that would typically not be available on the open market. **In any redesign of the market and the purchasing process that could have knock-on effects for trust based schemes, it will be important not to negate the benefits afforded in such arrangements by introducing restrictions on how pension savers can access an annuity.**

16. There is nothing to prevent a trust-based scheme compiling a restricted panel of annuity or drawdown providers, such as that developed by NEST, although trustees may be concerned about whether by doing so they are deemed to be giving advice. **Whether a provider or a trust-based scheme, it is important that the process of selecting a preferred annuity (or other retirement income) provider or panel is transparent and it seems wholly appropriate that any conflicts of interest are declared and, where commission is received, that this is disclosed up front to the buyer**.

17. Where members currently fail to make a decision, recent NAPF research suggests that trust-based schemes typically either leave the fund invested or continue to nudge the member to make an active decision through the open market. It is less clear what trust-based schemes will do going forward. Many may, in the short term at least, expect to facilitate access to the open market for annuities and other retail retirement income products through intermediaries, although many intermediary offerings have yet to be clarified or launched and the range of alternative products available in the market is likely to be complex and fragmented and difficult to compare. Others may wish to offer their members a solution that helps to mitigate some of the risks that Freedom and Choice opens up and which offers a pathway to those not wishing to engage with the open market.

18. Ensuring that advice and other mechanisms for shopping around deliver value to pension savers will be a critical element of the work of the FCA. The financial and other benefits of taking advice should outweigh the cost of that advice. **The NAPF would support the development of simplified advice solutions that can be delivered cost effectively to a wider group of pension savers than is currently feasible. However, the FCA should also recognise that advice is not the solution for all pension savers and that other routes to a good outcome may be suitable.**

Indicators of competition and innovation in the market

19. The NAPF agrees with the description of what constitutes a competitive market and that price, quality, range and service are important parameters of competition. The NAPF supports the FCA's approach to seeking to ensure that the characteristics of a competitive market are at the forefront of its approach to regulation. However, in the short term, pension savers are likely to feel less informed and more confused in the new market than they are at present. The solutions for early adopters of Freedom and Choice may well prove to be different than the solutions to create a competitive market. Solutions which meet certain standards but do not involve shopping around may well prove less harmful than encouraging consumers always to shop around. A balance needs to be struck between helping those retiring in the next few years and the longer term needs of the market.
20. The FCA is right to be concerned about the increase in complexity and choice for those reaching retirement. Monitoring changes in the market will be critical in shaping future regulation, both in the contract- and trust-based sectors of the market.
21. Bearing in mind the growing difficulty that pension savers will have in navigating the market and avoiding poor outcomes, the NAPF would caution against applying prescriptive rules and regulations based on the workings of the current market but to allow any future regulation to be shaped by how the contract- and trust-based sectors respond to the permissive override. While we recognise the importance of protecting consumers against providers who have an interest in retaining the relationship post retirement, in developing solutions to deal with this, the FCA should be mindful of new and worse risks that could arise by overstating the benefits of shopping around. In some, although not all cases, suitable products, as well as a less stressful process, may well be available from:
22. within their existing scheme; or
    - a special deal has been negotiated by their existing scheme or provider which is not available on the open market; or
    - from services provided by their employer (such as access to paid for advice or broking services).
23. As part of the guidance process, and any further rules developed by the FCA and subsequently by the DWP for trust-based schemes, savers should be encouraged to consider the options already open to them which may prove cheaper and more effective than any solution found by shopping around. The FCA should also consider both the benefits and future possible hazards that could arise from shopping around in a market that is immature and does not yet have all of the traits of a competitive market identified in this report.

Further work required?

24. While the work carried out for this project is comprehensive, before finalising the findings, we would ask the FCA to consider in more detail the interaction between the trust-based scheme sector and FCA regulated firms and products, in particular in relation to its recommendations. The NAPF would be happy to help further in evaluating the issues and providing access to issues facing trust-based schemes in this new market.

NAPF views on proposed remedies

Recommendation 1 - Compare quotes to open market

25. The NAPF supports the requirement for FCA-regulated firms to provide their customers with a comparison of their annuity rate with the open market, showing not only the annual difference but also the estimated lifetime difference. Such a move should either stimulate more shopping around by consumers or, at the very least, make the difference more evident to the consumer, enabling a more informed decision to be taken.
26. In arriving at a final recommendation on this issue, the FCA should also gather evidence of whether such a move would reduce or widen choice and competition in the annuity market. The FCA should consider whether the move is likely to trigger the withdrawal from the market of any annuity providers (recognising that there may be other changes that could bring about a similar effect).
27. Consideration will also need to be given as to the additional costs of introducing this requirement and how that cost is to be borne by pension savers. In particular, The FCA should consider the implications of the change for pension savers whose schemes and funds are subject to the charge cap being introduced in April 2015. Creating additional costs that have to be borne by such savers could mean that they either have to bear the cost directly or, in some cases, that other services are sacrificed to keep under the charge cap.
28. While the FCA rules will apply only to contract-based providers of pensions, it is important to state that the requirement to provide this comparison should not be applied to trust-based schemes where the trustees have selected a preferred supplier or a panel of annuity providers. In such cases, the trustees' responsibilities to the scheme member should be relied upon to deliver good outcomes.

Recommendation 2 - Take into account framing effects and biases

29. The NAPF supports the view that FCA-regulated firms should take account of consumer biases and the role of framing in supporting improved consumer outcomes. This will become all the more important as the choices available to consumers and the products serving those choices become more diverse and complex from April onwards.
30. Framing information in a way that ensures a good outcome is important but so is clarity on what a good outcome for the consumer is. In a world where pensions were intended to deliver an income throughout retirement, the outcome was clear and framing that ensured a sustainable income was relatively simple and supported by the legal limitations in drawing that income. In a world of Freedom and Choice, it is less clear what represents a good outcome and what framing should be seeking to achieve.
31. The NAPF would support a move towards a clear statement from the FCA (and HMT and DWP) of what constitutes a good (and a bad) outcome and more specifically that a good outcome in relation to retirement income decisions is a sustainable income that affords the member flexibility and/or certainty. Framing can then be considered in the light of this. The key issues then become

clearer. Helping savers understand the implications of investment and longevity become central to the debate.

32. Rules of thumb, such as the guidance that taking x% of the pot as income is appropriate or probability of living to a certain age, require very careful testing and consideration. The FCA will need to test not only whether these help in framing decisions but also whether they might prove misleading by suggesting that by following the rule of thumb, individuals come to believe that they will not run out of money in retirement. If the latter proves to be the case, firms or schemes using these rules of thumb could face the challenge of misselling in the future. Rules of thumb should be encouraged only where the risks remain evident to the pension saver and do not oversimplify what will remain a complex and risky set of decisions.
33. While supporting further work in this area, the NAPF anticipates that it will be difficult to regulate for framing and would advocate that detailed rules are not imposed either on FCA regulated firms or on trust-based schemes. It will be equally important for *Pension wise* to take account of the points made above.

Recommendation 3 - New wake up pack

34. The changes to the market and to consumer decisions being introduced in April demand that firms and schemes change the way in which they communicate with their members. A thorough review of the material required to be sent to pension savers in advance of, at retirement and in some cases through retirement is critical.
35. While it remains for the FCA to decide how best its regulated firms should communicate, we would call on the FCA and DWP to consider carefully the implications for trust-based schemes, where employers and trustees work hard to ensure that their communication to members reflects the make-up and needs of their particular member profile. Careful consideration also needs to be given to parts of the automatic enrolment market where communication with members is largely achieved on-line.
36. The NAPF would not support the universal application of a standard and imposed approach to either the content or medium of 'at retirement' communications. However, guidance on what key messages, the broad shape of communication and the most appropriate timing, with scope for schemes to adapt to their own style of messaging, would be welcome.
37. In providing guidance on appropriate forms and content of communication, the FCA should be cognisant of the cost implications of any changes and the way in which those costs will be borne by pension savers in the form of higher or additional charges.

Recommendation 4 - Pensions dashboard

38. The proposal to develop a Pension Dashboard for all UK pension savers is laudable. Subject to cost considerations, any move that helps savers see all of their pension savings in one place should help savers to achieve better retirement outcomes.
39. However, information alone will not in and of itself not necessarily deliver higher levels engagement or better outcomes and it should not simply be the feasibility of this project that determines its progress but also evidence that it makes a real difference to behaviour. The project is likely to bring significant additional costs that will need to be borne by pension savers in many instances. A detailed cost benefit analysis should be carried out as part of any decision to progress.

40. As noted by the FCA, attempts to deliver a dashboard in the past have been explored in some detail but have failed to be achieved. New technology may make it easier to achieve today but progress will only be made if the whole pension sector and government support its development.
41. The NAPF would be happy to contribute to further debate on this issue but would want the debate to be carried out in the context of other initiatives and regulations, in particular the latest proposals for pot follows member and the charge cap.

Recommendation 5 - Monitor the market

42. The NAPF wholeheartedly supports the recommendation that the FCA monitors market developments from the perspective of both supply and demand. In monitoring supply of retirement income solutions, it will be important to track not only developments in the FCA-regulated space but also developments in the trust-based sector and in particular consider how scheme developments might influence the recommendations made by the advice sector and the guidance delivered by *Pension wise*. Today and potentially more so in the future, the best outcomes for pension savers may not come from shopping around in the retail market.

Other remedies

43. While the NAPF concurs with the FCA ideal of what a competitive market should look like, we have particular concerns about consumers' ability to shop around for the most suitable retirement income product in the short to medium term. As the FCA report points out, shopping around for a drawdown product is not easy, requiring as it does the ability to compare vastly different product structures, risks and charges. To find a suitable product on the open market, the majority of pension savers are likely to require advice. However, advice may either not be available because the saver has too small a pot or advice may be too costly for the consumer to bear (or be willing to bear).
44. While the NAPF acknowledges that shopping around is an important indicator of a competitive market, we would argue that it may be unrealistic to expect to achieve this in the near term. It matters more that pension savers get a good retirement income solution that is not irreversible with risks that are understood than shopping around itself. While the market evolves, better outcomes might be achieved by presenting pension savers with a narrower range of solutions than by asking them, or even advisers, to shop around across the whole market.
45. The FCA should not seek to close the door on providers, advisers and schemes who seek to help pension savers by presenting a more narrow range of options but should require such arrangements to be transparent in the way that they are constructed and subject to the broader requirements of TCF.
46. Further consideration needs to be given to the role that IGCs play or should play in supporting good retirement income outcomes for pension savers in contract based schemes. The NAPF would support extending the terms of reference for IGCs to include consideration of retirement solutions.