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Pensions: annuities

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Summary

Individuals with defined contribution (DC) pensions build up a pension fund using contributions, investment returns and tax relief. The pension tax legislation in force until 6 April 2015 strongly encouraged the purchase of an annuity, allowing flexible or lump sum payments only in limited circumstances. People did not have to purchase an annuity from the provider with whom they saved, but under the Open Market Option (OMO) had to be given the opportunity to choose who they purchased their annuity from.

In its Thematic Review of Annuities, published in February 2014, the Financial Conduct Authority (FCA) said that "some parts of the market were not working well for consumers".

In Budget 2014, the Government announced that from 6 April 2015 people aged 55 and over would have more flexibility about when and how to draw their DC pension savings, subject to their marginal rate of income tax. No-one would have to buy an annuity (HC Deb 19 March 2014 c793). The changes to pension tax legislation needed to implement this are in the *Taxation of Pensions Act 2014.*

In December 2014, the FCA published the interim report of its Retirement income market study. This reinforced the importance of shopping around. It also found that for people with average-sized pension pots, the right annuity purchased on the open market offered good value for money relative to alternative drawdown strategies and may therefore be a good option for those with low risk appetites. Looking forward, the FCA expected to see more 'hybrid' products emerge, combining annuity and drawdown features. While many savers would welcome the increased flexibility, there was a risk that greater choice would reduce consumers' confidence and appetite to shop around and that more complex products would be less directly comparable. Proposed remedies included annuity quote comparisons and developing an alternative to the current wake up packs, which were "too long, difficult to navigate and full of jargon." In the final report published in March 2015, the FCA said it would test these options further and continue to monitor developments in the market.

In Budget 2015, the Government said it would change the tax rules from April 2016 to allow people already in receipt of an annuity to sell that income to a third party, subject to agreement from their annuity provider. The proceeds of the sale could then be taken directly or drawn down over a number of years, and would be taxed at their marginal rate, in the same way as those taking their pension after April 2015. It launched a consultation on Creating a secondary annuity market, which closed on 18 June 2015.

Other relevant Library Notes include SN06891 Pension flexibilities. Income drawdown is discussed in SN 712.

1. Background

Money purchase schemes - such as occupational Defined Contribution (DC) pensions, group personal pensions, stakeholder pensions and individual personal pensions - build up a pension fund using contributions, investment returns and tax relief.[1]

Until April 2015, most people with a DC pension used it to purchase an annuity. A lifetime annuity is a contract with an insurer to provide a series of payments over the lifetime of the individual (or, in the case of a joint-life annuity over the remaining lifetime of the longest survivor). There are different types of lifetime annuities including:

- In the absence of a guarantee, a **single-life annuity** will only pay out during a person's lifetime. A **joint-life annuity** which, although it would pay out less during the scheme member's lifetime, would continue to pay an income to a partner after death;
- A **level lifetime annuity** pays the same income each year whereas an **escalating lifetime annuity** pays a lower initial annuity but then increases each year.
- Lifetime annuities with a **guarantee period** continue to pay the pension in full for the duration of the guarantee period and therefore provide some protection for dependants. If the scheme member dies after the guarantee period, the payments stop.
- **Enhanced or impaired annuities** pay a higher than normal income to people in ill health or with unhealthy lifestyles.
- **Investment-linked annuities** make payments at a level that changes depending on the performance of various underlying financial investments.

According to ABI, in 2013, there were 353,000 annuities sold by ABI members in the UK, worth £11.9bn in total. The average (mean) annuity was bought with a pension fund of around £35,600 but the median was around 20,000. 29% were brought with a pension pot of less than £10,000. The proportion of enhanced (i.e. medically underwritten) annuities continued to rise and as at 28% in the fourth quarter of 2013.[2]

An annuity rate is the level of income that is guaranteed in return for a DC fund.[3] It can be expressed as a percentage, or as so many pounds of income for each £10,000 invested in a pension fund. For example, an annuity rate of 6% is the same as £600 a year income for every £10,000 in a pension fund.[4] A number of factors determine annuity rates, including interest rates at the time of purchase, the annuitant's age and state of health and where they live, the type of annuity

1 DWP, Reinvigorating workplace pensions, November 2012, CM 8478
2 ABI, The UK Annuity Market: Facts and Figures, February 2014
3 Financial Services Consumer Panel, Annuities and the annuitisation process: the consumer perspective. A review of the literature and an overview of the market, January 2013, p5
4 Money Advice Service, Your retirement options, August 2011

purchased and the mark-up paid to the life insurer to cover its costs and profits.[5] The Association of British Insurers (ABI) regularly publishes example annuity rates. In its November 2014 survey it found that:

> […] a 65-year old buying an annuity with £24,000 from their pension, could receive between £840 and £2,100 a year in income, **depending on their age, type of annuity, personal circumstances and the provider**.[6]

Some policies include a guaranteed annuity rate (GAR) which can be valuable. As Lord Newby explained in debate on the *Pension Schemes Bill:*

> Guaranteed annuity rates were typically issued in the late 1980s and 1990s, their distinguishing feature being an enticement to customers promising that when they came to take these pensions, if they bought their annuity with the provider with which they had accumulated the pension, they would get an annuity rate specified at the point of purchase. Due to the decline in annuity rates, the pensions these guaranteed annuity rate arrangements provide by means of annuities are especially generous.[7]

5 Edmund Cannon and Ian Tonks, Annuity Markets: Welfare, Money's Worth and Policy Implications, Panel Paper 24, June 2011; ABI – what affects annuity rates?
6 ABI website - what affects annuity rates?
7 HL Deb 12 January 2015 c609

2. Options at retirement before 6 April 2015

2.1 Overview

Until 6 April 2015, most people (75%) with a DC pension use it to buy an annuity – a financial product which provides a regular income, usually until death.[8] The pension tax legislation in force up until 6 April 2015 strongly encouraged this outcome, applying a 55% tax charge to lump sum or flexible payments other than in limited circumstances.[9]

The main alternatives to buying an annuity were:

- Those with small amounts of overall pension saving, or very small individual pots, had the option from age 60 to take them as a lump sum;[10] and
- Income drawdown, which allows the individual to draw an income from their fund while leaving the rest of it invested. However, except where the individual could show that they had other pension income over a set amount, there was a cap on the amount they could draw down each year.

In advance of more radical changes introduced in April 2015, the Government introduced changes from 27 March 2014 increasing the size of pension pot that could be taken as a lump sum and introducing more flexibility into income drawdown arrangements:

- The size of a single pension pot that could be taken as a lump sum increased from £2,000 to £10,000;
- The number of pension pots below £10,000 that could be taken as a lump sum increased from 2 to 3;
- The amount of overall pension savings that could be taken as a lump sum increased from £18,000 to £30,000.
- The amount of guaranteed pension income needed to access savings flexibly reduced from £20,000 to £12,000; and
- The amount that could be withdrawn from 'capped drawdown' increased from 120% of a comparable annuity to 150%.[11]

2.2 The requirement to annuitise

A 'requirement to annuitise' tax-relieved savings dates back almost a century to the *Finance Act 1921*.[12] The *Finance Act 1956* made it a

[8] HM Treasury, Freedom and choice in pensions, Cm 8835, March 2014, para 2.17
[9] RPSM09200030
[10] Finance Act 2004 (FA 2004), s 164 and Sch 29 para 7 to 9; The Registered Pension Schemes (Authorised Payments) Regulations 2009 (SI 2009/1171); HMRC *Registered Pension Schemes Manual* (RPSM), RPSM09104905
[11] HM Treasury, Budget 2014, March 2014, HC 1104, para 1.164; *Finance Act 2014*, s41-2
[12] Section 32; Mamta Murthi, J. Michael Orszag and Peter R. Orszag, *The Value for Money of Annuities in the UK: Theory, Experience and Policy* (1999)

requirement to annuitise between the ages of 60 and 70.[13] The upper age limit was increased to 75 by the *Finance Act 1976.*[14]

The last Labour Government supported the continuation of this policy for three reasons:

- tax relief on pension contributions is provided so people can save for an income in retirement, not for other purposes;
- annuities pool people's risk, ensuring that they are the most financially efficient way of turning capital into an income stream; and
- annuities make sure that people continue to receive an income from their savings no matter how long they survive, thus reducing their possible future need for income-related support from the Government.[15]

However, it saw merit in introducing flexibility to the rules. An 'unsecured pension' (from which withdrawals could be made while leaving the fund invested) was already an option up until age 75. In April 2006, it introduced the 'Alternatively Secured Pension' for those aged 75 and over. This was in response to the concerns of some religious groups who had principled objections to the pooling of mortality risk through annuities. It did not expect the option to be widely used.[16] There were limits on the amount that could be drawn down each year.[17]

Critics of the 'requirement to annuitise' argued that people should be able to exercise choice over their pension funds, provided they did not fall back on means-tested benefits. In opposition, a number of Conservative backbenchers introduced Private Members Bills with the aim of providing for an alternative. These stated that people with pension funds large enough to buy an annuity providing a minimum retirement income above the level of means-tested support, should be able to re-invest any residual funds in a "Retirement Income Fund" which they could use as they liked. [18]

Before the 2010 General Election, both Conservative and Liberal Democrat parties had argued for a change in the rules.[19] The Conservative-Liberal Democrat Coalition Government's *Programme for Government* included a commitment to "end the rules requiring

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13 Section 22 (2)
14 Section 30
15 DWP and Inland Revenue, Modernising annuities. A consultation document. February 2002; See also HM Treasury, 'Simplifying the taxation of pensions: increasing choice and flexibility for all', December 2002, para 5.45
16 HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003
17 *FA 2004*, section 165 ; HM Treasury, Removing the requirement to annuitise by age 75, July 2010, para 2.5-7
18 These included David Curry's *Pension Annuities (Amendment) Bill 2001/02*, Edward Garnier's *Retirement Income Reform Bill 2002/03* and Adrian Flook's *Retirement Income Reform Bill 2003/04*
19 See, for example, Theresa May, Providing for Pensions. Principles and Practice for Success , Politeia, 2010; The Liberal Democrat Manifesto 2010

compulsory annuitisation at 75".[20] In July 2010, the Government launched a consultation on proposals for reform to support is objective to "re-invigorate private pensions saving, by giving people greater flexibility to choose the retirement options that are best for them."[21] It proposed that from April 2011, there would "no longer be a specific age by which people effectively have to annuitise". The option of income drawdown would be available throughout retirement, rather than just to age 75. However, except for those who could show they had secured a sufficient minimum income to prevent them from "falling back on the state," there would be a cap on the amount that could be drawn down each year:[22] This was legislated for in the *Finance Act 2011.* There have been changes to the detail of the policy over time, including the cap on withdrawals and the level of other income needed for flexible drawdown.[23] This was in advance of the more radical changes introduced in April 2015 (see section 4 below).

2.3 The Open Market Option (OMO)

People do not have to purchase an annuity from the provider with whom they saved. Under the Open Market Option (OMO), they must be given the opportunity to choose who they purchase their annuity from.[24] The OMO has been available since 1978 and firms have been obliged to inform their customers of it since 2002.[25]

Individuals can make a significant difference to their retirement income by exercising their rights under the OMO.[26] However, it will not always be advantageous to buy from a different provider. For example, some policies include a 'guaranteed annuity rate' which is higher than is likely to be available on the open market."[27]

Measures to improve the effectiveness of the OMO have been announced over time. In 2007, the Labour Government announced a number of measures.[28] More recently, the Pensions Regulator has issued

20 The Coalition: our programme for government, 20 May 2010
21 HM Treasury, Removing the requirement to annuitise by age 75, July 2010, para 2.1
22 Ibid p9
23 For more detail, see Library Note SN 712 Pensions: income drawdown (May 2014)
24 *Finance Act 2004*, Schedule 28, paragraph 3 (1) (b); HMRC's Registered Pension Schemes Manual, paragraph RPSM09101760
25 David Blake, Pension schemes and pension funds in the United Kingdom, Second Edition, p252-3; DWP and Inland Revenue, 'Modernising annuities. A consultation document. February 2002; FSA, Disclosure: Trading an endowment policy and buying a pension annuity August 2001Consultation Paper 106; Financial Services Authority, Disclosure: Trading an endowment policy and buying a pension annuity, Feedback on CP106, April 2002
26 Pensions Institute, National Association of Pension Funds, Treating DC scheme members fairly in retirement, February 2012, para 2.4; Work and Pensions Committee, Improving governance and best practice in workplace pensions, Sixth Report for session 20 12,13April 2013, para 73
27 FSA, Quality of advice on pension switching, December 2008, para 3.7. A GAR is a right to buy an annuity at a rate guaranteed in the policy
28 See, for example, HM Treasury, 'Outcome of the Review of the Operation of the Open Market Option', 9 October 2007

guidance for trustees on establishing a robust retirement process.[29] In March 2012, the Association of British Insurers (ABI) launched a code of conduct, to be effective from 1 March 2013. The aim was to ensure customers had "access to information to enable them to make an informed decision about annuities appropriate to their needs and lifestyle in retirement." It required ABI members to:

> Provide clear and consistent communications to ensure customers are able to make informed and proactive decisions about retirement income products, and are able to shop around for the most appropriate product.
>
> Prominently highlight enhanced annuities, and the much higher income they can potentially offer, and inform customers whether they offer these products, and how to find out who does.
>
> Clearly signpost customers to advice and support, both from regulated advisers and government-backed advice organisations.
>
> Establish transparency in the annuity market so that customers have a clear picture of how individual providers' product offerings fit in with the wider market.[30]

As a baseline against which to measure progress, it commissioned research in 2012. This identified positives, such as more people switching at retirement. However, it also found plenty of room for improvement.[31] The code was welcomed as a step forward, although some questioned whether it went far enough.[32] The Government supported the introduction of the code.[33] It would evaluate its effectiveness and consider further steps of necessary.[34]

In its *Thematic Review of Annuities* published in March 2013, the Financial Conduct Authority found that although awareness of the OMO was high (with nine out of ten consumers aware that they could purchase their annuity from a different provider) just under two-thirds (63%) of consumers shopped around and the proportion had remained at about this level for the last ten years, with initiatives to improve this resulting in only incremental increases. [35]

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[29] The Pensions Regulator, Defined contribution schemes, November 2013; See also The Pensions Regulator, Discussion Paper: Enabling good outcomes for members of DC schemes, January 2011

[30] ABI, Insurance industry takes big steps to help customers make the most of their pension savings, 5 March 2012; ABI, Consumers in the Retirement Income Market, March 2012; See also, ABI, Consumers in the Retirement Income Market, Consultation document, December 2011

[31] ABI, Customer engagement in the annuity market in 2013, June 2013

[32] Josephine Cumbo, FSA steps up pressure after years of prodding, *Financial Times,* 31 January 2013; NAPF comment on the launch of the ABI annuity code, 26 February 2013

[33] HC Deb, 11 Dec 2012,c 289W

[34] DWP, Reinvigorating workplace pensions, CM 8478, November 2012, Chapter 2; HC Deb 7 January 2014 c22WH

[35] FCA, Thematic Review of Annuities, TR 14/2, February 2014, p8

One of the conclusions of its retirement income market study (see section 5 below), was that the FCA should consider how the ABI Code could fit within its rules.[36]

[36] FCA, Retirement income market study – Final Report, MS14-03-3, March 2015, para 1.12

3. 2013/14 reports on annuities

Two influential reports in 2013/14 drew attention to ways in which the annuities market was not working well for consumers.

3.1 Financial Services Consumer Panel

In a report published in December 2013, the Financial Services Consumer Panel (FSCP) said that that consumers were "poorly placed to drive effective competition amongst providers and distributors of annuities." It found there were many barriers inhibiting consumers' full engagement when they decide to annuitise:

> […] low financial capability; fear of product complexity and of making an irreversible, high-cost mistake; general distrust of professional advisers, and inability to find appropriate advice at acceptable cost. [37]

A literature review highlighted the complexity of the process for consumers. It said:

- Annuitisation was a very complex process for most DC consumers;
- A 'good annuity outcome required expert help in most cases;
- A high proportion of DC customers did not shop around for the best deal; and
- Many consumers did not understand the differences between advice channels or know where to go for professional help.[38]

The FSCP said that while recent developments, including the ABI code of conduct, might prove helpful, further regulatory and government-led structural reform was needed:

> The chances of mass consumer detriment are, in our judgement, too high to trust to current market-driven solutions alone: hence our recommendations for further regulatory and government-led structural reform.[39]

The FSCP report was welcomed by the National Association of Pension Funds.[40] Some advisers called for the FCA to ban non-advised annuity sales.[41] Ros Altman (now Pensions Minister), described annuity reform as "long overdue" and said it could not be left to industry to self-regulate.[42] On the other hand, Yvonne Braun of the ABI said:

> The media coverage of the Panel's report focused on the charge that consumers are "exploited" by insurers. It is unfortunate that the conclusion lacking an evidence base attracted the most

[37] FSCP, Annuities: Time for Regulatory Reform, December 2013, para 3.1
[38] Annuities and the annuitisation process: the consumer perspective – A review of the literature and an overview of the market, December 2013, Summary of findings, paras 1.2-5
[39] Ibid
[40] 'NAPF response to FSCP annuities report', 10 December 2013
[41] Samuel Dale and Tom Selby, 'Advisers demand FCA ban on non-advised annuity commission', Money Marketing, 12 December 2013 (£); Michael Trudeau, Do non-advised demands go too far, or not far enough? FT Adviser, 10 December 2013
[42] Ros Altman, 'Annuities – now FCA Consumer Panel calls for urgent reform', 9 December 2013

> attention, rather than the more thoughtful recommendations about a greater role for the Money Advice Service, and the role of intermediaries.[43]

3.2 FCA - Thematic Review of Annuities

The Financial Services Authority (the body which preceeded the Financial Conduct Authority) announced its intention to undertake a thematic review of annuities in January 2013. This would explore the "risk of detriment that consumers may face as a result of not shopping around when purchasing an annuity."[44] The review was met with "broad approval from the industry", although there was some disappointment it would not cover trust-based pension schemes.[45]

The Financial Conduct Authority (FCA), announced the findings of this review in February 2014. It emphasised the complexity of the decisions consumers are required to make at retirement:

> There are a number of decisions that consumers must engage with to make a well-informed decision about buying an annuity. Alongside the timing of their retirement, they must also consider whether or not to take benefits through income drawdown, and if they choose an annuity, the 'shape' of annuity to purchase. Consumers often have not engaged in building up their pension savings and this affects how they engage with their retirement income choices.
>
> Once consumers are confronted with annuity choices they are faced with decisions that require them to consider their future circumstances, and attribute a future value to options such as joint versus single life, guaranteed periods, inflation protection and death benefits. These decisions all require making judgements about what will happen in the future and the relative values placed on protecting their income against uncertain events. This is something that is very challenging, even for consumers with high levels of financial capability.[46]

It recognised that most consumers found it "difficult to assess risk and uncertainty in financial products." This resulted in a "general lack of engagement in the annuity purchase, with many consumers struggling to evaluate the options to find the best deal at retirement."[47]

The FCA concluded that "some parts of the market were not working well for consumers" and identified a number of concerns. In particular, it found an apparent lack of choice and ability to switch for those with small pension funds and a lack of access to enhanced annuity rates for some consumers annuitising with their existing provider:

> The majority of consumers (60%) do not switch providers when they buy an annuity, despite the fact that we estimate 80% of

[43] Yvonne Braun, The FSCP's report into annuities – more heat than light? 11 December 2013
[44] FSA, Insurance conduct supervision newsletter, January 2013, Issue 1
[45] Michael Trudeau, 'FSA 'missed a trick' in thematic review; MGM, FT Adviser, 31 January 2013
[46] FCA, Thematic Review of Annuities, TR 14/2 February 2014, p26
[47] Ibid

> these consumers could get a better deal on the open market, many significantly so.
>
> We estimate that the aggregate benefits that consumers miss out on by not shopping around and switching is the equivalent of between £115m and £230m of additional pension savings. We recognise that this may not be realisable, as changes in switching behaviour would be likely to result in changes within the market.
>
> In part consumers miss out on the benefits available from shopping around and switching due to their lack of engagement in pensions and annuities, the confusing trade-offs they face and the impact of behavioural biases that makes it difficult for consumers to make the right choices and may result in many of them not shopping around effectively.
>
> There is also an incentive on providers to retain their existing pension customers, as overall the estimated levels of expected profitability of standard annuity business sold to existing pension customers is more than the expected profitability of annuity business sold on the open market.
>
> The differences in retention rates (i.e. proportion of pensions annuitising with their pension provider rather than switching) between firms varies widely and some firms have relatively high retention rates and have active retention strategies that may increase customer loyalty and reduce the propensity to shop around.
>
> There are particular groups of consumers where it appears that the market is not working well. There is an apparent lack of choice and ability to switch for those with small pension funds and lower annuity rates available to these consumers generally, which is likely in part to be due to the fixed costs of providing an annuity representing a larger proportion of the customer's funds.
>
> There is also a lack of access to enhanced annuity rates for some consumers annuitising with their existing pension provider and not shopping around.[48]

It decided to conduct a competition market study on retirement income products (see section 5 below).[49]

48 Ibid p29
49 Ibid p30

4. Options at retirement from 6 April 2015

4.1 Budget 2014

In Budget 2014, the Chancellor announced short-term changes – increasing the size of pot that could be taken as a lump sum and making the income drawdown rules more flexible. Under a more radical reform of the pension tax system, from April 2015 people aged 55 and over would be able to choose when and how to withdraw their savings, subject to their marginal rate of income tax:

> **1.165** Under the current tax system, people are charged 55% if they choose to withdraw all of their defined contribution pension savings at the point of retirement. This means the majority of people instead purchase an annuity and receive taxable income over the course of their retirement. Under the new system, an individual will be able to withdraw their savings at a time of their choosing subject to their marginal rate of income tax. The government anticipates that under these circumstances some people will choose to draw down their pension sooner in order to suit their personal situation. This will increase income tax revenue in the short to medium term. [50]

The Chancellor of the Exchequer said the changes would mean no-one would have to buy an annuity:

> We have introduced flexibilities, but most people still have little option but to take out an annuity, even though annuity rates have fallen by half over the last 15 years. The tax rules around these pensions are a manifestation of a patronising view that pensioners cannot be trusted with their own pension pots. I reject that. People who have worked hard and saved hard all their lives, and done the right thing, should be trusted with their own finances, and that is precisely what we will now do: trust the people[…] I am announcing today that we will legislate to remove all remaining tax restrictions on how pensioners have access to their pension pots. Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want: no caps; no draw-down limits. Let me be clear: no one will have to buy an annuity.[51]

He said the reforms were needed both because annuities were "no longer the right product for everyone." Furthermore, the market was not working in the best interests of all consumers:

> As the nature of retirement changes, annuities are no longer the right product for everyone. People are living longer and their needs are becoming more varied. Our reforms to the State Pension and the triple lock guarantee give certainty to pensioners on what they will receive from the state. The introduction of Automatic Enrolment will dramatically increase the amount of pension savings. The landscape has completely changed.

[50] Ibid
[51] HC Deb 19 March 2014 c793

> Moreover, the annuities market is currently not working in the best interests of all consumers. It is neither competitive nor innovative and some consumers are getting a poor deal. It is time for a bold, modern and progressive reform.[52]

4.2 Legislation

Under the *Taxation of Pensions Act 2014* from 6 April 2015, a scheme member coming to take their benefits would have the option of:

- Buying a lifetime annuity (with some previously-existing restrictions removed);
- Taking a scheme pension;
- Designating some or all of their funds to a flexi-access drawdown arrangement; or
- An uncrystallised funds pension lump sum (UFPLS), or series of lump sums.

In the case of a lifetime annuity or flexi-access drawdown, there will normally be the option of a 25% tax-free lump sum at the time of taking the pension. For UFPLS, 25% of each withdrawal is tax free.[53]

Where an individual has accessed their DC pension savings 'flexibly', the amount they can contribute annually to a money purchase scheme would reduce to £10,000.[54] People already in a 'capped' drawdown on 6 April 2015 could convert to flexi-access drawdown. Existing flexible drawdown funds would become flexi-access drawdown funds.[55]
The new flexibilities are discussed in more detail in HC Library Briefing Paper SN06891 Pension Flexibilities (June 2015).

The Government recognised that, in expanding the range of choices available, there was a corresponding need to help consumers navigate those choices, so that they could make good decisions which suited their needs and circumstances.[56] It therefore proposed that from April 2015 everyone who retired with a DC pension would be offered "free and impartial face-to face guidance on their choices at the point of retirement."[57] The guidance service – Pension Wise – was introduced under the *Pension Schemes Act 2015.* For more detail, see SN07042 Pensions: the guidance guarantee (March 2015).

Flexible annuities

The Act also removed some of the restrictions applying to annuities. Where an individual becomes entitled to a lifetime annuity before 6 April 2015, it has to meet certain conditions, i.e. that:

> (a) it is payable by an insurance company,

[52] HM Treasury, Freedom and choice in pensions, March 2014
[53] Section 1 and Sch 1
[54] Sch 1 Part 4
[55] Sch 1 Part 1
[56] HM Treasury, *Freedom and choice in pensions,* Cm 8835, March 2014, para 4.7-9
[57] HM Treasury, *Budget 2014,* HC 1104, March 2014

> (b) the member had an opportunity to select the insurance company,
>
> (c) it is payable until the member's death or until the later of the member's death and the end of a term certain not exceeding ten years, and
>
> (d) its amount either cannot decrease or falls to be determined in any manner prescribed by regulations made by the [HMRC].[58]

From 6 April 2015, some of these restrictions are removed. Although a lifetime annuity must still be payable for life by an insurance company:

- It can decrease;
- It can continue to be paid after a member's death if the member dies before the end of a guarantee period of any length specified in the annuity contract;
- A member is no longer subject to the unauthorised payments charge if they have not had the opportunity to select the insurance company paying the annuity.[59]

Guidance is in the Pension Tax Manual – PTM062400 – Member benefits: pensions: scheme pensions: lifetime annuity.

4.3 GAR – requirement for advice

As discussed above, a guidance service has been introduced to inform people of the options available from April 2015.

Over and above this, people with 'safeguarded benefits' are required to take independent advice before converting them into 'flexible benefits.'[60] This requirement only applies where the value of the benefits exceeds £30,000.[61]

The legislation defines safeguarded benefits as benefits other than money purchase and cash balance benefits.[62] The FCA explained that this meant "primarily benefits in DB schemes but may also be benefits such as guarantees or other promises in other types of scheme."[63] This would include schemes which include the promise of a specific annuity rate - a guaranteed annuity rate (GAR) - at retirement.

The FCA published a consultation document on this in March 2015.[64] In June 2015, it said the calculation of the value of benefits must take into account the value of any GAR:

> A number of respondents asked whether providers should attempt to value the GAR for the purpose of determining whether the exemption from the advice requirement applies. The DWP

58 *FA 2004* section 165 (rule 4) and Schedule 28
59 Taxation of Pensions Act 2014 – Explanatory Notes, para 106
60 *Pension Schemes Act 2015* – Explanatory Notes, para 199
61 *Pension Schemes Act* s48 (3); HM Treasury, Freedom and choice in pensions: the government's response to consultation, Cm 8901, July 2014, para 4.24; For the debates in Parliament, see SN 7105 Pension Schemes Bill 2014/15 – House of Lords stages (February 2015), pp 29-32
62 *Pension Schemes Act* s48 (8);
63 FCA, Proposed changes to our pension transfer rules, CP15/7, March 2015, para 2.3
64 Ibid

> have confirmed that, where benefits include a GAR, the calculation of the value of the benefits must take into account the value of the GAR.
>
> Providers may wish to determine broad values in relation to the types of GARs held by their members, to assist in determining whether the exemption is likely to apply in cases where the realisable assets under the member's policy do not exceed £30,000. Where this approach produces a figure close to the £30,000 threshold, providers may need to calculate the value of the individual member's benefits, in accordance with the regulations, to determine whether the member will be required to take independent advice.[65]

The *Financial Times* reported concerns that some savers might have unwittingly cashed-in pension policies with valuable features because the rules were not finalised in time.[66]

In response to a PQ on 18 June, Work and Pensions Minister, Justin Tomlinson said the Government did not have data on the number affected:

> Stephen Timms: To ask the Secretary of State for Work and Pensions, how may people who converted their pension benefit since 6 April 2015 and were not required to see advice will now be required to seek advice under the rules announced by the Financial Conduct Authority Policy Statement PA15/12 published on 8 June 2015:
>
> Justin Tomlinson: The April 2015 reforms have given people more freedom and choice on how they fund their retirement. Individuals with Defined Benefit Pensions and pension benefits which contain a guaranteed annuity rate can transfer to a Defined Contribution scheme if they wish to access their pension savings flexibly, after they have taken independent financial advice.
>
> The Government is committed to monitoring the new pension flexibilities as they bed in. This is why the Chancellor has announced a consultation to identify the extent to which people are facing unfair barriers to accessing their pensions flexibly and to identify whether further interventions are necessary. We will be working with Treasury, the Financial Conduct Authority and the Pensions Regulator to ensure the flexibilities are delivering for consumers.
>
> DWP does not currently have data on the number of people who have converted their safeguarded benefits to a form that can be taken flexibly since 6 April 2015, or on the numbers of people who have taken independent advice.
>
> Nor do we have data on the number of people who would not have previously had to take advice but now will as a result of the FCA rules announced on 8 June 2015. Those affected may include members with a DB pension or a pension with another form of safeguarded guarantee whose total benefits are worth over

65 FCA, Proposed changes to our pension transfer rules. Feedback on CP 1516 and final rules, PS 15/12, June 2015, p14-5

66 'Government faces calls to review victims of pension transfers', *Financial Times,* 12 June 2015

> £30,000 as well as people with Guaranteed Annuity Rate entitlements.[67]

On 19 June, the ABI argued that the requirement for people with pension savings with a GAR valued at £30,000+ to take independent advice should be replaced by a 'customer control mechanism' – delivered by Pension Wise or the Pensions Advisory Service through a specific guidance session.[68]

4.4 Expected impact of new flexibilities on the annuities market

The Government said the annuities market was "currently not working in the best interests of consumers":

> It is neither competitive nor innovative and some consumers are getting a poor deal. It is time for a bold, modern and progressive reform.[69]

It expected its reforms to stimulate innovation and competition "with providers creating new products to satisfy individual consumer needs and meet new social challenges such as funding care later in life."[70]

Witnesses to the Treasury Select Committee shortly after the 2014 Budget said that the impact on the annuity market was difficult to predict. The FCA said that "predictions that the annuities market would effectively disappear due to the changes might be too pessimistic". The ABI expected initial market contraction followed by recovery:

> In the next five to 10 years [you will see] lower levels of annuity take-up, but as people move through their retirement process, a recovery and growth again in the annuity market, because its positive aspects continue to be positive—the certainty it gives people and their ability to plan for the future, and they know that they will not run out of money.[71]

Annuity rates might continue to worsen under certain circumstances:

> If you have a healthier pool of customers, they will live longer. If they live longer, clearly the rate that the market as a whole can offer will become less attractive. One factor certainly could apply: if the only people who take annuities are a particular type of individual that will shape the annuity pool and the pricing. But I do not think contraction in itself is likely to be the issue.[72]

The Pensions Policy Institute, based on experience of international retirement systems, said that in future those who were risk averse and uncertain how long they would live could still find annuities attractive in future. Partial annuitisation could play a bigger role in future, if people

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67 PQ 2569 [Pensions] 18 June 2015
68 ABI sets out action plan to help customers get most from pension freedoms, 19 June 2015
69 HM Treasury, Freedom and choice in pensions, March 2014, Cm 8835 , Foreword
70 Ibid, para 3.19
71 Treasury Select Committee, Budget 2014, 13th report 2013-14, HC 1189, May 2014, para 149
72 Ibid para 150

wished to use only part of their DC savings in order to secure guaranteed income or insure against longevity.[73]

The Strategic Society Centre looked at the experience of countries with voluntary annuity markets and academic research on the 'annuity puzzle' i.e. the low prevalence of annuity purchases where this is voluntary, given the fact that economic modelling suggests a rational, utility-maximising' individual with uncertain life expectancy would annuitise all of their wealth. This was because of: supply-side factors, such as 'value for money'; 'rational' demand-side factors, such as wanting to preserve wealth to heave it as an inheritance; and 'behavioural' demand-side factors such as inertia in the face of complex choices.[74]

The latest available ABI figures are for the first quarter of 2015:

> This data from the last quarter shows the decisions savers were making before the full pension reforms came into force.
>
> - The number of income drawdown contracts sold by ABI members during 2015 Q1 increased by 64% over the past year, from 6,700 to 11,500 (very similar to the number sold during Q4 2014).
> - The number of annuities sold continued to fall, with 20,600 annuities sold during the quarter, compared to 28,700 the previous quarter and 74,100 in 2014Q1.
> - 62% of annuities sold during Q1 were internal (the same as in Q4 2014), compared to 47% a year earlier; 42% of drawdown customers were internal, compared to 40% during Q4 2014 and Q1 2014.
>
> Rob Yuille, Manager for Retirement Policy at the ABI comments:
>
> "These figures show the impact that pension flexibility had even before the full reforms came into force in April. The product choices being made on the eve of the changes reflect a changing market but also a diverse set of needs and preferences. This is a good reminder that people need guidance or advice to help them find the right retirement product for their circumstances."[75]

The wider impact of the reforms is discussed in HC Library Briefing Paper SN06891 Pension Flexibilities (June 2015).

[73] PPI, Freedom and Choice in Pensions: comparing international retirement systems and the role of annuitisation, May 2014
[74] James Lloyd, New Annuity era: Understanding retirement choices and the annuity puzzle, Strategic Society Centre, 2014
[75] ABI retirement income statistics Q1 2015

5. FCA - Retirement income market study

Following its review of annuities, the FCA launched a retirement income market study.[76] The terms of reference, revised following the March 2014 Budget, were:

> The market study into retirement income will consider products such as annuities and income drawdown. These are products purchased by individuals with their accumulated pension pot that provide an income during retirement. We will also be considering new financial products which might be offered to those approaching retirement. We will examine competition and choice in the context of the various options open to consumers when retiring. As part of this work we will assess the value for money associated with different at-retirement products in the future landscape.[77]

The review's interim report, published in December 2014, confirmed that many were missing out on a higher income by not shopping around for an annuity. There were a number of reasons for this:

> 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, 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. [78]

The tendency to buy from existing providers weakened 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.[79]

The review found that, despite a common perception among consumers that annuities offered poor value, the right annuity purchased on the open market offered good value for money relative to alternative drawdown strategies and might therefore be a good option for those with low risk appetites.[80]

Looking forward, the FCA expected to see more 'hybrid' products emerge, combining annuity and drawdown features. While many savers

[76] FCA, Thematic Review of Annuities, TR 14/2 February 2014, p30
[77] FCA, Retirement income market study: revised terms of reference, 9 June 2014
[78] FCA, Retirement income market study: Interim Report, December 2014; See also, FCA, The value for money of annuities and other retirement income strategies in the UK, December 2014
[79] FCA, Retirement income market study: Interim Report, December 2014
[80] Ibid

would welcome the increased flexibility, there was a risk that greater choice would "reduce consumers' confidence and appetite to shop around". In particular, more complex products were 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.[81]

The FCA asked for reviews on proposed remedies, including requiring firms to "make it clear to consumers how their quote compares relative to other providers on the open market" and the development of an "alternative to the current wake up pack":

> **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 consumer's 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.[…]

81 Ibid

In the longer term, it recommended the development of a 'pensions dashboard' which would enable consumers to view all their lifetime savings) including the state pension) in one place.[82]

The FCA said it would monitor the market as it evolved:

> 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, and will continue to take enforcement action against such activity. We will remain on high alert for scams targeting consumers at retirement.[83]'

In its final report published in March 2015, the FCA confirmed that its findings were final. It would take its proposed remedies forward, with consultation on design and implementation where appropriate. The next phase of work would form part of its wider review of rules in the pension and retirement area in summer 2015. [84]

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[82] Ibid
[83] Ibid
[84] FCA, Retirement income market study: Final report – confirmed findings and remedies, (MS14/3.3) March 2015, para 1.2

6. Proposals for a secondary annuity market

6.1 Debate

In January 2014, Pensions Minister Steve Webb suggested allowing annuity recipients to sell to the highest bidder:

> When you take out a mortgage, in a few years if rates change you can switch your mortgage", he said. "But when you take out an annuity, that's it – for life. This could easily be for a quarter of a century. Why shouldn't you be able to change your annuity provider so a few years later somebody else could offer you a bigger pension? Why shouldn't you be able to shop around?[85]

In January 2015, the *Telegraph* reported that the Minister was considering reforms to:

> […] create a new market in 'second hand' pensions, as insurance firms and other companies buy up individual's annuities, bundle them together and sell them on in bulk.[86]

In terms of how the proposal could work there appear to be two broad options: either the annuity holder and insurance company agree to cancel the contract and the individual is paid a lump sum by the provider; or the annuity income stream continues but the annuity holder sells it to a third party for a lump sum.[87]

The proposal had the support of Ros Altmann who identified the following groups as likely to benefit:

> People who purchased an annuity because they had no choice but need the money now to repay debts or pay for health or care needs or other urgent spending.
>
> People who have other pensions and for whom the annuity is not an important source of their retirement income.
>
> People who purchased small annuities, for whom the small amount of ongoing income will make little difference to their standard of living in retirement. For example, someone with a £5,000 pension fund who bought an annuity at age 60 might have less than £5 a week for life, whereas having a few thousand pounds straight away could make a real difference to their lives.[88]

She argued that people should have a choice:

> Of course, insurance companies would charge to buy back the annuity income, the cash-in value would be less than original

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[85] 'Government plans reform to end UK pension system 'lottery', The Telegraph, 5 January 2014
[86] 'Sell your pensions for cash in retirement, Steve Webb says', *The Telegraph,* 3 January 2014
[87] 'Webb's 'well-meaning' annuity resale plan risks creating disorderly market – Fidelity', *Investment Week*, 6 January 2015
[88] Cashing in unwanted annuities', Ros Altmann, 12 March 2015; See also, 'Stephen Lowe: Why Osborne is right to pursue tradeable annuities reforms', Money Marketing, 16 March 2014

> pension and would depend on assessments of health and life expectancy. However, as nobody is forced to sell their annuity, it is just an option for them, this is not a reason to deny them the chance to change their product. They should be required or encouraged to take independent financial advice to explain the risks of re-selling and help them find a good rate, but if they still believe this is what is best for them, they would then have the chance to undo their unwanted purchase. [89]

However, a number of commentators expressed concern about whether consumers will be able to get a 'good deal'. If an individual got a poor deal in the first place, then selling the annuity on would not reverse this and there would be costs of sale to take into account.[90] And it would be difficult for them to judge whether they were being offered a good deal:

> Experts fear that millions of annuitants will be tempted to cash in their £10,000 a year or less annuity. While the lump sum might look massive, actually it would be bought at heavily discounted prices giving the consumer a really bad deal. As with any financial market, there is always a cost of trading and few pensioners would be better off as a result. Worse still, it would be difficult to know what really is a good deal due to the complex pricing systems used. The most vulnerable members of society would be left exposed to unscrupulous financial companies, leaving them impoverished and reliant on meagre government hand-outs in their final years.[91]

The extent of competition in the market will be an important determinant of this. However, the *Financial Times* found that few firms had so far expressed an interest:

> […] to be effective, industry observers say, a second-hand market would need many players. Currently, there are 25 annuity firms selling to retain customers but only a few big names, including Legal & General have indicated interest in such a market. [92]

Tom McPhail of Hargreaves Lansdown thought there would be challenges:

> […] the rather more simple proposition of selling someone an annuity in the first place failed to create a competitive market. There is no obvious reason why the market in reverse would be any better.[93]

The appropriate form of consumer protection seems likely to form part of consultation on any proposals for reform. Some have suggested introducing a requirement to take independent advice.[94]

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[89] Ibid

[90] Cash for annuities could create new misselling scandal', Andrew Tully, Pensions Technical Diector at MGM Advantage in *Money Marketing*, 29 January 2015

[91] Pensions spotlight: future of annuities,' *Money Management,* 1 February 2015; Cash for annuities could create new mis-selling scandal', Andrew Tully, Pensions Technical Director at MGM Advantage in *Money Marketing*, 29 January 2015

[92] 'Annuity trade-in idea draws mixed reaction', *Financial Times,* 12 March 2015

[93] Tradeable annuities: A lifeline for retirees or potential mis-selling disaster', *Money Marketing,* 16 February 2015

[94] Pension Schemes Act 2015, Part 4, Chapter 2

Some practical and legal issues would also need to be addressed. For example, there would need to be arrangements to enable insurers to trace "the existence/death of those annuitants who have sole their policies to third parties."[95]

6.2 Budget 2015 announcement

In his Budget speech on 18 March 2015, the Chancellor said:

> First, we will give 5 million pensioners access to their annuity. For many, an annuity is the right product, but for some it makes sense to access their annuity now, so we are changing the law to make that possible. From next year, the punitive tax charge of at least 55% will be abolished. Tax will be applied only at the marginal rate, and we will consult to ensure that pensioners get the right guidance and advice. That means freedom for 5 million people with an annuity.[96]

The Government would change the tax rules to allow people already receiving income from an annuity to sell it to a third party:

> **1.229** This government has already introduced major reforms to allow people entering retirement much more flexibility over how they use their defined contribution pension pot, instead of being required to purchase an annuity. The government now wants to allow people who have already bought an annuity to also enjoy flexibility in how they access the value of their annuity, without interfering with binding contractual requirements.
>
> **1.230 From April 2016, the government will therefore change the tax rules to allow people who are already receiving income from an annuity to sell that income to a third party, subject to agreement from their annuity provider.** The proceeds of the sale could then be taken directly or drawn down over a number of years, and would be taxed at their marginal rate, in the same way as those taking their pension after April 2015.
>
> **1.231** The government believes that for most people, continuing to hold their annuity will be the right decision. However, for others, this reform will allow them the flexibility to use the value of their annuity as they see fit. The government is therefore publishing a consultation on how best to remove the barriers to the creation of a secondary market in annuities, inviting views on how best to ensure that consumers are in a position to make an informed decision. The government will work with the Financial Conduct Authority (FCA) to consult on how best to support people's choices through consumer protection, and protect those who are most vulnerable. [97]

It expected an increase in income tax receipts in the early years as a result:

> The costing depends upon an estimate of the number of people who make use of the ability to assign their annuity. This leads to

[95] 'Stephen Lowe: Why Osborne is right to pursue tradeable annuities reforms', *Money Marketing,* 16 March 2015; Webb's 'well-meaning' annuity resale plan risks creating disorderly market – Fidelity', Investment Week, 6 January 2015

[96] HL Deb 18 March 2015 c778

[97] HM Treasury, Budget 2015, HC 1093,18 March 2015

an increase in income tax received in early years as individuals will now pay tax on the proceeds of any annuity sale. There will then be reduced income tax on annuity payments in later years.

When an individual reassigns the income from their annuity, this could therefore change their entitlement to means-tested social security benefits and leads to an Exchequer cost. The estimated costs assume that rules relating to the deprivation of income will be applied.

However, the government is consulting on whether individuals on means tested benefits should be able to reassign their annuity income.

The proceeds of any annuity sale could either be held as part of a flexible drawdown product or taken in full as a lump sum. Any sum received from the sale of an annuity will be taxed at the individual's marginal rate of tax at the point of withdrawal. It is therefore expected that many individuals will opt to withdraw their funds as part of a flexible drawdown product over a period of time to avoid having to pay tax at a higher marginal rate.

The costing also depends on estimates of the value individuals receive in exchange for annuities.

Exchequer impact (£m)	2015/16	2016/17	2017/18	2018/19	2019/20
Exchequer impact	0	+533	+540	-130	-120
Welfare cap impact	0	-15	-30	-30	-30

The welfare cap impact of this measure is reflected in the aggregated line on 'Welfare Cap impacts' in the scorecard.

Areas of uncertainty

The main uncertainties in the costing relate to the number of people who will choose to sell their annuities, which in turn is likely to be impacted by the value individuals receive in exchange for annuities which is itself uncertain.[98]

Comment

The NAPF said a full consultation would be "essential to ensure a fair and balanced market is created":

> The consultation would need to look at how the buy-back price of an annuity would be calculated so people selling their annuity could be assured of good value; and also consider a prescribed process for introducing buyers and sellers to avoid excess costs, which would inevitably be carried by the consumer. And clearly, if this comes into effect the Pension Wise service would also have to be equipped to provide thorough guidance on this topic.
>
> This suggested reform should not distract us from or undermine the Freedom & Choice reforms which are due to begin imminently. The Government will need to make sure this doesn't divert focus or resource from Pension Wise, damage the broader

[98] HM Treasury, Budget 2015 – policy costings, March 2015, p15

> annuity market or slow down the development of a much-needed market in retirement solutions.[99]

The ABI said the reforms would extend choice further but that people would "face considerable complexities, especially around the tax implications of cashing in their annuities."[100]

Paul Johnson of the IFS commented that although the proposal looked sensible in principle, it was less clear what the effect would be in practice:

> Allowing a market to exist does not mean it will spring into existence. There is a classic adverse selection problem here. Who is most likely to want to cash in their annuity? Someone who now knows they don't have long to live. How much will they get for their annuity? Not much. What might annuity companies assume about anyone wanting to cash in? That they have reason to believe they won't live long. How much will they get paid for their annuity? Not much.[101]

6.3 Consultation

The Government launched a 12-week consultation on Creating a secondary annuity market.[102] It explained that the main reforms would be to:

> **Change the tax treatment in relation to annuity holders wishing to realise the value of their annuities.** This will include the removal of the "unauthorised payment" tax charge of up to 55% (or even 70%) that deters annuity holders from assigning their annuity. Individuals will, upon agreement with their annuity provider, have the opportunity to assign their annuity to a third party in return for a lump sum. Individuals can take this lump sum directly, or transfer the lump sum to an alternative retirement income product, drawing income down over a number of years and being taxed at their marginal rate.
>
> **Work with the Financial Conduct Authority (FCA) to ensure appropriate consumer protection is in place for annuity holders as they consider their options.** This may include the provision of guidance to annuity holders or the requirement to seek advice so they are in a position to consider fully the impact of their decision and ensure they are receiving a competitive price.[103]

A secondary market

The proposal was to create the conditions for a secondary market in which third parties (such as asset managers, pension funds, insurers and intermediaries) would be assigned the rights to annuity holders' income

[99] NAPF comments on Chancellor's intention to support the creation of a secondary annuity market,15 March 2015
[100] ABI response to the Chancellor's announcement on secondary annuity market, 15 March 2015
[101] IFS, IFS Post-Budget Briefing 2015, Paul Johnson's opening remarks, 19 March 2015; See also, Stuart Adam's presentation, Pensions, savings and business taxation
[102] HM Treasury and DWP, Creating a secondary annuity market: call for evidence, Cm 9046, 18 March 2015
[103] Ibid, para 1.5

streams in return for a lump sum. There would be no interference with contractual agreements:

> Instead, where annuity providers agree, it allows the annuity holder to access the value of their assets where they can find a willing buyer. The annuity provider would continue to hold the underlying assets and pay the annuity income to the third party for the lifetime of the annuity holder.[104]

The Government estimated that five million individuals were in receipt of annuity payments. Although for many, continuing to hold an annuity would be the right decision, reasons for assigning it could include: freeing up funds where there was sufficient other income to meet daily needs and meeting a particular financial need - such as paying down debt.[105]

How the market would operate

In terms of how the market would operate, the Government said it envisaged that annuity holders would assign their right to payments to a third party in return for either a lump sum, flexi-access drawdown fund or flexible annuity. The third-party buyer would either provide this themselves or release the funds to a party who would.[106]

The price offered to the annuity holder would reflect factors such as the estimated value of the annuity, transaction costs and a profit margin.[107] To protect annuity providers and funds, the Government proposed not allowing annuity holders to terminate their annuity contract with the existing provider.[108]

The Government proposed restricting retail investors from the market owing to "the complexity and difficulty in determining a fair price."[109]

There were a number of operational considerations that firms would need to consider, including how the provider would know when payments should cease. Approaches to address this could include requiring the annuity holder to put in place arrangements to instruct the executor of their estate to notify the provider upon their death.[110] Another issue was the level of costs charged by the annuity provider. The Government proposed to work with the FCA to monitor this and take action if necessary.[111]

Options for individuals

The Government proposed that under new tax rules, individuals would have three options:

> a) **Lump sum cash payment.** Individuals will be able to receive a lump sum cash payment in return for assigning the rights to their

[104] Ibid
[105] Ibid para 2.4
[106] Ibid para 2.12
[107] Ibid
[108] Ibid para 2.15-7
[109] Ibid, para 2.9
[110] Ibid para 2.21
[111] Ibid para 2.23-4

> annuity payments to a third party buyer. The whole amount received will be subject to income tax at their marginal rate. We propose that tax will be deducted at source through Pay-As-You-Earn (PAYE).
>
> b) **Flexi-access drawdown fund.** Individuals will be able to arrange for any funds released from the assignment of their annuity to be paid by the buyer into a flexi-access drawdown fund. This flexi-access drawdown fund could be provided by the third party buyer, or an alternative provider. The proceeds transferred into the flexi-access drawdown fund by the buyer would not be subject to income tax on transfer, would not be eligible for pensions tax relief, would not count towards an individual's annual or lifetime allowance, and would not trigger entitlement to a tax-free lump sum. Individuals would be able to draw down from this fund as they wish over time, with amounts drawn down subject to income tax at their marginal rate. We propose that tax will be deducted at source through PAYE.
>
> c) **Flexible annuity.** Individuals will be able to arrange for the proceeds of the assignment to be used to purchase a flexible annuity. Again, this flexible annuity could be provided by the third party buyer, or an alternative provider. As above, proceeds used to purchase the flexible annuity would not be subject to income tax, would not be eligible for tax relief, would not count towards an individual's annual allowance, and would not trigger entitlement to a tax-free lump sum. We propose that tax will be deducted at source through PAYE, as usual for pension annuities.[112]

Individuals who have assigned their annuity to a third party would become subject to the £10,000 money purchase annual allowance. This applies to people who 'flexibility' access their pension savings on or after 6 April 2015 and means an annual allowance of £10,000 applies to their defined contribution pension savings from that point.[113]

As regards the tax treatment of unused funds on death, the Government proposed to treat individuals who had assigned their annuity income in line with the changes made by the *Taxation of Pensions Act 2014.*[114]

Consideration would also be given to: the information requirements that would apply to schemes; the treatment of the annuity after sale (for example, how it should be treated for tax purposes in the hands of the buyer); and provisions to protect against tax avoidance.[115]

Consumer protection

The Government said individuals considering assigning their annuity to a third party would need to consider a range of factors:

> These include their health, their current financial needs, what other income they will receive, their saved wealth and their

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[112] Ibid para 3.3

[113] Taxation of Pensions Act 2014, Schedule 1, Part 4; See Library Note SN 6891 Flexibility for DC pension savers from April 2015 (December 2014), section 4.2

[114] HM Treasury and DWP, Creating a secondary annuity market: call for evidence, Cm 9046, 18 March 2015, para 3.6-7

[115] Ibid p17

> aspirations for future needs. Individuals will also have to consider dependants' needs – both now and in the future – and the implications for their own future welfare and social care needs.[116]

They were likely to find it difficult to judge the value of their annuity:

> 4.3 Judging the value of an annuity in payment is particularly difficult and complex and subject to behavioural biases. Individuals are likely to find valuing their annuity difficult for a number of reasons:
>
> - accurate calculation of the net present value of an annuity is relatively complex – and beyond the capability of most consumers if they do not have access to expert help
> - many people apply a high effective discount rate; with a strong preference for payment now over future payments
> - people consistently underestimate their own predicted life expectancy, leading to the risk that they will have too little saved for future needs. Conversely, people in poor health may feel under pressure to assign their annuity payments in order to pass on money to relatives
>
> 4.4 Individuals who have bought their annuity recently may assume that a fair rate will be close to the purchase price minus any payments. However, they are less likely to be able to properly consider legitimate changes in value caused by changing economic circumstances (such as interest rates, or returns on investment), or deterioration in health. They may also find it difficult to determine what level of fee is reasonable for a purchaser to seek to compensate for their costs and risks. All of these could result in a material difference between the price paid for an annuity and the value the individual can now obtain for it.[117]

The Government was considering a number of potential safeguards: a requirement to take financial advice; an offer of guidance; and regulatory interventions such as risk warnings. It would need to achieve a balance - protecting consumers without imposing disproportionate costs.[118] Measures to help consumers determine a fair value for their annuity could include requiring annuity providers to offer a benchmark selling price and requiring individuals to obtain a number of quotes.[119] Measures to protect the rights of any dependants under the policy would also need to be considered.[120]

The Government said it was considering whether individuals on means-tested benefits should be able to reassign their annuity income:

> 4.24 The means tests for welfare, social care and council tax reductions take into account levels of income and capital. Based on the current rules, where an individual decides to assign their annuity to a third party, thereby exchanging income for capital, this may change the level of support they are entitled to through

[116] Ibid, para 4.2
[117] Ibid
[118] Ibid para 4.5-6
[119] Ibid para 4.16-8
[120] Ibid p4.20-2

> these mechanisms, and the deprivation of income or capital rules would apply.
>
> 4.25 The government wants individuals using these new freedoms to understand what this might mean should they need support in the future and if they are already accessing support. This will be particularly important in light of the wider reforms to how people pay for social care that will come into force in April 2016.
>
> 4.26 The government therefore wants to consider carefully how to explain the interaction between annuity income, capital, and deprivation rules in the welfare, social care and council tax reduction systems to those who are considering assigning their annuity to a third party. The government will consider how best to support these decisions through the development of an appropriate consumer protection regime for the assignment of annuities and would welcome views on this point.
>
> 4.27 In order to protect the taxpayer, the government does not intend to compensate individuals through welfare for any loss of income resulting from assigning their annuity to a third party and would therefore like to consider whether those receiving means-tested benefits should be able to do so.[121]

Responses to the consultation

In its response to consultation, the Financial Services Consumer Panel (FSCP) called for thorough analysis and research before proceeding:

> The Panel feels strongly that such a radical proposal should not be introduced without robust analysis to ascertain the impact on the supply and demand for annuities in the primary market and the money's worth of those sold in the secondary market. Annuities are not necessarily a 'bad' decision. The FCA's research shows that consumers like the option of a guaranteed income for life – it is purely the name 'annuity' that carries with it the perception of poor value.
>
> Moreover, the consultation paper acknowledges that, for most people, keeping their annuity income will be the right decision. Given this, and the currently confused thinking on what type of advice might be available to help consumers with this complex decision, the Panel feels strongly that thorough analysis and research is needed to consider whether a secondary annuity market should be developed at all.[122]

It had "serious concerns that the proposals as they stood would lead to consumers suffering great detriment." For example:

> 1. As the Treasury notes in the consultation, it is questionable whether the average seller would be able to evaluate value for money. Sellers would be exposed to the risk of predatory pricing. The remedies proposed are untested and likely to be ineffectual. The historic record of regulation in this market does not inspire confidence.
>
> 2. For buyers there is the fear of adverse selection. The seller may be presumed to have inside knowledge of his or her mortality, depressing the price. An 'Akerlof lemons' market syndrome could develop. Long life annuitants could be put off selling by the

[121] Ibid; See also HM Treasury, Budget 2015 – policy costings, March 2015, p19

[122] FSCP, Response by the Financial Services Consumer panel to the call for evidence on creating a secondary annuity market, 18 June 2015

> average low prices on offer in the secondary market, which would be increasingly dominated by those with presumed inside-knowledge of short life expectancy, leading to a further drop in prices and a market collapse.[123]

It was concerned that adequate advice and support would not be available:

> […] the Panel believes there is currently no market solution to the question of how adequate advice and support can be provided to consumers, irrespective of income level, to help them assess whether they are being offered a fair price for relinquishing the right to such a valuable asset. Regulated financial advice may be available, but at a high price. The call for evidence says that it is unlikely advice will be mandatory, as to force people to pay to be told they shouldn't transact seems perverse. And let's be clear, in most cases any reputable financial adviser would recommend that the annuitant should not sell.
>
> So how will the government work with the FCA to support people? One answer might be to extend the scope of Pension Wise so that free, impartial advice (and it is advice – not guidance) is provided through this service. This would mean existing Guides being equipped with the same level of knowledge and experience that regulated financial advisers possess in order to assess an individual's position correctly and provide a recommendation for action. Consumers would also have to have access to redress in the same way they would if they took regulated advice. Guidance with no responsibility and the absence of a clear recommendation – as with the current Pension Wise service – will not do for this decision.
>
> The pension freedom reforms have had little time to bed in, and the impact on the market has not been assessed. There has also been no assessment of the Pension Wise service (indeed even the number of sessions held has not been published to date). But early, anecdotal, information seems to show that consumers are not accessing the service, but going straight to their providers demanding their money.
>
> Surely this behaviour is likely to be replicated when consumers are told they can sell their annuities?[124]

Citizens Advice was concerned that people in receipt of an annuity faced particular risks:

> Existing annuity holders face particular risks around means-tested benefits (MTBs), as those with incomes around the level of Pension Credit may immediately see a drop in income as a result of selling their annuity.
>
> They are also at risk of getting poor value for money: buying a pension product for the second time round means consumers lose money twice through transaction costs.[…]
>
> They are likely to be older, which may for some heighten vulnerability to scammers and make it harder to make complicated investment choices. They are also less likely to be able to take paid work if they run out of savings.[125]

[123] Ibid
[124] Ibid
[125] Creating a secondary annuity market: Citizens Advice response, 18 June 2015

The National Association of Pension Funds (NAPF) expressed concern that the creation of a secondary annuity market could be "could be so expensive as to greatly reduce the value available to most annuitants." It raised a number of issues, including the need for independent advice:

- Buyers will be wary of adverse selection and will compensate accordingly, either through pricing 'short longevity' into all contracts or through individually underwriting each transaction, both of which will increase costs. Either way, the value available to all, or some, sellers will be reduced.
- Many sellers will need protection in the form of independent advice. This will come at a significant cost and reduce the value of the transaction to the seller.
- By releasing the annuity's value in a lump sum sellers risk a higher tax bill than if they had drawn the income from an annuity, further reducing the value the annuitant ultimately receives. […]The cost of building the infrastructure needed to package and sell annuity contracts will be significant – especially as the lifetime of the market looks limited and all costs would need to be recouped within a short period of time, rather than spread over decades. This will further erode the value to sellers.
- Even if the infrastructure for a market were to be put in place, it is not clear who will be the buyers of the annuities. A NAPF survey of members suggests a very limited appetite from pension schemes for packaged annuities. Only 13% of defined benefit (DB) respondents to our survey expressed an interest, with 67% 'not interested'.[126]

The ABI expressed support in principle but urged that implementation should not be rushed, given the challenges in establishing a functioning market and ensuring adequate protection for consumers. It said clarity was needed around:

- How the rights of dependents and beneficiaries will be protected, particularly as many of them will be older people who may be vulnerable due to illnesses and reduced mental capacity.
- How we will protect people from scams and fraud.
- The exact scope of the proposals, which must be well defined, so that consumers are clear about exactly what is included.
- Whether consumers are allowed to sell their annuities back to the provider they originally bought them from, recognising that providers are not obliged to 'buy back'.[127]

The Association of Consulting Actuaries talked of the need for robust safeguards to protect consumers.[128]

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126 ''Value hard to find in secondary annuity market, says NAPF' 18 June 2015
127 ABI sets out what is needed to make secondary annuity market proposals work for consumers, 26 June 2015
128 ACA, Response to HM Treasury consultation – creating a secondary annuity market, June 2015

A survey of people aged 55 and over by the Institute and Faculty of Actuaries had found that 48% of respondents valued the certainty their annuity gave them and 40% believed there was a high risk they could end up worse off by cashing it in.[129]

[129] Institute and Faculty of Actuaries, Majority of pensioners do not want to cash in their annuity, 23 June 2015. The total sample was 1531 adults over 44 of which 348 were actually receiving payments from an annuity

7. Proposals for an annuity brokerage service

In July 2012, the Centre for Policy Studies recommended making the OMO mandatory, "achieved via an annuities clearing house; essentially, a marketplace in which all annuity providers participate."[130]

The National Association of Pension Funds (NAPF) has recommended that, in the event of "market failure", consideration should be given to introducing a national annuity brokerage service.[131]

In 2013, the then Shadow Pensions Minister, Gregg McClymont, called for a brokerage service, arguing that:

> Only a minority of people use the open market option now and with a mass inertia-based auto-enrolment system, it is highly unlikely that engagement will improve. It seems far more likely that not-for-profit brokerage services would be better able to achieve a genuine open market outcome. NEST, for example, requires competing annuity providers to make sealed-bid offers to supply people who save with NEST.[132]

In response to an amendment to that effect during Report Stage of the Pensions Bill 2013/14, the then Pensions Minister, Steve Webb said:

> The danger with the rigidity of new clause 11 is that it presumes a backward-looking annuity model. Annuities in their current form were designed for a world where people lived for 10 years with pensions and then died. We now have a world where people might annuitise in their early 60s, or want to stop contributing to their pension pot in their early 60s, and live into their 90s. There are serious questions about the suitability of annuities for everybody. For example, people with big pension pots might want to look at a mixture of draw-down. They might want to look at alternatives, deferral or a range of options. It would be a backward step to hardwire into primary legislation that the only good thing that can be done with a pension is to annuitise through this particular model. We should give people new options at decumulation, not hardwire them into the annuity model.[133]

The issue was raised again in debate on the *Pension Schemes Bill 2014/15* – see Library Note SN 7105 Pension Schemes Bill 2014-15 – House of Lords stages (February 2015) (section 3.2) and SN 7030 Pension Schemes Bill 2014-14 – House of Commons stages (December 2

130 Michael Johnson, Put the saver first, Centre for Policy Studies, July 2012
131 NAPF, Treating DC scheme members fairly in retirement? February 2012, Executive Summary
132 Gregg McClymont MP and Andy Tarrant, Pensions at Work, that Work, 2013
133 HC Deb 29 October 2013 c790-9

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