NAPF

Securing the future of pensions

Creating a Secondary Annuity Market: a response by the National Association of Pension Funds

June 2015

www.napf.co.uk

Contents

Executive Summary

1. The NAPF supported the previous Government's proposals for greater freedom and choice in how people access their money at retirement. We feel they have the ability to increase the attractiveness of retirement saving and give individuals greater flexibility to tailor their retirement savings to their needs.

2. The proposals to create a secondary annuity market by changing the tax treatment of assigned annuities can be seen as an extension of these freedoms. However, these proposals do mark a critical shift, with existing beneficiaries of a retirement income now being allowed access to the pension freedoms.

3. The NAPF is concerned that key structural issues will make it extremely challenging for a fair and balanced market to develop:

    a. the numbers of sellers (today's annuitants) is uncertain and is likely to be time limited;

    b. buyers will be wary of adverse selection and will compensate, either through pricing short longevity into all contracts or through individually underwriting: either way, the value available to some or all sellers will be reduced;

    c. sellers need protection in the form of independent advice and this will come at a cost, removing further value;

    d. the cost of building the infrastructure needed to package and sell such contracts to institutional investors will erode value further; and

    e. even with this infrastructure in place it is not clear who will wish to buy annuities, our survey of NAPF members suggests a very limited appetite among pension schemes.

4. There is a real risk that consumer expectations have been raised and yet the key components do not exist in which a viable, fair and efficient market can develop. This would only further damage the perception of the industry and retirement provision more generally. The NAPF believes that the Government must be fully confident that there is a realistic way of proceeding with these proposals before it raises consumer expectations further.

The NAPF

5. 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.

6. We aim to help everyone get more out of their retirement savings. To do this we promote policies that add value for savers, challenge regulation where it adds more cost than benefit and spread best practice among our members.

Introduction

7. The NAPF supported the previous Government's proposals for greater freedom and choice in how people access their money at retirement. We felt they had the ability to increase the attractiveness of retirement saving and give individuals greater flexibility to tailor their retirement savings to their needs.

8. However, we were quite clear in our response to those proposals that success rested on three factors:
   - the development of appropriate and good value retirement income solutions and defaults;
   - the emergence of Guidance services that support people making retirement decisions; and
   - a coordinated and timely approach to implementation of both the Budget proposals and the DWP's proposals for governance, transparency, a charge cap and automatic transfers that minimises the risk of detriment for savers.

9. Much progress has been made on the second and third factors in the last 15 months. However, there is still some way to go in the provision of appropriate and good value retirement income solutions and defaults. The NAPF's primary concern in responding to this consultation on further flexibility is that proposals for a secondary annuity market should not distract from or undermine the implementation of the central Freedom and Choice reforms. In particular the Government must make sure this does not divert focus or resource from the development of a much-needed market in retirement solutions.

10. The proposals to create a secondary annuity market by changing the tax treatment of assigned annuities can be seen as an extension of the retirement freedoms introduced at the end of the last Parliament. However, these proposals do mark a critical shift, with existing beneficiaries of a retirement income being allowed access to the pension freedoms.

11. The NAPF believes there are a number of key structural components required to ensure that a secondary market for annuities works effectively for both the sellers (the existing annuitants) and the purchasers (those acquiring the income stream). Our response assesses whether these components are present, or are likely to develop in order to assess the viability of such a market.

12. In informing this response we have drawn from recent research conducted with consumers who will be able to access the pension freedoms and a survey we conducted of scheme members to assess their appetite for investing in secondary annuities[1].

Creating a secondary annuity market.

13. The NAPF believes that for a fair, balanced and efficient secondary market to develop the following key components are required:

    a. Sufficient annuity holders willing to assign (sell) their annuity so that there is a plentiful supply to attract investors and justify building the infrastructure needed to support this market.

    b. Sufficient appropriate investors willing to buy these annuities and sufficiently confident that they can manage the selection of the appropriate annuities to meet their investment needs or can access appropriately packaged annuities from third parties.

    c. Infrastructure that brings together buyers and sellers in a way that is cost efficient and readily accessible by all parties and provides a mechanism for fair pricing.

    d. An appropriate regime that protects the annuity holder.

Are there enough sellers?

14. At present it is difficult to predict the level of consumer demand for assigning annuity contracts. As the consultation points out there are currently around 6m annuity contracts paying out £13bn to 5m people each year. Analysis by the Institute for Fiscal Studies[2] shows that these are mainly paid to people aged 65-74, demonstrating the relatively recent emergence of DC pensions and recipients in that age category have annuities of relatively higher value, as they have longer to live. The weighting of annuity contracts towards the more recently retired, some of whom may feel that they have been defaulted into an annuity or had no other options, could suggest that there may be a reasonable level of demand from this cohort. However, there is a real risk that assessments of the appetite for assigning annuity income is being based upon a small group of very vocal and unhappy buyers of annuities and extrapolated to the market as a whole.

---

[1] As part of its Understanding Retirement research programme the NAPF undertook two baseline surveys earlier this year. The first was a survey of NAPF pension scheme members from April to May 2015. There were 174 respondents with a mixture of public and private, DB and DC schemes. We also undertook a consumer survey March to April 2015 with 1024 individuals aged 55-70 with a pension pot they had yet to access.

[2] Annuity buy-back: thoughts on the potential market and possible pitfalls for pensioners, IFS, April 2015.

15. Factors such as inertia, concerns about how they will make ends meet without that regular income, low interest rates, a fear of being 'ripped off', the potential for a complex and time consuming process and cost of assigning annuities may all act as barriers to generating a significant supply of income streams for investors.

16. It is certainly the case that annuities have in recent years attracted considerable antipathy from consumers and the media. However, a recent NAPF survey of DC savers who can access the pension freedoms found that the current low rates were the main reason for not purchasing an annuity (48%). Not being able to leave money to family and not being able to change one's mind were much less likely to be cited as a reason not to buy (8% and 6% respectively).

17. The NAPF Understanding Retirement research programme suggests that those approaching retirement and those who are already retired are generally cautious about making rash decisions about their retirement security as shown by the most recent survey findings:

    a. Generating an income in retirement is still seen as the most important role for pension savings (84% of pension savers aged 55-70 agree that this is what they expect of their pension).

    b. Among DC savers who currently qualify to access the pension freedoms (aged 55-70), only 15% said that they would be accessing their funds in 2015. Furthermore, 55% are either waiting to see how the market develops or don't yet know how they will access their retirement funds.

    c. Among those who have some idea of what they want to do with their DC savings, a quarter still plan to buy an annuity with some or all of their DC savings. Among those who would now buy an annuity, 79% would do so because it provides security of income and just 21% saying that they would do so because they could sell it again if it proved to be a mistake.

    d. In addition 74% are attracted to the idea of drawdown for all or some oftheir DC savings. Only 10% plan to take all of their DC savings as cash.

    e. Only 3% of those with DB pensions are planning to move them to DC in order to access the freedoms.

18. Furthermore, the Government's own figures assumed that 70% of people will continue to purchase an annuity under pensions flexibility[3], although as suggested above, this may prove to be an over-optimistic estimate.

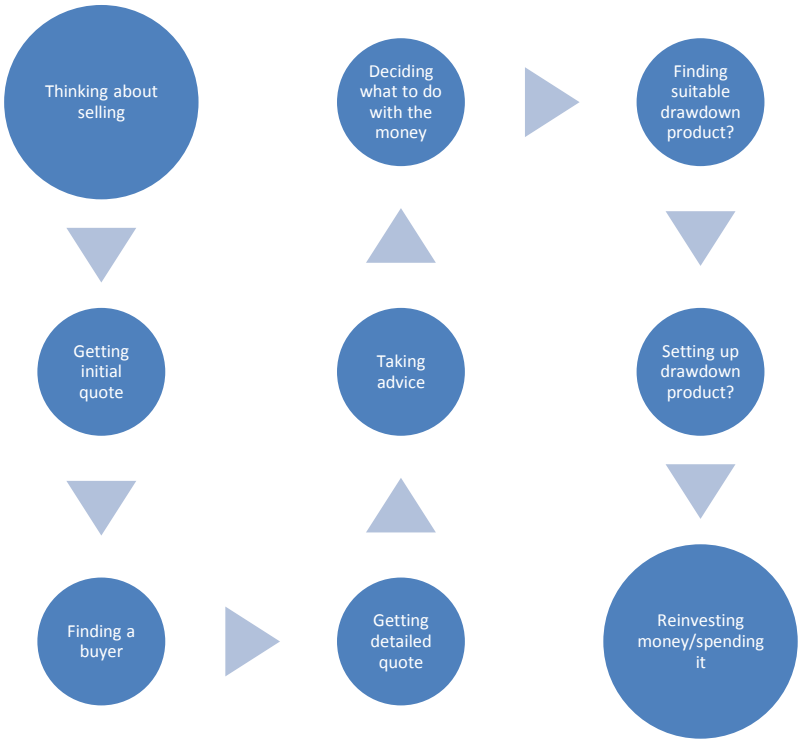
19. It is also worth considering which annuitants will be offered terms that they consider attractive or fair. The way in which the buyers of the income streams put a value on their investment will be one factor influencing the value that annuitants are offered and the perceived value for money. Buyers can either assume adverse selection among all annuitants and discount the amount that

[3] Budget 2014: Policy Costings.

they offer to all to account for that or each contract can be individually underwritten. In the case of the former, those in good health will receive a poor return while those in worse health may achieve a better return. If the latter, those in poor health may be offered what they perceive to be poor value while those in good health may find the market more attractive. Other factors that will influence whether the price offered appears to be value for money will be age, original annuity rate and gender. Women looking to sell their annuity may receive a lower quote if the insurer is unable to reflect the fact that they will live longer in the pricing.

20. Demand may also be suppressed by the complexity and cost involved in 'selling' an annuity. There are a considerable number of steps a consumer would have to take from thinking that they want to sell through to receiving their lump sum or reinvesting it. Figure one attempts to map out the steps a consumer would have to take to assign their annuity. A number of these come at cost, for example taking advice, which may prove an additional barrier but a necessary one given the complexity of the decision consumers are making in assigning their annuity.

Figure 1: The steps to annuity assignment



21. There are also question marks about the sustainability of this market. It is quite likely that any initial demand will drop off quickly. Whilst some of those who have purchased an annuity recently may welcome the ability to assign this contract in exchange for a lump sum due to the high frictional costs and access to greater flexibility it is unlikely that there will significant demand from future annuitants to unwind their decision. The supposition is supported by the Chancellor's policy costings, which show high levels of tax income in 2016/17 and 2018/19 as people 'sell' their annuities and pay tax on the lump sums they receive. This tax income then drops off

significantly and in fact reports a net loss in the longer term as people are no longer paying tax on their previous annuity income. [4]

22. In addition it would be argued that developing an expectation that people can 'unwind' their annuity whenever they feel like it could damage the annuity market to the detriment of those individuals who do want to fully hedge their longevity risk.

Are there enough buyers?

23. There are a number of potential buyers in this market:

    a. Insurance companies;

    b. Drawdown providers;

    c. Institutional investors, such as pension funds;

    d. Other investors looking for an income stream, potentially including overseas investors.

24. Given the NAPF membership, we have focused our remarks on appetite amongst our pension schemes to purchase these annuities. In particular defined benefit (DB) pension schemes as they are providing a scheme pension and are therefore seeking investments that provide a steady income stream linked to, amongst other things, the longevity of pension scheme members.

25. DB pension schemes are looking for a significant and sustained supply of assets that match their liabilities, in particular assets that provide a steady income stream and are a good hedge against inflation and changes in longevity. DB schemes are looking for such a substantial and sustainable supply of such assets that the current supply of inflation-linked gilts is estimated to outstrip demand until 2038[5]. Even if all current annuity contracts provided an appropriate match and could be sold with minimal intermediation there would still be a significant gap between supply and demand. Furthermore, most annuities contracts are fixed or flat-rate, rather than indexed, and therefore fail to offer DB schemes the inflation-proofing they increasingly seek from fixed income assets.

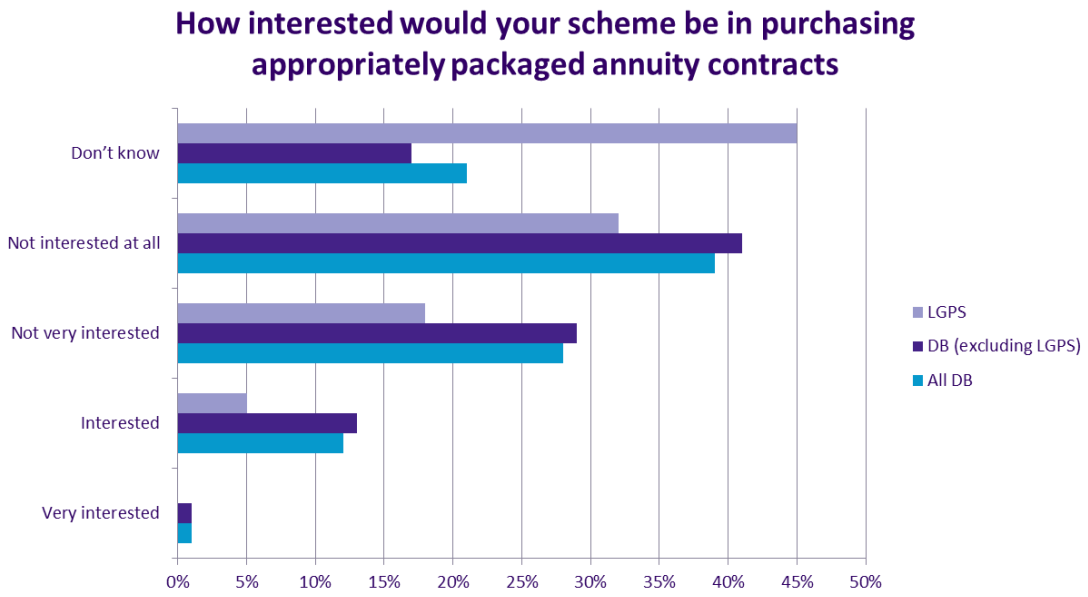
26. Annuity contracts could provide a partial hedge against longevity but only if packaged up in a way that meets the specific life expectancy of a DB schemes pensioner profile. Accessing these assets would require a significant amount of intermediation and added cost. Pension schemes would only access the market through securitisation or other forms of bundling and this would significant cost implications that are likely to outweigh the benefits of accessing these income streams.

---

[4] Budget 2015: policy costings.
[5] DB Run Off, NAPF, June 2014.

27. The lack of appropriate match and the costs of intermediation mean that appetite amongst our DB pension scheme members is likely to be limited. In a recent survey of NAPF DB fund members we asked them about their appetite for appropriately packaged annuity contracts. As figure 2 shows only 12% expressed interest, with just 1% very interested.

Figure 2



Sample Size: 160 (all DB respondents)

Appropriate infrastructure

28. In addition to sufficient demand from both the buy and sell-side of the market there also needs to be appropriate infrastructure in place to bring together buyers and sellers in a way that is cost-efficient and readily accessible by all parties and provides a mechanism for fair pricing.

29. There will be a significant cost in building such infrastructure, particularly if built by organisations other than the insurance sector, costs which will ultimately be passed onto the seller thereby increasing the frictional cost of selling annuities. Given that it is not all clear whether there is sufficient demand on either side of the market it is difficult to see the business case for investing in appropriate infrastructure. However, without such infrastructure it will be difficult for consumers, especially those with smaller annuities to find buyers without incurring even higher costs.

Consumer protection

30. It should be acknowledged that there will be circumstances in which it would be appropriate for a member to 'sell' their annuity, for example where an annuity was the only option open to them under the previous regulations but the income stream is not needed to support the household income. However, while there may be a set of rational decisions to 'sell', there may also be annuitants who are more vulnerable to the appeal of a lump sum and for whom 'selling' a secure income stream does not represent a good outcome, for example:

    a. We know that individuals consistently underestimate their life expectancy and struggle to understand investment returns and inflation. This will be an even greater issue as cognitive function declines with age and older annuitants may be more likely to struggle with these calculations.

    b. People are unlikely to be aware of the tax charges they will face should they assign their annuity in return for a lump sum. Depending on when this lump sum is paid relative to other income that individual may have received within that tax year they may be pushed in the higher rates tax brackets and could face tax charges of up to 45%.

    c. In addition those selling their annuity contracts may already be in receipt of the state pension and perhaps additional means-tested benefits, including pension credit. Those who retired before April 2016 are more likely to be in receipt of means-tested benefits as they will not qualify for the new State Pension and they need to fully understand the interaction between these benefits and any capital amount they receive from selling their annuity.

31. This is the primary concern as individuals need to fully understand the value of the benefit they may be giving up. The NAPF would argue that giving up a guaranteed income for life in order to access cash or a more flexible form of drawdown is the equivalent of a DB to DC transfer and therefore the NAPF strongly believes that those selling their annuity should receive **appropriate independent financial advice**. There has been some suggestion that an extension of Pension Wise would be sufficient to ensure that people were aware of the risks and that the price they were being quoted was fair, perhaps through some form of secondary annuity brokerage or benchmarking service. However we know from our own research that of the numbers of people who say that they will seek support the number who plan to use Pension Wise is limited - just over half of respondents to our consumer survey (51%) were very or quite likely to use Pension Wise and 35% were not very likely or not likely at all to use Pension Wise. It is also difficult to see the case for Government developing a secondary annuity brokerage service for what is likely to be a small and time-limited market.

32. Therefore, we would support the requirement that any individual wishing to assign their annuity to a third party must take independent financial advice if the notional value of their annuity (using a method to be determined) is above a certain amount.

33. There is a rationale for linking this amount to the £30k limit for DB to DC transfers; however this will depend on Government being confident that smaller value annuities are being priced fairly. It could be argued that those with smaller annuities who do not receive advice are at greater risk of being offered an unfair value for their annuity, and may be under greater pressure to realise the capital. They are also more likely to have interaction with the means-tested benefit system, either now or in the future and need to understand the implications of selling their annuity. An alternative might be to set the advice requirement at the small pot level of £10k as annuitants can currently surrender their annuity if it falls below this amount.

34. However, the requirement for advice presents issues in terms of capacity in the market to advise on such a transaction. The FCA needs to consider as a matter of urgency the qualifications IFAs would require to give such advice and whether that adviser should be capable of assessing whether the individual is receiving a fair price for their annuity. This is particularly critical in the absence of any secondary annuity price benchmarking as it will be difficult for individuals to ascertain whether any quotes they receive represent good value.

35. We are also a little concerned about the proposal to allow third parties who are 'buying' the annuity contracts to 'sell' their own flexi-access drawdown products to the annuity contract holder. This has the advantage of simplifying the process for the consumer, removing the need to find an alternative product and potentially pay for further advice. However there is the potential for real conflicts of interests here and it could create the potential for annuities liberation or scams. Therefore **the FCA should review its disclosure and conduct of business rules to ensure to that 'sellers' are informed of their rights to purchase a drawdown product with another provider.**

Legislative changes

36. The consultation asked about the scope of these proposals. The NAPF believes that it is sensible to exclude annuities specifically bought by occupational pension schemes from these proposals. However it is likely that, for definition reasons, this would not exclude former DB scheme members who now have their pension secured through an individually-assigned annuity. This is not necessarily a concern for schemes as it is likely that such annuities have been assigned as part of a buy-out process and as long as the member receives advice (see the consumer protection section above) there should be no knock-on impact on the scheme. It would seem inconsistent to ban an individual from selling an individual annuity contract simply because it was once a DB scheme pension.

37. Whilst it makes sense for individuals who assign their annuity in order to access the cash more flexibly to be subject to the £10k Annual Allowance, we are concerned that the information requirements that fall on other pension savings that individual may have will be disproportionate and we call on Government to consult fully on the details of any new disclosure requirements.

Conclusion

38. In conclusion the NAPF has a number of significant concerns with these proposals and the aim to develop a viable secondary market for annuities. It is not at all clear whether there will be an adequate supply of sellers or purchasers. The costs of infrastructure and intermediation are likely to be high, especially if only a limited market emerges. There are also significant costs involved in ensuring that consumers are adequately protected when making what is a complex decision. Even with this protection in place there is still a high risk of consumer detriment and the associated damage this will do to the reputation of the industry.

39. There is a real risk that consumer expectations have been raised and yet the key components do not exist in which a viable, fair and efficient market can develop. This would only further damage the perception of the industry and retirement provision more generally. The NAPF believes that the Government must be fully confident that there is a realistic way of proceeding with these proposals before it raises consumer expectations further.

40. If the Government does proceed with the proposals, then the NAPF has the following recommendations:

    - Any individual wishing to assign their annuity to a third party must take independent financial advice if the value of their annuity is greater than a certain value;
    - The FCA needs to consider as a matter of urgency the qualifications IFAs would require to give such advice, in particular the ability to assess whether the individual is receiving a fair price for their annuity;
    - The FCA should review its disclosure and conduct of business rules to ensure to that 'sellers' are informed of their rights to purchase a drawdown product with another provider; and
    - Individuals who assign their annuity in order to access the cash more flexibly should be subject to the £10k AA. However, the Government to consult fully on the details of any new disclosure requirements.