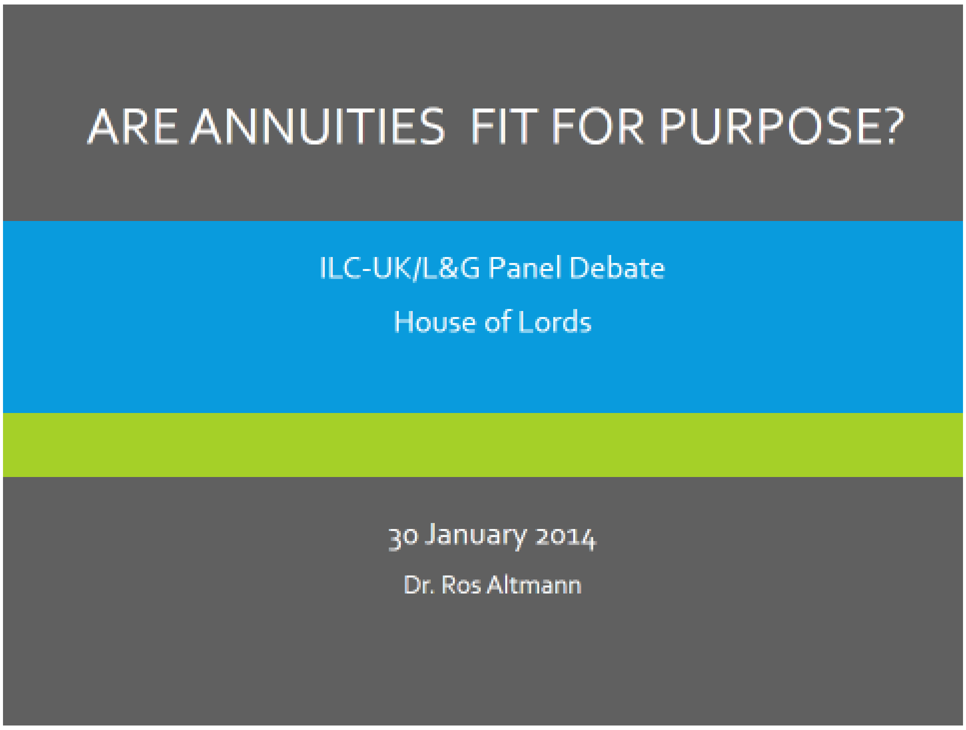
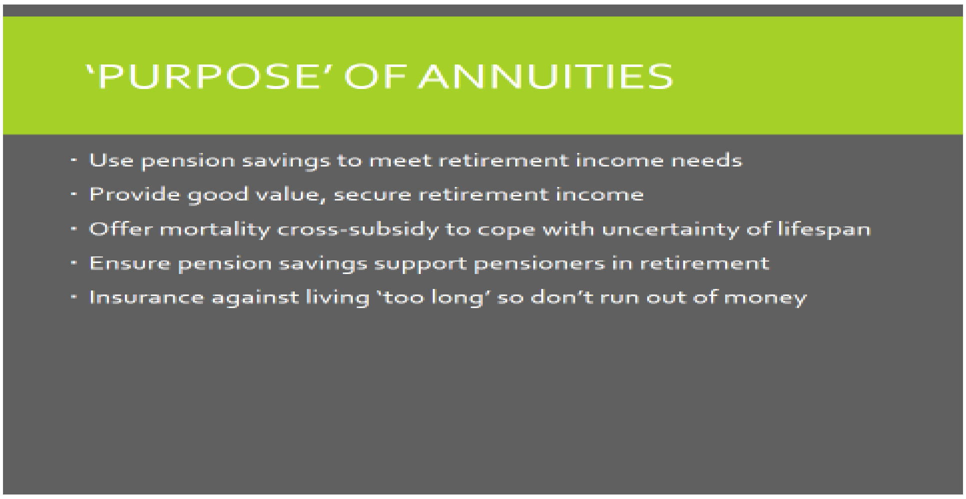


Thank you to ILC-UK and Legal and General for organising this really important debate. We are here to discuss whether annuities are fit for purpose. So let's first consider what IS the purpose of annuities?



You save for a number of years to build up a pension fund and then, at retirement, you use those pension savings to help you meet your retirement income needs. You would hope that your savings will provide good value and a secure retirement income. The reason why annuities have been used for pensions is that they can offer a mortality cross-subsidy, to cope with the uncertainty of people's actual lifespan. Only insurance companies can sell annuities and the original aim was to provide insurance against living longer than expected, and living 'too long' so that your income will keep being paid and you don't run out of money. Right, so that is the 'purpose' of annuities, now let's consider whether they are actually fit for that purpose.

Unfortunately, as retirement has changed significantly, annuities are too much of a one-size-fits-all product, that is not really fit for all at all. It is just too much of a lottery.

Most annuities sold are 'standard' annuities – single life, level annuities. These do offer a guaranteed income, which in theory sounds quite appealing, but in practice, as our lives are not so much longer, the standard annuity only covers one of the risks people will have to cope with during their retirement. Living 'too long' could be a problem, but there will be many other risks that pension savings might be able to help with, however after buying a standard annuity, the pensioner will face those risks without protection.

These drawbacks are often ignored in the ongoing debate about reform of annuities. All the focus is on 'shopping around' for the best rate. That drives people to buy the standard type of annuity, which will usually pay the highest starting income. Getting the best rate for a standard annuity is not good enough. In the first place, of course, those who buy an ordinary annuity but are in poor health will be far poorer than they should be throughout their retirement. But even those in good health, who buy a standard annuity, will not be protected against many of the risks they will face. Unlike with a final salary-type pension, there is no automatic inflation-linking of the pension income with a standard annuity. It keeps on paying the same amount each year, even after 30 years, which will obviously be worth much less as time goes on. Also, unlike traditional pensions, these standard annuities do not offer a pension that will keep paying to a partner or dependents. The so-called 'single life' annuities could leave widows with no pension when their husband dies.

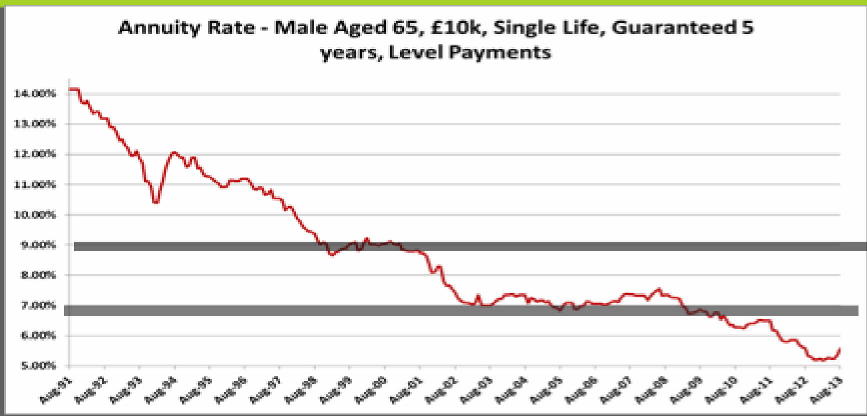
In all the focus on having a secure income, the fact that all the capital is at risk is also ignored. No risk warnings have to be given to explain to people that they could lose their entire pension savings if they die relatively soon.

Another major drawback is the inflexibilty of annuities. You will never do better if your health or other circumstances change. Also, you will never benefit from good investment returns in future, or get higher income if interest rates rise. This is particularly relevant now after the sharp falls in annuity rates as a result of the Bank of England's monetary policies of Quantitative Easing.

And once you've used your pension savings to buy an annuity, if you need long-term care, the money is all gone. There will be nothing left to pay for care, which will become an increasingly important issue for 21st century retirement.

Let's just look at what has happened to annuity rates in recent years.

ANNUITY INCOME FROM AGE 65...



The above chart shows the dramatic drop in annuity income since the 1990s. Annuity rates were around 14% in 1990, then fell sharply to stablise around 9-10% in the late 1990s, again falling to around 7% in the years 2002-2009, but then dropped sharply to around 5% in 2012. They have now recovered by more than 10% from their lows, but of course the hundreds of thousands of people will be permanently poorer because they bought at those exceptionally poor rates. Even the best annuity providers were offering very poor annuity rates a year ago.

The debate about annuities reform tends to be driven by the industry, but it is important to consider the customer perspective of annuities.

THE REALITY OF ANNUITIES

- Unique financial product – complex and irreversible
- Asymmetry of information – poorly informed customers who only buy once in a lifetime, often buy wrong product
- May be secure income, but all capital at risk, no risk warnings
- 'Small' funds can't find value
- No controls on charges, rates, value for money, suitability
  - Customers pay 'commission' even if no advice received
- Must live to **90** or even **>100** to get value!

Annuities are a unique financial purchase. They are complex, but they are also irreversible. If a better product comes along in future, you will never be able to buy it if your pension savings were spent on buying an annuity.

The market is not working well for customers due to a worrying asymmetry of information. Those buying annuities are usually poorly informed customers who only buy once in a lifetime, and they do not understand what they are doing. They receive a letter stating that they should buy an annuity in order to get income from their pension fund, so they don't realise they may not actually have to buy. They also don't know what the different types of annuities are. They are generally offered a single life, level annuity, the standard product, which will not reflect their health or marital status, and they will therefore often buy the wrong product. Those who use advisers are far more likely to buy 'joint life' annuities and will get enhanced rates if applicable. Firms can sell customers an annuity without any risk warnings or suitability checks, even though all their capital could be at risk unnecessarily. The secure income is supposed to compensate for that risk perhaps. However, those with small pension funds are even more at risk, because there is no competition at the very small end of the market and rates are often extremely poor. In fact, a 'small' fund is anything under around £10,000, which to most ordinary people is actually quite a lot of money. When it comes to annuities, though, this is not an amount that can give you good value.

Astonishingly, there are no controls on the charges, rates or value for money offered by annuities. Firms can charge what they like and price the annuities as uncompetitively as they wish. Even people who buy an annuity direct from their pension provider will have to pay commission, although those charges are often hidden and customers don't realise this. There are also no controls or checks on whether the product is actually right for the customer or reflects their circumstances. If someone is in poor health, they can still be sold a standard annuity. And their company can offer them a really poor rate. For many of the rates quoted in the market today, someone who buys at age 65 actually needs to live to age 90, or in some cases well over 100, before they have received back more than their original pension fund plus a 3.5% or 4% long-term rate of return. Just look at the following table and one has to ask if this is treating customers fairly.

VALUE FOR MONEY – MIS-SELLING?

Name of insurer	Age when insurer pays more than original fund if earns the assumed returns	
	Assume 3.5% return on fund	Assume 4% return on fund
Prudential (MAS quote)	102	107
Abbey Life	100	105
MGM	97	102
Countrywide	96	100
Standard Life	95	98
Halifax/Clerical Med/Scot Widows	95	98
Pru/Royal London	95	98
HSBC Life	94	97
Sun Life of Canada/Phoenix	93	97
Aegon	93	96
LV	92	95
ReAssure	91	94
Legal and General	90	92
Canada Life	90	92
Reliance Mutual	89	91

Of course there are some providers who offer better value than others and those who live beyond age 90 will have better value, but using rates from the Prudential, taken from the Money Advice Service website, the Pru would only pay 20% less for life than all the other providers. Nothing stops them from quoting such awful rates, yet many people may feel that the Prudential is a leading company and fail to realise what poor value they are offering. Without an adviser, many will buy and be poorer for the rest of their life. The table suggests that for some firms, there is very little, if any mortality cross-subsidy at current annuity rates. Customers, however, have little understanding of this and, if they buy from their current provider because they find shopping around to difficult and have no adviser to help them, they will certainly be at risk.

Yet, the UK regulatory system for annuities has failed to adapt to protect customers properly. It seems that annuities are being sold as a ‘no risk’ product which is suitable for everyone.

For years there has been worrying regulatory failure. The FCA has absolutely failed to protect customers and has left it to the ABI to self regulate. Some small changes have been made, but as the excellent report from the Financial Services Consumer Panel highlighted, urgent changes are needed to make the market work fairly for customers.

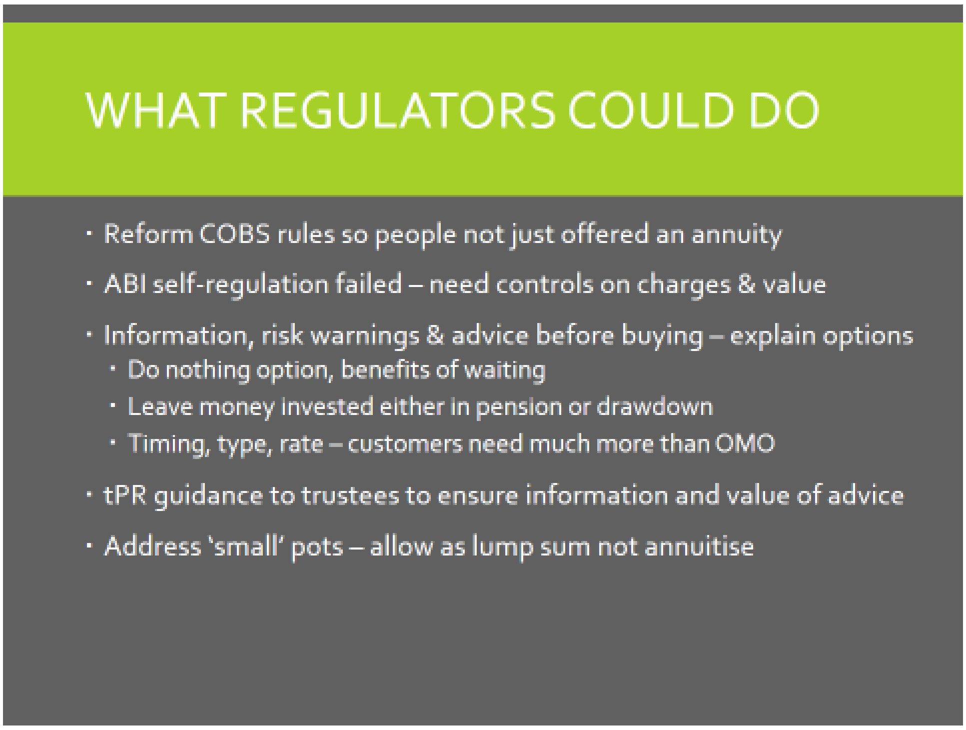
Apart from there being no controls on the charges or value for money for customers, the high charges customers face are often hidden. They will unwittingly end up paying commission which could be used to fund advice, even when they have either no help at all, or just guidance that gives no regulatory protection. Nobody needs to give customers risk warnings or make suitability checks, it’s just caveat emptor, even though this purchase is irreversible.

The FCA has relied on the open market option to drive better outcomes, but this is not enough. It often leaves people bewildered, or leads them to just shop around for a better rate, but for the wrong product!

I estimate that men who buy a single life annuity could result in widows losing £1bn a year in future, meaning more poverty as a result of their husbands failing to realise the consequences of taking a slightly higher initial income. Standard, single life annuities are clearly not fit for purpose for men whose wives do not have their own pension provision, but nobody has to check this.

There is also worrying regulatory failure as a result of the RDR (Retail Distribution Review). The RDR has biased the market against people actually getting advice to help them with this important and irreversible purchase. Brokers, pension providers and non-advice services are allowed to charge commission, which does not need to be properly disclosed and is not explained until the point of sale, whereas advisers who offer regulated individual advice have to agree a fee at the beginning of their engagement with the customer for their at retirement advice. Many IFAs will advise people for a fixed fee, such as £750 or so, and this can be cheaper than using a non-advice service that charges 3.5% commission. But clients are put off by the up front fee and believe they can buy on their own using what is advertised as a 'free' service. This means they don't get the advice they really need, are left to manage this complex process on their own, pay more for their purchase, may buy the wrong product and have no regulatory protection if things go wrong. This is a direct result of well-meaning reforms that were supposed to protect the customer!

So what can regulators do about all this? A few things are urgently needed.



A really urgent reform is to ensure people approaching retirement are not just automatically offered an annuity. Reform of the Treasury's Conduct of Business rules, COBS19.4, would mean pension companies do not have to automatically lead customers to believe they need an annuity to get income from their pension fund.

There also need to be controls on the charges and fees for annuity purchase, as well as the value for money offered by annuity companies. The ABI has been left to self-regulate, but has failed to ensure that customers are treated fairly by all their members. Some companies do behave better, but the regulator needs to ensure better value for all, because this transaction is irreversible. This is not like other insurance or investment products where, if you have done the wrong thing, you can move to a better firm.

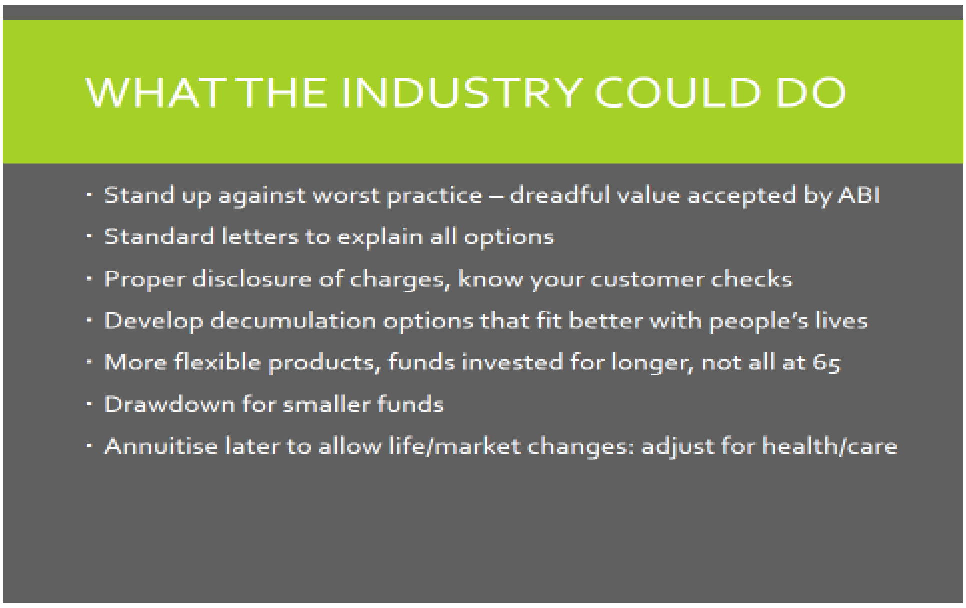
It is also important that the Regulator requires people to be given proper information, risk warnings and advice before they buy. The options should be properly explained and these will include options that do not involve buying an annuity.

The first point is that many people do not have to do anything. The 'do nothing' option has merit because people may still be working and not need any income. Someone in good health, who has other pensions, may be better off keeping their money invested and waiting longer before buying. They could also use income drawdown, but without an adviser they may not realise this. They also need to know what type of annuity to buy. Before using their open market option, they need to ascertain whether now is the right time, if so what type of product they need and only then do they want to shop around for the best rate.

The Pensions Regulator also needs to amend its guidance to DC pension trustees to ensure they provide members with information that highlights the value of individual advice, rather than just using self-help or guidance from brokers which they may not understand and which may not get them the right product.

Particularly urgent is the issue of 'small' funds which get even poorer value than others. For example, we should consider allowing people with funds of, say, under £10,000 to take the money as a taxed lump sum or use it to buy more state pension rather than getting a few extra pounds a week from an annuity at a very poor rate.

And, of course the industry itself could do far more to look after customers.



It does sadden me that those providers who want to do better for customers do not stand up against the worst practice. The ABI has just accepted the dreadful value offered by some of its members, which is so much lower than others. The first ABI annuity window contained rates that were so far below others, yet the rates were just published without comment or criticism of those who offered so much worse deals to captive customers.

The industry could get together to draw up standard letters for people approaching retirement which will explain all the options and let them know they do not have to buy an annuity at this time.

And let's have proper disclosure of the fees and charges, rather than hiding them away. And it is surely inexcusable that there are no 'know your customer' checks before people buy. There are great campaigns in the media pushing for reform – the Telegraph, Sunday Times, Daily Mail, FT are all on to the problem as they have heard so many terrible stories from readers.

Annuities are not fit for purpose for everyone reaching retirement, so the industry needs to develop decumulation options that better fit with people's lives. More flexible products that will allow people's pension funds to stay invested for longer, rather than spending all the money at age 60 or 65. Perhaps some kind of simplified drawdown for smaller funds or for those who don't want to choose their own investments, rather than buying one irreversible product despite having a 25 or more year time horizon. It is really important to have flexibility to allow for market or life and health changes, so that pensions fit better with people's lives.

So to conclude. We are considering whether annuities are fit for purpose. I have three main points to summarise:

- **If annuities are being bought without any suitability checks or advice we really have no idea whether they are fit for purpose for those buying them now.**
- **A standard single life level annuity, which is irreversible and inflexible and which people buy at a relatively early stage in their later life is unlikely to be suitable for all and not fit for purpose.**
- **Having high charges that are hidden and biased against the advice people need means annuities are not treating customers fairly.**

As millions more people are auto-enrolled into DC pensions, we MUST reform the way this market is working. Thank you for listening.