

Treating DC scheme members fairly in retirement?

*'There's no point telling people to shop
around for their annuity when they don't know
where to look and when most of the shops
are closed. The shop needs to be part
of the scheme.'*

An NAPF and Pensions Institute Research Report

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The NAPF and the Pensions Institute sponsored the report and Dr Debbie Harrison collaborated closely with Melanie Duffield, Head of Research, and Verena Menne, Senior Researcher, in compiling the report and developing the findings and recommendations. However, the opinions expressed in the report remain those of the author.

The author and the NAPF would very much welcome feedback to this report. Please contact Dr Debbie Harrison (dr.debbie.harrison@gmail.com) and/or Melanie Duffield, (melanie.duffield@napf.co.uk).

List of abbreviations

ABI	Association of British Insurers
AMC	Annual management charge
DB	Defined benefit
DC	Defined contribution
EBC	Employee benefit consultant
FSA	Financial Services Authority
FSCP	Financial Services Consumer Panel
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
HMRC	HM Revenue and Customs
HMT	HM Treasury
MAS	Money Advice Service
NAPF	National Association of Pension Funds
OMO	Open market option
PI	Pensions Institute
PICA	Pension Income Choice Association
PMI	Pensions Management Institute
RDR	Retail Distribution Review
TPA	Third Party Administrator
TPAS	Pensions Advisory Service
TPR	the Pensions Regulator

Foreword from the Chief Executive of the NAPF

For those in the private sector, saving into a Defined Contribution (DC) pension is likely to be the future. Securing good outcomes for members from a DC pension depends on a number of factors, including the level of contributions, the asset allocation, and the charges in the scheme.

These accumulation issues have all been debated in the development of the workplace pension reforms and in many areas requirements and benchmarks have been introduced; including the minimum contributions that employers must make, the requirement for a default fund to be offered, and the low benchmark charges being offered by NEST. Whilst the accumulation side may not yet be perfect, the 5-8 million individuals starting to save in a pension as auto-enrolment rolls out should at least feel assured that the policy for them has been well thought through.

The decumulation stage, in contrast, is woefully under-developed, and the experience of individual members can vary greatly. Member outcomes will be driven by the level of governance that surrounds the scheme, any professional support that is offered to them and brokered by the employer or trustee, and the approach taken by their scheme provider, as well as their own levels of financial capability and confidence.

For those who have relied on the default fund in the accumulation phase, this decumulation lottery is likely to lead to poor outcomes and significant losses of income in retirement, potentially wiping thousands of pounds off the value of the pension pot that the member and employer have worked so hard to build. And while decisions about contributions and investments can be changed, the process of buying an annuity is a one-off event which cannot be reversed or corrected later.

The challenging findings and recommendations in this report span the role of the Government, the Regulators, the insurance industry, intermediaries, and employers and trustees. At the NAPF we are conscious that the DC market in the UK is still a developing one, with some long established schemes and some very new schemes. We have heard from our members that there are barriers both for those running trust and contract-based schemes to going beyond the regulatory minimum and we welcome the recommendations, particularly in relation to regulatory clarity, made in this report.

We hope this report gives other NAPF members some food for thought and shares some of the best practice that currently exists amongst our members, across all types of DC schemes. Going forward, we will work with our members to promote this best practice and to develop practical guidance for employers and trustees on how to put systems and processes in place that will help secure better outcomes for scheme members at retirement.

We also hope it sends out a warning call to the industry that there are some acute problems in the current operation of the annuities market that need addressing. Without action, there is a growing risk that some of the worrying stories which have surfaced during the production of this report will turn into newspaper headlines and further dent trust and confidence in pension saving. The announcements expected on the Open Market Option (OMO) Review Group at the Budget in March 2012 are a timely opportunity for the Government to set out its plans on this important issue.

I would like to thank Dr Debbie Harrison for her tireless efforts in compiling this report and all those who have contributed to the research. I would like to thank in particular the NAPF members who took time to tell us about their own approaches to decumulation and who shared their candid views about the areas where action is needed.



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Foreword from the Director of the Pensions Institute

The baby-boomers began to retire in 2010 and, over the next 40 years, the number of retired people is set to rise by more than a third. Most of the early retiring baby-boomers will enjoy good defined benefit pensions. But the later cohorts, together with Generations X and Y that follow, will have to rely on pensions from defined contribution schemes, if they work in the private sector.

It has long since been evident to us at the Pensions Institute that annuities are the ‘weak tail’ in DC pension provision. Debbie Harrison’s report *‘Treating DC Members Fairly in Retirement?’*, jointly sponsored by the NAPF and the Pensions Institute, clearly demonstrates that this is still the case. Debbie’s interviews with NAPF members and with a wide array of industry practitioners show that many DC members are at risk of getting a poor outcome when it comes to buying their annuity, whether their DC scheme is contract-based or trust-based.

Part of the reason for this is the absence of transparency in the industry. Part is due to advisers’ reluctance to offer advice to members with small pots, because the fees or commissions are too small. But the main reason is that the majority of DC scheme members just do not understand annuities and the complexities of the decumulation process. They should not be blamed for this. Buying an annuity is a one-off decision, so people cannot rely on previous experience to guide them. Further information provision and appeals for greater customer engagement will not get around this problem alone.

This should be an urgent concern for the government, which has established new benchmarks through NEST and other qualifying schemes that demonstrate how dependent the auto-enrolment system is on defaults. Many auto-enrolled members will never make an active choice during the entire accumulation phase, having been auto-enrolled with a default contribution rate into a default investment fund: hence the description ‘serial defaulters’. Yet at the time of retirement, they will suddenly be confronted with complex choices that they do not have the skill, experience, or inclination to make. Do they take a fixed or an inflation-linked annuity? Do they buy an annuity now or wait and draw an income from the fund? How long should they wait? And how do they know if they can secure an enhanced annuity that delivers a fair rate in relation to their health conditions and lifestyle issues?

Financially intelligent consumers do not need heavy regulation to protect them when they make their purchasing decisions – they know how to avoid both poor suppliers and poor advice. But most DC scheme members – and particularly those being auto-enrolled cannot be assumed to be financially intelligent consumers. So they first need to rely on the good internal governance of their scheme to see that they are treated fairly when they come to buy their annuity. If that fails, they need to be able to rely on a regulatory framework that is fit for purpose, but not overly burdensome, given that the costs of regulation always fall back on consumers. The current regulatory system, for historic reasons, drives inconsistencies for scheme members, with two different regulators for contract- and trust-based schemes. Along with a simplified regulatory framework that operates in the best interests of members, a good decumulation default also needs to be designed. For most people, this is likely to involve the simple choice that considers an index-linked annuity and an enhanced annuity, purchased at the time of retirement. Most people will not have a pot big enough to justify anything more sophisticated.

As previous Pensions Institute research has demonstrated - and as this latest report with the NAPF confirms - we are still at a primitive stage in the design of DC schemes, rather like the early days of commercial airline

flight. All sorts of poorly designed aircraft were tried and failed, often with disastrous consequences for passengers. But in time, the industry settled on a small number of well-designed aircraft which get passengers to their desired destination on time, in safety and economically. In time, I believe that DC pensions will be as well designed as commercial aircraft are today, and there are some strong examples of best practice in this research for us to build upon. Debbie's report highlights the problems DC members currently face at retirement and makes important recommendations about how those problems can be resolved.

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Executive summary

This research addresses widespread concerns about the outcomes DC scheme members achieve when they buy their annuities and concludes that, for most employees, membership of a workplace DC pension scheme represents an illogical and uncoordinated journey.

The DC member journey begins with an institutional asset management model, which is designed primarily for the defaulter. The journey concludes at retirement with a requirement for the member to select an individual long-term retail insurance product (the annuity) – a process that many interviewees said demands an above-average level of literacy and numeracy. For the defaulter there is no learning curve derived from the experience of accumulation; for the most common types of annuity the decision is one-off and irreversible.

We consulted about 90 organisations, which are listed in the acknowledgments and together represent about 80% of the major providers and advisers as well as employers, trustees, consumer organisations, academics and trade associations. The experts interviewed for this report said that unless the decumulation system changes, improvements in the accumulation stage through higher contributions, better-quality asset management, and lower charges will be undermined by the fact that members buy an inappropriate annuity for their circumstances, frequently at the wrong price. By chance some will actually secure a good price for the wrong type of annuity but many will lose out on both counts.

Unless there are changes in industry and governance practices, the number of people who lose out at retirement, as well as the aggregate lifetime detriment each annual cohort of retirees suffers, will grow under auto-enrolment. Auto-enrolment will bring 5-8m additional low-to-median earners into the market, who are likely to passively accept default features during the accumulation phase, but who will be without practical support when they make their annuity selection and purchase.

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

- ***Each annual cohort of pensioners loses in total around £500m-£1bn in lifetime income¹. This could treble as schemes mature and auto-enrolment brings 5-8m more employees into the system.***
- ***This represents 5-10% of the annual amount consumers spend on annuities.***
- ***An estimated 20% of this loss is likely to be transferred to the Government and the taxpayer through reduced tax revenues and the increased demand for means-tested retirement benefits.***

Findings

Buyer-side barriers

Barriers on the demand or buyer side (scheme members, employers, trustees, consultants, and advisers) and on the supplier side (scheme providers and annuity providers) prevent members from securing good outcomes at retirement. Our key findings are:

- **‘Serial defaulters’ – the 80-90% of members who do not make active decisions during the accumulation stage – lack the capability required to secure the right annuity at the right price.** The accumulation phase – especially under auto-enrolment – formally encourages inertia, and yet members are blamed by the

¹ The evidence and sources are set out in Chapter 3

industry for inertia and lack of engagement at retirement. The sudden transfer of risk and responsibility at the point of retirement, from the knowledge community to the consumer, is inappropriate and a governance failing. The result is an annual loss of £500m-£1bn per annum in terms of each retiring cohort's lifetime income.

- **Helping members secure the right annuity at the right price is entirely optional on the part of employers, trustees and providers.** The only regulatory requirement is that they provide basic generic information about annuities and the OMO. They can discharge this duty simply by giving members a leaflet. Trustees have more scope to implement good governance because they are the owners of member assets and data. Employers with contract-based DC are in a weaker governance position because the scheme provider (which in most cases is also an annuity provider) has the primary relationship with the member and owns the assets and the data. Those acting on behalf of DC members do not have strong incentives to go beyond the very minimal requirements in relation to the Open Market Option and face regulatory barriers when they do so.
- **For DC members who try to use the OMO, it is virtually impossible to find the top OMO advisers, and if they do, full advice shops are closed to those with smaller funds.** Unless a member is lucky enough to be pointed in the direction of a specialist annuity broker that covers the whole of the market they are unlikely to secure a good outcome. If members attempt to shop around, the postcode search engines used by adviser websites do not direct them to specialists. For those with smaller funds – the 80% of members with pots worth less than £50,000 – most annuity advice shops are closed because there is no money in it for the adviser. Nevertheless, most DC members implicitly pay commission when they annuitise, whether they receive advice or not. This is because major annuity providers factor the cost of commission into their prices.

Supplier-side barriers

Despite headline figures from the industry that indicate more consumers are shopping around for their annuities, the research reveals that many of these are likely to be retail customers and that the picture for scheme members is very inconsistent. Our key findings on the supply side are:

- **Pricing practices in the annuity market lack transparency.** It was impossible to investigate formally the internal annuity rates offered to customers (the 'roll-over market') but we understand that pricing can be poor, particularly where the provider manages closed books that it has purchased from other insurers. Annuity advisers said that where the provider participates in the open market there can be a differential between a provider's internal rate and OMO rate of up to 20%. Providers say that this cannot happen.
- **Evidence of rate adjustment.** Annuity advisers said they are aware of rate adjustments (described as 'manipulation'), whereby a scheme provider adjusts downwards the internal rate (and corresponding OMO rate, where applicable) in anticipation of a substantial tranche of internal DC member funds reaching maturity.
- **Cliff-edge rates bands exploit member inertia.** Even where individuals do shop around, unless they receive advice they will not know about the impact of a provider's rate bands, which apply outside of the most commonly quotes rates of £50,000 and £100,000. This means customers miss out on the opportunity to improve their rate by retaining an extra £1 in the pension pot from the tax-free cash allowance, and by aggregating and splitting pots.
- **Enhanced rates lack transparency and benchmarking.** Some providers do not offer enhanced or impaired annuities, which is a particular concern for those who buy the internal annuity. Even where

they do offer enhanced rates, this might be little more than an extra £1 per month and the rate can be 15% lower than the top standard rate on the open market. Moreover, enhanced rates secured through execution-only OMO websites are likely to be ‘underwriting-light’, which means that members secure only a percentage of the potential uplift. This is due to the fact that the enhancement is based on a simplified, rather than a full, medical questionnaire. We argue that the enhanced market, which is comparatively new, requires greater analysis – particularly in relation to the underwriting assumptions and financial strength of providers – and benchmark percentage uplifts.

- **Providers in both the scheme and annuity market benefit from retention rates of 80-90%.** They have little incentive to encourage customers to transfer funds to competitors. The ABI’s proposed Code of Conduct might help but the current lack of transparency facilitates high retention rates. However, some EBCs predict that the ‘roll-over’ market is set to change in response to increased segmentation and enhanced annuity business.²

Recommendations

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

Recommendation 1: Improve transparency

- **Transparency must be improved to increase competition and establish trust in the market.** The lack of transparency in annuity providers’ pricing practices is detrimental to consumers who do not have access to a specialist adviser that understands the complex underwriting system. The Government, the FSA and the ABI should collectively drive transparency in annuity pricing and commission factors. For reasons explained in this report the ABI’s proposed Code of Conduct³ is unlikely to go far enough to address these issues.

Recommendation 2: Improve sponsor governance at retirement

- **Employers and trustees should be able to support members at retirement without fear of regulatory reprisals.** The Government should support the FSA and TPR’s work on principles for DC by developing with the regulators a simple and single set of rules for non-regulated advice in the workplace. The Government and Regulators should also work with industry representative groups and employers to consider whether it is necessary to introduce safe harbour rules to protect employers and trustees who have complied with the rules.

Recommendation 3: Clarify the meaning of the OMO and make it the true default

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

² Professional Pensions, [Rollover annuity market is set to plunge](#), 26 January 2012

³ http://www.abi.org.uk/Publications/ABI_Publications_ABI_Consultation_Paper_Consumers_in_the_Retirement_Income_Market_6b0.aspx

to the annuity purchase. The research identified clear examples of this model in both contract and trust-based schemes, and across a wide range of sectors, including the ‘tough end’ of the market where members are low-to-median earners with lower levels of financial literacy, and where employers cannot afford to pay for full member advice.

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

Recommendation 4: Establish baseline measures for the OMO and monitor them

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

Recommendation 5: In the event of ‘market failure’, introduce a national annuity service

- At present the annuity market is still very much in flux. In theory, all the component parts are present to deliver a service that secures a good member outcome across the whole private sector DC market. In practice, it is not clear if those with the power to deliver the reforms are able and willing to do so, particularly in relation to members with smaller pots (as will increasingly be the case under auto-enrolment) and where the employer is not engaged.
- The Government should consider the example it has set in the accumulation market through the introduction of auto-enrolment and NEST, which is purpose-built to correct market failure, and whether there is a need to replicate it in the annuity market. Such intervention would be well-aligned with the Government’s proposals to facilitate transfers and consolidate ‘orphan’ pots during the accumulation stage. We anticipate that a national annuity service would have the scale to deliver member support and the full OMO brokerage process within the current commission costs factored in to annuity pricing. This could build on existing generic advice platforms, and take a carousel approach to draw on the large-scale advice and brokerage services currently provided by advisers and third-party administrators, among others.

Chapter 1: Background to the Research

The future security in retirement of private-sector employees will depend on the success of defined contribution schemes. DC cannot be ‘fixed’ by higher contributions, better asset management and lower charges if members purchase annuities that are inappropriate and poorly priced. ‘Detriment’ might be found in any financial market but we argue that the DC scheme market, under auto-enrolment, is of particular relevance because it forms a key plank of the government’s policy for private welfare and it includes compulsory aspects for employers and quasi-compulsory aspects for employees.

This report investigates the operation of the annuity market for members of contract- and trust-based DC schemes in the private sector workplace. The UK has the largest annuity market in Europe. Currently this is worth about £12bn per annum and is expected to increase to about £23bn by 2014-15.⁴ Under the Finance Act 2004, all schemes providing DC benefits must offer the Open-Market Option to members.⁵ TPR states that at present there are 2.5m members in DC trust-based schemes (also known as occupational DC) and 3m in contract-based schemes (also known as work-based personal pensions).⁶ Between 5-8m additional employees are expected to start saving in these schemes under auto-enrolment, which will be phased in from autumn 2012. Most current DC members – 80-90% – are in the default fund for the accumulation phase – the same fund that is expected to be used by the vast majority auto-enrolled members.

This research project began in the summer of 2011 as an investigation to identify examples of best practice in relation to the governance processes used by DC schemes when members approach retirement. However, it quickly became evident that good governance is entirely voluntary, that incentives for trustees and pension scheme managers to go beyond the regulatory minimum are often unclear and that there can be regulatory or contractual barriers that stop them from doing so. Clearly, a much broader piece of research was required to understand barriers to an efficient and well-functioning market.

Our objective was to identify the existing practices that can lead to detriment – that is, the reasons why members make the wrong annuity choice and/or do not secure a fair price. While estimates vary, this detriment has been well documented and can be quantified as an aggregate annual loss of between £500m-£1bn in terms of the annuitants’ lifetime income. Without change, these losses inevitably will grow as DC schemes mature and auto-enrolment is implemented. For the success of DC in the private sector, and to ensure trust and confidence in the pensions industry, it is crucial to address these problems.

The primary focus of this report is the low-to median earner, towards whom the workplace pension reforms are targeted and for whom the success of the DC pension system, in the form of an annuity income, will provide financial security in retirement and independence from means-tested benefits. An annuity is the only financial product that provides a guaranteed income for life, irrespective of both market conditions and how long the annuitant lives. The fact that interest rates are low and that longevity is increasing does not change members’ need for a guaranteed lifetime income. The report does not enter the debate about whether annuities are the right product for decumulation, but questions the ways in which the consumer or scheme

⁴ [ABI statistics](#) for 2011; [Retirement Supermarket](#). Not using OMO has cost UK Pensioners £7bn in the last decade

⁵ See [The Pensions Regulator's website](#)

⁶ Office for National Statistics and Standard Life put the figures at 4.7m in total: 3.5m contract-based and 1.2m trust-based.

member is expected to interact with the market that sells the product. It also questions whether some scheme providers that sell directly to internal clients deliver fair outcomes.

In the medium term – the next five to 10 years – the funds of defaulters are likely to be worth less than £100,000, and for about 80%, they will be worth less than £50,000. The mean fund size in 2012 will be £25,000, according to DCisions. As the switch from DB to DC in the private sector continues, cohorts of savers will increasingly rely on DC for their private pensions. Changes being implemented under the Retail Distribution Review (RDR) will make it likely that many regulated advisers will withdraw their service for those with pots below the £50,000 mark. Unless employers, trustees and scheme providers step in to fill the member-support gap – by making a robust OMO process the scheme default – many members will continue to suffer detriment.

At present there is a clear default annuity, for contract-based DC members in particular, which exploits their inertia in a similar way to auto-enrolment, but with potentially detrimental results. During the course of this research, most providers that operate in both the scheme and annuity market declined to reveal their retention rates. Of the minority that were candid, one provider said that it retains 60% of DC scheme customers at retirement through the sale of internal annuities; another that its retention rate is 86%, which, coincidentally, is the about the same proportion of members that currently use the default accumulation fund.

The impact of a strong brand name and customer loyalty in relation to these retention rates cannot be overstated. Unpublished consumer research, to which we had access, demonstrated that participants in the control group that were told the scheme provider was not the best annuity provider were so impressed by the provider's 'honesty' that they decided to stay put simply out of loyalty.

In the process of carrying out this research, we consulted more than 90 organisations, including about 80% of the major scheme and annuity providers and the same proportion of the specialist annuity advisers and major EBCs. In addition we consulted with the government, the regulators, consumer groups, academics, analysts, independent trustees, and the main trade organisations that represent insurers and asset managers. We interviewed a wide range of DC schemes and the governance processes used by a sample selection can be found in Chapter 3. As the acknowledgements indicate, our scope encompassed schemes that accommodate financially literate, above-average earners through to the schemes that operate in markets where earnings are low-to-median, and which are characterised by high levels of job turnover.

We found excellent examples of good governance at both ends of the spectrum. But we also identified structural problems in the workplace decumulation market in terms of lack of transparency, conflicts of interest, advice gaps, pricing anomalies, and poor governance practices. These combine to create a formidable barrier to a successful member outcome for any member trying to go it alone, in terms of the selection of an appropriate annuity secured at a competitive price. We base our findings on the evidence and our recommendations on what the research indicates are achievable, affordable and, importantly, readily-available propositions.

Chapter 2: Findings and Recommendations

These findings are the result of extensive research and interviews with key players on current market practice. The details can be found in Chapters 3 and 4.

There is an urgent need for an efficient, cost-effective and transparent default annuity process so that private sector DC schemes can deliver good outcomes for all fund sizes. At retirement DC scheme members lose an aggregated lifetime income worth between £500m to £1bn per annum.⁷ Auto-enrolment will bring an additional 5-8m people into DC schemes and so this level of detriment is likely to treble in future, unless the underlying causes are addressed.

Member confidence is critical to the success of the retirement phase of DC, but so too is the employer's confidence in its ability to retire employees at a time that is mutually convenient. The impact of the abolition of the compulsory retirement age in October 2011 has yet to be felt, but it is in the employer's interests to make sure older employees can afford to retire. The alternative is a growing cohort of potentially discontented older workers, which is unlikely to be good for business.⁸

While there are barriers to change, there are strong incentives for reform. It is in the employer's best interests to ensure that company pension contributions achieve value for money and deliver good outcomes for employees. It is in the best interests of the Government to balance the cost of tax relief on contributions with the tax revenue from annuity incomes. At present it may be losing about 20% of the estimated member detriment at retirement, which is worth £100-200m a year in tax revenue, a figure that will rise as the DC retirement market grows exponentially. Above all, it is in the industry's best interests to increase consumer trust and confidence and to avoid the requirement for regulatory interventions and full Government intervention if the market cannot self-reform.

The barriers to an efficient market are set out below. The first section focuses on the buyer side – individuals, employers and the advisory community; while the second half examines the supplier side – the scheme providers and annuity providers.

The buyer side

2.1 Individuals: Serial defaulters

Consumer detriment is embedded within the annuity market due to member 'inertia', which leads to the passive or ill-informed acceptance of inappropriate and uncompetitive rates. The scale of financial loss, in terms of retirement incomes, will escalate under auto-enrolment when 5-8m new employees join the private sector workplace DC system.

'Inertia' and 'lack of engagement' are not neutral terms when they are applied to DC members at retirement: they serve to stigmatise the member who is not capable of making an informed choice. There was a common perception among experts interviewed for this research that member 'must' become engaged and that if they

⁷ See Chapter 3, page 25

⁸ The [LV= Working Late Index](#) (November 2011) shows that 6.1m people aged 50+ plan to work past the state retirement age – on average for up to six more years. Two-thirds of these will do so because they cannot afford to retire.

‘won’t’ they are responsible for the poor outcome. This does not sit comfortably with the FSA’s Treating Customers Fairly principles.⁹

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

Overall this means that the present system is deeply flawed, due to the ease with which the ‘knowledge community’ can transfer inappropriate responsibility and risk to the member. Beyond providing the member with very basic generic information about annuities and the OMO – a regulatory requirement that can be met by giving the member a FSA or TPR leaflet – governance processes that help members to buy the right type of annuity at the right price are entirely optional.

The problem of member ‘inertia’ is partly concealed by industry statistics on ‘shopping around’. While ABI research indicates that more DC customers are shopping around, we understand that the figures are more indicative of activity in the individual personal pension market, where individuals ‘buy’ a pension product, usually through an adviser, rather than in workplace DC, where employees ‘join the company pension scheme’.¹⁰ The blurring of market data is unhelpful, given the differences in the retail and workplace environments. In the former the consumer makes an active decision; in the latter, membership under auto-enrolment will increasingly be passive.

Moreover, the term ‘shopping around’ is very poorly defined and is not evaluated. Until baseline measures are established, it is very misleading to equate shopping around with making informed choices that lead to appropriate outcomes.

At the heart of the problem is the lack of an effective and transparent default annuity process, similar to the default accumulation process established with auto-enrolment. At present, there is a detrimental disconnection between the DC saving stage (accumulation), which is designed for the 80-90% of scheme members classed as ‘defaulters’, and the annuity purchase stage (decumulation), which is designed for well-informed, literate and numerate investors, with strong conceptual and problem-solving capabilities (10-20%).

While the first stage assumes most members cannot make effective investment decisions, the second assumes they can make choices that require an understanding of inflation and interest rates, and morbidity and mortality trends in relation to their own life and the life of their spouse or partner, where relevant. The member’s experience of buying life assurance – the main product they are likely to have encountered where the underwriting takes account of morbidity and mortality assumptions – will have given them the impression that ‘being in poor shape’ is a negative rather than positive factor in pricing.

⁹ Financial Services Authority, [Treating customers fairly](#)

¹⁰ Association of British Insurers, [Consumers in the retirement income market](#), 2011

Not all members need full advice – far from it – but they do need support. Opinions vary on member capability. Most equate the proportion of members in the default fund with the proportion that needs help at retirement.

One relevant piece of research identified DC member capability in relation to the OMO as follows:¹¹

- 15% are confident and able to make an informed decision on an execution-only basis. Even here, the system needs to ‘sanity-check’ decisions and intervene if they look inappropriate, for example if it appears that the customer has a health or lifestyle condition that indicates a better rate could be obtained through individual underwriting.
- 45% of members need help of a generic kind to ensure they are making appropriate choices.
- 40% need a full advisory service.

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

2.2 Employers: helping members to secure a good outcome is optional

Weak incentives and light-touch regulations

Current regulation does not require schemes or providers to ensure members secure the right type of annuity at a fair price. The minimum requirement is that the member is given basic generic information – for example the annuity and OMO leaflet written by the FSA (contract-based DC) or TPR (trust-based). Additional governance is optional on the part of scheme providers, employers, the trustees, and their advisers.

The research for this report found that certain contract-based schemes operate what appears to be an effective default annuity process, where the member outcome is driven by professionals and which requires a minimal level of member interaction. These schemes said they measure and evaluate the outcomes, in terms of the suitability of the annuity type selected and the price. Trust-based schemes use this model more widely and have the capacity to exert more influence on member outcomes, but in practice the model varies from the excellent to the leaflet-only approach.

Most employers set aside limited time for DC members at retirement because the number of cases per annum is often low and the corporate decision-maker is likely to be more concerned with the DB scheme deficit. Trustees, as legal owners of DC funds, have a duty to discharge their responsibilities. This is achieved when they transfer the member’s funds from the scheme to an annuity written in the member’s name. Even where trustees help members to make the right decisions, this service rarely extends to deferred members.

Employers and trustees should support members at retirement regardless of their fund size; otherwise they might be accused of bias and embedding inequality in their governance process. This point was noted by TPR in a recent report, which considered it poor governance to implement a ‘Two-tiered annuity broking service that provides enhanced services for members with large funds and limited services for members with small

¹¹ Retirement Angels

funds.’¹² It said that ‘members with small fund balances are just as likely (if not more so) to benefit from smoker/enhanced rates if access to such rates is offered’, and ‘if the fund balance is small, it is just as important for a member to get best value from the proceeds of their retirement fund’.

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

Provider exclusive ownership of contract-based assets and member data

For contract-based schemes in particular, there are significant barriers to good governance that relate to ‘ownership’ issues. Employers that were advised to implement contract-based schemes, due to the fact that they were considered ‘regulation light’ compared with the trust-based model, face very specific obstacles.

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

Under a trust-based scheme, the trustees are the effective owners of the member data and assets. This confers the ability to implement close supervision of annuity processes. It also enables them to manage better the accumulation stage as, for example, they can transfer member assets automatically to a new asset manager appointed to improve returns and to reduce charges and risk.

In contract-based DC, the owner of both member data and assets is the provider and there is no obligation to share member data with the employer or with the employer’s adviser. This means the provider has the primary relationship with the member and can drive the annuity decision both explicitly and implicitly: it does not have to inform the employer or its adviser when it sends important information to members.

The ownership problem is also evident in the accumulation stage. When an employer changes the scheme provider, there is no automatic transfer of assets. Each member has to sign a transfer form, which is inefficient and time-consuming. On average only 15-20% of members transfer when the employer changes its contract-based scheme. The result is that most members build up deferred or frozen pots that might suffer from sub-optimal asset management and higher charges – a point the DWP should consider when it looks at the orphan or small pots issue.

Recently TPR has encouraged employers with contract-based schemes to establish governance or management committees and many have done so. However, these committees have no regulatory teeth. Moreover member representation on governance committees is considered to be weak. Employers say that it is difficult to find members who are willing to participate and that there is no formal process to ensure that they develop the necessary knowledge and understanding. This creates a disconnection between the member,

¹² The Pensions Regulator, [A review of retirement information for DC members](#), 2009

who is the primary stakeholder, and the scheme. TPR recognises the importance of member trustee training through its trustee services and Trustee Toolkit, but there is no equivalent system for contract-based DC.

2.3 Advisers: specialists few and far between

Barriers to finding a specialist annuity adviser

At present, finding a specialist annuity broker is a lottery unless the member is directed to an appropriate firm and their basic data passed on automatically, so that the specialist can contact the member directly with the 'wake-up' pack and guide the member through the annuity selection and purchase process.

Currently, only about 10 firms of independent advisers and TPAs appear to have the systems and scale to provide DC schemes with a cost-effective annuity service that includes a service for members with smaller funds (less than £30,000 at present, rising to £40-50,000 in 2013). The Government and regulators know the identity of the specialist firms, as do trustees, EBCs, and scheme providers.

The only stakeholders in the DC market left in the dark are the scheme members. Postcode search engines, such as those used by unbiased.co.uk and the Personal Finance Society's findanadvisor.org (the first two organisations listed in the FSA and TPR annuity and OMO leaflets) do not help.

Adviser shops are closing to smaller funds: the Retail Distribution Review

Among the limited number of specialist annuity advisers there is evidence of strong innovation. However, the annuity advice market as a whole will shrink in 2013 under the FSA's Retail Distribution Review (RDR), which is expected to trigger a reduction in the number of independent firms. The potential impact of RDR is complicated but it might reduce the number of advisers that offer affordable whole-of-market annuity advice to customers with smaller DC pots by up to 40-50%.¹³ The FSA acknowledges this trend in financial advice when it says that 'firms are looking to move into a phase of growing revenue by attracting profitable customers and reducing unprofitable customers'.¹⁴

From the beginning of 2013, advisers will provide independent advice (whole of market), restricted advice (where the adviser is tied to the products of one or more providers), or generic advice (where the adviser offers support on the website and/or phone, but the decision is the customer's).

Under RDR, commission will be abolished for regulated and restricted advice – where the adviser makes the decision – but will still be permitted on products sold via generic advice, where sales are designated 'execution-only'. This is the model used by existing annuity websites. Firms that offer an execution-only service and receive sales commission have to demonstrate that the customer has made all the decisions, which means that in theory they can only deal with DC members who are financially literate and well-informed. In practice there is no way to assess if this is the case, unless outcomes are evaluated, which they are not.

The FSA's assumption, which this report suggests is badly flawed, is that the DC member will understand the difference between the different types of advice, identify the services for which they are paying – in the form of a fee or commission – and understand when they are taking responsibility for the outcome. A recent survey

¹³ Estimates of the percentage of firms that will withdraw from the full advisory market vary from 25% (Ernst & Young, [An ever decreasing adviser pool](#)) and 50% (Money Marketing, [Half of advisers would shun small pension pots](#), 27 October 2011)

¹⁴ Financial Services Authority, [Treating customers fairly](#)

found that 85% of intermediaries believe their clients do not understand the difference between independent and non-independent advice.¹⁵

Advice, commission and compensation

The cost of advice typically is built into the annuity pricing, whether the member takes advice or not. This varies from 1-3% (more for fully underwritten impaired annuities) with major advisers commanding higher rates. The industry average commission is about 2% of the fund value after tax-free cash – which is worth £600 on a £30,000 pot and £2,000 on a £100,000 pot. If the member accepts the scheme provider's internal annuity, this commission element is retained by the insurer, unless a rebate is negotiated by an adviser to the scheme. Where the member uses an execution-only website, the commission is paid to the website owner, even though in regulatory terms the adviser has not given advice and is not responsible for the outcome: the member has made the decision and therefore cannot claim compensation for poor 'advice'.

The research concluded that most 'defaulters' are unlikely to understand the different types of advice at present and that this is unlikely to change under the new regime in 2013; that they will continue to accept their scheme provider's annuity or to use a generic OMO site but with potentially sub-optimal results, by which we mean that they might get a good price for the wrong annuity.

They are unlikely to be aware of their pension contract's features, such as a guaranteed annuity rate on a with profits plan. Perhaps one-in seven contracts incorporate features where the best outcome is not necessarily related to the OMO rate.

Under current regulations, the only possible claim for compensation in relation to a poor outcome from an execution-only service is to argue that the website did not make available sufficient information for the customer to make an informed choice. However, such cases are very rare. This is likely to be because few customers understand what they might have missed in terms of an enhanced or guaranteed rate.

Sales commission is paid to EBCs and IFAs that provide an advised service. It is also paid to providers and third party administrators that establish arrangements with annuity advisers, although some make a point of not accepting annuity commission.¹⁶ In some cases the organisation arranging the sale will arrange for part or all of the commission to be rebated, which improves the member's rate.

Scheme members cannot negotiate a rebate of commission directly with a provider; this can only be done through an adviser. This 'rule' is market practice rather than regulatory in origin – providers are reluctant to negotiate directly with customers because they rely on the advisory community for distribution of their products.

¹⁵ [Financial Adviser](#) (Jan. 2012): The report cites a survey by PanaceaIFA, which found that more than 90% of advisory clients do not understand the Retail Distribution Review and that 85% of intermediaries believe clients do not understand the difference between independent and non-independent advice.

¹⁶ NOW: Pensions (a master trust scheme), B&CE (a multi-employer stakeholder scheme) and Capita (a TPA), for example.

The supplier side

2.4 Pricing ‘anomalies’

Differentials in internal vs. OMO rates

The difference between an internal rate and the top OMO rate can be as high as 40-50%. However, there also appears to be a differential between a provider’s own internal and open market rates of up to 20%. It was difficult to assess the extent to which this type of differential occurs, since the main providers in the scheme and annuity OMO market say that their internal and OMO rates are the same. Aegon, Aviva, Legal & General, and Standard Life confirmed this, while Prudential offers a rate that is slightly higher than their OMO rate (1-2%). Friends Life, Scottish Life and Scottish Widows are among the providers that do not offer the OMO and so only sell annuities to existing customers. Phoenix and Resolution also sell to internal customers and specialise in buying back books of pension business from other insurers.

Internal rate adjustment or ‘manipulation’

Several annuity specialists referred to practices of rate adjustment (‘manipulation’ was one term used), whereby a scheme provider adjusts downwards the internal rate (and corresponding OMO rate, where applicable) in anticipation of a substantial tranche of DC member funds reaching maturity in the near future. Where their internal and OMO rates are said to be the same, they maintain competitive rates for the fund sizes most frequently quoted in the press – £50,000 and £100,000 – and thus are able to retain their overall position as market leaders.

Members unaware of ‘cliff-edge’ annuity rate bands

It is not just consumers who do not understand how annuity rates work. The research indicated that many employers, trustees and their advisers are also unfamiliar with the complexity of underwriting processes and policies.

An individual provider’s rates are not linear but incorporate significant increases and decreases, which are applied at a series of bands in relation to fund sizes. Internal purchasers have no way of knowing that an extra £1 retained from the tax-free cash allowance could secure an improvement in the rate, as would the amalgamation or splitting of DC pots. While rate differentials do not present a problem where the annuity is selected through a whole-of-market search, which uses a software system that maps the full range of rate variables, they do raise questions where the annuity is purchased internally or via an execution-only OMO website.

Lack of transparency condoned by regulation

Unless providers become more transparent voluntarily, it will not be easy to improve matters, since lack of transparency – or the protection of ‘confidential information’ – is enshrined in regulation. Section 348 of the Financial Services and Markets Act (FSMA, 2000) prohibits the FSA from publishing ‘confidential information’.¹⁷ ‘Confidential’ is defined widely, to include information received by the FSA in relation to ‘the affairs of a firm’ and for ‘the purpose of the discharge of the FSA’s functions’. This indicates that even if the FSA were to gather information about internal rates, it would be prohibited from publishing the details without the specific permission of the companies concerned.

¹⁷ [Section 348 of FSMA](#) forbids the FSA from disclosing firm-specific information.

2.5 Providers benefit from the status quo

The lack of transparency in the annuity market outlined above would not be an issue if all DC members used a well-designed OMO service. Since they do not, it should be a major concern to the Government and to employers and trustees.

We asked providers that operate in both the scheme and annuity market to tell us what proportion of scheme members they retain at retirement through internal annuity sales. Most said this was confidential information. However, one scheme said it retained 60% of scheme members; another said its retention rate was 86% of members. In a third case a provider that does not offer an OMO, and currently retains about 25% of members, plans to increase its retention rate to 50%.

What this evidence indicates is that where a strong retention rate is part of the business model, providers can be very successful in leveraging brand loyalty and member inertia. Therefore, in some cases there is likely to be a disconnection between some providers' public support for the OMO and their private agendas.

2.6 'Enhanced' rates: inadequately defined and not benchmarked

Enhanced annuities are not defined in the regulation. The term simply means the rate is higher than the provider's standard rate for a healthy individual with the same size pot. If the rate is £1 per month higher, it can be called 'enhanced'. Yet it might be 15% lower than a more competitive provider's standard rate. 'Enhanced', therefore, is not an indication of good value and can be very misleading for consumers.

Moreover, enhanced rates quoted on the open market are 'underwriting-light', as they are based on a simplified questionnaire. The provider makes an allowance for a higher level of risk, due to inaccurate underwriting, and pays on average about 20% of the potential uplift. Moreover, there are concerns about the robustness of some providers underwriting practices, and associated future insolvency risks.¹⁸

Recommendations

Due to the problems outlined above in relation to both the buyer and supplier side, the annuity market does not work well for many DC scheme members.

Our recommendations to address these problems fall into five categories:

- Improve transparency
- Improve sponsor governance at retirement
- Clarify the meaning of the OMO and make it the true default;
- Establish baseline measures and monitor them
- In the event of 'market failure', introduce a national annuity service.

Recommendation 1: Improve transparency

Greater transparency in the industry's pricing practices is required to improve market efficiency and competition, both in terms of annuity prices and the levels of commission paid for advice.

¹⁸ Under existing Financial Services Compensation Scheme provisions, annuity holders would only be eligible to receive 90% compensation in the event of insurer insolvency.

Recommendations:

- The Government should consider amending the FSMA rules so that the FSA can investigate and publish details on annuity pricing practices, in particular in terms of internal vs. external rates, cliff-edge bands, and rate manipulation.
- The FSA should work with the industry to establish a definition and benchmark for enhanced annuities and require providers and annuity websites to make clear the difference between full medical underwriting and 'underwriting-light'.
- The FSA should investigate whether commission rates for generic advice, including execution only websites, represent fair value for money.

Recommendation 2: Improve sponsor governance at retirement

Employers and trustees generally are trusted by members and therefore are in a very powerful position to drive member behaviour, as the examples of best practice in this report demonstrate. They also have the power to drive change in market practice by demanding and implementing robust OMO default processes.

Recommendations:

- FSA and TPR should agree a single set of simple rules for non-regulated advice in the workplace. This should stress that schemes should not differentiate between member support based on the fund size. In addition, the Government should work with industry representative bodies and employers to consider safe harbour rules to protect employers and trustees where it is evident that they have followed the rules.
- Employers and trustees should promote examples of best practice in the OMO default process to prompt wider adoption of these models.
- Industry organisations that support this reform should endorse and promote best practice, and provide information and support to employers and trustees.
- The industry and/or the regulators should develop a robust training programme for members of contract-based DC scheme governance or management committees. As a minimum there should be an equivalent service to TPR's free online Trustee Toolkit.
- FSA should address ownership issues in relation to contract-based scheme member data and assets. In particular it should encourage data-sharing through service agreements.
- It should also facilitate the transfer of member assets, where an employer changes the company's contract-based DC scheme. We understand that there are conflicts here, as it is in the interests of incumbent asset managers to do nothing about what they describe as 'passive' or 'dormant' members. The very language implies inertia selling. This issue will be of interest to the DWP in relation to its consultation on small pots. We would stress, however, that that this is not just an issue for small pots: the size of pot is irrelevant.¹⁹
- The Government should review the take up of tax incentives for employers and schemes that pay for member annuity advice, and encourage advisers to develop cost-effective workplace services that can facilitate better use of this tax relief.

¹⁹ Department for Work and Pensions, [Meeting future workplace challenges: improving transfers and dealing with small pension pots](#), December 2011

Recommendation 3: Clarify the meaning of the OMO and make it the true default

There has been a lot of discussion lately about making the OMO the 'default', and various suggestions as to how this might be achieved. Most vocal has been PICA in its 2009 report *Optimising Income in Retirement*.²⁰ The DWP and HMT working group on the OMO is expected to report on its own findings at the time of the Budget 2012.

An immediate first step towards a default OMO is to establish a central register and website for specialist annuity brokers. A true default OMO, however, would require the scheme to direct all members through an annuity broker or panel that can steer members through their choices and make the purchase on the open market. Regulator or Industry guidance may be necessary on due diligence around selecting an annuity broker.

Recommendations:

- The industry / specialist annuity advisers should create a common national website that can be used by employers, trustees and providers to deliver a good OMO service and that can also be used by individual members, so that those going it alone don't face the postcode lottery of the current adviser search engines. We list the firms in this market of which we are aware in Section 3.
- The industry should work towards a clear and workable definition of an effective and proactive annuity default process. This should be predicated on an agreement between the employer, trustees or the provider, with an advisory firm that has the expertise and capacity to provide support and the OMO service for all fund sizes above the trivial commutation level.
 - Employers, trustees or the provider should present this process to the member as an integral part of the scheme.
 - The provider or scheme adviser should pass on member data automatically;²¹ the member maintains the right to opt out of this arrangement.
 - The adviser should initiate contact with the member and actively drive the process through to the annuity purchase.
 - The ABI should consider amending its proposed Code of Conduct to encourage providers to direct members automatically to a whole of market brokerage service. It should monitor progress in relation to insurers' retention rates.

The research indicates that it is possible to deliver a full open-market service at no additional cost to the customer other than the commission payment already deducted by providers at present, *provided* there is a high volume of business for larger pots as well as small ones and the broker has the systems and member-support services in place. Chapter 3 provides examples of such models that are already in use.

Recommendation 4: Establish baseline OMO measures and monitor them

The current evidence and statistics on 'shopping around' and the use of the OMO are unsatisfactory, as is the understanding of the level of financial capability and literacy members require to use the services.

²⁰ Pension Income Choice Association, [Optimising Income in Retirement](#), 2009

²¹ Data protection issues can be overcome where the member signs an agreement for data to be transferred in this way on joining the scheme or when the new OMO process is put in place.

Recommendations:

- The Government, through its working party on the OMO, should establish clear baseline measures and implement processes for monitoring and evaluating member outcomes actually achieved in relation to member circumstances and the systems used.
- The Government and TPR should assess levels of understanding among employers and trustees.
- The Government and FSA should establish baseline measures for member capability and for their understanding of the regulation of advice.
- The Government and regulators should examine the impact of inappropriate brand loyalty. They should consider their findings in relation to generic information leaflets and websites.²² These should stress that the annuity, as an insurance product, is very different from the investment product used as the pension plan/scheme and that brand loyalty at retirement is misplaced.
- The ABI should monitor the effectiveness of their proposed Code of Conduct by implementing a data and statistics system that can separate out workplace and retail sales of contract-based DC products and gauge true levels of engagement in 'shopping around'.

Recommendation 5: In the event of 'market failure', introduce a national annuity service

The annuities market is still very much in flux. Some employers, trustees, and providers will adopt the best-practice default OMO model described in this report. Others have already done so. Inevitably, however, the voluntary approach may be limited in its success, particularly for those sectors, employers and individuals that were the same target groups for auto-enrolment reforms and NEST, but who may not all be members of NEST.

Recommendations:

- The Government should consider whether there is a need to replicate a NEST-style intervention in the at-retirement stage. Such intervention would be well-aligned with the Government's proposals to facilitate transfers and consolidate small pots during the accumulation stage. The key role for the national annuity and brokerage service would be to be able to harness economies of scale to support those members without a true OMO default from their employer or provider and who may have smaller pots. As with NEST, it might be used by employers as the sole service for members or for parts of the membership.
- We anticipate that a national annuity service would have the scale to deliver member support and the full OMO brokerage process within the current commission costs factored in to annuity pricing. This could build on existing generic advice platforms, for example TPAS, MAS and the Pension Tracing Service, and take a carousel approach to draw on the large-scale advice and brokerage services currently provided by advisers and third-party administrators, among others.

²² The [MAS leaflet](#) on financial advice runs to 28 pages; we suggest it is too long and confusing for most consumers.

Chapter 3: The role of different agents in the annuity market

This chapter provides the background to the findings and recommendations set out in Chapter 2. It begins with an examination of the potential member detriment and then considers the member journey, from accumulation to decumulation, in order to identify governance inconsistencies and failures. It explores the regulatory differences between contract- and trust-based schemes and presents examples of the ways in which employers and trustees support members at present. Importantly, some of these examples relate to large scale, low-cost schemes suitable for the auto-enrolment market, and demonstrate that effective member support through good governance is not synonymous with higher employer, member, or scheme costs. We conclude the chapter with our analysis of the major participants in the scheme and annuity provider market, and annuity advice and brokerage market.

3.1 Member detriment

The annuity market is worth about £12bn a year at present, in terms of annual annuity purchases. In due course, as DC schemes mature, and 5-8m more employees are auto-enrolled into a workplace pension, the market is expected to treble. One short-term estimate is that the market will grow to £23bn by 2014-15.²³

The aggregated member detriment is likely to be between £500m and £1bn per annum, in terms of the lifetime annuity income lost by a retiring cohort in a given year. This range is based on the size of the current market and conservative estimates of what a proportion of DC customers will lose if they do not secure the right type of annuity at the right price. This is in line with other estimates, for example Retirement Supermarket stated that ‘not using OMO has cost UK pensioners £7bn in the last decade’.²⁴ Assuming an average income tax offset of around 20% for the average pensioner with some private pension income, this detriment implies that the Government loses annual tax revenues of £100m-£200m from retirees, with further costs likely to be incurred through increased demand for means-tested retirement benefits.

We stress that our range figure is an estimate: its purpose is to indicate the potential scale of the problem. It is impossible to provide an accurate and specific figure, due to the lack of transparency in internal annuity rates, the absence of baseline measures of member outcomes (for example, where people do not shop around, and also where they ‘shop around’ but buy through an execution-only website), and the complexity of the factors that can influence the rate the member might receive through an advised OMO process.

Alan Higham, Director of Retirement Angels, calculated the estimated scale of detriment for this report. The Retirement Angels’ research included analysis of its own business figures (for Annuity Direct, a whole-of-market broker) and also referred to a wide range of data and research, including that of the FSCP, Oxford Economics, and Pica, among others. With reference to Annuity Direct, Mr Higham reports that the average annual increase in the annuity rate achieved over the course of one year is more than 20%. Clearly, 20% cannot be used as an average detriment for the market as a whole, since many people who accept an internal annuity rate might passively secure the right annuity at the right price. Nevertheless it is a useful indicator.

Overall, Retirement Angels concluded that the detriment was likely to be in the order of 8% – which would indicate a loss in terms of lifetime income of about £960m in 2011, which falls in the range suggested above.

²³ ABI, [Statistics for 2011](#), Retirement Supermarket for 2013-14

²⁴ Retirement Supermarket, [Not using OMO has cost UK pensioners £7 billion in the last decade](#)

The difficulty we faced in attempting to estimate detriment highlights the pressing need for more accurate data and baseline measures.

3.2 The DC member journey from the institutional to the retail market

The DC member's journey is set out in Table 1. The table demonstrates the ways in which significant design and regulatory differences between institutional (wholesale) investment and retail insurance models arise at the point of converting a pension pot into an income stream, which result in inconsistencies in governance and also confusion over where responsibility lies for decision making.

While the investment trend in accumulation is moving away from individual personal pensions and towards wholesale asset management and institutional-style governance, decumulation retains its retail contours and is focused on the one-off, usually irreversible, purchase of a long-term insurance product (the annuity), where the trend is towards individually-underwritten enhanced policies.

Table 1: The DC member's journey under auto-enrolment

Savings/accumulation			Annuity purchase/ decumulation:		
Wholesale model: Business-to-business transaction	Growth	25-35 years	Retail model: Business- to-consumer transaction	Decision	less than 6 months
	De-risking	5-15 years		Impact	rest of life

Product type: institutional asset management	Product type: retail insurance
Designed for: defaulter (c.80-90%)	Designed for: engaged, financially aware consumer (10-20%)
Governance: employer, trustee, provider responsibility; manages risk to a large extent	Governance: optional on part of scheme decision-makers, beyond giving member basic generic information
Member risks: investment, inflation; interest rates (de-risking)	Member risks: inflation, interest rates, morbidity & mortality (member plus spouse for joint life annuity); members required to manage all of the risk
Decision risks: spread over 40+ years via regular contributions; multiple transactions; regular review of performance	Decision risks: concentrated in last months before retirement; income for life, 20+ years, plus spouse's life (joint annuity); one-off transaction
Member flexibility: can change contribution level, fund choice, retirement date	Member flexibility: none; once one-off decision made it is irreversible
Min. regulatory requirements: to set minimum contribution rate; to provide a life-styled default fund suitable for membership profile	Min. regulatory requirements: to give member basic generic (leaflet) information on annuities and OMO
Advice: professional; sell-side driven by EBCs, IFAs, asset managers etc; but limited or absent for low-value schemes; cost of advice amortised over large sums and multiple accounts	Advice: needs to be personalised; buy-side driven; difficult to locate specialists via post-code-based adviser website search engines; shrinking market 2013; plenty of 'execution-only' services via internet search engines but require member to make decisions; cost of advice borne by the member
Member engagement and understanding: not required, because decisions are made by professionals	Member engagement and understanding: required, because the decisions are member-specific and irreversible

Table 2 sets out a comparison of the different contract- and trust-based DC models and highlights a key issue for the regulators. At present, while the Pensions Regulator issues good-practice guidance²⁵, the only regulatory *requirement* is for employers, providers or schemes to provide members with very generic information about annuities and the OMO. This duty can be discharged by simply giving members a leaflet, which directs those interested in using the OMO to postcode-based adviser search engines. This is highly unlikely to put them in touch with the specialist annuity advisers that have the processes and scale to provide an advisory service for smaller funds within the price of commission factored into the annuity rate.

²⁵ The Pensions Regulator, [Member Retirement Options](#)

Table 2: Comparison of DC scheme models

Scheme Type	Features	Potential issues	Discretionary elements
Trust-based: Generic	Regulated by TPR. Minimum requirement: to give member generic information, eg the TPR annuity/OMO leaflet.		
Trust-based: Unbundled	Model: Institutional asset management; 3 rd party administration. Governance: Trustee board, usually with EBC advice. Trustees 'own' assets & member data.		Provision of advice to members (costs borne by employer, scheme or member): Low: TPR OMO leaflet. Medium: Member directed to annuity adviser; member takes initiative. High: Member data sent to annuity adviser; adviser takes initiative.
Trust-based: Bundled	Model: Institutional asset management (but retail model used in smaller schemes). Single provider asset management & admin. Governance: Trustee board and provider.	Governance balance of power between scheme and provider variable; typically determined by scheme size. Size: Key issue in this market. Many bundled schemes have < 20 members. Older/smaller bundled arrangements may be run by a life office on a quasi-retail basis in terms of fund choice and charges. No provider retention data available but thought to be high for smaller schemes.	Provision of advice to members – as unbundled. Scale tends to drive level and quality of member support. Estimate: Low-medium: small schemes Medium-high: larger schemes
Trust-based: Master trust	Model: institutional asset management and admin combined. Governance: within master trust.	No provider retention data.	Comparatively new model; provision of advice to members under development. Estimate: Medium-high: provision of advice by a specialist firm.

Scheme Type	Features	Potential issues	Discretionary elements
Contract-based: Generic	Regulated by FSA; TPR guidance. Minimum requirement: to give member the FSA annuity/OMO leaflet.		
Contract 1: Provider in both scheme and annuity markets	Model: GPP/stakeholder; institutional to retail asset management & charges. Governance: confused. Employer responsibility, but 'contract' is between provider and individual. Usually single employer. Operates as a series of individual contracts.	Provider owns assets and member data. Operates as a series of individual contracts, so 'scheme' data cannot be separated from individual personal pension data. No clear entity identified as responsible for member outcomes. Primary relationship is between provider and member. Governance committees not formally recognised under regulation in same way as trustee boards. Provider retention 25-86% via internal annuity sales.	Governance committee – no regulatory power Range of provision of advice to members: FSA leaflet; member given details of specialist firm; scheme makes specialist firm the default. May be guided by proposed ABI Code of Conduct in future. Low, medium high categories apply. Most likely to be low-medium, with high provision only where the employer takes a strong governance role to override default relationship between provider and member.
Contract 2: Provider in scheme market only	GPP/Stakeholder; institutional asset management. Governance: employer responsibility, but 'contract' is between provider and individual.	Provider owns assets and member data. Provider retention: 0%, as there is no possibility of internal annuity sales.	Governance arrangements: Emerging model is to have an arrangement with a specialist adviser. Member data passed on automatically; adviser takes initiative.

3.3 Workplace DC scheme models

DC schemes fall into two broad categories, as set out in the regulations: trust-based (also known as occupational DC) and contract-based (confusingly, also known as workplace DC). There is an assumption that trust-based DC schemes should have better governance processes than contract-based schemes. This is because trust-based schemes have a board of trustees, whose job it is to ensure that the scheme works in the members' best interests (in practice this position is contested – see Chapter 4). Trustees are the 'owners' of the assets and member data, which in theory puts them in a stronger position than employers that use contract-based DC, where the owner of assets and member data is the provider. Moreover, trust-based schemes are overseen by TPR. As its only role is to regulate work-based pensions, unlike the FSA which has a broader remit, TPR is perceived as more focused, 'hands-on' and interventionist in terms of pension scheme governance.

Contract-based schemes are run by the scheme providers (life offices), which are regulated by the FSA. The annuity market is also regulated by the FSA. The FSA's broad remit is to maintain market confidence, stability and solvency; to prevent crime; and to protect consumers of financial products. It is an independent non-governmental body given statutory powers by FSMA.²⁶

Despite the very evident differences in regulation, the research found examples of good governance in contract-based DC in schemes ranging from the older multi-employer schemes in the construction, electrical and printing industries, through to the emerging sophisticated schemes based on life office solutions and platforms constructed by asset managers and EBCs.

One of the issues that emerged in the analysis is that where schemes or providers establish a default OMO service for their members, this does not appear to be classed as 'shopping around' and 'using the OMO' in the ABI's statistics. Under this scenario, the scheme or provider would forward member data to the appointed specialist annuity adviser; the adviser then takes the initiative in making contact with the member and steers the whole process from the selection of the annuity type and features through to the purchase. From discussions with TPR, it is thought that this might account for the apparently low levels of 'shopping around' observed in trust-based schemes.

Another issue that adds complexity to the workplace annuity market is a category of annuity classed as 'in-house', which is an internal annuity with commissions stripped out and also some form of rebate from the profit margin. In theory, therefore, the in-house annuity gives a more accurate estimate of what an economically efficient annuity rate would look like. However, it was difficult to find examples of this process, which might suggest that this is an historic arrangement.

Table 2 describes the regulation and characteristics of the different DC structures. The evidence in the table, which is based on the results of extensive research, is that the dominant factor that influences the member outcome is not the scheme structure, but rather it is the level of voluntary, hands-on governance implemented by the relevant combination of the employer, the provider, the trustees, and the EBC.

²⁶ In 2013, the FSA will be replaced by two new regulatory bodies. The Prudential Regulation Authority (PRA), a subsidiary of the Bank of England, will be responsible for promoting the stable and prudent operation of the financial system through regulation of all deposit-taking institutions, insurers and investment banks. The Financial Conduct Authority (FCA) will be responsible for regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets. The FCA will also have responsibility for the prudential regulation of firms that do not fall under the PRA's scope. See the [FSA website](#).

Trust-based schemes

These schemes emerge from the DB trust-based model and might be established as a section of the employer's main DB trust deed and rules, although they are also established as independent trusts. The key governance feature is the trustee board, which is the effective owner of the assets and member data. The board is responsible for looking after the member's interests.

Trustees need to discharge their liabilities when the member retires. Typically this is achieved by transferring the liability to the member in the form of an annuity, which is purchased by the trustees or Third Party Administrator (TPA) in the member's name. Although the rules on compulsory annuity purchase changed in 2011, the new flexibility for drawdown only applies to members with substantial funds, so for most members it is assumed that annuitisation will take place by age 75.²⁷

Trust-based schemes can be established in several ways, including:

- **Unbundled schemes:** These account for 74% of occupational DC schemes.²⁸ The trustees appoint the asset managers and the third party administrators, among other service providers. The trustees are responsible for member communications. Unbundled schemes typically are arranged by EBCs on a fee basis.
- **Bundled:** These account for 16% of occupational DC members, although industry sources suggest this figure is a low estimate on the part of TPR.²⁹ Typically a third party (a life office) provides the trust, the asset management and the administration. The trust is specific to the scheme, so this is a single-employer arrangement. There is a scheme trustee board, but the provider is likely to be responsible for member communications. These might be branded in the employer's name. Bundled schemes are arranged by EBCs on a fee basis and by IFAs on a fee or commission basis. TPR found that 'in some cases, trustees displayed a lack of awareness of their scheme retirement process and requirements'.³⁰ This was particularly the case for bundled schemes where employers and trustees often rely on the provider for the key aspects of the retirement process.
- **Master trust:** These account for the remaining 10% of the trust-based market. A master trust is designed to accommodate more than one unrelated employer, but it varies in its structure. From the employer's perspective it operates more like a bundled product. Typically a third party provides the trust and a range of asset management services that form the core funds for each associated employer. The trust also provides administration services and a range of governance services.

²⁷ From 6 April 2011 it is not necessary to buy an annuity provided the member has the equivalent of a minimum of £20,000 of pension income in any tax year, including the state pension. Taking account of the state pension, this would require a fund size of about £245,000 for a 65-year-old male non-smoker, who buys a level single annuity with a five-year guarantee. This would provide an income of about £14,700 per annum ([Money Advice Service](#)). The basic state pension in 2011-12 is just over £5,300.

²⁸ TPR's breakdown in its DC consultation paper, [Enabling good member outcomes in work-based pension provision](#), is 74% unbundled, 16 bundled and 10% in multi-employer schemes with non-associated employers.

²⁹ Standard Life suggests the figure for bundled is closer to 40% by active membership.

³⁰ The Pensions Regulator, [A review of retirement information for DC members, 2009](#)

Box 1: Examples of unbundled trust-based DC

The only regulatory requirement for trust-based schemes is that the trustees should provide the member with generic information about annuities and the OMO, for example by giving the member the TPR leaflet. Some schemes 'encourage' members to shop around by suggesting members contact an annuity broker's website, while others in effect make the OMO the default because they automatically use an annuity adviser and provide the firm with basic member data so it can guide members through their choices and broker the market on the member's behalf. According to the NAPF 2011 Annual Survey, of those that responded, 51% of trust-based schemes and 19% of contract-based schemes use the latter process. However, it should be noted that the NAPF survey does not capture the many thousands of smaller schemes (both contract- and trust-based).

Volkswagen

The company has used auto-enrolment for the past four years. The investment strategy uses a target retirement date (TRD) to adjust the lifestyling mechanism to suit the member's decumulation date and the scheme makes regular contact with members to keep this on track. Members can change their TRD online and this automatically adjusts their asset allocation. There is also an online pension forecast planner, which shows members their projected fund and annuity, based on their current circumstances.

The trustee contacts the member three months before the TRD and arranges a confidential one-to-one 'surgery' to discuss the member's options. This is delivered under generic advice rules. Once the member has made the decision the details are sent to the TPA, which provides quotations based on the OMO rates. The trustee then arranges the purchase on the member's behalf and retains the documentation – an aspect the scheme considers to be an important element of the at-retirement governance and which 'gives reassurance to the member that trustee still looking after them and that the member is still part of scheme'. The scheme sees this as critical, since most current members have a DB benefit (where they will remain in contact with the scheme as pensioners), as well as the DC pension.

Box 2: Example of bundled trust-based DC

Trinity Mirror Pension Plan

The chairman of the trustee board described the at-retirement process decisions as a 'combined effort between the trustees, the employer and the product provider'. The DC scheme is very new and therefore, at present, the main focus for at-retirement governance is the member's DB benefits, but this will change and processes are already being developed to cater for the need for increased support for DC members. The focus will be on an advisory service that can help members with both their DB benefits ('they need to know if they are getting a good deal on commutation') and their DC pot.

The scheme is arranged with a provider that does not sell annuities. The at-retirement service under development will involve the appointment of a specialist annuity adviser so that all members can use the OMO as the default. This service will not include full advice but the employer will offer members £750 to pay for independent financial advice and will provide a panel of three firms from which they can choose. The chairman stressed that while annuity brokers can provide a good service, ideally members need advice on their full financial situation.

Box 3: Example of unbundled trust-based multi-employer DC

NEST – www.nestpensions.org.uk

The scheme formally opens for business in 2012 but has been operating on a voluntary basis since 2011. As a new scheme, early retirees are more likely to take cash under the trivial commutation rules. The process under development for the at-retirement service will give members guidance on how to use the OMO and will offer an alternative, which is to use the NEST annuity provider panel, where providers will offer quotes based on a simple questionnaire. Panel providers were appointed on the basis that they must cater for very small pots. The providers are:

- Canada Life (conventional and enhanced)
- Just Retirement (enhanced)
- Legal & General (conventional and enhanced)
- Partnership (enhanced)
- Reliance Mutual (enhanced, specifically for smokers)

The member-engagement and support processes will use the jargon-free communications NEST has championed. The web-based service will set out member options and the issues they need to consider, including cash options, deferment, pot amalgamation, and also the type of annuity, with a limited set of products based on a simple-choices basis (inflation-linked or level, partner/spouse pension or single, 10 year guarantee or no guarantee). Enhanced annuities based on a simplified medical questionnaire will also be provided through the panel.

At present NEST cannot accept transfers in, which means that the annuity panel can only be used for NEST pensions. The restriction on transfers will be reviewed by the Government in 2017.

Box 3: Example of bundled trust-based multi-employer DC

BlueSky - www.blueskypensions.co.uk

The JIB Pension Scheme – established under an agreement between employers and unions – was renamed BlueSky in 2011 and is a not-for-profit multi-employer DC scheme that serves employees in the electrical industry. All BlueSky staff benefit from Pensions Management Institute (PMI) training. Assets are managed by Alliance Bernstein (in conjunction with Axa Wealth) and the investment service is provided through target date funds. The pre- and at-retirement communications process begins when the member is aged 60, when the annual benefit statement starts to prepare them for their annuity choices ('this is when the education process should start in earnest'). Communication material that describes the annuity process is written by the scheme and the language is designed for the membership profile.

At retirement the scheme provides a 'hands-on' generic support service and helpline, which guides members through their choices (the same adviser helps the member throughout). Once the member has chosen the type of annuity required, the scheme uses a specialist annuity broker to make the OMO purchase. The scheme said it is in the process of changing its annuity adviser to a firm that can offer an execution-only service that is better-aligned with the scheme's member-support services. As with other multi-employer schemes in the manufacturing sector, a high proportion of BlueSky members (about 50%) secure an enhanced rate.

Contract-based DC

These schemes are regulated by the FSA, although more recently TPR has taken an active role in contract-based DC governance issues and has published guidance.³¹ Contract-based schemes typically are established on a single-employer basis but there are several examples of multi-employer schemes.³² Under contract-based DC, the provider is the owner of the assets and the member data. Therefore the primary relationship, in terms of all services provision, is between the provider and each individual member. In effect these 'schemes' represent a series of individual contracts – a feature that reflects the emergence of contract-DC schemes from the individual personal pensions market.

At retirement there is no single governance entity (as there is in trust-based DC in the form of the trust board) that has regulatory responsibility for the member outcome. In theory the employer might be considered responsible, and might be advised by an EBC on a fee basis, but its duties in relation to supporting members through the OMO process are unclear under the regulation.

A trend in recent years – encouraged by TPR – is for employers to establish governance or management committees, which include member-nominated representatives in the same way as trustee boards. The NAPF 2011 Annual Survey found that half of contract-based scheme respondents have already set up some form of governance committee; and of those that didn't yet have a governance committee, 18% of respondents said they were planning to set one up, up from 11% last year. However, the NAPF membership, and hence survey base, tends to disproportionately reflect larger employers. Moreover, the regulatory position and power of such committees is questionable. Much will depend on the strength of the service agreements employers can arrange with providers and advisers.

At retirement, members can buy their annuity in several ways. The main options are: direct from the scheme provider, where the company sells both schemes and annuities; in the open market through an execution-only website; and in the open market via an independent whole-of-market adviser.

The different types of contract-based scheme arrangements in relation to the transition from accumulation to decumulation are not driven by regulation, but by history. The two main models encountered in this research were:

- Schemes where the provider is a life office that also sells annuities (internal or both internal and through the OMO)
- Schemes where the provider is life office that does not sell annuities

While governance processes are not dependent on this distinction, nevertheless it serves to highlight provider models where there is a potential conflict of interest (where the provider might be keen to retain DC members at retirement), and where there is not (the scheme provider does not sell annuities).

³¹ See, for example, The Pensions Regulator, [IGG publishes final investment governance principles for DC schemes](#)

³² The industry-wide or multi-employer schemes have adopted this structure, for example PIPS (print industry). B&CE's EasyBuilder for the construction and civil engineering sector is contract-based, but the new People's Pension is trust-based.

Box 4: Examples of contract-based DC governance

Arup

The company is an employee trust and describes itself as 'paternalistic'. It is keen to provide a scheme that meets the need of deferred as well as active members (they have the same annual management charge, for example), because 'people come back'. The scheme is comparatively new and therefore many employees also have DB benefits. Recent experience indicates that members tend to use their DB benefits immediately at retirement and defer the DC annuity purchase. During the deferment period they can continue to pay contributions at the same AMC, which is considered very low by industry standards.

At retirement the company uses a specialist annuity adviser, which provides the at-retirement annuity services, including consolidation of pots. Arup pays for member advice and uses the HMRC tax break to make this tax-efficient for the employer.

Philips Electronics UK Limited

The group stakeholder scheme has a governance committee (the Stakeholder Monetary Forum), which includes three member-nominated representatives. When employees join the company they attend a two-day induction course that explains the pension scheme (which includes salary sacrifice) and the flex benefits system.

The scheme provider, BlackRock, has a section of its website that has been branded for Philips employees and this includes a pension calculator that has been designed to incorporate the Philips matching contributions (www.pensions.philips.co.uk). BlackRock has an agreement with a specialist annuity adviser, which helps scheme members choose their annuity and then buys the annuity on the open market. This is primarily for conventional annuities but the member can ask for advice on other options, in which case there will be a fee.

Due to the various changes in pension provision over the years, in addition to any pots the employee might have from former employment, a current pension scheme member with long service at Phillips Electronics might have benefits from the current stakeholder scheme, the closed DB scheme (including AVCs) and the closed trust-based DC scheme (including Section 32A pots).

Box 5: Examples of contract-DC multi-employer

B&CE - www.bandce.co.uk/

B&CE Benefit Schemes is a not-for-profit organisation. Its board includes construction employers as well as member representatives and has financial services industry experts on the subsidiary boards. EasyBuild is one of the largest stakeholder schemes in the UK but the company also offers an extended range of financial products designed for its membership, including employee accident cover, employee life cover, employee healthcare and holiday pay. Pension scheme charges are the same for actives and deferred, which the company regards as essential, given the frequency with which its members change jobs.

At retirement the scheme provides 'hands-on' generic support for members, many of whom are low-to-median earners and are not financially sophisticated. This includes a helpline which most members use. Given that the scheme serves a largely manual labour market, the support centre, which does not accept

commissions, focuses in particular on enhanced rates, as many members suffer from ill-health conditions and often retire early for this reason. A simple medical questionnaire is included in the application form as 'default'. More than 90% of members complete the form.

The company has an arrangement with Partnership, an enhanced annuity company (also used by NEST), which provides the annuities. Members have the option to use the OMO if they wish and just under one-third of members do so. With the member's consent, B&CE passes on the data to Partnership so that it can arrange to send quotations. The application form includes information about non-B&CE pension funds, so they can be consolidated if the member wishes.

As B&CE have a large number of small value pots (about 30% are worth less than £1,000) there is an exclusive agreement with Partnership to provide annuities to members with funds of any value. B&CE monitors member outcomes and says that more than 60% of members secure an enhancement. The rate must be within the top five for standard annuities and B&CE monitors all rates regularly. The company is considering an arrangement with an adviser to cater for members with more complex medical conditions and with funds worth £30,000+.

In 2012 B&CE will launch the People's Pension, a trust-based DC scheme designed for auto-enrolment and which will be open to everyone (private sector, public sector, employed, self-employed, unemployed).³³

PIPS - <http://www.printindustrypensions.com/>

The Printing Industry Pension Scheme, established as an agreement between employers and unions, is a multi-employer group stakeholder/SIPP scheme. It provides advice to members (paid for through the AMC) via an appointed independent adviser, and this is available throughout the membership period as well as at retirement. Although this is a contract-based scheme it endeavours to operate like a trust-based model, serving active and deferred members, as well as pensioners. The committee comprises employer nominated and union members. The scheme has had problems in attempting to mirror the trust-based model for annuities because the providers (two life offices) are the owners of the member assets and data and do not automatically copy in advisers to the annuity process.

At retirement the adviser contacts scheme members with a simple letter, which explains that the service can combine all the member's pension pots, if required, and also explains the importance of enhanced rates and OMO option. The letter is signed by the PIPS adviser and provides personal contact details.

The adviser takes members through the annuity selection process and makes the purchase on their behalf of the best annuity. Under the agreement between the scheme and the adviser, the firm reports quarterly on member activity and including details about the annuities purchased in terms of the type, price and provider.

³³ <http://www.bandce.co.uk/MediaCentre/News/News634581601647581031>

Box 6: Examples of new multi-employer master-trusts schemes

Since NEST announced its entry into the auto-enrolment market, several other players have launched master trusts that claim to be able to deliver auto-enrolment services to most employers in the private sector. These include NOW: Pensions, L&G, Standard Life, and B&CE's People's Pension. We provide one example of the new models here.

NOW: Pensions - <http://www.nowpensions.com/>

The scheme is in the process of designing an annuity solution 'where regulated financial advice can be limited or eliminated'. It will not receive any commission or other payments for arranging annuities for members.

The aim is to provide member support through simple online tools and helplines: 'as with all communication, the key is to keep it simple, relevant and short.' The central message will stress the very significant differences between annuity providers' rates - 'We will not let our members get access to their savings without ensuring that they have answered a few important questions that can direct them towards the appropriate type of annuity'.

There will be three steps in the retirement process. The default position is that 10 years before retirement the scheme begins to de-risk members' investments by switching assets into the retirement protection fund and the cash fund. The second stage is to ensure the member chooses the right type of annuity. Scheme support includes online information and a call centre. One-to-five years before retirement the scheme will encourage members to consider this process more carefully by asking a range of simple questions about dependents, health and attitudes to the rising cost of living. The results of these questions will be translated into annuity income shapes.

The annuity-purchase system has yet to be finalised but it is likely to combine specialist adviser services that can deliver support for standard and enhanced annuities.

Box 7: EBC annuity services

Most EBCs offer client schemes an at-retirement service.

JLT's Benpal and Retirement Services

Under Benpal (JLT's on-line benefits management platform) as part of the accumulation process, JLT uses what it calls the 'active defaulter' system, which 'accommodates the default philosophy to direct members to the most appropriate default fund (based upon their own risk profiling) through a guide to risk and a personal risk appetite questionnaire'.

The Benpal service is available to JLT clients via their own internet/pension scheme intranet and, for the decumulation process, it is integrated with JLT's on-line Retirement Services, which is an annuity research system used by several organisations, including Age UK. Under Benpal, member data is uploaded onto the system, which in turn delivers regular educational communications to engage members during the accumulation phase. As members approach retirement, they can use their personal log-in details to obtain personalised annuity quotes via JLT Retirement Services. Since member data is pre-loaded and Benpal is the main communication site, the system delivers the default OMO annuity process (although members can go elsewhere if they wish).

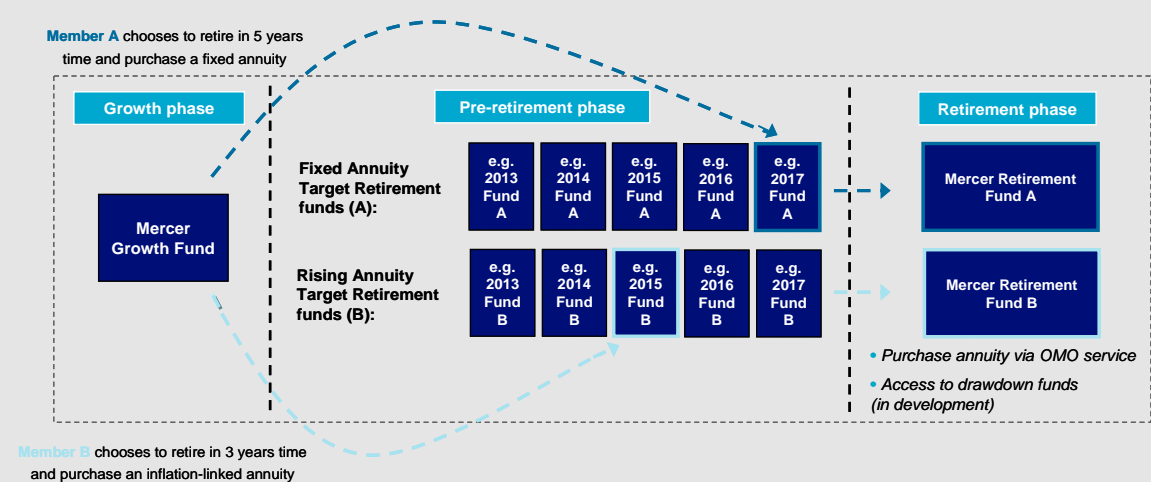
JLT says that Benpal is 'all about engaging with members and doing this in a way that does not necessarily require them to be active'. For example, members automatically receive regular emails and text messages, which confirm the date when each contribution has been paid, provide updates about fund values and performance, and information about important pension developments that affect their scheme. This ongoing engagement is considered vital to the at retirement process.

The pension modeller under Benpal illustrates the pension a member's contributions is likely to buy and how this might be affected by annuity features, such as inflation-linking, a partner/spouse pension, and rates. Combined with JLT Retirement Services, the impact of health and lifestyle features on enhanced rates can also be identified. This information can help members to target the most appropriate type of annuity during the accumulation phase and determine the required level of contribution.

Mercer

Mercer's approach to decumulation for the schemes that adopt the Mercer Default Strategy combines member engagement ahead of retirement, 'with governance embedded throughout the decumulation process' – and it ends with the firm's online personalised OMO service.

The decumulation process begins six and a half years ahead of the member's selected retirement age, when they are contacted to confirm their intended retirement age and to enquire about the type of annuity – in particular level or escalating – they intend to purchase. Based on this information, the member's assets are switched to an appropriate target retirement fund. The objective is to ensure the member is able to make retirement decisions within a sensible planning horizon and that the target date fund for decumulation is based on the type of annuity the member is planning to buy.

Figure 1: Mercer's decumulation process

Unlike traditional life-styling, where the switching process is mechanistic and does not take account of market conditions, the target date retirement funds use active management, which gives Mercer some discretion over the timing and size of the switches. The firm said that this 'enhances the potential outcome at retirement' through governance of the pre-retirement phase.

When a member reaches the year of his or her retirement, they are transferred into a Mercer retirement fund, from which they can retire at any time during the year. At retirement, members can purchase an annuity through a specialist annuity adviser provided by Mercer.

Towers Watson's Retirement Annuity Service

Towers Watson has provided annuity broking services to its clients for many years, especially where it also provides the third party administration. In 2011, it established an agreement with a specialist annuity adviser and introduced the Towers Watson's Retirement Annuity Service, which is available to all of its clients and provides scheme members with access to 'high quality' help and support during their journey to retirement.

The member's journey can begin up to 10 years before retirement with targeted communications ('countdown' guides and face-to-face sessions). Fact-finding and planning begins 18 months before retirement, when members are given access to planning tools and in some cases advice. Where appointed, the Retirement Annuity Service provides members with a personalised information pack between 6-9 months before retirement and this includes personalised quotations and access to a member facing website which helps the user model annuity shapes that are most relevant to them.

The EBC argues that an annuity broker service is an essential component of the new DC environment, particularly under auto-enrolment. The objective is to make the OMO process as simple and as painless as possible, while at the same time being available to all schemes and all scheme members, not just fee-based clients that are prepared to pay for such a service. The company believes this is critical as employers and trustees seek ways to provide genuine support to members that offers a robust approach to compliance but without necessarily adding to costs. The compliance process of the Retirement Annuity Service includes a full audit trail of the details the member has browsed and been shown, the options they have modelled through the online portal, and the type and price of the annuity purchased.

Scheme provider OMO services

One of the innovations in recent years is for scheme providers that do not sell annuities to provide a full at-retirement service through an agreement with a specialist annuity adviser. The only company of which we are aware that already offers this facility, as a default OMO annuity service to its clients, is BlackRock, which has an arrangement with one of the major annuity brokers. On joining BlackRock schemes, members agree that their data can be passed on to the annuity broker at retirement, so the system is fully automated. The service is funded through the commission payment embedded within the annuity price, although this is capped for members with higher-value funds. Members have the right to opt out of this arrangement if they wish.

Fidelity, which used to provide its own annuities before moving to a third-party arrangement with a major annuity provider, is in the process of establishing an advisory arrangement similar to the model adopted by BlackRock and plans to announce the details in 2012.

Other scheme providers do offer access to an annuity adviser but if the provider is in both the scheme and annuity market it is unclear the extent to which the adviser facility is utilised.

3.4 Scheme and annuity providers

The UK has one of the largest annuity markets in the world and it is growing rapidly. Currently it is worth £12bn per annum in terms of annuity sales. Estimates vary but one source expects the market to double within three years. Despite this growth, there is a trend towards business concentration in the hands of four or five standard annuity providers plus a similar number of enhanced annuity providers. We were not able to obtain data on market share from many companies but we understand that the major scheme and annuity players, in alphabetical order, are Aegon, Aviva, Friends Life, L&G, and Standard life. These companies probably account for about 70% of the market in terms of business sold this century. Also significant are Axa, Scottish Life and Scottish Widows. Canada Life, LV= and Prudential said that they do not sell new group DC schemes. Not all providers that operate in both markets compete in the open market. We stress that the market is changing rapidly at present.

Table 3: Scheme and annuity providers

Company	OMO	Internal annuity rate same OMO?	% DC scheme members buy an internal annuity? (Retention rate)
Aegon	Y	Y	N/D
Aviva	Y	Y	60% members/ 50% assets
Friends Life	N	N/A	25-30% by assets
HSBC Life	N	N/A	N/D
Legal & General	Y	Y	N/D
Prudential	Y	Y*	c. 35% member
Scottish Life	N	N/A	N/D
Scottish Widows	N	N/A	N/D
Standard Life	Y	Y	c. 46% member / 25-30% assets
Zurich	N	N/A	N/D

Notes: The table is based on information requested from companies between December 2011 and January 2012. We are unable to confirm the position of providers who did not reply within our deadline. One respondent has confirmed a member retention rate of 86% (70% by assets), but we are unable to name the provider in question.

N/A: not applicable because the company does not provide an OMO; N/D: no data provided. *Prudential offers internal DC clients an enhancement of 1-2% based on their OMO rate. Its retention rate overall is c. 80% but this figure reflects the dominance of the retail clients with guaranteed annuity rates.

There are several providers that only sell schemes. These include BlackRock and Fidelity. In addition there are the multi-employer DC schemes, which include B&CE, BlueSky, NEST, Now: Pensions and PIPS.

In the annuity OMO market, there are several enhanced specialists and these include Canada Life, Just Retirement, LV=, MGM Advantage, Partnership, and Just Retirement.

3.5 Specialist annuity advisers

The advice market and the commission system

Providing access to a 'trusted advisor' is the strategy most likely to improve use of the OMO amongst those who did not shop around.

ABI³⁴

Information leaflets and websites about annuities stress the importance of getting independent financial advice. Under the RDR, which takes effect from the end of 2012, the FSA says it will establish:

A resilient, effective and attractive retail investment market that consumers can have confidence in and trust at a time when they need more help and advice than ever with their retirement and investment planning.

The RDR aims to ensure that:

- *Consumers are offered a transparent and fair charging system for the advice they receive*
- *Consumers are clear about the service they receive; and*
- *Consumers receive advice from highly respected professionals.*³⁵

For current information about advice, the FSA directs consumers to the MAS website, which says:

You don't have to see a financial adviser when you're buying a financial product, but if you don't, you may choose something that isn't suitable for you and you'll have fewer grounds to make a complaint.

A financial adviser will assess your personal circumstances and recommend financial products that are suitable for you

*You may decide you want professional financial advice if, for example, you ... are coming up to retirement and want help converting your pension fund into retirement income.*³⁶

The MAS 28-page guide on financial advice explains the different types of advice available (currently tied, multi-tied and independent), but this is complex from a customer perspective, not necessarily because the MAS uses complex terminology, but because the system is complex and will remain so post-RDR, when there will still be three categories of advice service.³⁷ The guide does not discuss generic advice or execution-only services. It mentions annuities only once and this is in the jargon buster section under 'lifetime annuity'. It does not say that this is an insurance product and therefore that it is very different from the DC scheme or individual plan, which is an investment product. Nor does it say that the top pension investment providers are not necessarily the same as the top annuity providers.

The cost of providing a fully-advised OMO service varies considerably but the minimum at present is about £450-£600, which is equivalent to the commission rate of 1.5-2% for a level annuity for a fund of £30,000

³⁴ [Annuity purchasing behaviour](#), ABI, 2010, (this report examined the contract-based DC market, including the retail and workplace market).

³⁵ Financial Services Authority, [Retail Distribution Review](#)

³⁶ The Money Advice Service, [Getting financial advice](#)

³⁷ The Money Advice Service, [Getting financial advice - booklet](#), 2011

(higher for enhanced), so £30,000 is about the cut-off point at which most advisers are prepared to offer a full service. Clearly, where the firm has an arrangement with a scheme that brings in business above, as well as below this level, the firm is likely to agree to deal with all members equally. However, annuity advisers stressed that it takes as long to give advice on an annuity purchase for a £30,000 fund, as it does for a fund of £100,000, where the commission would be more than treble, so there are clear incentives for advisers to take on clients with larger funds.

Post-RDR the independent advice market is expected to shrink and the remaining independent firms are likely to move up the remuneration scale. Interviewees said that the minimum fund size likely to be of interest to independent advisers offering a full advisory service from 2013, where annuities are not the primary business focus, would be about £50,000. For this size fund the fee for a level annuity would be £750-£1,000. This is the same amount as the former commission rate and will still be deducted from the fund by the provider, where required (in other words, the only difference is that it will be called a fee rather than commission). Of course, some DC members with smaller funds will be prepared to pay an up-front fee for full advice, for example where they have other sources of retirement income and wish to use drawdown for their DC fund.

While most firms of independent advisers are able to arrange an annuity purchase, interviewees said that there are only a limited number of 'specialists' that can cater for the growing demand from DC schemes. By 'specialists' interviewees meant firms that have the expertise and systems to deal with annuity advice and the OMO purchase on a large scale and within the cost of the commission paid by the annuity provider, including for funds worth less than £30,000. These firms are also associated with innovation in terms of systems and, in some cases, communications, and also include TPAs which provide a commission-free member support and brokerage service.

Rate analysis is essential to an efficient OMO service. Providers at the top end of the OMO tables tend to change rates every few weeks and might even make more than one change within the space of a week, if market conditions are very volatile or if they decide they need more or less of a certain size of fund to meet their business plans. At the bottom end of the OMO tables, providers might change their rates once a year and only then because they've realised that through inaction their rate unintentionally has become attractive.

A specialist adviser can exploit these rate fluctuations and anomalies to the customer's advantage. The research indicated that the more inefficient and unpredictable the market, the more important it is for DC members to have access to a firm with the best software and systems. While the FSA tables adopt rate changes, they tend to provide only limited information. This can conceal 'cliff-edge' rate bands, which can have a significant impact on the outcome.

In theory specialist advisers are also best-equipped to negotiate the complex subject of financial strength. For example, there is a concern that some enhanced providers might not be using the most robust mortality assumptions and therefore might be exposed if longevity increases further, for example where a medical breakthrough improves the life expectancy of their annuitants. Equally, there is a concern that as more customers buy enhanced rates, the life expectancy of the healthy pool will increase and that this is not necessarily being taken into account by providers that offer standard rates.

Even within the small number of specialist firms, there are very different business models and their capacity varies considerably; at present some firms employ more than 80 annuity advisers and others only five. The

number of corporate clients ranges from about 20 to more than 600. Guaranteed response rates to initial inquiries ranges from 24 hours to five days. Moreover, we understand that some advisers focus on rates rather than on a service that can help members choose the right type of annuity for their circumstances.

An important feature of the best-practice scheme models we examined is that the scheme provides the adviser with member data, which enables the adviser to issue the first report to the client and therefore to take the initiative in a process that guides members through to the selection and purchase. Clearly this process is quite different from the execution-only service, which is the main distribution outlet for many annuity advisers and in which the member has to take the initiative and make the decisions. Most specialists offer a helpline for generic advice to support the information and guidance provided on the website. Some also offer full advice, where this is required, but this is usually on a fee basis, especially where the fund is comparatively small.

One point that is not clear is the adviser remuneration, where it provides a service to schemes that pay a fee per member case. Typically the fee is about £200-350 for an execution-only service that results in a conventional annuity purchase but we understand that unless the scheme makes fee-based advice available and/or negotiates a commission rebate (for example by agreeing a cap on total commission), the adviser would also receive the full commission payment from the annuity provider, typically 2% of the fund value. This is an area for concern and indicates that those responsible for scheme governance should review the value for money of their adviser agreements very carefully.

Analysis of the home pages listed below indicates that some firms are consumer-facing. Others assume that an adviser will drive the process. Moreover, the underlying software and systems used also vary. Independent analysis provided by interviewees for this research indicated that some systems are more sophisticated than others and that capacity varies considerably.

With these caveats in mind, the firms identified by the research that appear to have the necessary infrastructure to provide a service to DC schemes might include the following advisers. Even within this short and non-exhaustive list, not all firms will have the capacity to deal with the very large schemes.

- The Annuity Bureau <http://www.annuitybureau.co.uk/>
- Annuity Direct <http://www.annuitydirect.co.uk/>
- Better Retirement Group <http://www.betteradvice.co.uk/>
- Capita Annuity Services
<http://www.capitahartshead.co.uk/web.chi/capita.html?A=22002+Services&S=22049+Actuarial%20and%20Consulting%20Services&P=22078+Annuity%20Services>
- Hargreaves Lansdown <http://www.hl.co.uk/pensions/annuities>
- LEBC (The Retirement Adviser) http://www.lebc-group.com/retirement_adviser.asp
- The Open Market Annuity Service (also used as a platform – see below)
<http://www.theopenmarketannuityservice.com/>
- Origen <http://origenfs.co.uk/private/retire/index.aspx>
- Oval Group http://www.annuities-online.com/contact/annuity_enquiry.aspx

- Premier Retirement Services <http://www.premierretirement.co.uk>³⁸

In addition there are several annuity platforms used by firms of advisers:

- The Annuity Exchange³⁹ <http://www.annuityexchange.co.uk/>
- The Annuity Team <http://www.theannuityteam.co.uk/index.html>
- Assureweb <https://www.assureweb.co.uk/our-services.aspx>
- Avelo <http://www.avelo.com/>
- TOMAS (annuities only) <http://www.theopenmarketannuityservice.com/>

³⁸ Age UK recently entered the market with a specific focus on enhanced rates. [Age UK Annuities Service](#) is provided by Premier Retirement Services, which is a division of JLT Benefit Solutions Ltd.

³⁹ The site includes an electronic version of the Common Application Form, which is used to gather the necessary customer details about health: <http://www.annuityexchange.co.uk/Home.aspx/productPage>

Chapter 4: The experts' views

It's a good time to assess what is being done to make DC the retirement substitute for DB.

Don Ezra, Russell Group, keynote address to the NAPF investment conference 2011⁴⁰

In the process of carrying out this research more than 90 organisations were consulted or interviewed, including about 80% of the major scheme providers and annuity providers, as well as employers, trustees, specialist annuity advisors and major employee benefit consultants. This chapter of the report documents the candid opinions of the organisations interviewed. As noted in the acknowledgements to the main report, comments are anonymised unless they are drawn from a published document.

4.1 Treating the DC member fairly?

The quantification of member detriment in terms of lost lifetime income presents a powerful case for reform. The qualitative analysis interrogates the underlying causes for this detriment and explores the attitudes of those who are responsible for, or involved in, the annuity purchase process. An important focus of the interviews, therefore, was to understand the sell-side issues – the ways in which those with some responsibility for the annuity process perceive their role, in relation to member capability and also in relation to the economics of the provision of advice and generic support.

Member 'responsibility' and the annuity process

The minimum regulatory requirement for providers and scheme is to give the member generic information about the OMO. This duty can be discharged simply by giving members a leaflet, written by TPR for trust-based DC members and by the FSA for contract-based members, which directs members to postcode search engines on adviser websites:

Given the critical nature of the annuity decision, as a regulatory minimum this [the leaflet] is wholly inadequate. In the broader sense it just means that the entire knowledge community passes the buck to the member. - DC market analyst

It's not just members who don't understand the market – the same is true of a lot of trustees. They need to understand what it feels like for members to be faced with a maze of complexity. Trustees need to think 'what sort of help would I want and need in this position?' - Employee Benefit Consultant

In our research we found that more than 80% of interviewees in the advisory and consultancy market believe that even when members are told where to go for advice or support they do not get good outcomes and we have to ask why this is – where the barriers lie. - Annuity provider

Understanding the importance of brand is essential, if we want to change member behaviour. We've seen pilot studies on behaviour in which people react very oddly. They want to stay with their scheme provider because of 'loyalty', even if you tell them they can get a better rate elsewhere. The proposed ABI code [on the OMO] might not be effective. If you want more people to get better outcomes you've got to do it for them or with them. - Scheme provider

⁴⁰ Don Ezra, [A world tour of defined contribution](#), 2011

All DC members receive an information pack on annuities – the ‘wake-up call’ – typically four to six months before the expected retirement date, either from the provider, the trustees or the scheme adviser. A further information pack is sent about six weeks before retirement. There is no shortage of online websites that are intended to help members understand annuities and to guide them through the selection and purchase. Some interviewees expressed surprise that more was needed:

I just don't understand why making annuity decisions should be difficult. Most questions are simple and easy to understand – we should expect members to engage .- Scheme and annuity provider

But other interviewees said that in practice the barriers that prevent members taking responsibility are complex and legion, and that advice channels are too fragmented. According to ABI data, two of the main websites appear to be underused:

The Consumer Financial Education Body's Money Made Clear website was used by 7% [of DC retirees], TPAS online planner by 5% and TPAS helpline by 3%. - ABI⁴¹

The most frequently cited issue that undermines member engagement at retirement was the disconnection between the default processes used for accumulation and the sudden need for engagement at retirement. Interviewees said that this is a very sudden and inappropriate transfer of risk in relation to decision making and reflects serious shortcomings in DC governance:

It's madness to rely on member engagement in relation to complex DC decisions – the government admitted as much when it announced it was introducing auto-enrolment in 2012 and included the requirement for a default fund. You can't have a system that relies on employee inertia to make them save, and then expect them to get a grip on investment, inflation and longevity risk at the point of retirement. - Annuity adviser

As the new benchmark for DC schemes under auto-enrolment, the NEST model was considered disappointing by some in relation to decumulation:

NEST says that all of its research points to members not wanting engagement; wanting decisions made for them. It avoids forcing members to make decisions during the accumulation phase. The member is put in the scheme, the contribution levels are set, the investment default is there and yes, information is provided, but all actions are based on maintaining the inertia associated with defaults. At retirement these same members do not appear to have a similar default process. - Annuity adviser

Strong opinions were expressed about the ease with which those responsible for DC governance, most of whom rely on professional advisers to make scheme decisions, expect members to be able to find the right sort of annuity advice:

Telling DC members to seek advice about the OMO is just a cop-out on the part of regulators, providers, employers and trustee. - Employee Benefit Consultant

⁴¹ Association of British Insurers, [Annuity purchasing behaviour](#), 2010

What the current situation amounts to is that those in the know – the government, the regulators, employers and trustees – are passing the buck to those least able to make complex financial decisions. Even where members do go to an annuity website, there is a real danger that this makes it easy for them to make a bad decision. - Annuity adviser

At present the key decision-makers all know which firms offer specialist annuity advice. Why are they so reluctant to tell members? - Independent trustee

Of course, many schemes do tell members that they can get help from a particular firm of advisers, but in some schemes little or nothing is done to ensure that the member follows through:

It's helpful to let members know where to go for advice, but in contract-based DC in particular that's usually as far as it goes. Members need the adviser to initiate contact and drive the whole process. The scheme needs to evaluate how well the process works and the member outcomes, but this rarely happens. - Employee Benefit Consultant

Finding the right adviser was considered to be an extremely difficult process and it was felt that consumers are not able to distinguish between the regulatory classifications:

Consumers don't have a clue about the differences between generic, restricted and regulated advice, etc, as defined by the FSA. Why would they? If they phone the DC scheme helpline or the provider's helpline, they assume they've gone to an expert and that the expert has given them advice. End of story. Warnings that stress 'this is not advice' are meaningless. - Annuity adviser

Interviewees said that there is a disconnection between the language and presentation of information, and the member's capability:

These OMO leaflets are too long and don't give a clear steer towards the right type of annuity adviser. If you've got a small fund the chances are you'll be rejected or end up with a firm that is not an expert in annuities and doesn't have the streamlined processes to make using the OMO cost-effective for smaller funds. - Scheme and annuity provider

Several interviewees said that OMO information and broker sites assume a level of literacy and numeracy well in excess of what is realistic for DC members:

How can members use an open market option system without help? The average member has a reading age of 13. - Annuity adviser

It's not surprising most people buy a level annuity, even though inflation-proofing is essential over a 20-30 year retirement. Have you seen the graphs that show how the inflation-linked income works? Most people can't do the maths and unless they get the maths, the conceptual thinking required to appreciate the impact of inflation is also missing. - Annuity adviser

There was a strong view that DC members just don't get morbidity and mortality. Without advice, this means that they might misunderstand the whole purpose of the OMO health questionnaire:

The health questionnaire is counter-intuitive. Consumers automatically tend to understate health problems simply because this is what they have done all their lives in relation to employment and to insurance arrangements. It's not that they are lying – they are often in denial about how much they smoke, drink and weigh. And in any event, they reckon this information is bound to have a negative impact on whatever they are buying. Our research showed that one-in-two DC members think that declaring a heavy-smoking habit or having a cancer in the past five years, now in remission, would have no impact or would reduce their annuity rate. Six out of ten think the same about being very overweight. - Annuity adviser

What does 'member engagement' mean?

Member engagement is a mantra in the DC market, but interviewees said its meaning is unclear and that 'engagement' should not be equated with the capability to make an informed decision:

We need to evaluate very carefully the benefits of member engagement in complex decisions, for example accumulation investment decisions that require an understanding of investment and inflation issues, and decumulation annuity decisions that require an understanding of inflation and morbidity and mortality trends. Member engagement is not synonymous with good decision making. - Employee Benefit Consultant

There was concern that a member action – or an apparent decision not to act – is often interpreted as an informed choice:

A lot of schemes are satisfied that they have discharged their responsibilities if the member makes the annuity decision. But they don't consider whether these are informed decisions; they don't evaluate member outcomes. - Employee Benefit Consultant

Scheme providers say that members who buy an internal annuity have considered their options and have made an informed choice, but I've never seen any robust analysis on what this means in practice. In most cases staying with the provider is not an informed choice. If it's a 'choice', it's based on ignorance. Most likely it's a passive acceptance of an easy option in the face of what looks like a very complicated alternative. - Annuity adviser

Several insurance companies said that many of their scheme members 'consider' shopping around but 'prefer not to'. Such language was felt to be misleading, as TPR noted:

'Prefer not to' is an unfortunate choice of phrase, as in practice it is not a member preference to choose the default but a passive act of acceptance due to inability to make the choice. - TPR⁴²

It was also felt that this type of language masks a powerful and highly successful formula for inertia selling:

⁴² The Pensions Regulator, [Principles for investment governance of work-based DC pension schemes](#)

When the 'choice' is between ticking a box to accept the scheme provider's annuity and facing a 15-page OMO form, the odds are so heavily stacked in favour of the default that for most people there is no 'choice'. It's wrong to describe the decision to take the default as a 'preference'. The fact that members assume the scheme provider's annuity is an appropriate default represents inertia selling at its very worst. This is 'nudge' theory in a negative context, used by benefit providers to the detriment of the consumer. - Scheme provider

Consumers lack confidence in changing their provider because they might make a mistake. In behavioural terms it's known as 'fear of regret' and it's a huge factor that is easily exploited. - DC analyst

When the ABI and insurance companies talk about the importance of 'brand', what they mean is that brand is good for business, not necessarily for the member. Members assume that the scheme provider, chosen by their employer or the trustees, will see them right at retirement. In behavioural terms this is logical – brand and the employer or trustees' endorsement of the scheme serve to crystallise member inertia. - Annuity adviser

The FSCP, in its 2010 report on the annuity market, said that ABI data may overstate shopping around.⁴³ This view was echoed by many interviewees, who said that the ABI uses the term in an imprecise manner, often merely denoting that the member 'might have thought about it'. Here is an extract from the ABI's recent consultation report:

ABI figures show that increasing numbers of consumers are buying an annuity from a provider which is not their pension provider (44.4% in the second quarter of 2011, compared to 35.9% in the same quarter of 2009), and about 70% of people shop around, that is, consider switching provider.⁴⁴ - ABI

And here is one interviewee's response:

We really need to get the language sorted. 'Shopping around' suggests an informed process and is not the same as 'considered switching provider', which could mean little more than a passing thought that was immediately abandoned. - Independent trustee

These figures are based largely on the individual personal pension market, where customers are more likely to use an adviser. They are probably not reflective of the scheme market. - Scheme provider

One interviewee felt very strongly that the ABI, as a trade association that represents the most powerful companies in the DC scheme and annuity market, was too conflicted to initiate real reform:

The ABI proposes that 'all CEOs of member firms will be asked to sign a letter annually confirming that their communications and processes are encouraging their customers to shop around'. Who is going to judge what 'encouraging' means?

It also says its proposed code 'addresses the stage where the customer chooses the product they wish to buy and the provider they wish to supply it'. The way this is worded puts the onus on the member,

⁴³ Financial Services Consumer Panel, [Annuity Process and Consumer Detriment](#), 2010

⁴⁴ Association of British Insurers, [Consumers in the Retirement Market](#), December 2011

who is assumed to know how to make the right choice, probably without proper advice. Trustees and employers would not make such complex decisions without professional advice. Why is the customer assumed to have this capability? - Annuity adviser

Lack of baseline measures for communications

There was a strongly-held view that communications and information provided to members about annuities and the OMO is meaningless unless outcomes are measured and assessed:

For communication to take place it requires a giver and a receiver. It's a simple enough point, but not one the pensions industry understands. Those responsible for sending out information and building websites are under an illusion if they think that communication has taken place. – Employee Benefit Consultant

Communication without measurement and evaluation is like sending a letter and assuming the recipient has received it, opened it, read it, inwardly digested the information, understood it, and acted upon it in an appropriate way. What the industry does is just sends the letter. That's not communication. - Annuity provider

Interviewees said that improved analysis of the member's experience and outcome under different at-retirement governance processes would help to make sure the right type of support is used and to avoid unnecessary costs:

Everyone talks as though it's all or nothing – that if you implement a system for member advice it has to be fully-regulated independent advice. This stops progress dead in its tracks because the same people then say that it's too expensive to look after members at retirement properly. It doesn't have to be regulated advice – all members need is a good support framework that's been well-designed from the member's point of view. – Employee Benefit Consultant

Advice is tailored to the fund size and member status

Most interviewees said that professional annuity services are plentiful for members with larger pots and are scarce for members with smaller pots, and that this pattern is reflected in the services schemes provide. They said that this is unfair because it segregates quality according to wealth, yet under auto-enrolment all employees above a very limited earnings threshold would be expected to join the system:

Trustees have a duty to beneficiaries. It's wrong to differentiate so that members with larger funds get a better service than those with smaller pots, but in practice this happens, for example where advice is only offered to members with funds above a certain size. It's also wrong to differentiate between active and deferred members, but it's often the case that where advice is made available this is only to actives.

Under contract-based DC this differentiation is built in to the advisory market. Unless something radical is done this situation is going to get a lot worse from January 2013 under RDR and auto-enrolment. - Annuity adviser

Several interviewees insisted that advice would make little difference to the member with a small pot and that it was not worthwhile. This view was challenged:

'Not worthwhile' is one of those disingenuous phrases banded around in the industry. It suggests it's not worthwhile for the customer but what it really means is that it's not worthwhile for the adviser. - Annuity adviser

There's a widespread assumption that it's not worth the effort to secure what looks like a minor percentage difference for a small fund that might increase the income by £10-20 per month. For many retirees an apparently minor increase can make a very significant difference and over time it can add up to thousands of pounds. This type of attitude is insensitive, to put it politely. - Annuity adviser

Descriptive language used to promote OMO services to trustees can give the impression that members with smaller funds have 'simple needs', while those with larger funds have more complex needs, and therefore require more attention. Here's one example:

Our non-advised service will generally be appropriate for scheme members with simple needs or smaller funds. ... Scheme members with more complex needs, or larger funds, recognise they require a highly personalised and individual service that takes into account the options available to them from the entire market. Our advised service is designed to deliver just that. - EBC annuity brochure

A recent industry survey commented on this practice, as follows:

Industry commentators and product providers have always focussed too heavily on a few wealthy pensioners at the expense of thinking of the mass market. ... Execution only is generally viewed ... as inevitable for the smaller pension fund pots where the cost of advice and the availability of internet based information makes 'self-service' or an execution only service commercially attractive. - Affinity Paymaster⁴⁵

According to the FSCP 2010 report, the division in the advice market between services for smaller and larger funds reinforces the consumer perception that shopping around is 'complex, costly and of little benefit to those with smaller funds and results in reduced income in retirement'.

One interviewee wondered if this might be a deliberate, if implicit, message:

We make it possible for customers with smaller funds to get the right support but we're not popular with other advisers because our model challenges their pricing and service levels. There's a vested interest in making advice look expensive. A lot of advisers don't want a customer if he's only got a small pot because there's no money in it. - Annuity adviser

⁴⁵ [Annuity Industry Survey](#), 2011

4.2 Potential conflicts of interest

Potential conflicts of interest that lead to member detriment in the annuity process were identified in trust-based schemes, but the most pressing concerns focused on contract-based DC schemes run by a life provider that also sells annuities.

Differential between internal and OMO rates

Over the past two years, the most significant piece of research that has attempted to penetrate the internal underwriting processes was the FSCP's 2010 report 'Annuitisation and Consumer Detriment', which said:

There remain some market concerns about providers taking advantage of weak consumer power by not providing competitive internal rates; no published data was found to substantiate or quantify claims.

Annuity advisers have access to open market option rates but said that generally they only see internal rates when customers get a quotation:

We have plenty of anecdotal evidence that internal rates can be 20% lower than the corresponding OMO but it's hard to quantify formally because the rates are kept secret – the only way you find out is from the quotes your clients receive. - Annuity adviser

We have access to research that shows conclusively that the difference between default vesting rates and the best open market standard rates can be up to 20%. - Scheme provider

Internal annuity rates are not published. They are made visible only when a customer is sent a personalised illustration. The reason why they are not published might have something to do with maintaining an imperfect market from which insurance companies benefit. - Annuity provider

Some providers use the same rates for internal conversions and the OMO, and are happy to advertise this fact. Other providers are silent on this point, which suggests they use different rates. - Annuity adviser

The situation is further complicated where annuity providers establish tied arrangements with advisers, where non-standard terms and commission rates are agreed. The number of tied advisers will rise significantly in 2013, when many firms are expected to switch from fully independent (whole-of-market) to 'restricted' advice. In other words, the fully advised OMO market is likely to contract for those with smaller funds.

In the case of a single tie distribution deal, for example, the customer rates or the adviser commission may be different from other internal and external rates. - Annuity provider

Interviewees pointed out that in theory a provider's internal rates should be better than its OMO rates because of the ease of the sale and the fact that there is no commission paid to an adviser – a cost that is built in to the pricing:

External rates will have the cost of adviser commission assumed in the customer rates. Internal rates should, one could argue, have no allowance for commission, but that is not always the case, which

means that internal customers are paying commission for advice they have not received. - Annuity provider

Interviewees said that lack of transparency in the market was a subject for regulatory investigation but that they were not aware that this ever takes place and that even if it does the results are not published:

Internal rates should be inspected frequently by the regulators. The regulators should name and shame providers that over-charge or sell inappropriate products and they should issue fines. - Employee Benefit Consultant

Enhanced rates

The number of people who are thought to qualify for an enhanced rate is in the order of 40-60%. Whilst the market appears to be rapidly growing, at present about 25% of OMO sales secure an enhanced rate but we understand that only 1-5% of internal sales are enhanced:

Our research shows that the 40% of people who are eligible for enhancements for reasons of health or lifestyle conditions can get rates that give them uplifts of up to 37% on typical default vesting rates. - Scheme provider

95% of enhanced annuity sales are reported to be through IFAs (Trott 2009), which indicates that sales of enhanced annuities through internal conversions are significantly lower than through OMO and that this is a major area of potential customer detriment - FSCP 2010 report

We found that only 1% of internal annuitants are securing an enhanced rate. If the average percentage of OMO cases is 25% – and this figure understates the potential – then something is going badly wrong with internal conversions. - Annuity provider

While the proposed ABI code of conduct for annuity providers might help to increase the supply of enhanced rates, interviewees said that exploitation of customer inertia would always be a problem where the onus lies on the scheme provider to drive the process. The detriment can be very significant, as the following case demonstrates. Details have been anonymised but the case relates to a major scheme and annuity provider:

Mr Smith belonged to a multi-employer contract-based DC scheme. The scheme had appointed an independent adviser that was available to members at all times and which was responsible for taking them through their annuity decisions and making the purchases through the open market.

When he was 61, Mr Smith discovered he had two-to-three years to live. He contacted the provider directly for an annuity quote. His fund value was £140,000.

The provider, which did not sell enhanced annuities, offered a single life annuity of £3,600 per annum. The adviser intervened and secured an annuity of £26,000, plus a lump sum of £37,000, through a provider that specialised in enhanced and impaired life annuities.

The scheme manager, in the above case, said that he had written to the provider several times to ask to be copied in to all material correspondence. The provider had refused. We understand that this provider is not alone in regarding member data and correspondence as proprietary information, which it is under no obligation to disclose.

In theory, the potential customer detriment in the above case might have been prevented if the scheme provider had offered an enhanced annuity from a different company. In practice advisers were sceptical that this type of arrangement works well:

We know of a major life office that has an arrangement with an enhanced provider. It says it passes on all enhanced cases but we believe that in practice the proportion of cases forwarded is limited. - Annuity adviser

There was also concern about the use of the term 'enhanced', which implies a good rate:

One provider's enhanced rate might be no better or might even be worse than the best standard rate in the open market. We should be very wary of equating 'enhanced' with a good deal. - Annuity adviser

Compared with the top standard annuity rates, an 'enhanced' rate can be anywhere between less than 10-15% and more than 30%. - Scheme annuity provider.

Furthermore, interviewees expressed concern about the uncertain data that underpins enhanced rates:

One major provider is taking a flyer – its capital reserving is poor, as are its mortality assumptions. It wouldn't take much – an improvement in medical innovation that impacts impaired lives – and it will go bust. OK, members will get 90% of their income protected by the FSCS, but how many people can afford a sudden drop in their pension of 10%? Nobody really understands this stuff – specialist advisers should, as should EBCs, but they don't. Even the rating agencies don't see the risks. - Scheme and annuity provider

'Cliff-edge' bands

Annuity advisers say that the complexity of the underwriting process is not fully appreciated, even by employers, trustees and their advisers:

Those responsible for governance get the fact that the most competitive providers in the OMO change their rates frequently. What they don't necessarily get is the way rates change in relation to different fund sizes. A single provider can have as many as five or six band rates, so it might be competitive for £50,000 and uncompetitive for £49,999, and so on. The provider isn't going to tell the internal customer about this. - Annuity adviser

With a sophisticated OMO system, the adviser can help customers get a much better deal, for example by retaining an extra £1 from the tax-free cash allowance to qualify for the higher rate band, combining pots and splitting pots. Internal customers don't get this type of help, while those that shop around for a single fund size won't know how they can vary their tax-free cash or combine or split pots to get an overall better rate. - Annuity adviser

Rate adjustments that anticipate customer retention

Interviewees said that the explicit and implicit trends in the internal versus OMO market are at odds and suggested that providers might have a very different private agenda from that proposed by the ABI in its recent consultation paper on the OMO:

The ABI says it's keen to increase the use of the OMO. We know of at least one company that has disclosed plans to shareholders in which its aim is to increase its member retention rate from 25-50%. The company does not offer the OMO. - Annuity adviser

Interviewees said that where a provider expects to retain a significant proportion of DC members at retirement through the internal annuity process, it can manipulate rates to exploit the impact of customer inertia:

Providers analyse the fund sizes of DC members coming up to retirement. Where there is a significant tranche of a certain size about to mature, the provider drops its rate in relation to this fund size. Where it operates in the OMO, it drops this rate too, so that rate manipulation is not explicit but just looks like another rate band. Such practices do not affect the provider's position in the OMO, as rate manipulation only applies to specific fund sizes, so it is able to retain competitive OMO rates in general, particularly at the £50,000 and £100,000 mark, which are the most quoted in the press and on websites. In fact providers use these two rate bands as loss-leaders. - Annuity adviser

If providers know that a lot of passive annuities are coming through from their schemes, they will drop their internal rates, for example for pots worth £30,000, and do the same for their OMO, but only at this rate, so they remain competitive otherwise. They might lose a few £30,000 pots from the open market but it's more than worthwhile if they roll-over 60-70% of internal scheme members. - Annuity adviser

The biggest problem for the unsuspecting consumer is that they don't have any experience and don't spot when a provider has effectively priced itself out of the market. Most people buying car insurance can tell immediately if an insurer doesn't want them or has suddenly hiked its rates in the hope of exploiting inertia. For the annuity customer this is a one-off purchase, so there is no learning curve. Insurance companies can pick up some very lucrative business this way. 'Pricing out' is a euphemism for a rip-off. – EBC

Irrespective of whether this type of practice is considered an anomaly or an unreasonable manipulation of rates, advisers stressed that only through the use of the OMO, with appropriate support, can members be sure to avoid detriment:

DC members who use the open market option with support from an adviser will not suffer detriment, as the adviser will conduct a whole-of-market search to identify the most competitive rate and advise if it is worth aggregating pots, taking less tax-free, or splitting pots to get the best rates. Members who accept an internal rate might go so far as to check that this is the same as the provider's OMO rate and be satisfied when they see that this is the case. - Annuity adviser

4.3 Governance gaps

Design, supply chain and distribution system puts member last in line

The following critique of the DC supply chain was drawn from an interview with DCisions and also from its published reports.⁴⁶

The supply chain represents a top-down approach to design that builds on financial myopia – a short-sightedness, where each link in the value chain can only see the next one above and below.

1. *The asset managers build fund products to appeal to platforms, so they can secure distribution*
2. *Product and platform providers serve their distributors – the advisers and consultants*
3. *Advisers and consultants serve the employer or the trustees*
4. *The member – the ultimate owner of the assets – is right at the bottom and has little impetus to become involved in the supply chain*

The problem with this design production line is that there is not just one, but a series of disconnections between the objectives of those building the DC products and the member. At present decumulation design is driven by the industry's distribution models and not the end user. Targets are predicated on industry performance measures rather than the suitability of member outcomes.

So who is responsible for the member outcome?

Many of the discussions that took place in interviews centred on the fact that it is difficult to identify who is responsible for 'seeing the member right' at retirement because so many different organisations and professionals are involved in DC schemes: employers (pension managers, HR directors), trustees, scheme and annuity providers, advisers, and asset managers, to name the main parties.

There was a strongly held view that this situation leads to a lack of individual responsibility and undermines regulatory attempts to improve decumulation governance:

Under regulation, it might seem that the employer or trustee is responsible for implementing the annuity process, but in practice it can get very complicated. Employers are likely to delegate to their adviser and if they don't have an adviser or the adviser is hands-off then they will defer to the default, which is the scheme provider. The same is true of small bundled trust-based arrangements. - Independent trustee

Trustees in theory look after members at retirement, but who actually makes the decisions? The board might not have a clear view and will look to the company's pension or HR manager, or to the life office. At trustee meetings, the job often goes to the individual prepared to speak up. Often nobody really wants this responsibility and a collective approach rarely works. - Annuity adviser

There was a view that trustees often appear to be the 'good guys' in the DC market because their job is to look after the members' interests and they have the governance framework to do so. However, this view was challenged:

⁴⁶ Nigel Aston, DCisions, '[Choosers, users, winners and losers: Observations on defined contribution](#)', 2011 Macmillan, 1478-5315 Vol. 00, 0, 1–9,

We need to be clear about how trustees view their responsibilities under their scheme trust and rules. Often it's the case that all that trustees are required to do when the member reaches retirement is to ensure that the fund is transferred to the member, usually in the form of an annuity purchased in the member's name. This means that the trustees are no longer liable and have no further responsibilities. That's it; job done. - Independent trustee

Contract- vs. trust-based DC

Despite the evident governance and regulatory distinctions between contract- and trust-based schemes, the research found some of the best examples of good governance in at-retirement processes in contract-based models, while some of the 'best' trust-based based schemes, in terms of levels of employer contributions, for example, were deficient in aspects of their annuity governance.

Some of poorest practice around annuities is in trust-based schemes. Trustees think it's not their problem – but under trust law their role is to protect member interests. - Scheme and annuity provider

Most pension managers have a background in DB – as do trustees. Getting DC right is about change management – you need to think beyond the technical aspects and consider the behavioural issues from the member's perspective. - Pension manager

Many trustee boards still dedicate most of their time to the DB scheme, which represents a very pressing financial issue, both to the scheme and to the sponsoring employer. In some cases, trustees don't take DC seriously enough. In others, they create a DC sub-committee, which is a good idea in principle, but in practice it shifts DC off the main board agenda. DC sub-committees often do not have senior management representation, so they have no power. - Independent trustee

Interviewees said that it is overly simplistic to assume trust-based represents good governance and contract-based DC poor, but that it is more difficult for employers with contract-based schemes to improve governance:

It's a question of transparency and visibility. With a trust-based scheme, I have access to all the information I need through service agreements with asset managers and the third-party administrator. With contract-based DC, access depends entirely on the provider's willingness to share data. I've had situations with contract DC when I've had no idea what benefits members are building up and when they plan to retire. How can I assess how well the scheme is working at retirement under this scenario? - Pension manager

Irrespective of the scheme's structure, interviewees said that there is a widespread fear of regulatory reprisal on the part of those responsible for governance (employers and trustees), which prevents members from getting the help they need:

What we need is a single set of DC regulatory rules instead of two. It's time the FSA and TPR got the message that two sets of rules and guidance is an anachronism now that virtually the whole private sector is DC. - Employee Benefit Consultant

The 'two regulators' situation is crazy and dysfunctional. It helps to explain why poor governance doesn't just get hit over the head with a TCF hammer. – Trustee

However, interviewees also said that fear of regulatory reprisal is often used as an excuse not to act:

Employers and trustees use the threat of regulatory reprisals as a smokescreen – without a doubt they hide behind this. - Independent trustee

If we know that most members need to be opted into a scheme, to have minimum contributions prescribed, and that they require a default fund to avoid having to make complex investment decisions, why aren't we comfortable with saying 'this is the default annuity process and it delivers value for money'? There's a mind-set problem here, but it's not clear whether it's a genuine mental block or if the industry collectively is avoiding responsibility for member outcomes – and in some cases profiting from member inertia. - Third party administrator

Moreover, where members do not make an active annuity decision in trust-based schemes, interviewees said there was a danger that they will defer the annuity purchase because they don't know what to do:

The trustees might not be too worried about this. It helps to retain assets in the scheme, which in turn helps them to negotiate lower asset management charges. It also means that they are responsible for a bigger scheme, which might be relevant to their position and status. - Annuity adviser

Interviewees also said that employers lack a vested interest in the outcome of DC members' pensions and that this is a significant barrier. While HR might take employee benefits very seriously, the finance director 'needs to see a return on the company spend':

In the 1990s and early 2000s, a lot of employers chose contract-based DC because they had serious DB problems. It was a corporate policy decision to choose a model that dissociated the pension scheme as much as possible from the employer and the balance sheet. Contract DC was sold by EBCs and IFAs as regulation-light. You can't engage these employers in discussions about governance committees – all they want to know is what they have to do to avoid legal and regulatory problems. TPR guidance on good governance washes over them. - Annuity adviser

It's always going to be difficult to fix a broken model. Trying to add layers of governance to contract DC is like trying to make contract-based the same as trust-based but without the teeth. - Independent trustee

A further problem that arises for employers with contract-based schemes is that in the 1990s and early 2000s many EBCs carried out the job of selecting the provider as a one-off fee-based exercise.

For many employers, there is no continuity of advice for their DC scheme. It was a one-off installation, with no thought given to ongoing advice. The assumption was that the provider would do everything – which, of course, they are happy to do and is precisely the problem. - Annuity provider

Several interviewees said that a recent change in employment law, which abolished the employer's right to enforce a compulsory retirement date, would draw attention to the shortcomings of DC decumulation processes in due course:

In the 1980s and early 1990s, the DB pension scheme was an important retirement management tool. It was used as a slush fund to pay for early retirements by the score, when employers wanted to get rid of staff they considered to be uneconomic to employ. Employers have to wake up to the fact that they probably want people to go at 65 and that the feeling is probably mutual – but if employees can't afford to retire, they will have to stay put. This does not make for a happy and productive workforce and it's going to put a huge strain on the corporate recruitment and promotion policy. - Independent trustee

Member representation in contract-based scheme governance

Interviewees said that contract-based DC scheme governance might be improved if more members were directly involved, since it is the member who bears most of the risks. As Mark Hyde Harrison, NAPF Chairman put it:

This is a classic agent-principal issue: in DC the individual saver does not normally have any agents whose interests are completely aligned with theirs. Solve this and many other issues become easier.⁴⁷

In practice, respondents said that very few DC members have the knowledge and understanding necessary to become more involved in decision making. Indeed employers that have set up contract-based scheme governance committees – as recommended by TPR – said that it is a struggle to find even two or three members who will volunteer.

The Pensions Regulator insists trustees have a minimum knowledge base and it provides a lot of support to help them achieve this. Lay members of DC governance committees need the same level of training. - Pension manager

Moreover, employers were concerned that the governance committee lacks teeth because it is a voluntary arrangement, it does not have regulatory support, and the provider owns the member data:

We set up a governance committee for our stakeholder scheme and it includes three member representatives – they were hard to find. We had to set up service agreements so we can get regular reports from the provider on member activity and fund performance. In practice though, it's not like a trustee board – it has no teeth, but it's the best we can do. - Pension manager

4.4 Can the industry work voluntarily towards a default annuity process?

Views were very mixed as to whether the industry could work towards an efficient and cost-effective default annuity process of the type set out in this report, but few would welcome increased regulation:

I'd be reluctant to see further regulation, as this usually leads to increased member costs. We really need to find a way to get the member engaged but, at present, it's hard to see how we can achieve this. - Employee Benefit Consultant

⁴⁷ Pensions World, November 2011, p. 10.

While a lot of the focus is on the OMO rate, interviewees drew attention to the role played by scheme providers that only offer internal rates:

Some of these rates are so bad they're off the scale – but they are also invisible. Customer retention in these cases really should be investigated, especially in the case of the companies that buy back books of business. Their business model is quite simple: make a profit and screw the customer to within an inch of the law. - Scheme and annuity provider

Many employers, trustees and EBCs thought the way forward was simple and it needed to be adopted urgently:

If the provider or scheme does not have a strong independent advisory system in place for the annuity process then it should be the norm or default to make this the case. It's up to the industry to make this happen; otherwise the government will step in. - Employee Benefit Consultant

Employers and trustees think it's not a big problem because they only have a few DC retirees a year right now. That's going to change very quickly and for those that pay for member advice it's going to get expensive, so these employers and schemes need to think about ways to future-proof their DC schemes to avoid increasing at-retirement costs. This realisation is what's driving the trend towards the appointment of specialist annuity brokers, who can manage the whole process and do it within the commission that's paid by the provider. - Employee Benefit Consultant

Most interviewees agreed that the industry has the necessary capability and expertise to implement a system that could accommodate all DC members' needs, but that this needed to be turned into a simple member-facing service:

At present, all the component parts are there – the annuity brokers with the knowledge and systems, the OMO market, the sources of help, like MAS, TPAS and the Pension Tracing Service – but unless the employer or trustees put it all together as a one-stop shop the member faces too many disparate sources of help. - Employee Benefit Consultant

Can providers act as drivers of change?

Some interviewees felt that if employers and trustees drive the trend towards the use of specialist annuity services at retirement then providers will have to change their practices:

I believe that the private sector will respond and an active national annuity adviser service will emerge to meet this critical need. It will need support and one essential area is for the pension provider community to release contract-based scheme data to advisers so that a straight through, efficient annuity default experience can be provided in volume. It is outrageous that they feel able to treat such data as their own when the EBC has been instrumental in introducing and managing the scheme and supporting members throughout accumulation. - Employee Benefit Consultant

Several interviewees raised concerns about the structure of the OMO, which is served by about 13 players, several of which are enhanced-only. The FSCP 2010 report raised concerns about the trend towards an oligopoly among the major scheme and annuity providers:

While there is no current evidence of oligopolistic powers, the annuity market is consolidating and there is a need to review whether this remains the case.

... Market consolidation is limiting choice of annuity provider and may lead to imbalance in provider power and further consumer detriment.

Interviewees said that the current market has the capacity to deliver OMO rates for all DC members, but that it is dominated by providers that sell both schemes and annuities, which lack a rationale for pursuing this goal:

We cannot expect the providers to be drivers for change – or at least not the providers that sell both schemes and annuities. Why would they change the status quo when it works so well in their favour? - Annuity adviser

There are a number of ‘challenger’ annuity providers, but not enough. Solvency II is only going to reduce competition in the market, not increase it.⁴⁸ - Employee Benefit Consultant

There was some concern about the scheme providers’ remuneration, where they establish a default arrangement with an annuity adviser and take part of the commission payments. But equally it was felt that what is right for business can work in the customer’s favour:

There has to be an incentive for a scheme provider to introduce business to an annuity adviser, otherwise it’s easier and more profitable to try to keep the business through internal annuity sales. We need to make it clear that using a default annuity advisory system is good for business, in terms of profits, good for business in terms of being seen to provide a best-practice service for the member, and good for the member, because they get a decent outcome. - Scheme provider

Can advisers act as agents of change?

Although a lot of EBCs set up annuity processes and provider panels for client schemes, there were concerns about their expertise and vested interests, for example where they establish a single or limited range of annuity providers:

One well-known EBC uses a single annuity provider for its schemes. Its rates are good for some customers but certainly not for all. - Annuity adviser

EBCs often set up panels of providers for the schemes they advise but I’ve encountered examples where the panel doesn’t include a single enhanced provider. - Annuity adviser

There was a strong perception that the specialist annuity advisers could be instrumental in driving through a national OMO process that could be used by all schemes:

⁴⁸ Solvency II is a European directive that will impose tougher reserving standards on annuity providers in relation to their holdings of corporate bonds. It is likely to come into force in 2013.

The annuity advisers could make it [a national system] work commercially. If there are six of them on the carousel they'll get a good volume of the big business as well as the small funds. - Employee Benefit Consultant

However, while in theory specialist annuity advisers are well-placed to drive change, in practice they are considered highly competitive and dominated by specific individuals, who would struggle to collaborate:

Trying to get specialist annuity advisers to work together for the common good – or even their own good – is like herding cats. - Annuity provider

These firms also operate very different business models:

Trade groups in the annuity market are very good at disguising self-interest as altruism. Some advisers negotiate higher commission terms based on the volume of business they secure for annuity providers. Any move towards a national system that creates a level playing field and that imposes a cap on commission rates would hit their profits and anger shareholders. - Annuity broker

Interviewees also said that the quality of adviser services, particularly the execution-only websites, varies considerably and that in some cases customers get poor value in return for the commission payment that is deducted from their funds when they make an execution-only purchase:

Advisers can get very precious about their services – we need to take a hard look at what they actually deliver when compared with good quality generic advice call centres. - Annuity provider

Not all of the specialist annuity brokers I've encountered are what I would call ethical. I've been approached by two leading brokers that wanted to add 25 basis points to the AMC in order to cover their services at retirement – even though we said we wanted to pay a fee for their advice. They said our AMC was too low and that members wouldn't notice an extra 25 basis points. This seems to be a case where members are commoditised for the express purpose of increasing the annuity broker's profits. - Pension manager

The arrangement between a scheme and the annuity adviser should be on a nil-commission basis; otherwise the scheme ends up chasing the best deal. We've asked annuity advisers in and the first thing several have said is 'we can do this in a variety of ways; just name your commission terms'. - Scheme provider

4.5 Conclusion

As this chapter demonstrates, there is a high level of awareness and concern on the part of industry practitioners about the problems within the annuity market and the impact that these issues have on DC scheme member outcomes. This awareness and concern needs to be converted to action in order to drive voluntary reform towards a much more functional and transparent market that is genuinely member-focused.

However, the industry needs to demonstrate whether it is able and willing to treat members with smaller funds fairly or if there is a cut-off point at which it is genuinely uneconomic to deliver the OMO.

The Pension Commission's recommendations to the Government in 2005 were clear that the industry did not consider it economic to serve the large numbers of lower earners and transient workers who were not saving enough for retirement. As a result the Government introduced NEST alongside its auto-enrolment reforms, which operates as a scheme like any other except for one crucial feature: it cannot turn an employer or employee away on the grounds that 'there's no money in it'.

This report should prompt the Government and industry to tackle the same questions in relation to the private sector DC scheme annuity market. We hope that it informs the ensuing debate and that DC scheme members will be better served at retirement as a result.

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Barnett Waddingham	Partnership
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Deloitte	Retirement Angels
Department for Work and Pensions	Royal London
Dimensional Fund Advisers	Russell Investments
Fidelity	Scottish Life
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Financial Services Authority	Social Market Foundation
Financial Services Compensation Scheme	Standard Life
Financial Services Consumer Panel	The Open Market Annuity Service
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Hargreaves Lansdown	The Pensions Regulator
Hodge Lifetime	Towers Watson
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Hymans Robertson	Volkswagen
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The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure the security and sustainability of UK pensions.

We are a progressive and proactive organisation, committed to ensuring there is a sustainable environment for workplace pensions so that millions of people can look forward to fair and decent retirement provision. Our member profile is a key strength. We represent all types of scheme including defined benefit, defined contribution, group personal pensions and statutory schemes such as those in Local Government. NAPF members receive a range of benefits, including:

- guidance on best practice;
- industry news, opinion and knowledge leadership;
- forums for debate, discussion and networking; and
- an influential voice and representation in front of Government, regulators and the media.

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Securing the future of pensions

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