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Cass Business School
CITY UNIVERSITY LONDON

Pensions Institute

THE MEANING OF LIFE

An uncertain future for the traditional life company business model in the UK's private-sector pensions market

A Pensions Institute report for insurance companies, asset managers, policymakers, regulators, trustees, independent governance committees, actuaries, consultants, lawyers, and analysts.

Debbie Harrison

David Blake

November 2015

The meaning of life: An uncertain future for the traditional life company business model in the UK's private sector pensions market

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The Pensions Institute (www.pensions-institute.org) is the first and only UK academic research centre focused on pensions issues. The views expressed in this report are those of the authors and not the Pensions Institute which takes no policy positions.

Abbreviations

ABI	Association of British Insurers
AMC	Annual management charge
AMD	Active member discount
AUG	Actuarial User Group of the FRC
AUM	Assets under management
AVC	Additional voluntary contribution
B&CE	Building & Civil Engineering Scheme
BPA	Bulk purchase annuity
D2C	Direct to customer
DA	Defined ambition
DB	Defined benefit
DC	Defined contribution
DWP	Department for Work and Pensions
EBC	Employee benefit consultant
EPP	Executive pension plan
EV	Embedded value
FCA	Financial Conduct Authority
FSB	Financial Stability Board
FOS	Financial Ombudsman Service
FRC	Financial Reporting Council
FSAVC	Free-standing additional voluntary contribution
FSCP	Financial Services Consumer Panel
GAD	Government Actuary's Department
GDP	Gross domestic product
GPP	Group personal pension
HMT	Her Majesty's Treasury
IGC	Independent governance committee
IPB	Independent Project Board
IRA	Individual retirement account
ISA	Individual savings account
LTA	Lifetime allowance
MA	Matching adjustments
M&A	Merger and acquisition
MiFID II	Markets in Financial Instruments Directive II
MoJ	Ministry of Justice
NAO	National Audit Office
NEST	National Employment Savings Trust
NRA	Normal retirement age
OFT	Office of Fair Trading
PAYG	Pay as you go
PFM	Pot follows member
PIA	Personal Investment Authority
PPF	Pension Protection Fund
PPI	Payment protection insurance
PLSA	Pensions & Lifetime Savings Association
PRA	Prudential Regulation Authority
QE	Quantitative easing
RDR	Retail Distribution Review
RIY	Reduction in yield
RU	Regulatory Update
S32	Section 32 buy-out policy
S179	Section 179 funding level
SII	Solvency II
SIPP	Self-invested personal pension scheme
SME	Small- and medium-sized enterprise
SSAS	Small self-administered scheme
TER	Total expense ratio
TLP	Traded life policy
TPA	Third-party administrator
TPR	The Pensions Regulator
VfM	Value for money
WPC	With-profits committee

Preface

This report sets out the results of an independent investigation of the UK's life company business model in the context of the dramatic changes to the private-sector pensions market. The main focus is the defined contribution (DC) market, including the back books of the pre-2001 era and the books of more recent workplace schemes and individual plans for the periods of accumulation (contributions) and decumulation (withdrawals of cash and regular retirement income). We also consider insurance solutions in the defined benefit (DB) pensions market, namely, bulk-purchase annuities (BPAs).

These life company markets are vast, but the estimates of aggregate assets under management (AUM) – and aggregate liabilities, where relevant – vary considerably. Here we offer the following broad estimates:

- £420bn: The 'back book' market of pensions and long-term savings policies (largely pre-2001, but also including pre-2005-06 with-profits bonds). Some experts put the figure significantly lower at about £330bn, while others put it significantly higher at about £530bn.[1]
- £280bn: The workplace DC pension market post-2001.[2]
- £300bn: The retail DC pension market post-2001.
- £1.2trn: The private-sector DB scheme market by AUM. We classify these schemes, most of which are closed, as the back books of employer-sponsored schemes.
- £50bn: The value of the BPA market post-2007.

Since the turn of the century, both the DB and the DC markets have changed beyond recognition:

- DB: Change is due to the widespread closure of schemes (about 87% by number of schemes[3]) and the trend towards the transfer of these liabilities from the employers' corporate balance sheets to the balance sheets of BPA insurers and their reinsurers. This market is relevant to life companies, in their capacity as providers of BPAs, and also as third-party asset managers to DB schemes – a business line that is declining as more and more BPAs (largely bond-backed) are transacted.
- DC: Change is due to the development of modern mass-market auto-enrolment workplace schemes. With the exception of a small number of large single-employer trust-based schemes, mass-market workplace schemes began in the late 1980s and early 1990s, as a grouping together of personal pensions under a voluntary pension system. Today, the market is dominated by large-scale multi-trust, multi-employer schemes (known as master trusts) under a quasi-compulsory pension system. Auto-enrolment, which will be fully implemented by 2018, is compulsory for all private-sector employers and employees, although the latter have the right to opt-out (the 'soft compulsion' feature that distinguishes auto-enrolment from full compulsion).

1 The wide variation between these estimates is due to differences in the definition of 'legacy'. For example, the higher end of the spectrum includes older books of retail annuity business and takes into account some or all of the reserves held to honour guarantees on certain pension policies if they are maintained until maturity.

2 We do not include trust-based small self-administered schemes (SSASs), which are unusual arrangements, peculiar to the UK, used by small family businesses.

3 Source: PPF. See also PPF 7800 Index, November 2015: http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF_7800_november_15.pdf

In the DC market, a series of major policy and regulatory changes has broken the life company's historic monopoly of the 'value chain', by which we mean asset management and administration, in particular, which historically have been combined in-house under the life company 'bundled' or 'vertically integrated' business model, and which is still the case for many providers. This trend away from the life company dominance is particularly evident in the workplace scheme market, but it is also increasingly evident in the retail market for both accumulation and decumulation products.

Taken as a whole, the changes in the DC market call into question the fundamental purpose of the traditional UK life company business model. The largest and, arguably, the most visibly successful life companies are restructuring in order to compete with a diverse range of challenger-providers. Several of these challenger-providers have already demonstrated the merits of alternative business models in the master-trust auto-enrolment market and have gained a significant market share at the expense of traditional life companies.

As these challenger-providers move into the decumulation market – in which the historic distinction between 'retail' and 'workplace' will increasingly be recognised as an anachronism – life companies will find themselves beset on all sides. By 2020, the report predicts, certain well-known life companies will no longer exist in their present form. They will either be bought wholesale by a larger and more competitive life company, or they will be sold-off piecemeal as a series of books of business. These books will include pre-2001 life-company policies, but also more recent workplace schemes, retail accumulation products, drawdown products, and annuities.

At this watershed in the long history of UK life companies, clarity of understanding of market conditions, together with a clear vision for the future, is essential for survival.

While most of this report is dedicated to the analysis of the UK market, at times, we draw relevant lessons from overseas markets with national DC pension systems. Examples include: the Australian market, which has witnessed a massive consolidation of life companies involved in accumulation, and where a new trend is underway towards a DC decumulation market that incorporates a longevity hedge; the US market, which is characterised by the dominance of asset managers, rather than life companies in both the accumulation and decumulation stages; and the resilient popularity of the lifetime annuity (LTA) in Chile and Switzerland.

The research for this report took place between the beginning of April and the 25th of November, the date of the 2015 Autumn Statement. The first use of key definitions used in the report are highlighted in bold type and are explained in the 'A-Z of key definitions'. There is also a full glossary of terms at the end of the report.

We would like to thank the organisations and individual experts who helped with the research. Where we use quotations from published sources, these are cited in full. Where we quote from confidential interviews, the quotations are anonymised. This technique, pioneered by the Pensions Institute in 2004 for its practitioner reports, enables us to express the views of experts more candidly than might otherwise be the case. The organisations that were happy to be named are listed in the acknowledgements.

We would particularly like to thank the sponsor of this research, Phoenix Group Holdings, which is the UK's largest publicly-quoted closed life company. The views expressed in the report are those of the authors and not necessarily those of the sponsor, which did not seek to influence the research. Moreover, the views are not of the Pensions Institute as a whole, which takes no policy positions.

Debbie Harrison and David Blake
Pensions Institute, November 2015

Executive Summary

Findings in the workplace DC pension scheme market

1. Between 2016 and 2020, DC workplace pension scheme assets under management (AUM) are expected to double from about £280bn[4] to £550bn; but, by 2020, about 90% of these assets will be 'owned' by a 'premier league' of between five and seven major providers.
2. Massive consolidation in the auto-enrolment scheme provider market is inevitable and needs to be well-managed by the industry and the regulators in order to avoid market instability. The consolidation trend will intensify as further reforms – such as those from the legacy policy review – come into force.
3. Further market disruption and confusion would follow if, in the March 2016 Budget, the Government announces its intention to introduce an ISA-type tax model for pensions. This could bring into question the continued purpose of life company tax wrappers for contract-based pension schemes and products. Pension-ISA taxation would also undermine the purpose of auto-enrolment for lower earners – the very category of private-sector workers it was meant to benefit. This, combined with the understandable fear that a future government might decide to tax withdrawals – the main tax benefit of ISAs is that withdrawals are tax-free – could eliminate the last vestiges of trust in long-term government pension policy.
4. For weaker '**mid-tier**'[5] life companies, the **traditional** 'bundled' business model and reliance on commission-based intermediaries is anachronistic. It is not clear where the strengths of these life companies lie. Protection insurance is 'under-sold' at present and may represent an opportunity.
5. Policy and regulatory reforms have broken the near-monopoly of life companies in the DC market for accumulation and decumulation, facilitating the entrance and growth of powerful competitors in the master trust market.
6. Direct-to-customer (D2C) will be the main distribution channel in the auto-enrolment market for smaller employers. Larger employers may consider a switch to D2C in future, once the market has stabilised, in order to save costs.
7. Auto-enrolment schemes, in particular, are failing to meet employers' requirements: following the introduction of 'freedom and choice' and age discrimination legislation, the DC pension system no longer works as a corporate retirement-management tool.
8. Auto-enrolment is failing half of previously unpensioned private-sector employees, as 50% are not eligible for auto-enrolment, due to the terms of their contracts of employment.
9. While pension reforms are essential – for example in the markets for legacy pension policies, annuities and drawdown products – the fragmented approach adopted by the Government and FCA has led to confusing overlaps and inconsistencies and does not represent a coherent long-term policy strategy.
10. Understanding the tough lessons experienced by relevant overseas DC markets is crucial for predicting the success of the UK's auto-enrolment system for decumulation. Of particular note is the global trend towards greater security of income in retirement, which the UK has rejected in favour of 'freedom and choice'.

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4 Based on data from Spence Johnson. See http://www.spencejohnson.com/deeper-perspectives

5 The first use of key definitions used in the report are highlighted in bold type and are explained in the 'A-Z of key definitions'.

Findings in the back book (legacy policy) market

1. The report predicts a surge in sales of legacy back books, as life companies struggle with reducing member charges and increasing capital requirements under Solvency II, which comes into force in January 2016. The introduction of an ISA-type tax model for pensions could lead to the closure of many open books of pension business, including those in the auto-enrolment market.
2. Life companies with back books already struggle to deal with an unprecedented level of Government scrutiny, regulatory reviews, and consultation processes. This pressure may intensify if consumer groups argue persuasively that not enough is being done to address the estimated £30-50bn AUM, out of total AUM worth £420bn, held in individual (retail) policies which, relative to modern products, have high charges and restrictive terms and conditions.
3. Value for money for small legacy pots is undermined by fixed annual administration costs. Up to 50% of policies may be worth less than £10,000 and up to 20% may be worth less than £1,000.
4. The definition of 'back book' is out of date. In 2015, it should include private-sector closed DB schemes and bulk purchase annuities. The aggregate AUM of DB scheme 'back books' is almost three times the value of the legacy DC pension and long-term savings back book market, at about £1.2trn vs. £420bn, respectively.
5. More recent DC back books will come to market over the next five years. Retail annuity books will also be sold, creating the potential for commoditised funds in an alternative asset class. Equity release is likely to be a 'back book of the future'.
6. The market suffers from a skill shortage. The heyday of the with-profits policy – broadly mid-1970s to mid-2000s – is long over, although a few life companies still sell products based on this type of fund and, in some cases, have significant AUM. Despite these modern with-profits investment bonds and plans, the evidence of the report indicates that the market holds little or no attraction for younger actuaries, resulting in a skill shortage for life companies that manage back books.[6]

6 Data sources. These are provided in the footnotes throughout. In addition we drew on research from Magnus Spence, which provides an excellent source of regular data on the DC market. See, for example, Deeper Perspectives, Jan. 2015. http://www.spencejohnson.com/deeper-perspectives. We also used data from Autonomous, May 2015. Insurance Roadmap: UK Life – Still Life in the Old Dog Yet; Towers Watson, 2011. With-profits: adapting to a changing environment. http://www.towerswatson.com/en-GB/Insights/IC-Types/Ad-hoc-Point-of-View/2011/Insights-With-profits-adapting-to-a-changing-environment; and FSCP, 2007. Are customers in closed with profits funds being treated fairly? http://www.pensions-institute.org/closedlifefunds.pdf.

Recommendations – A cross-industry debate on the future of the life company

All the evidence of this report points to an urgent need to reconsider the design of the life company business model, so that the sector can continue to play a central role in the private pensions market. Therefore, we offer a single overarching recommendation, which is as follows:

> *The Pensions Institute calls for an urgent cross-industry debate on the future of the life company, and its business model in relation to the changing needs of the private-sector pensions market. We recommend that the debate has full cross-party support at policy level and has full regulatory support across the FCA, the PRA and TPR.*

1. **Participants in the life company sector need to address the following set of questions in relation to developing new business lines**

1.1 In the light of the potential for significant consolidation in the life company market between 2016 and 2020, should the FCA, Prudential Regulation Authority (PRA) and The Pensions Regulator then (TPR) develop, agree and publish a clear regulatory position with the Government on how this will be supervised?

1.2 What are the alternative sustainable lines of business for mid-tier life companies that cannot make a profit out of auto-enrolment? Examples include annuities (retail), bulk-purchase annuities (BPAs), equity release, 'schemes' for employees ineligible for auto-enrolment, simplified or robo-advice third-party services, and workplace group protection insurance.

1.3 What would be the best solution for the regulation of all forms of consumer and employer advice and guidance, which would meet the needs of both DC savers and advice/guidance service providers, and which would also eliminate barriers to innovation?

1.4 Could the life company sector play a role in encouraging the implementation of protection insurance in the workplace? One option might be to suggest employers bolt on the cost of group life assurance to auto-enrolment contributions, with a provision for employees to opt out. However, we are not optimistic about employers' interest, if they are not already committed to group protection insurance. Like pensions, under the old voluntary system, protection insurance needs to be sold; it is not willingly bought. Therefore, while we acknowledge that there are currently low levels of provision for both supply and demand reasons – with the exception of employees with substantial DB benefits (active members or deferred) – we believe that only a policy change could make a significant difference if protection assurance was believed to be socially desirable.

1.5 What are the opportunities for life companies in the market for non-pension workplace-based savings schemes that give employers the control they need over the retirement management of key staff? What structure might these schemes adopt, for example, in relation to trust law and the use of a life company wrapper?

1.6 What, if anything, could the industry do to persuade the Government to change its piecemeal approach to pension reform to one that is coherent, integrated and reflects a long-term cross-party policy consensus? Only in this way will trust in the pension system – which has been lost due to conflicted and inconsistent policy interventions, as well as due to life company mis-selling scandals – be restored.

2. Participants in the life company sector need to address the following set of questions in relation to the management of existing and new types of back books

2.1 The review of legacy workplace pension scheme charges, terms and conditions does not apply to books of retail policies. This is inconsistent in relation to treating customers fairly (TCF). Are there any plausible arguments – from a TCF, rather than life-company perspective – against a similar review of retail policies? Could life companies undertake a convincing but voluntary review of retail policies and agree reforms with the Government and the FCA on a voluntary basis?

2.2 Should the Government and regulators consider introducing a 'de minimis' return of fund for small legacy policies? If so, how would value for money be quantified to avoid the de minimis being applied to policies that are expected to result in a good outcome at maturity? Should the de minimis include a facility to return policy values to customers without requiring their permission, where they do not respond to an initial communication?

2.3 What is the evidence that consolidators could achieve improved economies of scale and a more efficient deployment of skills by managing both retail and institutional (BPA) back books?

2.4 What is the best way for the actuarial profession and the Financial Reporting Council (FRC) to address the with-profits skill shortage?

Findings

Overview

1. Traditional life companies are at a cross-road. Life companies are experts in identifying, analysing, quantifying, and managing risks. The decisions they make between 2016 and 2020 will determine the future of individual companies and also the business model as a whole in relation to the UK's private sector pensions market.
2. A clear understanding of the needs of the rapidly-changing market will enable life companies to determine the most sustainable business lines for the future.
3. Without this understanding of the market, life companies may be forced to withdraw from important lines of business, such as auto-enrolment, before they have developed more sustainable alternatives. Doing nothing is an action in itself and will make life companies vulnerable to a takeover, potentially on unfavourable terms.
4. The main risk facing life companies, and which is impossible to hedge, is unexpected changes in policy. The lack of consultation on the 2014 March Budget announcement to change the pension system from April 2015 is just one example where the Government has destabilised the market.
5. Life companies represent a very powerful force in the UK economy, as a major component of the UK insurance and long-term savings industry, which is the largest in the EU and third largest in the world.[7] As such, life companies are in a strong position to shape the future of the defined contribution (DC) pensions market going forwards.
6. This will not be easy, however, given the increasing fragmentation of the 'voice' of life companies. Over the past two years, it has become evident that major life companies and asset managers in the DC market prefer to engage on a one-to-one basis with the Government and the regulators, rather than as an industry, via trade bodies such as the Association of British Insurers (ABI) and the Investment Association (IA). Life companies, therefore, need to consider how best to develop their autonomy without losing a shared commitment to managing change.

7 UK insurers, in aggregate, hold £1.9trn AUM in invested assets and in 2012 contributed almost £30bn to the gross domestic product (GDP), which equates to more than 20% of the total gross value added for the financial services industry. There are about 9m individual customers with a long-term savings and/or protection product. Source: ABI key facts 2015. https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Statistics/Key%20Facts%202015.pdf

The changing shape of the DC pensions market; impact on life companies

1. **Between 2016 and 2020, DC workplace pension scheme assets under management (AUM) are expected to double from about £280bn[8] to £550bn, but, by 2020, about 90% of these assets will be 'owned' by a 'premier league' of between five and seven major providers.**

   Predictions for the auto-enrolment market in 2020:

   - £550bn AUM in aggregate – double the current figure
   - About 90% of these assets (almost £500bn) will be 'owned' by a 'premier league' of between five and seven major providers – halving the current number of major providers in the market of about 14.[9]
     - The premier league will be dominated by large-scale multi-trust DC schemes.
     - The 'relegated' providers will include 'mid-tier' life and pensions companies and smaller master trusts that do not have the scale and deep pockets to succeed in a market characterised by scale and a cut-throat pricing war. Assets held by relegated providers may be bought by the successful life companies in the auto-enrolment market and by the consolidators – a life-company category that is expected to grow in terms of AUM and the number of participants.
   - Several major UK life companies – including those with overseas parents – are expected to sell-up and exit, unless they secure premier-league status. Exits will be due to the increasing cost of regulatory compliance, including capital requirements, and the potential growth of overseas markets, for example, in Europe, the US and the Asia-Pacific region.

2. **Massive consolidation in the auto-enrolment scheme provider market is inevitable and needs to be well-managed by the industry and the regulators in order to avoid market instability. The consolidation trend will intensify as further reforms – such as those from the legacy policy review – come into force.**

   Consolidation triggers will include:

   - Increased capital requirements under Solvency II (from January 2016). Once the impact of Solvency II is better understood, several interviewees said they expected 'a feeding frenzy' in life company M&A activity.
   - Annual stress-testing under the Financial Stability Board's (FSB's) requirements.[10] This is expected to affect the largest life companies, based on the size of their global business. If caught by the rules, a life company might be required to increase capital reserving further. This, in turn, is likely to prompt a more risk-averse approach to the company's business model, with greater emphasis on business lines that are less capital-intensive.

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8 Based on data from Spence Johnson. See http://www.spencejohnson.com/deeper-perspectives

9 The largest GPP providers include Aviva, Aegon, Fidelity, L&G, Prudential, Scottish Life, Scottish Widows and Standard Life. Source: Employee Benefits Oct. 2015. For a list of ABI members that provide qualifying auto-enrolment schemes, see https://www.abi.org.uk/Insurance-and-savings/Products/Pensions/Saving-into-a-pension/Automatic-enrolment/Providers

10 See, for example, FT March 17 2015. http://www.ft.com/cms/s/0/1940e7dc-ccd4-11e4-b252-00144feab7de.html?ftcamp=crm/email/_2015___03___20150317__/emailalerts/Keyword_alert/product&siteedition=uk#axzz3UiiZq295

- Reduced sales of annuities: by 2020, we expect sales of annuities to stabilise at about 50% of pre-2014 levels, i.e., c. £6bn p.a.
- The ban, in April 2016, of the consultancy charge, which many corporate advisers used as a way around the sales commission ban that came into force in January 2013 under the Retail Distribution Review (RDR). For a swathe of employers, this will be the first time that they have been asked to pay a fee for advice, as intermediaries seek to replace the consultancy charge with a direct employer-borne charge.
  - The total ban might be softened, so that the consultancy charge might continue where it is demonstrated that this adds direct value for members, for example, where a member actively seeks advice. This could be a dangerous loophole, however, because the success of auto-enrolment is predicated on member inertia. It is not yet clear how providers and intermediaries might justify the consultancy charge with reference to demonstrable member engagement. Nor is it clear what the distinction would be between a fee for advice deducted from the member's fund or contributions, and a consultancy charge.
- The prospect of the increased use of pension charge caps, including:
  - A further reduction in the cap for auto-enrolment default funds, currently 0.75%.
  - The inclusion of transaction costs in the auto-enrolment default fund charge cap.
  - A cap on exit charges for older pension policies, which would reduce profits from this source and also reduce the potential to cross-subsidise new business costs from back books.
  - A cap on drawdown and hybrid annuity/drawdown annual charges.
- Over-capacity in terms of the number of providers chasing the same business.
- Auto-enrolment new business costs. Many life companies do not expect their auto-enrolment scheme(s) to break even for a minimum of another two-to-three years.
- The cost of modern technology, including building and maintaining new platforms[11] and building new advice/guidance models.
- Consolidation is also a major trend in the advice and platform market. Buyers include life companies and also firms of advisers taking over other advisers.
- Life company and adviser ownership of platforms is a high-risk business, due to excess capacity. The UK life and pensions market has about 30 platforms, whereas Australia and the US both have about 10.[12]

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11 Platforms use technology to enable pensions and investment providers, advisers, and their clients, to manage their assets efficiently. Features vary but can include open-architecture with access to a wide range of funds, consolidated valuations, fee collection, fund blending, automatic re-balancing, same-day fund switching (minimising out-of-market exposure), and transition management for customers joining and leaving. See, for example, http://mobiuslife.co.uk/solutions/fund-platform/

12 Coredata, Sept. 2015. Coredata Investment Platform Study 2015. http://www.coredataresearch.co.uk/research/investment-platform-study-2015/

3. **Further market disruption and confusion would follow if, in the March 2016 Budget, the Government announces its intention to introduce an ISA-type tax model for pensions.**

   - This could bring into question the continued purpose of life company tax wrappers for contract-based pension schemes and products. Pension-ISA taxation would also undermine the purpose of auto-enrolment for lower earners – the very category of private sector workers it was meant to benefit. This, combined with the understandable fear that a future government might decide to tax withdrawals, contrary to the ISA tax principle, could eliminate the last vestiges of trust in long-term government pension policy.
   - HMT's July 2015 consultation[13] set out three options for tax reform: no change, a single flat-rate of tax relief, and a switch from tax relief upfront to tax relief on withdrawal. The last option is the most controversial, as it converts the system of tax relief from front-ended to back-ended, which is how individual savings account (ISAs) are taxed, and which is why this potential reform is known as the 'pension ISA'.[14]
   - DC savers with small private pensions, who do not pay tax in retirement, would be worse off under this system. This raises questions about the benefits of auto-enrolment for lower earners – whether the employer contribution, based on a very small band of earnings, is worth the risk.
   - Entry level for providers offering a Pension-ISA are likely to be lower than is the case for FCA-regulated life companies that offer contract-based DC pension products. The Government should consider influx of poorly-capitalised providers of master-trust pension schemes - many of which we expect to close down - as a warning of one of the unintended consequences of the Pension-ISA.
   - The position of lower earners is also under review in relation to the single-tier state pension under new rules that come into force in April 2016. As with many reforms, there will be winners and losers.[15]

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13 HMT, July 2015. Strengthening the incentive to save: A consultation on pensions tax relief. https://www.gov.uk/government/consultations/strengthening-the-incentive-to-save-a-consultation-on-pensions-tax-relief

14 The current pension tax system is known as EET – exempt contributions, growth of the fund is exempt, and taxed withdrawals (with the exception of the 25% tax-free lump sum). The ISA system is TEE, which means that contributions are paid out of taxed earnings, fund growth is exempt, and withdrawals are exempt or tax-free.

15 http://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/state-pension-launch-15-16/

4. **For weaker 'mid-tier' life companies, the traditional 'bundled' business model and distribution via commission-based intermediaries is anachronistic: the days of making money from being a 'jack-of-all-trades and master of none' are over. It is not clear where the strengths of these life companies lie.**

    - Under the bundled model,[16] a life company owns and manages all of the component parts of a pension scheme or plan, including the product design, the technology that acts as a client/adviser interface, the asset management (investment strategy and investment management), and the administration. Asset management is now seen as the most important feature of auto-enrolment.
    - Mid-tier life companies are sinking under the weight of new business costs for auto-enrolment and, in several cases, the prospect of a significant reduction in profits from back books. They cannot compete with major providers that can demonstrate excellence in asset management.
    - 'Mid-tier' also denotes providers that have relied on paying sales commission and, more recently, the consultancy charge to corporate advisers, in order to secure distribution. From April 2016, all forms of sales commission may be banned, although, in October 2015, the Government indicated it might permit consultancy charging to continue in certain cases.
    - Major life companies have repositioned themselves in the market as asset managers. The exit from the ABI of L&G in particular – one of the biggest life companies in the auto-enrolment market – is symptomatic of this trend.[17] However, it is also symptomatic of a wider trend for major asset managers to 'go it alone' in terms of lobbying, with several of the largest managers expected to leave the IA, including Aberdeen, Fidelity Worldwide Investment, Invesco Perpetual, M&G, and Schroders.
    - The business model of asset-manager-providers is based on the assumption that this skill will enable them to increase auto-enrolment market share for accumulation, and, importantly, for decumulation – a market worth about £13bn p.a., in which income drawdown (i.e., investment) products are expected to take an equal share of what was formerly a compulsory purchase annuity (i.e., insurance) market.[18]
    - Mid-tier life companies should be aware that they need to demonstrate to their shareholders that they have a clear and achievable strategy for the future of the business. Analysts are questioning the business prognosis of these companies – will these companies survive and if so for how long and in what form?

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16 Note: Bundled refers primarily to pensions asset management and administration. 'Composite insurer' is quite different, as this denotes a company that has business lines in the life and pensions market, and also in the insurance market, for example protection insurance.

17 L&G left the ABI at the end of 2014, citing changes in its business model as the rationale. Reasons given included the transfer of the ABI's investment business to the Investment Association. Importantly, L&G said: 'the business of Legal & General has significantly evolved and in 2014 our business is now as much investment management as insurance.' Moreover, L&G said that it preferred to lobby the Government and regulators on a unilateral basis rather than via a trade organisation whose membership is very diverse and which includes L&G's competitors. See http://www.legalandgeneralgroup.com/media-centre/press-releases/2014/lg-to-withdraw-from-membership-of-the-association-of-british-insurers.html. In September 2015, Aegon followed L&G's lead and cited similar reasons.

18 ABI data published on 3 November 2015 showed that £4.7bn had been withdrawn under the new pension freedoms since April. https://www.abi.org.uk/News/News-releases/2015/11/Pension-Stats-six-months-on

5. **Policy and regulatory reforms have broken the near-monopoly of life companies in the DC market for accumulation and decumulation, facilitating the entrance and growth of powerful competitors in the master trust market.**

   Competitors include:

   - **Providers of master trusts for accumulation**, which are regulated by TPR, rather than the FCA. Several of the most successful master trusts do not conform to, or even remotely resemble, the traditional life company. The three best-known providers in this category are NEST, NOW: Pensions and The People's Pension.

     According to the research organisation Spence Johnson,[19] master trusts have about one-third of the auto-enrolment market – a figure that is expected to increase as smaller employers (with fewer than 30 employees) reach their staging dates over the next two years. NEST accounts for about 40% of employer memberships. Much of this business is low-value, however, with monthly member contributions averaging at about £35-40. Contribution rates will increase once the full 8% (employer, plus employee, plus tax relief) is required from October 2018.[20]

   - **Providers of master trusts for decumulation schemes** will present a powerful challenge to life companies that offer contract-based drawdown in the workplace and retail markets. NEST has established the blueprint for low-cost simple drawdown schemes that offer a later life longevity hedge.

     From 2017, we expect NEST to operate as an aggregator for employers that do not want to offer their own schemes – and also for the self-employed and employees who are not eligible for auto-enrolment under their contracts of employment. This second category is important, because the traditional distinctions between 'retail' and 'workplace' should no longer apply at the point of decumulation. We expect national scheme decumulation models to be launched by B&CE's The People's Pension and by schemes designed by major consultants in conjunction with major asset managers. The latter represent a powerful partnership model and a very serious challenge to traditional bundled life companies, combining strong employer relationships (via consultants) with innovative investment strategies (via asset managers). However, there are concerns about the conflicts of interest that arise where an independent consultant is also a provider of pension schemes in its own right.

   - **Asset managers**, which are regulated by the FCA, and which play a vital role in the provision of third-party investment services to providers of DC products and also to DB schemes. These companies can offer drawdown products in their own right. If the tax system for pensions changes to that of the ISA savings system, asset managers will no longer need life company wrappers for the accumulation and decumulation markets.

   - **Advisers and asset managers**, which offer their own SIPP. About 50% of this market is held by non-life company providers.

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19 See http://www.spencejohnson.com/deeper-perspectives

20 See http://www.thepensionsregulator.gov.uk/employers/contributions-funding-tax.aspx

- **DC and DB legacy-book consolidators** are usually defined as: life companies that have acquired by default (replacement of older products, acquisition of life companies with back books, for example), and by business model (where the primary purpose of the life company is to buy back books and to manage these as the main or only source of profit).

  This market also includes the BPA buy-out providers, which we class as consolidators and which we expect to grow AUM significantly, as sponsoring employers to closed DB schemes offload their liabilities to insurers. BPA providers are also interested in retail back books. To date, this interest has been confined to the back books of annuities. In future, we expect it to extend to retail books of mature with-profits policies. These policies are part-investment, but also part-insurance, particularly the with-profits policies that include guarantees of locked-in annual investment returns during accumulation and, at decumulation, offer a guaranteed annuity rate (GAR).

6. **Direct-to-customer (D2C) will be the main distribution channel in the auto-enrolment market for smaller employers. Medium and larger employers may consider a switch to D2C in future, once the market have stabilised, in order to save costs.**

   - Developments in the rapidly-changing private-sector pensions market have triggered a revival in direct sales, under an updated model known as direct-to-customer (D2C).
   - More than 1m employers, with fewer than 50 employees, are required to implement auto-enrolment by 2018. Some of these will have only one or two eligible workers. In aggregate, we expect at least 50% of these employers – about 500,000 – to select a scheme directly with providers. The decision to do so will be dictated by several factors, including employer preference, but also adviser/provider interest. The latter will want to know if the business will be profitable and this will depend largely on the profile of the employees in relation to earnings and length of service.
   - Employers looking for a D2C option should not assume that implementation is free, as some of the traditional life companies make an implementation charge.
   - As the major providers improve their D2C services, employer confidence will grow and the use of D2C will become more widespread, cutting out consultants and corporate advisers.

     To support D2C, advisers and providers are developing a range of cheaper advice models. These tend to focus solely or mainly on the client's pension requirements. At present the terminology – 'focused', 'simplified', and 'robo' advice, for example – is confusing and requires regulatory clarity.

   - Our research indicates that the success of low-cost advice models is predicated on the ease with which providers obtain clients. New business costs would be reduced considerably where the advice is offered on a D2C basis to members of a pension scheme that wish to draw on their DC pots. The same efficiencies could apply where a provider offers this type of service to its retail pensions customers.

7. **Auto-enrolment is failing to meet employers' requirements: under 'freedom and choice' and age-discrimination rules, the DC pension system no longer works as a corporate retirement-management tool.**

   - Employers are very concerned about the freedom workers now have to choose their retirement date and to draw on their DC pots from age 55. Employers fear that a log-jam of older workers – those who want to retire but cannot afford to do so, because they have already drawn on their DC pots – will stall company recruitment and retention of younger talent.
   - Larger employers are likely to introduce an additional workplace savings scheme for valued employees, in which the minimum age for access will be determined by the employer in relation to its recruitment and retirement strategy.
   - It is important to remember that under the voluntary system many employers with good-quality DC schemes and generous employer contribution rates did not necessarily encourage all employees to join. Instead, they targeted employees they considered of particular value and also employees who would be likely to stay with the company for a long time.

8. **Auto-enrolment is failing previously unpensioned private-sector employees, as 50% are not eligible for auto-enrolment due to the terms of their contracts or lack of employment.**

   - While opt-out rates for auto-enrolment have been lower than expected – at between 8% and 15%, as opposed to the predicted 28%[21] – this success masks a much broader concern, namely the huge number of employees who are ineligible for auto-enrolment. As at the end of October 2015, 5.5m eligible employees had been auto-enrolled and another 5.3m were classed as ineligible.[22]
   - Employees classed as 'ineligible workers' occupy a liminal territory between the employed and the self-employed. They might work for an employer for up to six years – broadly the average period employees as a whole spend in a specific job – yet they are classed under the auto-enrolment system as though they are self-employed.

21 NAO/DWP, Oct., 2015. Automatic enrolment to workplace pensions. https://www.nao.org.uk/wp-content/uploads/2015/11/Automatic-enrolment-to-workplace-pensions.pdf

22 TPR, Oct. 2015. Automatic enrolment: Declaration of compliance report. http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf

9. **Lack of clear and consistent data on the DC market undermines regulation and independent evaluation of areas of success and failure. It also creates the potential for regulatory arbitrage, for example, where contract-based schemes, which are regulated by the Financial Conduct Authority, can have their form replicated by master-trusts, which come under the lighter-touch entry requirements and ongoing regulation of The Pensions Regulator.**

   Problems arise in the DC market due to:

   - Inconsistencies in product classification, for example, the blurred distinction between early workplace DC schemes, such as group personal pensions (GPPs) and individual ('retail') contract-based personal pensions.
   - The aggregation of legacy pension and long-term savings policies, for example, with-profits pension policies and with-profits endowments.
   - The confusion between legal regimes, that is, between contract-based pensions arrangements and trust-based arrangements.
   - The different rules for entry and ongoing regulation of contract-based schemes under the FCA and for trust-based schemes under TPR, which is considered a 'light-touch' regulator of DC schemes in comparison with the FCA.
   - Double-counting, whereby transfers of pension assets, from one product or workplace scheme provider to another, are classed as new business, thereby distorting aggregate totals.

   Problems arise in the DB market due to:

   - The range of actuarial assumptions used to calculate assets and liabilities, which is due to the accounting rules for different types of valuations.
   - The difficulty in predicting which schemes might be able to afford a BPA buyout and which schemes might end up in the Pension Protection Fund (PPF),[23] which pays compensation to members of underfunded schemes that become insolvent.

23 The DB compensation scheme of last resort, established by the Pensions Act 2004. http://www.pensionprotectionfund.org.uk/Pages/homepage.aspx

10. **Understanding the tough lessons experienced by relevant overseas DC markets is crucial for predicting the success of the UK's auto-enrolment system for decumulation. Of particular note is the global trend towards greater security of income in retirement, while the UK has just started heading in the opposite direction.**

    UK life companies, the Government and the regulators can learn a great deal from overseas DC markets, but must consider carefully the legal and regulatory context to ensure lessons are relevant to the UK. Among other examples, they need to understand:

    - **Australia:** Why freedom and choice has been such a disaster for Australian DC retirees, due to the high number (c. 50%) of DC savers who empty their pots before age 70. Why the new annuity-based decumulation market, instigated by the influential Murray Review,[24] will ensure that most DC savers are protected from longevity risk, at a time when the UK's DC savers are eschewing this protection because they no longer have to buy an annuity.
    - **Chile and Switzerland:** How the government and regulators have built consumer trust in the annuity market through tight control of pricing and rates.
    - **US:** Why asset managers, and not life companies, dominate the US workplace DC scheme (401k) market for accumulation and the retail drawdown (individual retirement account or IRA) market, and why the US Government is likely to promote the greater use of annuities in future – again counter to the UK's policy-driven direction of travel.

11. **The market in third-party asset management services to private-sector DB schemes has a finite future. However, the demand for bulk purchase annuity (BPA) buy-outs will increase. Only composite insurers, whose business model offers both asset management and insurance services, might be able to compensate for the loss of business in the former line by increasing business in the latter.**

    - The demand for asset-management services will shrink significantly over the next 10-15 years, as employers transfer their liabilities from the corporate balance sheet to insurance companies via a BPA buy-out, or, in the case of schemes that are significantly underfunded when an employer becomes insolvent, by a transfer of the scheme into the PPF. Annuity companies invest in a wide range of debt instruments, but tend to have either nothing or very little in equities, hedge funds or direct property. Most BPA providers manage their assets in-house. Moreover, the PPF uses very few life company asset managers and is expected to move its asset management function in-house over time.
    - While there is scope for new entrants to the BPA market, this requires a very different business model from asset management, and also requires significant levels of capital reserves – a requirement that will increase when Solvency II comes into force in January 2016.

24 FSI, Dec. 2014. The Murray Review. http://fsi.gov.au/publications/final-report/. See also the Australian Treasury announcement: http://treasury.gov.au/ConsultationsandReviews/Consultations/2014/FSI-Final-Report. We are grateful for permission to include analysis here from 'the lang cat', an independent research centre. See the lang cat, April 2015. When the levee breaks: What next for the UK retirement savings market? http://langcatfinancial.co.uk/white-paper/when-the-levee-breaks/

The challenges for the back book market

1. **The report predicts a surge in sales of legacy back books, as life companies struggle with reducing member charges and increasing capital requirements under Solvency II, which comes into force in January 2016.**

   The expected increase in sales of back books is due to:

   - **Solvency II**: As noted above, once the impact of the new capital requirements are better understood, we expect this to accelerate the trend towards sales of back books, so that less well-capitalised providers can reduce the inefficiencies in the use of capital. It will also drive the trend towards increased scale and prompt further mergers and acquisitions.
   - **Downward pressure on legacy policy charges**: Life companies are under pressure from the Government and regulators to reduce charges and exit penalties on legacy policies. Life companies will need to determine if previously profitable legacy books have become unprofitable relative to the business as a whole. The sale of unprofitable back books will free up capital to invest in new business development opportunities.
   - **Cost of administration relative to AUM**: For non-consolidators, managing books in run-off is likely to become high-cost relative to shrinking AUM. Where the owner of back books is a quoted life company, shareholders and equity analysts will review the incentives and disincentives to maintain investment in the back book capital at risk, in comparison with the alternative of disposal of the book.[25]
   - **Reputational risk associated with 'tarnished' back books**: We expect certain life companies to sell back books for reasons other than purely financial. Even where a legacy book remains profitable, the increasing regulatory focus on legacy business will draw media attention to the ownership of old brands, some of which had a very poor reputation in the 1980s and 1990s. Life companies will be concerned about the risk of cross-contamination, where an old and tarnished or discredited brand becomes more visibly linked with the modern successful brand.
   - **Division of a mutual society's common fund**: For mutual societies, the opportunity to sell a back book is likely to be triggered by the decision to divide the 'common fund' of with-profits and unit-linked businesses, which is now possible under new regulatory freedoms.[26] The objective for some mutuals will be to ring-fence with-profits policies and then sell the book in order to invest in new unit-linked business development. Mutuals with with-profits policies in run-off, and which do not have a viable future in the unit-linked market, may seek a buyer for the entire business.
   - **The potential replacement of the pension tax model with the ISA-type tax model**: This could render obsolete many of the DC pension schemes and individual plans currently in use, if they are not able to make all the necessary adjustments. This would create overnight a swathe of back books that would need to be managed in isolation from schemes that met the new rules.

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25 See, for example, http://www.towerswatson.com/en-GB/Insights/IC-Types/Ad-hoc-Point-of-View/2011/Insights-With-profits-adapting-to-a-changing-environment. See also Autonomous May 2015. Insurance Roadmap: UK Life – Still Life in the Old Dog Yet. http://www.autonomous.com/

26 FCA, March 2014. Response to CP12/38 – Mutuality and with-profits funds: A way forward. https://www.fca.org.uk/static/documents/policy-statements/ps14-05.pdf

- **A potential review of retail policy back books:** If the Government decides that there is inconsistency between the treatment of consumers in legacy workplace pension schemes, which are under review, and consumers with legacy retail pension policies, which are not, it might launch a review of the latter, possibly after it has explored a voluntary review on the part of back book life companies. This would probably trigger further sales of retail back books, as profit margins are squeezed and administration costs increased.
  - The OFT investigation into competition in workplace DC pension schemes found £30bn in schemes characterised by high charges and restrictive terms and conditions relative to more modern schemes. This figure represents about 25% of the market, as defined by the OFT.
  - We estimate that an equivalent £30bn AUM in legacy retail pension policies are similarly affected. If long-term savings policies are included, such as endowments and single-premium bonds, the figure rises to an estimated £50bn.
  - The retail market is more extensive than the workplace market. For example, with-profit bonds were sold until about 2005. Some of these will have high charges, largely due to the above-average upfront sales commission life companies paid to advisers, worth up to 7.5% on single premium investments.[27] Legacy unit-linked policies, which had largely replaced with-profits business by 2000 in the pensions and endowment markets, are also affected.
  - If the Government and FCA fail to address the problem of charges on retail legacy policies through the reviews already underway, it is likely that consumer bodies will raise a 'super complaint' with the FCA, which can require the regulator to investigate 'any details about market practice, product features and/or pricing in relation to the relevant product'.[28]

2. **Value for money for small legacy pots is undermined by fixed annual administration costs. Up to 50% of policies may be worth less than £10,000 and up to 20% may be worth less than £1,000.**

   - Small pot values are a pressing problem for life companies with pre-2001 back books. We estimate that as many as 50% of these policies are worth less than £10,000 and 20% are worth less than £1,000. The very small pots (less than £1,000) are a result of the poor persistency rates in the market in the 1980s and 1990s, by which we mean that retail or workplace scheme customers paid just a few contributions ('premiums') many years ago, since when low investment returns – often a result of a de-risking strategy for mature books – combined with fixed annual administration costs, have meant that returns do not outstrip administration costs.
   - Life companies argue that if they treat policyholders with smaller pots more favourably – for example, by applying a cross-subsidy of administration costs from policyholders with larger pots – this would be financially disadvantageous and unfair to the latter cohorts.

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27 Cazalet Consulting, 'Polly Put the Kettle On: Pensions Profitability', January 2006. The report stated that 50% of new pension policies [at the time] lapsed within the first four years. Initial commission ranged from 3% to 7.5% at the end of 2005 for single premium policies, while the annual management charge was between 0.75% and 1%. The period over which providers recouped the cost of commission varied from 3.8 to 9.5 years. Commission clawback for early lapses ranged from 2 to 4 years and was 3 years on average.

28 FCA, June 2013. Guidance for designated consumer bodies on making a super-complaint under s234C.

3. **The definition of 'back book' is out of date. In 2015 it should include private-sector closed DB schemes and bulk purchase annuities. The aggregate AUM of DB scheme 'back books' is almost three times the value of the legacy DC pension and long-term savings back book market, at about £1.2trn vs. £420bn respectively.**

   - The original back book market refers mainly to books of pre-2001 with-profits, unitised with-profits, and unit-linked policies, plus with-profits bonds sold pre-2005. The total value of these books is estimated to be about £420bn, although, as mentioned above, some experts put the figure significantly lower at about £330bn, while others put it significantly higher at about £530bn. The stark differences are due to the definition of 'legacy'.
   - Today, it is evident that a back book is not necessarily an old book or a closed book, that there is synergy for providers that manage DC and DB back books, and that more recent books of DC workplace scheme business are expected to come onto the market in the future. Insurers that recognise these trends have the opportunity to use transferable skills and operational efficiencies to combine different types of back book under a single business model.
   - The BPA buy-out/buy-in market has grown by about £50bn since 2007, which represents less than 5% of the remaining DB scheme liabilities.
   - Of the 6,000 schemes in the Pensions Protection Fund (PPF) Index, 13% are open to new members and/or future accrual, 5,000 are in deficit and 1,000 are in surplus on a 'Section 179' (s179) actuarial valuation basis, which represents the cost of buying out liabilities that match PPF compensation levels ('PPF funding level').[29] As at the beginning of November 2015, total assets held by closed private-sector DB schemes were worth about £1.2trn and total liabilities were worth about £1.5trn on an s179 basis.[30] Experts told us that the aggregate cost of BPA buy-outs that would secure full replication of member benefits under existing scheme rules would be closer to £2trn.
   - Employers will either transfer their liabilities to insurers via BPA buy-outs or, if they become insolvent and the scheme is significantly underfunded, the scheme will pass into the PPF.
   - Market analysts have estimated that BPA providers will capture between 25% and 50% of the market in total.[31] The value of these deals in aggregate will depend on whether BPAs reflect the full cost of scheme liabilities, or a reduced cost due to changes in TPR's requirements. If full scheme liabilities are secured, the future BPA market will be worth between £500bn and £1trn.

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29 The PPF provides a monthly update on the aggregate position of all 6,000 schemes here: http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx. PPF-level compensation is lower than the full cost of benefits under individual scheme rules because the PPF does not pay non-statutory indexation and it also caps compensation for members who had yet to reach their scheme's normal retirement age (NRA) at the date the sponsoring employer became insolvent.

30 http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx. The PPF Index data is updated monthly.

31 See, for example, Oliver Wyman, 2014. The future of the UK life industry. http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/insights/financial-services/2014/September/LON-MKT10307-001%20-%20Future%20of%20UK%20Life%20-%20FINAL.pdf

- There are fewer than 10 providers in the BPA market – a market which has undergone considerable change since 2007, when employers started to offload their DB liabilities to insurers, via a series of acquisitions and mergers. At the time of writing the line-up included:
  - Pre-2015 entrants: Aegon, AIG, Aviva, Just Retirement/Partnership (in the process of merging), L&G (which took over Lucida), PIC, Prudential, and Rothesay Life (which took over Paternoster and MetLife, which in turn had already taken over AIG).
  - Recent entrants: Canada Life, Lloyds Banking Group, LV=, and Scottish Widows.
- We do not rule out further changes in market participants:
  - We expect more life companies to enter the market in a bid to recoup profits lost as a result of the fall in retail annuity sales and in response to other policy and regulatory reforms, such as the expected reduction in charges on legacy workplace pension schemes.
  - M&A activity is high in the BPA-provider market and we expect further deals in future. Private owners may seek to sell off their stakes in life companies in this market once the impact of Solvency II is better understood.

4. **More recent DC back books will come to market over the next five years. Retail annuity books will also be sold, creating the potential for commoditised funds in an alternative asset class. Equity release is likely to be a 'back book of the future'.**

   We expect the 'new-wave' of back books to include:

   - **Post-2006 books of with-profits business**: Several providers continue to sell with-profits business, e.g., Prudential, which has £76.7bn AUM in this fund, or have done so until very recently, for example L&G, which closed its £12bn with-profits book in 2015.
   - **Group DC 2001-2012, i.e. pre-auto-enrolment**: These schemes generally will not look competitive relative to the modern large-scale master-trusts and are likely to be replaced when employers re-broke the market.
   - **Auto-enrolment schemes sold between 2012 and 2018**: Over the next five years, we expect several mid-tier life companies to pull out of the auto-enrolment market because they will fail to secure a sufficiently profitable share and will suffer losses due to the cost of new business acquisition and to the loss of the ability to pay corporate advisers a consultancy charge to secure distribution. Apart from the contract-based schemes heavily sold in this market, we estimate that fewer than 10% of the estimated 70 master trust providers will also withdraw for the same reasons. These early auto-enrolment books of open business are likely to be transferred in to more competitive schemes when an employer makes the switch, but we expect some to be put up for sale.
   - **Retail annuity books**: Following the introduction of freedom and choice, which has temporarily decimated the retail annuity market, life companies will need to reconsider their role as annuity providers. Books that come up for sale be of interest to the BPA specialists, as well as the traditional consolidators, such as Phoenix, Swiss Re and Chesnara.

- **Equity release**: We predict new products that offer flexible drawdown facilities will replace older policies, which may be sold as 'back books'. This market will be a 'slow burner', since we expect growth to be gradual in terms of demand and also in terms of life company appetite, since, at the time of writing, it was not clear if it was possible to use these books as assets to back annuity liabilities under Solvency II. Nevertheless the signs are promising, with Q3 2015 figures at a record high, according to the Equity Release Council.[32]

5. **The market suffers from an actuarial skill shortage. The heyday of the with-profits policy – broadly mid-1970s to mid-2000s – is long over, although a minority of life companies continue to offer this investment strategy. The market holds little or no attraction for younger actuaries, resulting in a skill shortage for life companies that manage back books.**

   With-profits technical expertise is concentrated in a shrinking pool of talented actuaries with long experience in the market. Life companies will find it increasingly difficult to replace retirees from this skill pool.

32 http://www.equityreleasecouncil.com/news/equity-release-breaks-new-ground-with-biggest-quarterly-rise/

Recommendations Part 1: Participants in the life company sector need to address the following set of questions in relation to developing new business lines

1. **In the light of the potential for significant consolidation in the life company market between 2016 and 2020, should the FCA, PRA and TPR develop, agree and publish a clear regulatory position with the Government on how this will be supervised?**

   The key concern here is the potential for uncertainty and instability in the life company market, which, in turn, would undermine employer and employee confidence in workplace schemes pre- and post-auto-enrolment.

2. **What are the alternative sustainable lines of business for mid-tier life companies that cannot make a profit out of auto-enrolment? Examples include annuities (retail), bulk purchase annuities (BPAs), equity release, 'schemes' for employees ineligible for auto-enrolment, simplified or robo-advice third-party services, and workplace group protection insurance?**

   Potential business development markets for mid-tier life companies:

   - **Annuity market (retail)**: Lack of innovation in the annuity market (e.g., later life annuities and hybrid drawdown/annuity products) may present opportunities, but growth will be slow and the barriers to success may be insuperable. There has been little innovation in this market, in part due to the uncertainty over what customer buying patterns will emerge.

     However, we predict a backlash in the drawdown mass market by the early-to-mid 2020s, when customers who have used drawdown for smaller pots and have no other significant private source of retirement income, recognise that they cannot tolerate the volatility in investment returns and hence the income that can be taken from drawdown products. It is vital for life companies to maintain a competitive open market in lifetime annuities. They also need to develop deferred annuities, which NEST, for example, has indicated it plans to use as part of its decumulation scheme, otherwise NEST may look to the US annuity market for a third-party provider or counterparty for risk.

     Further opportunities may arise in the retail annuity market if life companies were able to develop commoditised annuity funds which would represent an alternative asset class for financial institutions seeking to diversify overall risk.

     This opportunity could be developed further if the Government introduces a secondary market for the c. 5m individuals with annuities. The consultation will be published in December 2015. To enhance the prospects of this market, life companies or the Government and FCA might develop a 'selling money's worth'[33] measure of value for money for policyholders.

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33 See, for example, http://www.bath.ac.uk/management/research/pdf/tonks-cannon-annuity-markets.pdf and https://ore.exeter.ac.uk/repository/bitstream/handle/10036/52333/rrep563.pdf?sequence=1

- **BPA:** This is the biggest opportunity for life companies, in terms of market size. BPA insurers currently have c. £50bn AUM, which represents less than 5% of the potential market, which has liabilities of £1.5trn[34] (some put the figure as high as £2trn), but assets worth 20% less at £1.2trn. The BPA market is tough and has witnessed a series of exits and takeovers and mergers, since it took off in 2007. Success requires keen pricing, a strong insurance company covenant, and evidence of a long-term commitment to the market.
- **Equity release:** DC customers who do not have a DB pension will turn to equity release to top up their income in later retirement. Flexible plans, that enable customers to make ad-hoc withdrawals, will be well-aligned with the way that DC customers use their pension pots.

  We strongly expect that the equity release market will grow. What is uncertain is the timing. If the build-up is slow, then life companies might need to tie up their capital in the expectation of low profit margins for the next 5-to-10 years.
- **'Schemes' for employees ineligible for auto-enrolment.** The challenge in this market is to create a scheme that mirrors the best features of mass-market schemes for auto-enrolment, where choices are simplified on the assumption that members will not be actively engaged in decision-making. NEST already permits the self-employed to join; life companies might consider offering a similar facility in order to capture a market that otherwise might become part of the non-life company SIPP market. Apart from appealing to potential customers, the simplified approach would have the advantage of reducing costs. Moreover, a simplified scheme could be sold via robo-advice (see below) to employers that wanted to cater for workers who are not auto-enrolled and who, under a master trust, could maintain membership if they continued in a self-employed capacity after the contract of employment expired.

  An investigation into the market for contract workers would be very useful, as little seems to be known about the hiring practices used to appoint these millions of individuals. What is known is that employers tend to avoid hiring contract workers directly, but instead use a recruitment agency for this purpose, in order to distance themselves for tax purposes. An industry-wide 'scheme' for recruitment agency workers, therefore, might be feasible.
- **Workplace group protection insurance for auto-enrolment accumulation and drawdown:** Lack of innovation in the group protection insurance market[35] may also present opportunities, but again growth will be slow. Despite under-provision of life assurance (only 24% of UK households have life assurance according to the ABI) and income protection insurance, for example, these products are notoriously hard to sell, unless employers contribute or pay in full for group protection schemes.

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34 This is a conservative estimate because it is based on the cost of replicating the compensation provided by the PPF, which is lower than the full benefits provided by most schemes.

35 See, for example, KPMG, Sept. 2015. A new world of opportunity: The insurance innovation imperative. https://home.kpmg.com/xx/en/home/insights/2015/09/the-insurance-innovation-imperative.html

3. **What would be the best solution for the regulation of all forms of consumer and employer advice and guidance from the perspective of both users and service providers, and which would eliminate barriers to innovation?**

   Life and pensions providers need to convince the FCA once and for all that the current regulatory system for advice and guidance, and for commission and fees, is absurdly complicated, both from a user and provider perspective. The result is a system that nobody understands, that delays and prevents transfers, and which leaves the door wide open for unscrupulous firms seeking to mislead or defraud DC savers.

   Fee-based advice for DC pots typically starts at about £1,000, irrespective of the pot size. This is worth a year's income for an annuity purchased with a pot of £30,000. Undoubtedly, there is an advice gap, but innovation is being stifled by the regulatory uncertainty over the design and delivery of 'simplified' services, which generally offer guidance or recommendations that are DC-pension specific, and which can be delivered by a web-based system ('robo-advice'), with or without a telephone or web-based helpline. The FCA's innovation hub is thought to contain new models for advice services.[36]

4. **Could the life company sector play a role in encouraging the implementation of protection insurance in the workplace?**

   - If life companies are concerned about private-sector employees' lack of protection insurance, they need to develop evidence-based arguments to support a call for change: for example, arguments to support the case that protection assurance might be appropriate once minimum contributions have been increased to a level that delivers an adequate retirement income of, say, £12-15,000 per annum.
   - A glance back in time will reveal that protection insurance has been a core component of state and private pension systems in the UK since the post-WWII welfare state was established between 1945 and 1949. The system that emerged from the Beveridge report (after William Beveridge's 1942 report, Social Insurance and Allied Services) provided insurance to protect employees from loss of earned income in the event of serious illness, death, and becoming too old to work (retirement). DB schemes emulated this system by providing disability pensions, death-in-service benefits, and pensions. When employers closed their DB schemes, protection insurances were not replaced in the move to DC.
   - To keep employee costs down, there would need to be an appropriate cap on the decreasing term assurance, e.g. £50,000. So, on death, a younger saver's estate would get the larger of the pot size and £50,000. As pot sizes grow, the cost of the decreasing life cover would reduce, so on a scheme basis there would be a cross-subsidy from those with larger pots to younger members and lower earners. An alternative would be for decreasing life cover to be provided on a per-member basis, so the individual premium would decrease over time. However this second approach would add to the cost of administration, whereas, a key factor in the success of auto-enrolment is the ability of employer payroll systems to forward a single monthly premium to their providers, on behalf of all scheme members.

36 See FCA, No. 2015. Regulatory sandbox. http://www.fca.org.uk/news/regulatory-sandbox

5. **What are the opportunities for life companies in the market for non-pension workplace-based savings schemes that give employers the control they need over the retirement management of key staff? What structure might these schemes adopt, for example, in relation to trust law and the use of a life company wrapper?**

    - We expect larger employers in particular to seek to introduce some form of trust-based savings scheme for their most valued employees, over which employers have control, i.e., they would set the minimum age for access.
    - Life companies should be well-placed to develop this type of product, which is likely to be trust-based, but not a pension product.
    - The fact that such trusts would not be as tax-efficient as DC pensions is less important to employers than the ability to retain control over when their employees begin to draw from their pots, especially in the light of Government changes to pension taxation, including the annual allowance for higher earners.[37]

6. **What, if anything, could the industry do to persuade the Government to change its piecemeal approach to pension reform to one that is coherent, integrated and reflects a long-term cross-party policy consensus? Only in this way will trust in the pension system – which has been lost due to conflicted and inconsistent policy interventions, as well as due to life company mis-selling scandals – be restored.**

37 The lifetime allowance (LTA) is a limit on the amount that can be withdrawn from a pension scheme without triggering an extra tax charge. It was introduced in 2006 at a level of £1.5m and increased to £1.8m by 2010. In the 2015-16 tax year the LTA was reduced to £1.25m. It falls to £1m from April 2016.

Recommendations Part 2: Participants in the life company sector need to address the following set of questions in relation to the management of existing and new types of back books

1. **The review of legacy workplace pension scheme charges, terms and conditions does not apply to books of retail policies. This is inconsistent in relation to treating customers fairly (TCF). What are the arguments for and against a similar review of retail policies?**

    - The arguments in favour of this approach appear to be compelling from a TCF perspective. However, there may be a case for a voluntary review by life companies, rather than a prescriptive regulatory thematic review, at least in the first instance.

2. **Should the Government and regulators consider introducing a 'de minimis' return of fund for small legacy policies? If so, how would value for money be quantified to avoid the de minimis being applied to policies that are expected to result in a good outcome at maturity? Should the de minimis include a facility to return policy values to customers without requiring their permission, where they do not respond to an initial communication?**

    - The reference point the Government and regulators might consider is the 'pot-follows-member' de minimis, which is expected to be £10,000. This was due to be phased in from the autumn of 2016, but has now been deferred.[38]
    - If a de minimis for small legacy pots is introduced, it would be essential for the FCA to investigate the smaller policy market and to incorporate appropriate rules to protect customers, for example, where a smaller policy has a good potential outcome if it is continued to maturity, due to the application of a guaranteed annuity rate. Consumer protection would need to be in line with the FCA rules, which permit transfers of policies with a GAR, provided the terms are fair. Another example would be selection on the part of a provider, whereby the life company sends automatic cash payments only to customers with policies that are unprofitable to the business. To the rest, it sends an 'uninformative' information sheet together with a complex application form to deter customers from requesting the de minimis right to cash. Given the endemic problem of legacy customer poor response rates to communication exercises, such a strategy would almost certainly work in the life company's, rather than the customer's, interests. The FCA would also need to ensure providers pay a fair value for policies and not take this opportunity to deduct disproportionate penalties.

38 The DWP predicts there would be 50m dormant pots by 2050 if no action is taken. See DWP Feb 2015: automatic transfers. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/402860/automatic-transfers.pdf. In addition, the Pension Tracing Service is being expanded. https://www.gov.uk/government/news/bigger-and-better-pension-tracing-service-ready-to-help

3. **What is the evidence that consolidators could achieve improved economies of scale and a more efficient deployment of skills by managing both retail and institutional (BPA) back books?**

   - Mono-line insurers in the BPA market may be seen as attractive targets for acquisition by large multi-line life companies and by consolidators.
   - Strongly capitalised BPA insurers may consider the acquisition of mature books of legacy with-profits policies, due to the synergy in the asset management of BPAs and closed books of policies with guarantees. The same synergy is already evident between the BPA and retail annuity-book market – the most recent example being Rothesay Life's acquisition of Zurich's retail annuity book.

4. **What is the best way for the actuarial profession and the FRC to address the with-profits skill shortage?**

   - The first step would be to quantify the problem. This might be achieved by an investigation on the part of the actuarial profession, in association with the Financial Reporting Council and its Actuarial Stakeholder Group, to assess the extent of the skill shortage. This could be followed by a consultation with the industry – i.e., among the actuarial profession and also the users of actuarial services.
   - It would be helpful for the regulators and industry as a whole to understand better the specific actuarial skills that are required to deal with with-profits books of business, and to draw comparisons with other similar lines of work, for example, underwriting BPA business, where this includes deferred as well as retired members. If there were common skills shared between legacy DC and legacy DB books of business, this might suggest a career path for younger actuaries that maximises the use of the transferable skills across the two markets.

A-Z of key definitions used in this report

- **Back books from the original legacy era (pre-2001-05)** cover a wide range of policies, including retirement annuity contracts (RACs – the predecessors of personal pensions), personal pensions, free-standing additional voluntary contributions (FSAVCs – used to top up a workplace pension scheme), Section 32 policies (s32, a type of deferred annuity, established under the relevant section in the Finance Act 1981), executive pension plans (EPPs), older group personal pensions (GPPs) and self-invested personal pensions (SIPPs), non-profit deferred annuities, older drawdown plans, and hybrid products that combine with-profits and unit-linked funds.
- '**Mass market**' definitions vary and by nature tend to be vague. In this report, we use this term to denote average earners, who do not have significant sources of wealth. Their investible ('spare') savings and investments outside of their DC pension are likely to be less than £30,000 at present, unless the individual has received a substantial bequest. In due course we would expect average DC pots to grow from about £15,000 – possibly to about £50,000 in 20 years' time[39] – but this will depend on many variables, including potential policy changes to the taxation of pensions.
- '**Mid-tier**' denotes a range of features that may make life companies struggle in the new DC market, including:
  - Size: Mid-tier life companies generally are medium-sized operations, as opposed to the 'giants', such as L&G and Standard Life, for example.
  - Distribution: Mid-tier life companies historically have relied on sales commission – including the consultancy charge, which was introduced in January 2013 as a way to get around the commission ban under the retail distribution review (RDR) – from the main distribution channel, namely corporate advisers to employers in the workplace scheme market. The Government is expected to ban all member-borne commission charges from April 2016. While some employers may be prepared to pay an advice fee, we expect many others to review their scheme arrangements and to consider going direct to one of the major master-trust auto-enrolment schemes. It is not clear what will happen to schemes that are abandoned by employers when they take this step.
  - Weakness in bundled schemes and products: Mid-tier life companies may provide bundled workplace schemes and retail products, but do not necessarily excel across the board. A key determinant for success in the new DC market is a reputation for excellence in asset management.

39 Estimates of average pot sizes vary. The PPI has estimated that the average DC pension pot might grow from about £14,100 to £56,000 in 20 years' time. See PPI, Nov. 2015. The Future Book: unravelling workplace pensions [2015 Edition]. http://www.pensionspolicyinstitute.org.uk/publications/reports/the-future-book-2015-edition-unravelling-workplace-pensions

- '**Traditional life company**' refers to the 'bundled' or 'vertically-integrated' business model that combines, in-house, all of the component functions necessary to deliver DC pension products. This business model uses affiliated companies within the group to provide a range of services, including the asset management of the default fund, asset management for other funds offered by the scheme via investment platforms, administration, and, in some cases, investment transaction execution services. It also includes distribution, a key function that has undergone profound change. During the 1980s, most life companies transitioned from direct sales (now known as direct-to-customer or D2C), and increasingly relied for distribution on intermediaries which, typically, were remunerated in the form of sales commission (see mid-tier above).[40]

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40 Many 'fee-based' intermediaries in the workplace and retail markets adapted this model, so that their fee was deducted from employer and employee premiums. In effect, this practice was just another form of sales commission, albeit with a known monetary amount that was pre-agreed with the employer or the individual customer.

Summary of key reforms in the DC market

- **2013: The retail distribution review (RDR)**, which banned commission-based sales of investment products via regulated advice, i.e., where the adviser or consultant makes a personal recommendation.[41]
- **2012-2018: The phasing in of auto-enrolment**, which put paid to the notion that employers had to be 'sold' pension schemes. Under auto-enrolment, employers are required by law to 'buy' a scheme (albeit usually paid for in full by members).
- **2013-ongoing: The investigation into legacy policies.** At the time of writing, the results of the FCA investigation (FCA statement on fair treatment of long standing customers in life insurance[42]) were imminent. This began with the Office for Fair Trading report (2013) on the lack of competition in the DC workplace scheme market, continued with the Independent Project Board's report (2014) on charges, and continues with the FCA's current review of the treatment of legacy policyholders and also on the impact of exit charges on the 'freedom and choice' regime, which is under review by the Government.[43]
- **2015: The new pension tax regime for decumulation**, which came into force in April 2015. The early results indicate that DC savers who want to access their pots from age 55, are largely eschewing the lifetime annuity (LTA, an insurance product) in favour of cash and, for larger pots, for drawdown (an investment product). Moreover, instead of passively accepting the LTA of their accumulation pension product provider, DC savers are much more likely to be proactive. This does not make them informed purchasers, which, in turn, provides support for the case for low-cost, simplified advice in the mass market, which is essential if DC savers are to avoid scams and unnecessary tax bills.

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41 Where a 'purchase' is made by a customer, the adviser can still receive commission because there has been no recommended sale, even if the firm's website provides clear guidance and the customer assumes he or she has received 'advice'. This is a good example of the confusion in the current regulation of advice.

42 FCA, March 2014. FCA Thematic Review into the fair treatment of legacy customers. http://www.fca.org.uk/news/fca-statement-fair-treatment-life-insurance. The FCA are looking at: (1) The firm's back book strategy (particularly around cross-subsidisation); (2) Performance of back book products and governance around asset management; (3) Allocation of expenses to the back book; and (4) customer communication. The FCA said that the review will not consider the suitability of historic advice; nor will it require a review of individual policies: *'We are not planning to individually review 30m policies, nor do we intend to look at removing exit fees from those policies providing they were compliant at the time. This is not a review of the sales practices for these legacy customers and we are not looking at applying current standards retrospectively – for example on exit charges.'*

43 See also OFT, Sept. 2013. Defined contribution workplace pension market study. http://webarchive.nationalarchives.gov.uk/20131101164215/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505. Independent Project Board, Dec. 2014. Defined contribution workplace pensions: The audit of charges and benefits in legacy schemes. https://www.fca.org.uk/static/documents/defined-contribution-workplace-pensions-ipb.pdf

- **2015-16: FCA review of the DC retirement income decumulation market,**[44] **plus the House of Commons Work and Pensions Select Committee review,**[45] which examines how the market is working post-April 2015 and which will look at advised and non-advised product sales.
- **2016: The end of member-borne commission charges?** From April 2016, the Government was expected to ban consultancy charging, which was a form of commission payment used from January 2013 that temporarily got around the RDR ban on sales commission. However, in October 2015, it appeared that the Government might be softening its position on the ban: further consultation[46] suggests it might be possible for intermediaries to continue the consultancy charge where it is demonstrated that members value the services.
- **2017: Default fund transaction costs review.** DWP review of whether transaction costs should be included in the annual member charge cap for auto-enrolment default funds.[47]
- **2017: NEST's restrictions lifted.** The annual contribution limit (£4,700 in 2015-16) and the ban on transfers in – will be lifted.[48]
- **2014-16: Investigation into the advice gap**, undertaken by the FCA[49] and also the Treasury.[50] The advice gap relates to the mass market, where it is clear that a typical fee-based advice cost of £1,000 is inappropriate for DC customers with smaller pots. Simplified and 'robo-advice' models are already available. More are under development and many of these are being tested in the FCA 'innovation hub'.[51] Clarity of the regulation is essential if providers and advisers are to invest in these systems and to proceed with confidence.
- **2015-16: FCA review of drawdown charges and transfers.**[52] This may lead to the introduction of product regulation, for example in relation to a range of low-cost, well designed drawdown products suitable for mass-market DC savers.

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44 FCA, March 2015. Review of the retirement income market. https://www.fca.org.uk/news/market-studies/retirement-income-market-study. The FCA's original thematic review of the annuity market was published in Feb. 2014: https://www.fca.org.uk/news/tr14-02-thematic-review-of-annuities

45 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Pensions/ABI%20response%20Department%20Work%20Pensions%20Select%20Committee%20inquiry%20retirement%20advice%20guidance.pdf

46 DWP, Oct. 2015. Better workplace pensions: Banning member-borne commission in occupational pension Schemes. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/470489/banning-member-borne-commission-consultation-oct-2015.pdf

47 The consultation is DWP, 2015. Improving transparency in workplace pensions: Transaction costs disclosure. https://www.gov.uk/government/consultations/improving-transparency-in-workplace-pensions-transaction-costs-disclosure

48 Announced in 2014 by the DWP. https://www.gov.uk/government/news/victory-for-consumers-as-pension-saving-limits-to-be-scrapped

49 FCA, 2014. Advice gap analysis. https://www.fca.org.uk/your-fca/documents/research/advice-gap-analysis-report

50 FCA/HMT, 2015. Financial Advice Market Review. http://www.fca.org.uk/static/documents/famr-cfi.pdf

51 https://innovate.fca.org.uk/

52 FCA, 2015. Pension transfers. http://www.fca.org.uk/firms/financial-services-products/investments/pension-transfers

Further policy and regulatory interventions are in the pipeline, which, if implemented, will continue the restructuring – or dismantling – of the DC pension system. These include:

- 2016: Reform of the pension tax regime.[53] The results of the Government's consultation in the autumn of 2015 will be announced in the March 2016 Budget. A key point for life companies is that a decision to subsume the tax regime for pensions into the tax regime for individual savings accounts (ISAs) – one of three options under consideration – might eliminate the need for life company pension 'wrappers', the provision of which is one of the most significant roles for life companies.
- 2017: Pot follows member. This regime was due to be phased in from the autumn of 2016.[54] It has now been deferred and the Government has not provided a revised timetable.
- 2017: A secondary market for annuities.[55] This is mooted for 2017 and will further undermine the concept of a DC pension as a product that provides a guaranteed income for life. There are about 5m annuity policyholders in the UK.[56]

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53 HMT, July 2015. Strengthening the incentive to save: a consultation on pensions tax. Relief. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/442159/Strengthening_the_incentive_to_save_consultation__print_.pdf

54 https://www.gov.uk/government/news/government-reforms-to-stop-savers-losing-mini-pension-pots

55 HMT, March 2015. Creating a secondary annuity market: call for evidence. https://www.gov.uk/government/consultations/creating-a-secondary-annuity-market-call-for-evidence

56 Source: The Actuary, Nov. 2015.

Summary of key reforms and developments in the DB market

- **2000-01**: Around the turn of the century, a series of developments transformed scheme surpluses into deficits: (1) the equity bear market following the dot.com crash, (2) new mortality tables that recognised increased longevity, and (3) accounting rules that put the deficit on the sponsoring employer's balance sheet for the first time, affecting the company's ability to conduct corporate transactions. (4) As a result of 1-3, employers start to close their DB schemes and replace them with DC schemes.
- **2004**: Pensions Act replaced the Occupational Pensions Regulatory Authority (OPRA) with the Pensions Regulator (TPR); established the Pension Protection Fund (PPF) – eligible DB schemes required to pay annual levies.
- **2007**: Bulk purchase annuity (BPA) market takes off as employers seek to transfer their DB liabilities to life companies via BPA buy-ins and buy-outs.
- **2008-09**: Global financial crisis
- **2009**: Beginning of quantitative easing, which negatively affected interest rates and gilt yields and, therefore, DB fund valuations.
- **2011**: Statutory indexation basis switched from RPI to CPI.
- **2014**: TPR's statutory objectives widened to include minimising any adverse impact on the 'sustainable growth' of an employer.
- **2015**: Fund deficits growing; employer contributions falling. Funding BPAs is made more challenging – a difficulty that is expected to be exacerbated under Solvency II in 2016.
- **2016**: Solvency II will introduce new capital requirements for life companies, which are expected to increase the cost of BPAs.

The UK back book market

Here we set out our analysis of the location of older brands and their books of retail policies and workplace schemes as at the end of October 2015, providing web links for the more complex cases.[57] The back book market is complex, partly because the term refers to different generations of policies, the best-known being pre-2001 books. That year broadly marked the end of multiple policy charges on new business, following the introduction of mono-charging stakeholder pension schemes. We discuss the movement of more recent books of closed and open business later in this report. Moreover, it is important to remember that back books do not only arise from acquisitions – in many cases, a major provider in the new business market will have back books under its own brand. A good example is L&G, which did not close its with-profits book until the end of January 2015.[58]

The opacity and complexity is also due to the fact that the data on older DC sales – especially of contract-based policies – does not readily distinguish between a 'retail' product, such as a personal pension plan (introduced in 1987) and a 'workplace' scheme, such as a group personal pension (GPP). This is because GPPs originally (the 1990s and early 2000s) were little more than a grouping together of individual retail policies.

Apart from the unreliability of data, the market is also characterised by a bewildering fragmentation of brands. This is because life companies have sold off their back books in stages, which means that several consolidators can own books previously run by the same life office – a life office that might still be open to new business. So, for example, Admin Re/ReAssure (owned by Swiss Re) has purchased books from Aegon in the past. Of course, Aegon is still open to new business and is a major provider in the auto-enrolment market.

Some providers make access to their legacy products easy, while others do not mention them directly on their main sites. Examples of the former include the consolidators. Examples of the latter include many life companies that are open to new business, for example Aegon, which owns the Scottish Equitable legacy brand, and Aviva, which owns multiple back book brands, and, from 2015, owns Friends Life, which brought many more with it (see entry below).

Aviva's purchase of Friends in 2015 in a deal valued at c. £5bn illustrates the complexity of corporate structures with multiple brands under the bonnet.[59] It also demonstrates the complexity of book-management in-house. For example, following its acquisition, Friends announced it planned to switch more than 1m pension savers – 58 funds valued at about £24bn – from AXA (previously Friends-owned) to Aviva funds. Many of the investors in these funds will be those who held a policy with AXA, or joined a pension scheme run by AXA, before the group sold its life insurance operations to Friends Life owner Resolution in 2010. AXA will continue to manage c. £11bn held in overseas equity and with-profits funds for Friends Life. Friends had already outsourced most pension assets, £12bn of which was still managed by Schroders at the time of writing, although Aviva has said outsourcing arrangements were subject to review.

57 Sources include IPB (Annex 7: Providers participating in the audit, December 2014), ABI, and ONS.

58 http://www.legalandgeneral.com/existing-customers/with-profits-information/with-profits-fund-closure/

59 A useful source of analysis, used here, is Citywire 5 Aug, 2015. http://citywire.co.uk/money/over-a-million-friends-life-savers-to-switch-from-axa-to-aviva/a831031

List of back books

- **Abbey Life:**[60] Ceased operations 2007. Closed books include:
  - Abbey Life Assurance
  - Hill Samuel Life Assurance
  - Target Life Assurance
- **Admin Re / ReAssure:**[61] Consolidator, owned by Swiss Re. Zurich-based Admin Re is Swiss Re's business unit. Admin's parent company, ReAssure, was previously known as Windsor Life. Admin/ReAssure has bought books from a long list of life companies, most, but not all of which are UK in origin.
  - Back books include: Aegon, Aetna, Alico, Barclays Life, Combined Life, Continental Life, Crown Life, GAN, Gresham, Grosvenor, Guardian Financial Services (latest acquisition – see below), HSBC, Lifetime, New Zealand Life, NM Pensions Tomorrow, Reassure UK, Tyndall Life, UK Life, and Windsor Life.
  - In September 2015, Admin Re announced the acquisition of Guardian Financial Services for £1.6bn. Guardian was also a buyer and consolidator of back books. The acquisition adds 900,000 annuity, life insurance and pension policies in the UK and Ireland, bringing Admin's total policies in the UK to more than 4m.
- **Aegon:**[62] A UK-based life company which is a subsidiary of Aegon N.V., a multi-national life insurance, pension and asset management company headquartered in The Hague, Netherlands.
  - Legacy policies were written under the company's previous brand name, Scottish Equitable.
- **Aviva (including Friends Life):**[63]
  - AXA
  - CGNU Life
  - Commercial Union
  - Colonial Life
  - Equity & Law
  - Friends Life
  - Friends Provident
  - General Accident
  - Hamilton Life
  - London & Manchester
  - National Mutual
  - National Westminster Life
  - Norwich Union

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60 https://www.abbeylife.co.uk/Pages/Home.aspx

61 https://www.reassure.co.uk/customers/pages/welcome.aspx

62 https://www.aegon.co.uk/index.html – but note, we were unable to find a direct reference on the site to older brands.

63 We were unable to find details about back books on the main website, but there are details here: http://www.aviva.com/investor-relations/institutional-investors/regulatory-returns/

- Provident Mutual
  - Royal Scottish Assurance
  - Sun Life
  - Winterthur Life
- **BlackRock Life Limited**
  - BlackRock
- **Canada Life**
- **Chesnara**[64]
  - Countrywide Assured
  - Save & Prosper Insurance
  - Save & Prosper Pensions
  - Direct Line life Assurance
- **Equitable Life Assurance Society**
- **Fidelity Worldwide Investment**
- **HSBC Life (UK) Limited**
- **Legal & General**
- **Mobius Life**
- **NFU Mutual**
- **The Phoenix Group**[65]
  - Phoenix Life Limited
  - Phoenix Life Assurance Limited
  - National Provident Life Limited
- **Prudential**
  - Prudential Assurance Company Limited
- **Reliance Mutual**[66]
  - Criterion Life Assurance
  - Family Assurance/Time Assurance
  - Hearts of Oak Insurance
  - University Life Assurance Society
- **Royal London Group**[67]
  - Co-Operative Insurance Company
  - Scottish Life
  - Royal London Plus
  - Royal London (CIS) Limited

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64 http://www.chesnara.co.uk/about-us/who-we-are.aspx

65 For the Phoenix timeline, which gives the full breakdown of acquisitions see: http://www.phoenixlife.co.uk/about-phoenix-life/history.aspx

66 https://www.reliancemutual.co.uk/about-us/with-profits/

67 http://www.royallondon.com/customers/

- **Scottish Friendly Assurance**
  - Marine & General Assurance
- **Scottish Widows:** Part of the Lloyds Banking Group[68]
  - Halifax Financial Services[69]
  - Clerical Medical Investment Group[70]
- **Standard Life**
- **Sun Life Financial of Canada**
  - Sun Life Assurance Company of Canada (UK) Limited
- **Wesleyan Assurance Society**
- **Zurich Insurance**[71]
  - Zurich
  - Allied Dunbar
  - Eagle Star

68 http://www.scottishwidows.co.uk/about_us/who_we_are/lloyds_banking_group_sites.html

69 http://www.halifax.co.uk/

70 http://www.clericalmedical.co.uk/

71 http://www.zurich.co.uk/life/existingcustomers/manage-my-pension/my-statement/your-funds.htm

Background to the Findings and Recommendations

Section 1: Challenges and opportunities for life companies in the new private-sector pensions market

To understand the reason why the end of 2015 represents a watershed for life companies in the defined contribution (DC) pension market, it is necessary first to consider the series of recent developments and reforms that have combined to break the sector's near-monopoly. Only then is it possible for individual companies to perceive where the future of this sector lies and to make informed decisions that might involve restructuring or merger and acquisition activity.

This section is arranged as follows. After a brief introduction, we begin the analysis with an overview of the most pertinent features of the new DC pensions market – in particular, the auto-enrolment system for private sector employers and employees – and consider the ways in which the life company business model has changed in response both to demand and to policy and regulatory reform. We then turn to the future shape of the annuities market, following the start of the 'freedom and choice' tax regime in April 2015 and the shift away from annuities to cash and drawdown. The advice and guidance market forms a crucial aspect of this analysis, given the complexity and risks associated with retirement income products that do not incorporate a longevity risk hedge. We conclude with an examination of the business models of competitors to traditional life companies in the auto-enrolment and retail markets for DC accumulation and decumulation, and consider how, in the light of this competition, life companies might future-proof their businesses.

1.1 Introduction

Just a few days before the publication of this report, the Chancellor, in his November 2015 Autumn Statement, confirmed that he would postpone his review of the pension tax system until the March 2016 Budget. The announcement was broadly welcomed by providers, consultants, employers, and consumer groups alike, all of which were concerned that further radical change, so soon after the 'freedom and choice' regime was introduced, would disrupt the DC market – already under strain from an overload of reforms and reviews – and undermine confidence and trust in auto-enrolment at a time of peak activity. Auto-enrolment began in 2012 with the largest employers, and will not be fully phased in until 2018. Between January 2016 and March 2018, 1.8m employers will reach their staging (introduction) dates – an average of more than 100,000 per quarter, which is ten times the number during 2012-2015. As traditional life companies and their competitors strive to meet the administration requirements of this massive influx of employers, they must also look to the near future and the changes it might bring.

HMT's July 2015 consultation on pension saving incentives[72] set out three main options for further reform: no change, a single flat-rate of tax relief, and a switch from tax relief upfront to tax relief on withdrawal. The second and third options

72 HMT, July 2015. Strengthening the incentive to save: A consultation on pensions tax relief. https://www.gov.uk/government/consultations/strengthening-the-incentive-to-save-a-consultation-on-pensions-tax-relief

are not mutually exclusive, but while simplification of the level of tax relief has been on the government agenda for many years, the prospect of a fundamental change in the timing of tax relief is new. The proposal is to convert the system of tax relief for pensions from front-ended (on contributions) to back-ended (on withdrawals), which is how individual savings accounts (ISAs) are taxed, and which is why this potential reform is known as the 'pension ISA'. While simplicity, as a principle, generally is to be welcomed, the proposal, if implemented, would have a very negative impact on DC savers who retire with small private pensions and who do not pay tax in retirement. This is at odds with the Government's wider objective for auto-enrolment, which is to help lower earners build up private pensions in order to reduce the burden on means-tested retirement benefits. For these workers, the rationale for saving in a pension scheme or plan would be questionable, given that the trigger for auto-enrolment is earnings of £10,000 per annum.[73]

We might be concerned about the prospect of further change, but we should not be surprised. Arguably, the shift away from pensions as a distinct form of retirement savings, characterised by guaranteed lifelong incomes, was already well established at the turn of the century, by which time life companies and private sector employers alike were increasingly anxious to reduce their exposure to the open-ended liabilities associated with guarantees linked to uncertain longevity.

In the 1990s, life companies questioned the case for selling with-profits policies with guaranteed bonuses and guaranteed annuity rates (GARs) and decided that it was unsustainable. At the time, this was due to unanticipated falls in interest rates and inflation, among other factors. Equitable Life, which collapsed under the weight of its GARs, was just the tip of the iceberg – the problem of large, unhedged liabilities was systemic. Over the course of that decade, life companies first reduced the level of guarantees and then began to abandon the with-profits structure altogether, in favour of unit-linked products, which were pure investment products with no guarantees. Already, the 'life' business was shifting to an investment-based model.

By the time of the equity bear market of 2000-2003, employers had come to the same conclusions about the spiralling unhedged liabilities of their defined benefit (DB) pension schemes. They realised that, by providing these schemes, they ran similar risks to insurance companies, but with a difference. The sponsoring employer of a DB pension scheme was the sole underwriter of guaranteed salary-linked pensions and protection insurances (life assurance, ill-heath, dependants' benefits, etc.). The fact that these costs related to benefits for ex-employees (deferred members), as well as existing staff (active members), confirmed to employers that the business case for DB was anachronistic in the modern labour market, which is characterised by increased job turnover.

73 http://www.thepensionsregulator.gov.uk/automatic-enrolment-earnings-threshold.aspx
Note: once this threshold is reached, contributions apply on earnings from £5,824 to £42,385 in 2015-16.

The equity bear market, combined with new and much less favourable (to employers) longevity assumptions, turned the DB surpluses of the 1980s and 1990s – which employers had used for a range of business purposes[74] – into a deficit, which in many cases was significant relative to the employer's market capitalisation (or enterprise value, in the case of private companies). Under new accounting rules, employers were required to show the funding position of the pension scheme on the corporate balance sheet for the first time. They discovered that a significant DB scheme deficit could stall corporate actions, including merger and acquisition (M&A) activities and raising new investment finance. The result was the widespread closure of DB schemes and their replacement with DC schemes, which in many cases were outsourced to third-party providers – usually life offices. Workplace protection insurances – previously paid for out of the DB fund – were either paid for by employers, under group insurance arrangements, or, increasingly, offered as 'flexible benefits', which were paid for by employees. Some employers dropped protection insurances altogether.

For the traditional life company, the shift from DB to DC was a very attractive business opportunity in a market over which they had a near-monopoly and in which their legal and tax status appeared to confer a sustainably privileged and unassailable position.

And so it did, until the years leading up to 2012 and the introduction of auto-enrolment. At this point, it became apparent that the commission-based sales distribution model, on which mid-tier life companies in particular depended for distribution, would disappear in 2013 under the retail distribution review (RDR), and that auto-enrolment would attract a new breed of large-scale provider. A cut-throat pricing war began in 2012, followed, in 2015, by the 0.75% member charge cap for auto-enrolment default funds – the funds into which more than 90% of members are auto-enrolled.

Life companies now realised that this was a market in which success was predicated on economies of scale and a parent company with a deep pocket that could keep giving for the minimum of five years it would take to recoup new business-development costs and break even. The downwards pressure on charges is expected to continue, as is the focus on default fund investment returns, which vary significantly and therefore can make a big difference to the final pot size at the point of decumulation.[75]

New providers – NEST and NOW: Pensions, for example – had a particular advantage over traditional life companies in that they were unshackled by back books of older (legacy) policies. Legacy workplace DC schemes came under Government scrutiny in 2013 in relation to their complex charges, terms and conditions, which were unfavourable compared with modern auto-enrolment schemes. Life companies with a large back book component discovered that to be at one and the same time a provider of a new transparent auto-enrolment

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74 DB scheme surpluses were used to fund early-retirement programmes and employer pension contribution holidays, for example.

75 According to JLT Benefit Consultants, employees auto-enrolled into the lowest performing funds have been losing out on 6% returns per annum compared with those in the best performing funds. The firm's calculations showed that an employee in their thirties, saving 8% of an annual salary of £30,000 in a lower-performing fund, could end up with about £185,000 at retirement. The same contributions in a higher-performing fund would provide a pot of about £715,000. See https://www.jlt.com/media-centre/news-and-press-releases/2015/november/auto-enrolled-dc-members-could-lose-up-to-6pc-of-annual-return-on-their-pension-investments.

scheme and of back books with opaque and questionable charges, terms and conditions, created tensions between different business lines and could give rise to a fragmented and confusing brand identity. Paradoxically, it seemed, the more a life company embraced modernity, the more open to criticism it became if it failed to treat its legacy pension customers fairly and if it continued to rely on the profits from legacy books to fund new business development.

By 2015, it became evident that the new breed of master-trust provider had broken the historic life-company monopoly in the DC pension accumulation market – a monopoly similarly broken by non-life company providers (advisers and asset managers) in the retail self-invested personal pension (SIPP) market.

Moreover, little more than six months on from the start of the freedom and choice pension regime, it is also evident that the provider-challengers are breaking the life-company monopoly in the DC decumulation market. DC savers, who do not take the whole of their pot in cash, are largely eschewing annuities – hitherto a near-compulsory purchase at retirement for all but the very wealthy DC savers – in favour of 'income drawdown' products, which are available from as many asset managers and advisers as they are from life companies.

Losing one monopoly might seem unfortunate. Losing three in as many years – the DC workplace pension scheme market, the SIPP market, and the market for decumulation products – might seem careless, especially from the point of view of a life company's shareholders.

1.2 The changing shape of the DC accumulation and decumulation markets

The turn of the century broadly marked the end of the era of the insurance-based with-profits fund and also the end of multiple product charges. Since then, the DC accumulation market has been dominated by workplace schemes and retail plans that are investment-only in structure – that is, there is no formal 'smoothing' of investment returns, as there is in with-profits (although some investment strategies do attempt to reduce the volatility of returns), and no guarantees of what the fund may buy in the form of an annuity at retirement.

A similar shift from insurance to investment is now taking place in the decumulation market. Until the March 2014 Budget announcement of the DC decumulation freedom and choice tax regime, most DC savers were required to purchase a lifetime annuity (LTA) at retirement, that is, they would use their accrued investment fund – less the tax-free lump sum – as a premium to buy insurance against longevity risk (in this case, the risk of outliving their DC savings). Only a minority of wealthier DC savers opted for income drawdown, which is a pure investment product. Following the implementation of the new regime in April 2015, the clear demarcation in the mass market between DC accumulation, as pure investment, and DC decumulation, as pure insurance, no longer pertained.

It is too soon to understand fully the impact of the new regime, although tensions are already evident. On the one hand, the success of the auto-enrolment accumulation stage is predicated on the behavioural trait of inertia. On the other hand, the success of the decumulation stage is predicated on the noble but somewhat unrealistic assumption that DC savers are capable of making rational choices when conferred with the freedom to take their retirement savings at whatever time and in whatever form they wish.

So far, DC savers have shown a marked preference for cash and drawdown over annuities, while the age at which DC savers are seeking access to their DC pot has fallen, with about 80% of withdrawals being made by those under the age of 65. In the second and third quarters of 2015, HMRC said that DC savers had withdrawn a total of £2.72bn.[76] Just weeks after this announcement, on 3 November, the ABI said the six-month figure had reached £4.7bn, comprising £2.5bn in cash lump sums and £2.2bn in income drawdown products.[77]

The early months of the new regime have been troubled by a series of issues, such as fraud and the inability of DC savers to access their funds in a timely manner without facing exit charges or advice fees that are large relative to most pot sizes. In October 2015, the House of Commons Work and Pensions Select Committee warned that unless DC savers were put in a position to make an informed choice, freedom and choice 'could lead to the next major pensions mis-selling scandal'.[78] The Committee called on Government to:

- Provide more anti-scam publicity and introduce stricter reporting requirements for pension providers;
- Reduce the use of jargon and complex pricing structures for savers trying to withdraw funds;
- Clarify the distinction between guidance and advice; and
- Clarify the definitions of safeguarded benefits.

Current trends in DC decumulation choices provide little indication of future patterns and preferences. This is not just because of fraud and mis-selling concerns. Over the next decade, many DC savers will reach retirement with a defined benefit (DB) pension from earlier employment. The DB pension may not be sufficient to cover all of a retiree's lifestyle aspirations, but it is likely to provide, together with the state pension, the minimum income required for a basic standard of living.[79] For these retirees, the DC pot could be used in more flexible ways involving greater investment risk than is likely to be the case in future, when the DC scheme will be the only source of supplementary pension income for private-sector workers. This is one very important reason why life companies have been slow to invest in innovation: it is difficult to justify to shareholders the costs associated with the design and launch of new decumulation products when it is impossible to predict future demand.

Where innovation is evident is in the auto-enrolment workplace scheme market, where a small, but significant minority of schemes now offer – or are developing – a 'straight-through' member journey from accumulation to decumulation in the form of ad-hoc cash lump sum withdrawals and regular income. It seems likely that such schemes will be well-placed to deliver good-quality administration, investment strategies and governance at a lower cost than is generally possible in the retail market, mainly due to economies of scale. The most notable example

76 https://www.gov.uk/government/statistics/flexible-payments-from-pensions

77 https://www.abi.org.uk/News/News-releases/2015/11/Pension-Stats-six-months-on

78 http://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/pension-freedom-guidance-and-advice-op-note-15--16/

79 This, of course, presumes that DB members will not cash out their pension, as they are also now entitled to do.

of innovation is NEST, the Government-backed national scheme, which announced plans for its default decumulation strategy in 2015.[80] Importantly, NEST's blueprint looks beyond the demand for drawdown to the need for later-life annuitisation. The Pensions Institute has long argued that for mass-market DC retirees, it is essential to hedge the tail of longevity risk to avoid pensioner poverty in old age. Drawdown – in the absence of paying for guarantees, which can be expensive – cannot guarantee to provide a regular income stream that will last a DC retiree's full lifespan.

As with the auto-enrolment accumulation stage, NEST has now set a clear benchmark for the design of decumulation schemes. Metaphorically speaking, it has thrown down the gauntlet to traditional life companies and asset managers to match or improve its blueprint. Life companies have good reason to be concerned about NEST, which is well-placed to extend membership of its decumulation scheme to firms that are not accumulation members. NEST is also open to the self-employed. Put simply, NEST has the potential to acquire a significant market share in both the workplace and retail decumulation markets.

1.3 The changing role of life companies

1.3.1 What is a life company?

We begin this subsection by asking: What is a life company? This is a surprisingly difficult question, as the purpose and business model of life companies has changed significantly over the years. The original life companies date back at least as far as the 18th Century and emerged as an important source of private welfare provision during the industrial revolution in the 19th Century.[81] Their business model was relatively simple and generally confined to the sale of insurance policies designed to protect dependants against the risk of the family breadwinner's loss of earnings. In exchange for a regular premium, life companies offered 'the insured' a hedge against a range of risks, such as death, disability or long-term illness, and old age (defined at the time as the age at which the insured was no longer able to remain in employment). Insurance policies were and still are legally-binding contracts between the insurer and the insured.

By the mid-C20th, life companies had expanded into the long-term savings market. Early products typically involved a combination of investment and insurance, most notably the with-profits policy, which, for many years, was the backbone of the DC retail and workplace pensions markets. With-profits funds were invested in a range of asset classes and used actuarial techniques to smooth returns and to provide valuable guarantees in the form of annual bonuses (once accrued, these bonuses could not be removed, even if markets fell) and a guaranteed annuity rate (GAR), which, at the retirement date, delivered an annual income expressed as a percentage of the final fund value. So, for example, a 12% GAR, in relation to a fund worth £100,000 at retirement, would provide a guaranteed income for life of £12,000. These guarantees represented the insurance element of the with-profits policy.

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80 NEST (2015).The future of retirement: A retirement income blueprint for NEST's members, June, https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement,pdf.pdf

81 Most life 'companies' were actually set as mutual societies which are not in fact legally incorporated as 'companies' under company law. We will – in line with common parlance – use the term 'life companies' to cover both companies and mutuals.

The following factors are relevant for our analysis:[82]

1. Insurance contracts represent a specific area of insurance law, incorporating concepts such us 'utmost good faith'.
2. Winding up an insurance company is a proscribed process, involving the run-off of liabilities before the remaining assets can be distributed.
3. Insurance companies are highly regulated and insurance accounting is highly specialised. Valuations require calculations of embedded value in order to determine what can be taken as profit for distribution to shareholders, in the case of companies, and to members, in the case of mutuals. In particular, there are specific regulatory requirements in relation to capital adequacy – that is, the reserves a life company must hold in order to back its guarantees to policyholders. In the UK, life companies are regulated for prudential purposes (i.e., to determine the soundness of the business) by the Prudential Regulatory Authority (PRA)[83] and for conduct of business purposes by the Financial Conduct Authority (FCA).
4. The PRA and FCA are also responsible for implementing mandatory European regulations for life companies. For example, there is a so-called European embedded value calculation.
5. Life companies benefit from special tax treatment which is why other financial services firms, such as assets managers, often have an insurance subsidiary. Life companies get special treatment because they enable transference of risk, for which they are paid a premium.
6. Pension investments can be held in contracts of insurance, because the liability requires an uncertain event to crystallise, i.e., the death of the policy holder. This means that pension investments can be structured as an insurance contract (e.g., a unit-linked life policy), rather than as assets in a mutual fund (e.g., a unit trust). This explains why compensation arrangements can be different, depending on whether the assets are held in a life company's unit-linked policy (a long-term insurance contract) or in an asset manager's mutual fund (an investment fund). Self-invested personal pensions (SIPPs) can be set up under both models, but the compensation rules favour the life company model, since this is classed as a long-term insurance business rather than pure asset management.[84]

The main life companies in the DC market are part of a larger group of companies that, at the most general level, includes a holding company, an asset management arm, a general insurance arm, and an administration arm. This enables them to offer a range of 'bundled' products, in which all of the component parts and services are managed in-house, and to sell annuities to DC accumulation customers.

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82 With thanks to Rajiv Jaitly, of Jaitly LLP, for his advice on insurance law.

83 See the PRA's Prudential sourcebook for Insurers (INSPRU), https://fshandbook.info/FS/html/PRA/INSPRU

84 In the event of the provider's insolvency, compensation for long-term life policies is uncapped, whereas for investments it is capped at £50,000. See http://www.fscs.org.uk/what-we-cover/products/pensions/fscs-compensation-for-pensions/. The rules are complicated and are different in the case of mis-selling, for example. The FCA and the Financial Services Compensation Scheme (FSCS) are looking to review the distinction and to consider bringing non-life company SIPPs in line with life company SIPPs.

1.3.2 1987-2012: From personal pensions to auto-enrolment – the heyday of the life company

In the late 1980s, when personal pensions and group personal pensions (GPPs) were introduced, life companies dominated the DC market. At this time, there were more than 100 life offices, building societies and friendly societies selling DC pension products in the corporate and retail markets. By 1990, the trend towards consolidation among life companies was well-established, driven by a combination of the personal pension mis-selling scandal in the late 1980s and early 1990s, and by the cost of with-profits GARs, among other factors, which increased as interest rates fell from a high of 15% in 1990 to virtually zero in 2015.

The late 1990s and early 2000s were busy years for consolidation.[85] This was also the era of demutualisation – when mutual life societies, owned by their members, converted to proprietary listed companies, owned by shareholders – which enabled life companies to tap into new sources of finance. Life companies took this opportunity to change their business model, broadly from one that focused on the accumulation of policies to one focused on selling profitable products with fewer long-term liabilities and, therefore, lower capital requirements. Some of the largest life companies, such as Standard Life, which demutualised in 2006, also shed thousands of jobs to reduce overheads.

The consolidation trend continues today – the merger of Aviva and Friends Life in 2015 being just the latest example. The result is that by 2015, there were only about 20 active providers of workplace and retail DC products. We expect this number to shrink further.

While life companies in aggregate still dominate the workplace DC pensions market, they no longer have the near-monopoly they enjoyed in the past. Life company status is still very valuable, since it enables the financial institution to provide tax and regulatory wrappers for DC funds, but today it is more a matter of convenience than a raison d'être.

1.4 Charge capping, product quality, and the continued price war

Product quality and charges have been very much on the minds of the Government and regulators for some time – and will continue to be so in future, whether the focus is on legacy books of pension business, new books of auto-enrolment business, or annuities and drawdown products. This is understandable, because, while it is impossible to predict future investment returns with any certainly, it is perfectly possible to predict the impact of capping annual charges.

1.4.1 The charge cap for auto-enrolment default funds (2015)

The value of the DC saver's pension pot at the point of decumulation will depend largely on the level of employer and employee contributions paid during accumulation and the investment returns achieved, net of the member's annual

85 In 1998-99 alone, examples included the merger of Commercial Union and General Accident, Friends Provident and London and Manchester, the public auction for National Provident Institution (NPI) which was bought by Australian Mutual Provident (AMP), and the bid by AXA, through Sun Life and Provincial, for Guardian Royal Exchange.

charge. Asset management[86] is an important component of the member charge, as is administration.

Over extended periods, apparently small differences in the annual member charge can make a material difference to the value of the final pot. The Department for Work and Pensions (DWP) has calculated that over a working lifetime, a 1% annual charge could reduce the value of a pension pot by about one-quarter.[87] While DC savers are unlikely to appreciate the impact of this compounding effect, the industry knows full well that a 10 or 20 basis point reduction in the annual charge really does make a difference.

It is reasonable to assume that auto-enrolment schemes in the mass market will be lower cost than earlier workplace schemes. This is partly a function of scale, but it is also because under the voluntary system, providers' new business expenses included a large allocation to the cost of actively selling schemes, first to employers and then to employees, assuming the employer did not operate auto-enrolment on a voluntary basis.[88] Under auto-enrolment, employers are obliged by law to put a qualifying scheme in place and to auto-enrol eligible workers, so there is no costly 'hard sell' to employees involved. Instead, there is a 'hard sell' to employers – competition remains fierce in providers' bids to sign up employers through marketing campaigns and through intermediary (for example, corporate advisers) awareness.

As mentioned above, from April 2015, the annual charge cap for employees auto-enrolled into the default fund, is a total expense ratio (TER) of 0.75% p.a. Regulatory changes that come into force in 2016, together with two potential policy changes, are likely to result in downward pressure on the charge cap, as we now show.

1.4.2 Crackdown on poor quality master trusts (2015-16)

The Pensions Regulator (TPR) has been very concerned about the proliferation of smaller poor-quality and under-resourced master trusts, which could leave members' pension assets at risk if they fail. The Government is supporting TPR in its bid to tighten the security of peoples' pensions. In October, the pensions minister, Baroness Altmann, said that the Government planned to address concerns about the quality and sustainability of master trusts, while in an article in the Financial Times,[89] Lesley Titcomb, chief executive of TPR, said she was particularly worried about the low level of entry requirements for master-trust

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86 See the Financial Services Consumer Panel 2014 report on investment costs: https://www.fs-cp.org.uk/sites/default/files/investment_david_pitt_watson_et_al_final_paper.pdf and https://www.fs-cp.org.uk/sites/default/files/investment_discussion_paper_investment_cost_and_charges.pdf

87 Illustrative calculations by the DWP in November 2013 (Pensions Bill 2013: Information Pack for Peers) show that an individual who saves throughout their working life into a scheme with a 0.5% annual charge could lose around 13% of their pension pot at retirement as a result of charges. A 1% annual charge could reduce that pot by 24%.

88 This was very rare in the private sector ever since the Thatcher government ended mandatory participation in occupational pension schemes in the 1980s. By contrast auto-enrolment has been the norm in public sectors DB schemes, which accounts for the c. 90% take-up rates at a time when private sector employers experienced much lower participation rates – in some cases below 10%.

89 FT, 16 Oct. 2015. http://www.ft.com/cms/s/0/033804d0-7403-11e5-a129-3fcc4f641d98.html?ftcamp=crm/email/_2015___10___20151016__/emailalerts/Keyword_alert/product#axzz3qG5JMxRJ

providers. 'There is no financial requirement on master trusts, on solvency or minimum capital levels', she said, echoing concerns raised previously by the Pensions Institute.[90] At the time of writing, TPR was examining the master-trust workplace pension market as a 'matter of urgency' after highlighting the fact that employees could be auto-enrolled into unsustainable schemes. At present only six master trusts, out of about 70, had achieved TPR's voluntary assurance framework for quality out of more than 50: [91] NEST, NOW: Pensions, SEI Master Trust, The People's Pension, Tower Watson's LifeSight, and Welplan.[92]

1.4.3 The ban on active member discounts (2016)

From April 2016, there is expected to be a ban on active member discounts (AMDs), a charging system that favoured active members over deferred members who were required to pay a higher charge. Depending on the ratio between active and deferred members, the ban could have a significant impact on providers' profits. The two most obvious choices are to take the cut in profits by bringing the deferred member charge in line with that of active members, or to set a charge for all categories of member that represents a compromise between the active and deferred rate.

1.4.4 The expected price war in the re-broking market for auto-enrolment schemes (2016)

Given that auto-enrolment is the Government's flagship pension system for the private sector, it may well decide that a further reduction in the default fund charge cap would be in the best interests of employees. However, the DWP is unlikely to consider taking this step until the phasing in of auto-enrolment is completed in 2018.

Several of the largest master-trust schemes – Legal & General (L&G), NEST, NOW: Pensions, and The People's Pension, for example – have an explicit or effective TER of about 0.5%,[93] which may give them a competitive edge as they gear up for the major re-broking exercise in auto-enrolment schemes that is taking place for the larger employers that reached their staging dates in 2012 and 2013. Employers are required to re-enrol opt-outed employees every three years. If the employer has experienced problems with the administration or with the payroll processing of its selected provider, this might well be a trigger point for checking whether other providers have developed a better reputation for these important features.

Therefore, we expect 2016 to be a busy year for auto-enrolment scheme reviews. The Government and regulators will see this as the natural duty of trustees of trust-based schemes and investment governance committees (IGCs) of contract-

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90 See Pensions Institute: Jan. 2014, Value for money, http://www.pensions-institute.org/reports/ValueForMoney.pdf; and Oct. 2012, Caveat venditor, http://www.pensions-institute.org/reports/CaveatVenditor.pdf

91 Professional Pensions provided the full list of master trusts as at August 2015: http://www.professionalpensions.com/professional-pensions/news/2352950/pension-master-trusts-the-definitive-list-of-providers

92 http://www.thepensionsregulator.gov.uk/trustees/master-trust-assurance.aspx#s19297

93 We say 'effective' because while most schemes have a single charge, some schemes – for example NEST and NOW: Pensions – have a dual charge. In addition to the annual management charge, NEST has a contribution charge and NOW has an administration charge.

based schemes, which are required to ensure that their schemes continue to represent value for money for members. No doubt employers, trustees and IGCs will be encouraged in this exercise by consultants, corporate advisers and, of course, providers, all of which will be eager to pick up the big-ticket business they missed first time around.

The three-year anniversary of the auto-enrolment staging of larger employers also coincides with the FCA's final ban on consultancy charging, which firms used as a way of getting around the RDR ban on sales commission introduced in January 2013.[94] In its consultation in 2015,[95] the DWP explained that consultancy charging 'was introduced following the Retail Distribution Review (RDR) and consists of a fee being agreed between an adviser and employer and then recouped through a member-borne charge' – i.e., it was commission in a barely disguised new form.

At the time of writing, it seemed that the DWP was minded to soften the impact of an outright ban, for example, where it can be demonstrated that members received a service, such as advice or guidance that they value. Given that, as mentioned, the whole success of auto-enrolment is predicated on member inertia, we argue that it would be difficult to provide convincing evidence to this effect.

Under the consultation, the 'advice' component of the consultancy charge might also refer to the advice the employer receives from the intermediary.

Many trustee boards for master-trust schemes, and IGCs for contract-based schemes, include provider representatives. This raises questions about whether such governance arrangements can be genuinely independent, for example, whether the board or committee would be willing to reject a provider's position on the consultancy charge.

The issue of member-borne commission charges is not limited to contract-based workplace schemes sold by 'bundled' life companies. In its October consultation, the DWP said:

> *Commission is more likely to occur in bundled pension schemes (where the employer or trustees procure administration and investment services through a single pension provider) than unbundled schemes (where the trustees procure investment management or administration services directly from separate providers). However, there is some evidence to show the presence of commission in unbundled schemes, so we consider that the commission ban should cover bundled and unbundled schemes as well as single and multi-employer schemes such as master trusts.*

The FCA gave firms that had used this form of charging three years to change their remuneration arrangements, implying that they had to switch from a form of commission paid by providers to an explicit fee paid by the employer by April 2016. We do not know how many employers agreed to the consultancy charge adviser-remuneration model in 2012-13, but we understand the practice was widespread, particularly for medium-sized companies.

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94 In other words, consultancy charging was sales commission in a different guise. FCA, March 2015, Final rules for charges in workplace personal pension schemes and feedback on CP14/24, https://www.fca.org.uk/static/fca/documents/policy-statements/ps15-05.pdf

95 DWP, Oct. 2015. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/470489/banning-member-borne-commission-consultation-oct-2015.pdf

As a result, employers may suddenly find themselves faced with a bill for the consultant or provider's implementation costs. This factor may also trigger an employer review of the market – a search for a provider that offers services direct to employers and does not impose an implementation fee. However, from the research, it seems that over the last 12 months, implementation fees have become the norm, leaving NEST as one of the few schemes that do not make this charge.

The major consultants that have launched their own-brand master trusts – for example, Aon, Mercer and Towers Watson – should be well-placed to capture re-brokered business, due to their close relationships with larger and medium-sized employers. However, it could be argued that these firms, as both independent consultants and scheme providers, are conflicted – a point we have raised in previous research.[96]

1.4.5 The inclusion of transaction costs in the DC default fund charge cap? (2017)

At present, the charge cap excludes the transaction costs associated with asset management. 'Transaction costs' are the expenses incurred when the asset manager (which may or may not be the scheme provider) buys and sells securities and include broker commissions and dealing spreads (the difference in the price the dealer and the buyer pays). Typically, such costs are hidden, but are reflected in a lower value of the assets than otherwise would be the case.[97]

The DWP plans to review the exclusion of transaction costs from the charge cap in 2017, but it already requires the trustees of trust-based workplace master trust schemes and the IGCs of contract-based schemes to request details of the default fund transaction costs from their asset managers.[98] At present, there are no regulatory requirements on asset managers to respond, but trustees and IGCs must publish the details of their enquiries in their annual reports, which is likely to put asset managers under pressure to 'come clean'.

We believe that the DWP is minded to formally include transaction costs in the charge cap after its review in 2017. It will be interesting to see whether it will adjust the member charge cap to accommodate the additional costs. If it does not, then, in effect, the member charge will have been reduced, although the extent of the reduction will depend on the default fund investment strategy, as passive index funds incur lower transaction costs than actively-managed funds. One example of the impact of transaction costs on charges is found in the Local Government Pension Scheme (LGPS), where reported asset management fees have increased by about 40%, following the inclusion of these costs.[99]

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96 See Pensions Institute, Jan. 2014, Value for money, http://www.pensions-institute.org/reports/ValueForMoney.pdf

97 For more details on investment costs, see FSCP, 2014, https://www.fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf. See also David Blake (2014). On the disclosure of the costs of investment management, Pensions Institute. http://www.pensions-institute.org/workingpapers/wp1407.pdf

98 The requirement can be found in the DWP October 2014 report, Better workplace pensions, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364567/better-workplace-pensions-putting-savers-interests-first.pdf

99 Reported in a letter to the Financial Times, 5 Nov. 2015. http://www.ft.com/cms/s/0/58ad07ee-8240-11e5-8095-ed1a37d1e096.html?ftcamp=crm/email/_2015___11___20151105__/emailalerts/Keyword_alert/product#axzz3qhb7Ugr6

1.4.6 A charge cap for drawdown?

It is clear from policy statements that the Government is unlikely to restrict its enthusiasm for charge caps to the auto-enrolment accumulation stage, and could extend this form of product regulation to drawdown products – a move that the actuarial profession has welcomed.[100] This will present challenges to providers and advisers in a market that has grown in a fairly disorderly manner following the 2014 Budget. Apart from the nascent market in institutional products, where decumulation options are bolted on to auto-enrolment accumulation schemes, retail products range from comparatively simple DIY drawdown plans, via complicated multi-charging advised retail products, to hybrids that combine drawdown with some form of guarantee.

The 2015 Which? report on drawdown costs showed the impact of high total charges:[101]

> *Which? calculated that someone with a pension pot of £50,000, taking 4 per cent a year through income drawdown, could be more than £3,000 better off over 10 years if they used the cheapest provider, Fidelity (£4,993), rather than the most expensive, The Share Centre (£8,100).*
>
> *The loss was even more dramatic for an investor with a larger fund of £250,000, who would see as much as £10,000 of their fund absorbed by charges depending on where they invested.*

Not surprisingly, providers and advisers have been largely hostile to the prospect of a charge cap for drawdown, but their arguments need to be unpicked carefully to separate self-interest from the more genuine concerns about stifling innovation. It is reasonable to argue that it is premature to introduce a charge cap in a market that is new and where consumer demand is likely to change, as DC decumulators come to depend increasingly on their DC pot for the bulk of their supplementary retirement income, although it is difficult to separate this point from the more self-serving arguments that have been put forward. Providers regard drawdown products as one of the few sources of significant profit in an industry that is already subject to a cap on auto-enrolment accumulation default funds, is subject to downward pressure on legacy policy charges, and in which sales of lifetime annuities have more than halved. For life companies in the auto-enrolment market, an ideal scenario would be to replace the steady flow of roll-over annuity business sold to scheme members with roll-over retail drawdown plans.

There is a particular concern about the widespread use of complex multiple charges for drawdown plans, which can only be analysed and compared using the traditional 'reduction in yield' (RIY) formula – a formula that many customers do not appear (and arguably should not be expected) to understand. These include set-up fees, annual charges, platform fees, TERs, additional costs for certain types of funds, and charges for each withdrawal. In one example that we were shown, the 'wrapper' costs (an annual flat-rate fee for the use of the provider's SIPP), the TER applied as a percentage on funds, the hidden costs on sub-funds in multi-asset funds, plus the adviser's annual fee/commission, resulted in a total RIY of 4%. We believe that this is an extreme case, but we cannot be sure.

100 http://www.theactuary.com/news/2015/06/government-urged-to-cap-drawdown-charges/

101 FT, 21 July 2015.
http://www.ft.com/cms/s/0/b1fb7b12-2f90-11e5-8873-775ba7c2ea3d.html?ftcamp=crm/email/follow/author/Q0ltMDAwMTI3NQ==-QXV0aG9ycw==/product#axzz3hIRe08LM

The Government and the regulators are right to take a keen interest in this issue, since the benefits of a single and comparatively low TER for auto-enrolment accumulation can be lost during decumulation. However, the very complexity of drawdown charges raises an important question in relation to policy and regulation; namely, which charge or charges would you cap? Due to the administration costs of withdrawals, a fully-flexible drawdown plan does not lend itself to a single charge. The simplest structure we identified was a scheme with a TER and a per-transaction cost, where 'transaction' means a withdrawal. The alternative, if a single charge were required, would be for the scheme to limit the number of withdrawals to, say, four per year, at quarterly dates set by the scheme. This approach might work well in the mass market, where full flexibility is not required, especially if the DC decumulators end up paying for features that are never used.

1.5 The future shape of the annuities market

Annuities have come under a barrage of criticism in recent years. Some of this is justified, for example, the poor rates available in the roll-over market (where the customer passively accepts the accumulation provider's rate), the sale of a conventional annuity when medical underwriting would have secured a better rate, and the opacity of insurance company underwriting techniques (including the mortality tables used), and their profits.[102]

Even in a competitive open market, annuity rates will appear unattractive to DC customers unless they fully understand the pricing of a longevity risk hedge and can trust the market to work in a competitive manner. Unfortunately, until their near-monopoly on the DC market was threatened, life companies were rather complacent and did not bother to explain in plain English the value of annuities – until it was too late and customers, now encouraged by the new freedom and choice regime, have sought alternatives to this product.

With a LTA, the annuity 'rate' is the level of annual income the insurance company guarantees per £100 of the pot size (the insurance premium). Annuity rates fluctuate because they depend on a range of factors, including interest rates (insurers hold gilts and corporate bonds to back their annuity payments, although increasingly other assets are held due to low bond yields), the age and the life expectancy of the annuitant, and the 'load factor', which is the deduction insurers make to cover profits and overheads, including distribution costs. Annuity rates have fallen steadily over the past 20 years, due to increasingly longevity, falling gilt yields, and quantitative easing (QE), among other factors. The prospect of a continuing period of very low interest rates is a real concern for both prospective annuitants and for providers which must hold reserves against annuity guarantees, including GARs. Such reserves are likely to increase under Solvency II (see below).

1.5.1 An important, but more flexible role for annuities in DC decumulation

One of the unintended consequences of liberalising the decumulation market has

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102 See FSCP, Dec. 2013, Annuities and the consumer perspective, https://www.fs-cp.org.uk/file/publication/research-paper-annuities-and-consumer-perspective. Since Feb. 2014, the FCA has published a series of reports on the retirement income market. See, for example, http://www.fca.org.uk/news/tr14-02-thematic-review-of-annuities and http://www.fca.org.uk/news/fca-publishes-the-findings-of-its-work-into-annuities-sales-practices-and-retirement-income-market

been to turn a compulsory purchase annuity market into a voluntary market. While medical underwriting will continue to evolve to cater for annuitants with life-shortening lifestyle and medical conditions, the voluntary nature of the purchase will affect the underwriting approach. This is because insurance companies, quite rightly, will be concerned about adverse selection – i.e., in a voluntary market, purchases are likely to be made by those who believe that they will enjoy above-average longevity, possibly because of their family history and their healthy lifestyle.

We expect the next five years to be challenging for annuity providers. Annuity sales have fallen by almost 80% in 2015,[103] although this is at least in part due to the pent-up demand for alternatives following the announcement of freedom and choice in the March 2014 Budget, and its implementation in April 2015. The consultant Oliver Wyman[104] has predicted that annuity sales will stabilise at about £6bn per annum by 2018 – that is, about half the size of the pre-April 2014 market. This figure is in line with our own prediction.

Despite the above challenges, we firmly believe that annuities (both immediate and deferred) have a crucial part to play in the mass market for DC decumulation. However, the shape of the market and the design of the products offered will change. An important feature of the annuity market post-April 2015 will be the timing of purchase, which we expect to be staggered, rather than concentrated at the point of retirement, as was previously the case.

1.5.2 Lessons from overseas markets

There will continue to be a significant market in immediate annuities purchased at retirement. Here the Government and FCA might learn from the experience of successful overseas annuity markets where annuitisation is common at the point of retirement. In Chile and Switzerland, for example, the annuity markets are more tightly regulated, with the result that confidence in the product in terms of value for money is much higher than is the case in the UK.

The experience in New Zealand is interesting, particularly in relation to the bequest motive and, in particular, the crucial connection between the appetite for annuities and the level of the state pension. In 1993, there were nine annuity providers In New Zealand. In 2013, the last provider exited the market, having sold just one policy in the previous year. JP Morgan provides the following overview of the reasons for the decline and fall of the NZ annuity market:[105]

> *First, there's the bequest motive: the desire to leave some assets to the next generation. Second, life insurance companies in New Zealand have historically been taxed at a higher rate on annuity assets than the marginal rate for many individuals, taking the shine of annuities as a retirement option. And third, in 2001, the New Zealand Superannuation Fund (NZ Super) was created to provide a basic level of income for all individuals that have lived in the country for at least 10 years, of which at least five should be since age 50. So Kiwis can count*

103 Sources: ABI and FCA.

104 Oliver Wyman, 2014, The future of the UK life industry, http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/insights/financial-services/2014/September/LON-MKT10307-001%20-%20Future%20of%20UK%20Life%20-%20FINAL.pdf

105 http://insights.jpmorgan.co.uk/adviser/commentary-and-analysis/why-the-uk-annuity-market-wont-go-the-way-of-the-dinosaurs/

on a guaranteed lifelong income that keeps pace with inflation, and even adjusts to lifestyle changes. With a guaranteed income like this, buying an annuity on top seems counterintuitive.

We believe that in the UK, DC retirees' interest in annuities will increase in later life, due to the natural desire to avoid the risk of running out of money in favour of a secure life-long income. There is no consensus at present about the age for this trigger point, but it is likely to be at some point between age 75 and 85 – as opposed to the previous age range for annuity purchase, which was between 55 and 65. Innovation in the annuity market, therefore, will be driven by the demand from drawdown customers for later-life longevity-hedging products, for example, a competitive immediate annuity market for those aged 75+, and the introduction of retail and scheme-based deferred annuities. NEST has already decided to incorporate some form of later-life annuity purchase in its auto-enrolment scheme decumulation default stage, and we expect other auto-enrolment providers to follow suit. Life companies have the opportunity to design and develop the annuity products these schemes need. Lessons from the US will be relevant in relation to deferred annuities, where the product has been available for some time, although overall demand still remains low.

In Australia, where its own version of freedom and choice has led to a crisis situation, with about half of DC savers emptying their pension pots by the age of 70, the Australian Government has decided to adopt the proposals of the Murray Review. [106] It has announced its commitment to develop and consult on legislation by the end of 2016 that would 'facilitate trustees of superannuation funds providing pre-selected comprehensive income products for retirement', in effect annuities. It is ironic that as DC savers in the UK begin to enjoy the fruits of freedom and choice, their counterparts in Australia are heading in the opposite direction towards a more secure retirement income.

1.6 A secondary market for annuities?

It is difficult to predict the impact of a secondary market in annuities should the Government give the green light in 2017. However, essential lessons might be learned from the US traded life policy[107] (TLP) market, where the success of this secondary market has been undermined by weak governance in the value chain and by moral hazard and market abuse – as we noted in a previous Pensions Institute report.[108] The sale of TLP funds in the UK retail market led to a mis-selling scandal. This came about partly as a result of the sale of this high-risk alternative asset in the mass market – it was sold as a 'safe' high yield investment.

Of immediate concern is the question of what represents value for money (VfM) for customers seeking to sell annuities. To enhance the prospects of this potential

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106 Financial System Inquiry (FSI), Dec. 2014, The Murray Review, http://fsi.gov.au/publications/final-report/; Australian Treasury announcement: http://treasury.gov.au/ConsultationsandReviews/Consultations/2014/FSI-Final-Report. See Sydney Morning Herald, 20 Oct. 2015, Annuities and private pensions to replace lump sums as default for retirees

107 This is a type of whole of life insurance policy. In the US market, the most commonly sold product is called universal life, which pays out a sum on death in return for regular premiums. Such policies were sold in the UK in the past and now form a component of 'legacy' back books.

108 TLPs are also known as life settlements in the US. See Pensions Institute, July 2008, And death shall have no dominion: Life settlements and the ethics of profiting from mortality, http://www.pensions-institute.org/DeathShallHaveNoDominion_Final_3July08.pdf

market, life companies – or the FCA – might develop a 'selling money's worth'[109] measure of VfM for policyholders.

Apart from the sales process, which in itself poses questions about the fair treatment of customers, this type of market might also raise concerns about data protection, as the organisation that buys annuities acquires considerable information about an insured's age, state of health, and financial circumstances.

The price buyers will be prepared to pay will be based on medical underwriting at the point of purchase. The price will also be discounted – possibly deeply – to offset the mortality risks the purchaser bears. The infrastructure is likely to be expensive – a cost the seller will bear – due to the complexity of the value chain and the requirement for several layers of intermediation. If it goes ahead, the success of the new asset class will depend on the purchasers' expertise in portfolio construction, the accuracy of life expectancy (LE) reports, and robust standards in the regulation of purchase and resale processes. We believe that the Government and regulators should consider very carefully the target market for funds of retail annuities. While institutional purchasers – such as DB pension schemes and insurance companies – can be expected to apply actuarial and investment methodologies in order to evaluate the risk-reward profile, sales of such funds in the retail market will represent a high risk to customers, advisers and to the FCA.

If the secondary market for retail annuities does go ahead and proves popular, we see the potential for buyers of these retail policies to develop commoditised funds which could be attractive to pension schemes[110] and insurers seeking to invest in alternative asset classes to diversify their longevity risk exposure. Interest in this type of strategy is already evident. A recent example is the Canada Pension Plan Investment Board's (CPPIB's) 2014 purchase of Wilton Re Holdings, a US provider of life insurance and reinsurance and a leading consolidator in closed books of life assurance policies. The CPPIB considers closed books of life policies (which include the US equivalent of whole of life) to be an asset class with attractive risk-adjusted returns, well-suited to its long-term horizon.[111] This example is also interesting because it demonstrates that the market in back books – and, in this cases, in whole consolidation businesses – operates on a cross-border, as well as national level.

109 See, for example, http://www.bath.ac.uk/management/research/pdf/tonks-cannon-annuity-markets.pdf and https://ore.exeter.ac.uk/repository/bitstream/handle/10036/52333/rrep563.pdf?sequence=1

110 DB pension schemes might consider such funds as an alternative asset class that can aid diversification and form part of a liability driven investment (LDI) strategy.

111 http://www.cppib.com/en/public-media/news-releases/2014/cppib-wilton.html

1.7 Identifying the pension and benefit needs of private-sector employers

The position of employers in relation to the business benefits of workplace pension schemes is complicated and now – unlike in the past – conflicted.

1.7.1 Employers' concerns about DC decumulation freedom and choice

While employers may wish to ensure their DC pension scheme members make informed choices at retirement and secure value for money in the retirement income products they buy, most are equally keen to sever the connection between the employer's business and the pension scheme in relation to retirees. Employers told us that that there is no business benefit in providing services to people who no longer work for them. They also said that there is a reputational risk, and possibly also a regulatory risk, if a workplace drawdown scheme, for example, does not deliver what its members expect. These attitudes are now very different from the paternalism shown by such employers in the past.

For most employers, it will now be more attractive to outsource the DC decumulation function. Where their existing provider does not offer this facility, they will look to third parties to provide a 'default' for members, by which we mean employers will automatically transfer members to the third-party decumulation scheme, although members will have the right to opt out. Some employers might find the default mechanism a concern, for the regulatory reasons mentioned above. In these cases, they will include the transfer as an option rather than a default in the pre-retirement packs. The main advantage for employers that offer access to a decumulation scheme, with strong suggestions about the maximum rate of withdrawal, is that this may deter employees from depleting their DC pots too quickly and too early. Nevertheless, employers remain nervous about making such suggestions.

The challenge and opportunity for life companies is to develop third-party decumulation schemes that are open to non-member employers as well as existing employer customers. If life companies do not rise to this challenge, then employers are likely to use NEST for this purpose or The People's Pension, assuming it develops a decumulation scheme shortly, as rumours suggest it might do. Consultants, such as Xafinity, have entered this market, but it will be some time before we see whether they secure a profitable share, especially if a charge cap on drawdown schemes and plans is introduced.

1.7.2 Employer-controlled long-term savings schemes

Employers, especially the larger quoted companies, have supported voluntary workplace provision for many decades. They have also given their support to auto-enrolment. Unfortunately – albeit for very good reasons – their enthusiasm is waning.

In the interviews for this report, finance directors were vociferous about the fact that the business purpose of a pension scheme no longer pertains, yet employers must contribute the minimum required under auto-enrolment and, in many cases, voluntarily contribute well in excess of the minimum. FDs – and HR directors – said they cannot rely on the pension scheme to facilitate retirement management, that is, to ensure employees can retire at an age that suits the company, which, in turn, ensures the company can maintain its retention policy in relation to talented younger employees.

The original purpose of the company pension scheme as a retirement management tool has been undermined by two recent policy changes, which were wholly separate in purpose, but when combined have had very important unintended consequences:

- The abolition of the default retirement age[112] in 2011 means that an employer cannot force an employee to retire, even if the employee has reached the pension scheme's 'normal retirement age' (NRA).
- The April 2015 pension regime means that workplace pension scheme members can draw on their DC pots from age 55. In theory, they could deplete their entire pot before NRA and hence not be able to afford to retire.

This problem affects all companies, not just the larger and more paternalistic employers. One solution would be for the Government to reverse part of the April 2015 reforms and increase the age at which DC savers can access their retirement savings to 65, as was proposed by the Society of Pension Professionals (SPP) in November 2015.[113]

Employers are also angry about the loss of tax reliefs that were previously available to higher earners and which will now be severely capped, due to the restrictions on the lifetime allowance.[114] This was introduced in 2006 at a level of £1.5m. It was then increased each year to £1.8m in 2010, since when it has been reduced. In the 2015-16 tax year, the lifetime allowance was £1.25m. It falls to £1m from April 2016. The effect is to disconnect higher earners – directors included – from their company pension scheme, as it will no longer cover their anticipated retirement income needs.

As a result of these developments, we understand that some of the larger employers – in particular those with low staff turnover that employ people through to retirement – are looking for new types of long-term savings scheme over which they would have full control in terms of the timing of withdrawing cash. Employers could use this alternative type of arrangement, which would most likely be set up under trust, for all employees (where older workers are an important cohort of the workforce) or for executives only, in an attempt to regain control over the retirement management and recruitment functions.

1.8 The advice and guidance market

Our research identified a serious gap in the DC decumulation advice market. Advisers, understandably, said that they fear the risk of regulatory reprisals if they make a personal recommendation in relation to a low-value DC pot that the customer wishes to use for a high-risk drawdown investment strategy. They are equally reluctant to make go-or-stay recommendations in relation to older DC policies that have a complex combination of guarantees and exit penalties.

112 https://www.gov.uk/retirement-age

113 Reported in the FT, 13 Nov. 2015.
http://www.ft.com/cms/s/0/98de7dec-8962-11e5-9f8c-a8d619fa707c.html?ftcamp=crm/email/follow/author/Q0ltMDAwMTI3NQ==-QXV0aG9ycw==/product#axzz3rZackUKB

114 See, for example,
http://www.pensionsadvisoryservice.org.uk/about-pensions/saving-into-a-pension/pensions-and-tax/the-limetime-allowance

Adviser and provider concerns – again understandably – are further exacerbated by the activities of modern claims management companies ('ambulance chasers'), which have successfully exploited the PPI mis-selling scandal and, at the time of writing, had turned their attention to packaged bank accounts. Given the PPI ambulance-chasing window is coming to an end, and the packaged bank account 'mis-selling' campaign is likely to have a similarly limited lifespan, sales of drawdown plans and transfers of legacy policies will be attractive propositions to these large and sophisticated organisations. The ABI's proposal, in September 2015, that claims management companies should be regulated by the FCA, is timely.[115] At present, these companies are licensed and regulated by the Ministry of Justice (MoJ), which outsources this function to the Staffordshire County Council Trading Standards Department.

The challenge for the FCA and the Government is to introduce a form of low-cost simplified or focused decumulation advice suitable for clients with medium-sized pots which leaves those clients with little or no recourse for redress if the product towards which they are steered ends up giving a poorer outcome than anticipated. This challenge is made more testing by the fact that the success of auto-enrolment is predicated on member inertia. DC decumulation does, however, need to be initiated by the member. Members do have to contact their providers if they want to draw money from their DC pots: they have to provide personal bank details or the details of the provider to which they wish to make a transfer. This point of contact is not, of itself, sufficient, but it could be used to direct DC customers into a focused advice service, which might take the form of a helpline and a guided-choice website.

Interviewees for our report said that many DC savers do not need – and certainly do not want to pay for – fee-based advice, which might cost a minimum of £1,500, even where the DC pot is only worth £20,000, for example.

One interviewee put it this way:

> *Mass-market customers don't want holistic advice – they want straight answers to specific questions like 'should I buy an annuity or should I do drawdown?' and 'if I do drawdown, which is the best product?' Customers with older policies have similarly specific questions which boil down to 'should I go or should I stay?'*

Another said:

> *Above all DC customers want to understand the risks in plain language. The risks of drawdown were demonstrated only too clearly at the turn of the present century and again in 2008-09, when customers who were heavily invested in growth assets saw their pots decimated by the equity bear market and global financial crisis. The high charges associated with drawdown plans exacerbated the damage. Today, smarter design seeks to construct a growth investment strategy that is less bullish and is more focused on volatility-management, but there is no way you can compare drawdown with an annuity. There is no such thing as a 'safe' drawdown plan.*

115 https://www.abi.org.uk/News/News-releases/2015/09/ABI-clampdown-rogue-claims-management-companies-as-people-continue-bombarded-by-nuisance-calls-texts

The imperative to fill the advice gap was made clear in a report from the consultant Oliver Wyman:

> *A critical decision will be to decide the firm's [pension provider's] appetite and strategy around direct distribution, guidance and advice. Customers will seek out help to support their multiple retirement decisions, and are likely to place business where they find this help. Insurers cannot afford to let the fear of regulatory risk stop them meeting this demand. Conduct risk issues will remain, but it is expected that the regulatory uncertainty that has prevented insurers (and others) developing simplified advice models will start to be addressed by the FCA, allowing insurers to more confidently deliver guidance, execution-only and simplified advice models, with a focus on automated processes, digital channels and mobile.*[116]

We believe that focused or simplified advice delivered on a direct-to-customer (D2C) basis, which dealt with questions relating to the DC pot, would meet most DC savers needs. Clearly this type of service would need to spell out in plain language the degree of responsibility the service took for the customer outcome and the degree of responsibility remaining with the customer.

Major life companies told us that they were ready to provide a D2C focused advice service – or that they can secure this by outsourcing to a third-party. Some companies have already established this arrangement, but others are holding back because the regulation of this type of advice is unclear. Given the complex FCA rules, they are concerned that any form of 'non-advice' – i.e., generic support that encourages the customer to make a choice of decumulation product – could easily stray into the regulator's definition of regulated advice which can lead to the provider being sued many years later if things go wrong.

A key factor in the successful business model of any focused or simplified advice proposition is the ease with which it attracts customers. Customer acquisition costs are estimated at £200 per case in the UK. According to a report by FinaMetrica, this is 'beyond the means' of many advisory firms and explains their slow growth.

As reported in Professional Pensions,[117] FinaMetrica takes 'a macro look at automated advice models around the world'. Robo-advice is 'established and blooming' in the US market, 'but almost invisible in the UK by comparison'. The report argues that 'robo-advisers are the most significant development in the delivery of financial advice in the past three decades', but says that in the UK, the future of this business model 'lies in the white label market, via channels that target communities'.

The need for cheaper forms of advice first emerged after the RDR in 2012 and again after the introduction of the freedom and choice pension regime in 2015. By the fourth quarter of 2015, there was increasing evidence that some form of 'robo-advice' was expected to play a major role in the UK DC-decumulation market.

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116 Oliver Wyman, 2014. The future of the UK life industry. http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/insights/financial-services/2014/September/LON-MKT10307-001%20-%20Future%20of%20UK%20Life%20-%20FINAL.pdf

117 FinaMetrica, Nov. 2015. The Robo-Revolution. http://www.riskprofiling.com/ereport.
The report costs £995. It was described in Professional Adviser, 5 Nov. 2015. http://www.professionaladviser.com/professional-adviser/news/2433425/robo-advice-report-detects-elephant-in-the-room?utm_medium=email&utm_term=&utm_content=Robo-advice%3A%20Report%20detects%20%27elephant%20in%20the%20room%27&utm_campaign=IFA.SP_06.Update_RL.EU.A.U&utm_source=PA.DCM.Editors_Updates

By November 2015, the robo-advice service ('Cora', Clear Online Retirement Advice) developed by LV= and Wealth Wizards, a technology-driven advisory firm majority-owned by LV=,[118] was up and running. The service charges £199 to produce a report that sets out product recommendations based on the user's input in relation to their objectives and risk tolerance. The key feature of this algorithm-based technology is that it provides fully regulated advice, which means that LV= takes regulatory responsibility for the product recommendations.

We cannot overemphasise the importance of having an acceptable (by the FCA) advice-delivery mechanism for mass-market DC decumulators. Otherwise, customers will either opt for a risky DIY model, fall for a scam, or accept the accumulation provider's 'roll over' decumulation strategy, which is what happens in the US market.

The DC decumulation and advice market in Australia[119]

Lack of trust in advisers is not confined to the UK market, as the Australian experience demonstrates, where the compulsory workplace-based DC system has been in place since the early 1990s.

The accumulation stage has been largely successful in building up significant assets, although concerns remain about very high member charges. However, the real flaws in the system relate to the decumulation stage. Although annuities are available, the market is very small: most DC retirees take their capital in a series of lump sums. This has caused two significant problems, which are very relevant to the UK's future experience of 'freedom and choice'.

The influential 2014 Murray Review found that about half of DC retirees withdraw all their DC savings by the age of 70. Murray criticised pension providers for failing to innovate and offer better-designed products to help DC decumulators to hedge longevity risk. His proposed solutions, which have largely been accepted by the Australian Government, are set out below.

DC savers with large pots use 'self-managed superannuation funds' (SMSFs), which are similar in structure and investment choice to SIPP drawdown products in the UK. The Australian risk tolerance consultant FinaMetrica Risk has been critical of the investment risks associated with SMSFs. Paul Resnik, co-founder, said:

> *The language those retirees use is one of 'taking control'. It's nonsensical. They're not in control; they're running a high-risk formula they don't understand.*

Almost all of SMSF money is invested in Australian assets. About 70% on average is in growth assets, creating 'a huge concentration risk', Resnik said. His conclusion was that the DIY model is flawed and that DC retirees need expert advice.

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118 https://www.wealthwizards.com/lv-invests-in-leading-robo-adviser-wealth-wizards. See also, FT, 6 Nov 2015. http://www.ft.com/cms/s/0/a8598908-8316-11e5-8e80-1574112844fd.html?ftcamp=crm/email/follow/author/Q0ItMDAwMTI3NQ==-QXV0aG9ycw==/product#axzz3qoZfmwZZ

119 We are grateful for permission to include analysis here from 'the lang cat', an independent research centre. See the lang cat, April 2015. When the levee breaks: What next for the UK retirement savings market? http://langcatfinancial.co.uk/white-paper/when-the-levee-breaks/

Unfortunately, The Association of Superannuation Funds of Australia believes that the advice market cannot meet DC retirees' need. Pauline Vamos, chief executive, said:

> *The problem is both caused and compounded by a dislike of financial advisers. We are seeing trends across the world, including in Australia, in terms of where advice is going and we know that, over the next few years, the vast majority of advice will be self-guided advice. Australia is all about do-it-yourself: they hate advisers; they hate intermediaries.*

It is very interesting to note that the lack of trust in the retail intermediary market is a problem for other major DC systems. Given the maturity of the Australian market, which is 20 years older than the UK auto-enrolment system, the UK Government, regulators, and product advisers should look very carefully at the issues noted above. Without affordable and easily-accessible advice, DC decumulators will make very big mistakes in terms of the charges they pay and the investment risk they take in their drawdown plans.

The Murray Review proposals for DC decumulators in Australia

1. Set a clear objective for the superannuation system to provide income in retirement.
2. Improve long-term net returns for members by introducing a formal competitive process to allocate new workforce entrants to high-performing superannuation funds.
3. Meet the needs of retirees better by requiring superannuation trustees to pre-select, on members' behalf, a default 'comprehensive income product for retirement' (CIPR) which included a longevity risk hedge. This would exploit behavioural biases to encourage, rather than discourage the use of products that provide longevity risk protection.

The report argued that the introduction of the CIPR, as a scheme default for decumulation (i.e., members would have the right to opt out) would influence behaviour but not limit personal choice and freedom. It would 'bring the policy philosophy at retirement closer to that of the accumulation phase'. Importantly, the CIPR would be run on a scheme basis, so that the longevity risk would be managed through a risk pool. 'An enduring income stream would give retirees the confidence to spend in retirement, which would help to sustain economic growth as the population ages and reduce the extent to which longevity risk falls on the taxpayer', the report said.

The US decumulation model

The US DC market is more mature than the new UK system, due to the earlier decline in the DB market. While some employers still offer DB schemes, most offer what are known as '401k'[120] schemes, which in practice operate in a similar way to the UK's DC auto-enrolment workplace schemes. Coverage is far from universal. In October 2015, Bloomberg reported that half of US workers in paid employment are not covered by 401k schemes.[121]

At retirement the most common form of decumulation is an individual retirement account (IRA), which is similar to the UK's income drawdown plan. Lifetime annuities and deferred annuities are available in the US market but these are not popular options, accounting for less than 5% of the market. It is likely that the US Government will do more to encourage annuitisation in future.

There are two relevant lessons from the US for UK life companies:

- The US DC market is dominated by asset managers rather than UK-style traditional life companies. Big names include Fidelity, BlackRock and Vanguard. The reason for the dominance of asset managers is the absence of a strong annuity market – accumulation and decumulation are delivered via investment products. Having said that, the dominant asset managers benefit from a similar 'rollover' market that has benefited UK insurers in the past. The difference is that instead of rolling over from an investment-based accumulation stage into an annuity, the roll-over is to an investment-based IRA. Inertia, it seems, is a major force in customer choice irrespective of the products offered or where the customer resides.
- As we noted earlier, in Australia the major concern is that DC retirees are drawing too much too soon from their pension pot, with the result that half of retirees have emptied their pot by age 70. In the US the opposite is true. According to Fidelity the average age at which DC retirees *start* to make withdrawals is 70.

120 These are '401 (k)' schemes named subsection 401(k) of the Internal Revenue Code, which was enacted into law in 1978 and which allowed the setting up of tax-qualified DC pension accounts.

121 Bloomberg, 21 Oct. 2015. http://www.bloomberg.com/news/articles/2015-10-21/bad-math-68-million-americans-no-401-k-epic-savings-crisis

Competitive markets for annuities in Switzerland, Denmark, Chile and Singapore

In Switzerland, enrolment in an occupational scheme is mandatory, as it is in Australia. However, the DC system is largely 'cash balance', which means that the retiree gets a lump sum at retirement which depends on the contributions made and a pre-agreed investment return on these contributions – irrespective of the actual performance of the underlying investment fund.

As the Pensions Policy Institute (PPI)[122] has observed, despite the fact that DC savers in Switzerland have the same decumulation freedom and choice that is now available in the UK, annuitisation levels are remarkably high at about 80%. 'This is attributed to cultural attitudes; Swiss workers are described as being "financially conservative" and "preferring guaranteed incomes for life" over taking lump sums.'

We believe that there is more to this pattern of decumulation than cultural attitudes, however. In Switzerland, annuities are heavily regulated by the Government, including the annuity rates, which are considered to be very generous. While in the UK, low interest rates and increasing longevity have forced down annuity rates, this has not happened in Switzerland.

It is not clear if such favourable rates are sustainable, particularly since they are funded by the occupational pension schemes, which might give rise to concerns about scheme solvency in the future. There is a private market for annuities, but, at present, this is small because insurance companies cannot compete with the generous rates provided by the occupational schemes.

In Denmark, most employees belong to the national earnings-related ATP scheme (ATP is the parent company of NOW: Pensions in the UK). A minority of employees are covered by private schemes and there is also a voluntary pension scheme market for employees who are not eligible for either of the above. ATP pays a lifetime income direct from the scheme. PPI says that for those in other voluntary pension schemes, there are different options available at retirement which include life annuities, fixed-term annuities and access to lump sums. Each pension scheme has different rules regarding how pension savings can be accessed.

In Chile, the annuity market is also very popular and this is once again attributed to government intervention in pricing. The DC market is mandatory in Chile and at retirement about 70% of DC savers buy an annuity. Annuity providers are required to offer a minimum rate of return, which is backed by the Government. The PPI explains:

> *On reaching retirement, Chileans who wish to access their DC pension savings must opt either for a lifetime (deferred or immediate), index-linked annuity or for phased withdrawals from a pension fund. Married DC savers are required to purchase joint-life annuities. The fund providers must guarantee a minimum rate of return, which is backed by the Government. The number of DC savers purchasing*

122 PPI, Nov. 2015. Retirement funding: analysis of retirement income patterns. http://www.pensionspolicyinstitute.org.uk/publications/reports/retirement-funding-analysis-of-retirement-income-patterns

an annuity in Chile has risen from 3% of pensioners in 1985 to just under 70% of DC savers for whom annuities were an option in 2007. This also equates to around 70% of DC assets.

There is a high demand for lifetime annuities in Chile, attributed to the restrictions on accessing savings and on the lack of a sufficient universal state pension to fall back on. The annuities market in Chile is highly competitive and developed.

In Singapore, the mandatory system for employees builds pots that are used for a range of purposes including pensions, healthcare and housing. At age 55, savers with pots above a minimum size are required to buy either a deferred annuity or a form of longevity insurance that hedges the risk by providing a standard annuity that pays out until age 90 and then what the PPI describes as a 'deeply deferred' annuity that pays out from age 90. Joint-life and index-linked or escalating annuities are not available.

1.9 Competitors to traditional life companies in the auto-enrolment market

A clear taxonomy of the major players in the auto-enrolment market has yet to emerge, due to the constantly shifting boundaries between life companies, asset managers and investment consultants, among others. Another confusing factor is the trend towards mergers and acquisitions, often between firms with different business models, for example, the acquisition of an asset manager or a firm of advisers by a life company. It can be difficult to determine the true profile of the merged company until well after the event.

Past convention tended to divide providers into ABI and non-ABI member firms – the latter generally being members of the Investment Association (IA). In other words, providers marketed themselves as (multi-line or mono-line) life companies or as asset managers.

This approach to provider classification is now outdated, as major providers in the auto-enrolment market have emerged from very different backgrounds, including asset management, advisory, and, of course, public policy, as in the case of NEST. Moreover, both the ABI and the IA are currently losing high-profile members, as major financial institutions question the role of trade associations in a rapidly-changing market where difference and autonomy are perceived as more valuable than consensus.[123]

Another way to classify auto-enrolment schemes is by their legal structure, i.e., trust-based schemes, which are regulated by TPR, and contract-based schemes, which are regulated by the FCA. In the past, this distinction was very clear-cut, but again the lines have blurred under auto-enrolment. Originally, trust-based DC schemes were established by employers that closed their DB schemes but which wanted to run a DC scheme just for their own employees. Such schemes used the DB trust framework and ran the DC scheme's investment strategy along similar lines, for example, by appointing external asset managers and third party administrators. The hallmark of the original trust-based scheme, therefore, was that it was associated with a single employer.

123 L&G and Aegon left the ABI in 2014 and 2015 respectively.

Multi-trust, multi-employer schemes have flourished under auto-enrolment, but they sit uncomfortably within TPR's remit, since most are run more like contract-based group personal pensions (GPPs), than like traditional single-trust, single-employer schemes. One of the advantages of the trust-based model is that when employees change employer, they can remain in the former's scheme as deferred members. Another advantage is that trustees have the power to make block transfers of members where they decide to change the incumbent asset manager or administration provider, or the provider of a bundled scheme. This is because the service contracts are between the trustees and the provider. Blanket transfers generally are not possible under a GPP because the contract is between the individual member and the provider, which means that a transfer requires all individuals to consent.

1.9.1 The position of life companies in the auto-enrolment market

In a 2014 report, 'Value for Money',[124] the Pensions Institute predicted that the number of mass-market providers of workplace schemes would fall from about 20 at the turn of the century to about five or six, as those providers that fail to generate critical mass leave the industry. We do not believe that this will lead to a cartel-like behaviour by the surviving providers, given the very different structures of the dominant auto-enrolment multi-employer schemes. However, the Government and regulators do need to consider how best to ensure effective competition is maintained, particularly for smaller employers. There is already evidence of providers withdrawing from sections of the market they originally planned to serve. The Government and regulators also need to ensure that further consolidation happens smoothly, so as not to undermine confidence in auto-enrolment.

Life companies that are very active in the auto-enrolment market tend to offer both a contract-based and trust-based scheme. In most cases, these are mirror arrangements, that is, they use the same organisations for administration, asset management, and even governance. At the time of writing, there were fewer than 10 traditional life companies that offered qualifying auto-enrolment schemes. These included Aegon, Aviva (which now owns Friends Life), L&G, Prudential, Royal London, Scottish Widows, and Standard Life.[125]

Life companies are also dominant in the retail DC pensions market, where they sell personal pensions and SIPPs for accumulation, and annuities and drawdown plans for decumulation.[126] SIPPs are also available from providers other than life offices, such as investment trusts, asset managers, advisers, wealth managers and platforms. Examples include Alliance Trust and Hargreaves Lansdown.

In the mass market for auto-enrolment, there are some powerful competitors to the traditional life companies and these providers have non-standard business models that appear to be very successful. Of the major master-trust providers, probably the toughest competition comes from The People's Pension, NEST and NOW: Pensions.

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124 Pensions Institute, Jan. 2014.

125 https://www.abi.org.uk/Insurance-and-savings/Products/Pensions/Saving-into-a-pension/Automatic-enrolment/Providers. The list also includes B&CE, which we consider to be a 'challenger'. L&G and Aegon are no longer members of the ABI.

126 They also sell small self-administered schemes (SASSs), which are used by small family businesses.

What distinguishes these providers from traditional life companies is the mono-line business model: their main or sole focus is their auto-enrolment schemes. In addition, one of the hallmarks of The People's Pension, NEST and NOW is that they are among the lowest-cost providers in the market and their trustee boards are independent of the provider.

Successful business development under this mono-line low-cost model is predicated on scale of operations and volume of new business. The People's Pension, NEST and NOW compete in broadly the same market – that is, they are more than happy to accept larger employers and/or employers with an attractive workforce profile, but they have made a point of promoting their open-door policy to employers that are less attractive to traditional life companies, for example, where the company is very small, has a high staff turnover rate and/or a large proportion of lower earners.[127] NEST is the only scheme with a public service obligation to accept any employer that applies to join. However, NEST's contribution charge of 1.8% will disadvantage older eligible workers who are enrolled for a short period. For thousands of employers and their employees, direct-to-provider is likely to be the only option – this substantial tail-end will be unprofitable for traditional provider and adviser alike.

This point is well-understood by the Government, which, in an October 2015 report,[128] said:

> *The profile of employers affected by automatic enrolment is now changing dramatically. Small employers are expected to have different requirements and responses to automatic enrolment. They will also create greater operational challenges as volumes increase.*

At the time of writing – Q4 2015 – auto-enrolment was being rolled out to employers with fewer than 50 employees. The process will be completed by 2017-18, with the staging of micro-employers with fewer than five employees. The number of employers implementing automatic enrolment duties is expected to peak between July and September 2017.

What this means is that we have entered the high volume/low profitability phase of auto-enrolment staging. The next two years will prove to be the true test of the auto-enrolment system as a whole, and of The People's Pension and NOW's open-door policy, in particular. Volume of business is essential if these schemes are to maintain their low charges and to be profitable – although we emphasise that profitability is defined in different ways for not-for-profit providers, such as The People's Pension, which has no shareholders and ploughs profits back into the business.

Although mono-line, these multi-employer schemes also have the potential to exploit the biggest opportunity since auto-enrolment was announced, namely, scheme decumulation. NEST set out the details of its scheme design in 2015[129] which could well become a benchmark for the industry, as happened with the

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127 In the past, life companies used underwriting techniques to price new business, which meant that they increased the member charge if staff turnover was high and/or earnings were low. This had the unfortunate effect of penalising lower earners in general.

128 NAO/DWP, Oct. 2015. https://www.nao.org.uk/wp-content/uploads/2015/11/Automatic-enrolment-to-workplace-pensions.pdf

129 NEST, 2015, The future of retirement, https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement,pdf.pdf

scheme's accumulation model. The People's Pension and NOW have not so far announced their own plans.

With the caveat that boundaries and distinctions are changing constantly, we can make the following distinctions between providers' business models and scheme structures.

1.9.2 Government-backed master-trust: NEST

The first, and most obvious challenger to the traditional life company model is NEST. In 2012, NEST set a clear benchmark for the design and governance of low-cost multi-employer schemes in the auto-enrolment accumulation market. In 2015, it set a similar benchmark for scheme decumulation.

NEST is a non-departmental public body (NDPB) and is run as a trust by NEST Corporation, which is the trustee. The scheme was introduced by the Government to avoid the danger of market failure under auto-enrolment, whereby employers considered economically unattractive to traditional life companies might not be able to find a suitable provider. NEST is a fully outsourced model in terms of asset management for its target date funds (TDFs) and the administration. The same is true of its scheme decumulation model, announced in 2015. The proposed scheme caters for both members who want to take their pot as cash and those who want to use drawdown with a deferred annuity to hedge longevity risk. The UK does not have a retail deferred annuity market at present, although bulk purchase annuity (BPA) buy-outs do involve such a product. We expect NEST to design its deferred annuities and to outsource this function to a life company or possibly to provide its own deferred annuities, assuming it achieves the appropriate critical mass to manage the longevity risk.

NEST's legal structure is very similar to a multi-trust scheme, but as a NDPB, NEST Corporation is accountable to Parliament through the DWP. NEST does not have shareholders (unusual, but not in itself unique in the auto-enrolment market) or a parent company that provides new business capital. Instead its establishment and administration costs are funded by a Government (DWP) loan facility.

At present, NEST operates under significant restrictions, namely a cap on annual contributions and the inability to accept transfers in. Even with these restrictions in place, it has proved to be a formidable competitor in the auto-enrolment market. When the restrictions are lifted in 2017, we predict it will be a top-three provider in terms of number of employers and number of employees. By 2018, when the staging for auto-enrolment is complete, we expect NEST to be the largest provider in the market in terms of numbers of members, although not necessarily in terms of AUM. Whether it will be profitable is a very different question. As mentioned above, it is the only scheme with a public service obligation to accept all employers irrespective of profile.

An unusual feature of NEST is that it is open to the self-employed. This means – in theory at least – that it can compete in the retail market as well as in the workplace market. To date, it has not devoted significant resources to promoting this feature, but it might well do so in future if the Government decides to address the plight of the millions of private-sector workers whose contracts of employment exclude them from auto-enrolment. If the Government were so minded, it could require employers to direct contract workers into NEST, which would offer them a straight-through accumulation and decumulation service.

We expect NEST to develop a major role in the market as an aggregator for scheme decumulation for those employers and providers that do not wish to offer this service.

The above overview, suggests a promising future for NEST. But while its new-business acquisition targets look very substantial, in terms of the number of employers it will take on by 2018, it is not yet clear whether NEST will ever become profitable or when it will finally repay its Government loan.[130] The Government has said that NEST's funding model is 'inherently uncertain':[131]

> *The role of NEST within the pensions market is still evolving. Revenues at NEST and other pension providers are highly uncertain and are affected by greater than expected private provision, extensions of start dates and lower real wage increases. NEST is funded by a Government loan and it will grow its funds under management as enrolment and contributions increase. It will need to grow funds under management significantly before it can be self-supporting.*

In the same report, the Government said that it would continue to review NEST's role in the auto-enrolment market, the impact of the competitive restrictions that it faces, and the long-term sustainability of the current funding arrangement.

1.9.3 Overseas entrant: Example – NOW: Pensions

The most obvious example of this category is NOW: Pensions, which is proving to be successful in the same mass market as NEST. NOW's reputation rests on its in-house asset management, which is run by the scheme's parent company in Denmark, ATP, one of the largest pension funds in Europe. ATP's experience of managing the 'straight-through' customer journey, from accumulation to decumulation, may make NOW well-placed to develop scheme drawdown, possibly with an in-house annuity function if it achieves the appropriate critical mass. However, unlike NEST, NOW has made no public statements on this point to date.

1.9.4 Industry-wide heritage: Examples – The People's Pension, the Pensions Trust, and BlueSky

Further challenges comes from former industry-wide schemes, for example, The People's Pension, the Pensions Trust, and BlueSky. The advantage these schemes have is a long history of administering the comparatively low-value pots of workers in industries associated with peripatetic careers and, in the case of The People's Pension in particular, seasonal variations in the job markets on which it formerly focused exclusively (building and civil engineering).

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130 The initial loan was £171m. By 2013 this had increased to £239m. By March 2015, it had increased to £387m. Details about the loan are available here: https://www.gov.uk/government/publications/national-employment-savings-trust-nest-loan-agreement. However, one section redacted in this document relates to the applicable interest rate. This is because 'the description contained within it could prejudice Government policy in future lending to other public sector bodies and the methodology used by the Debt Management Office in setting interest rates for such loans'. A second redaction has been made 'because we have concluded the information would otherwise prejudice NEST Corporation's commercial interests and has commercial importance to other pension providers'.

131 NAO/DWP, Oct. 2015. The National Audit Office shares the Government's concerns about NEST's ability to become self-sustaining. NAO, Nov. 2015. Automatic enrolment to workplace pensions. https://www.nao.org.uk/report/automatic-enrolment-to-workplace-pensions/

The People's Pension is a multi-trust, not-for-profit scheme. Where B&CE's stakeholder scheme was only open to employers in the building and civil engineering sector, The People's has no restrictions. The scheme outsources asset management to Legal & General Investment Management (LGIM) and undertakes the administration and customer services in-house.

BlueSky has a similar background and was first off the block with its scheme drawdown product, based on AllianceBernstein's TDFs, which it also uses for accumulation stage. The Pension Trust also uses AllianceBernstein's TDFs.

1.9.5 Pension and employee benefit consultants: Examples – Aon Hewitt, JLT, Mercer, and Xafinity

Most employee benefits and investment consultants have introduced their own schemes, usually using in-house asset management capabilities together with a life company platform. While these schemes incorporate a very significant level of expertise and also knowledge about the employer market, these entrants have caused tensions in the market, with traditional providers raising questions about the 'independence' of a pension and employee benefit consultant that is also a provider in its own right. Nevertheless, as the closed DB market shrinks, we expect DC provision to become a major profit source for EBCs.

1.9.6 Platforms: Example – Hargreaves Lansdown

Hargreaves is best-known for its investment platform and, in the pensions market, for its self-invested personal pension (SIPP), which it offers for accumulation and decumulation. In the corporate market, it offers a GPP and a group SIPP, as well as an at-retirement service, using its annuity desk and its drawdown expertise. For employers, it offers a 'corporate wrap' which provides access to and the management of a range of workplace investment schemes, including the group SIPP, a stocks and shares ISA, and a fund and share account.

1.9.7 Asset managers as investment solution providers: Examples – AllianceBernstein and SSgA

Under auto-enrolment, asset managers have raised their profile as third-party providers of investment solutions, in particular TDFs. The provision of a total investment solution via TDFs is quite different from the provision of asset management in the form of an outsourced mandate for a specific asset class or as a third-party component of an open-architecture 'choice' platform for retail plans or workplace schemes. In particular, TDFs incorporate multi-manager skills, governance and outsourcing as part of the package.

One of the earliest entrants in the TDF market was AllianceBernstein. In many ways AllianceBernstein performs the same function as NEST's in-house investment team, which also uses TDFs. SSgA (State Street Global Advisers) is just one of several large US-based asset managers that is moving into this market. SSgA's brand for auto-enrolment scheme decumulation is 'Timewise Target Retirement Funds'.

1.9.8 Asset managers as scheme providers: Examples – Fidelity and BlackRock

In a market, where success is predicated on asset management rather than insurance solutions, life companies face increasing competition from high-profile asset managers in the UK, including those with US parents that are major players in the asset-management dominated DC market for workplace accumulation plans (401k) and decumulation products (IRAs). In the UK, Fidelity and BlackRock operate multi-disciplinary in-house pension functions that rival those of traditional life offices.

It is becoming increasingly difficult to distinguish between an 'asset manager' that starts its own life company to distribute retail and workplace DC products (in this case Fidelity and BlackRock, for example), and a life company with an asset-management capability, such as L&G/Legal & General Investment management (LGIM) and Standard Life/Standard Life Investments (SLI), for example).

What both models have is the ability to offer a 'straight through' customer journey from accumulation to decumulation. Fidelity, for example, is known for its extensive funds platform, its low-cost drawdown model and also its in-house annuity-broking operation.

1.10 Future-proofing the life company business model

To maintain a model based on purported excellence in all relevant areas of expertise – asset management, insurance, administration, and governance – is a challenge only the largest and most successful multi-line providers will be in a position to undertake. Even so, they will still face tough competition across all their functions and many are prepared to outsource some functions where appropriate. The careful management of business partners can provide greater flexibility to expand and contract the outsourced functions in line with changing demand. In this way, outsourcing confers the potential to reduce costs and to avoid tying up capital in business areas where demand has fallen.

While we expect a small number of large-scale bundled life companies to survive and thrive, others will need to give careful consideration to the future focus of their business model to concentrate on areas of the business that they believe reflects their core strengths. This might be asset management, for example, but if so, this needs to have a genuine reputation for excellence that can be demonstrated through third-party mandates with both DC and DB schemes. Administration and a life company platform are alternatives, the latter already in evidence, as the consultants usually use a third-party life platform for their auto-enrolment schemes. The sale of non-core business lines, especially back books, will enhance this more focused-business model and lead to a more efficient use of capital.

Mid-tier traditional life companies are particularly vulnerable to the pace of change in the DC pensions market. In the past, these companies relied largely – often exclusively – on commission-based corporate advisers and IFAs to sell their products in the workplace and retail markets. This model is now obsolete, partly because of the ban on sales commission, but also because of the development of direct-to-customer (D2C) sales channels. Employers – especially medium and smaller firms – may find that D2C is the best route to the available auto-enrolment scheme providers, while individual customers will increasingly buy their pension savings and decumulation products via non-advice platforms, product comparison websites, and direct from providers.

For vulnerable life companies, there are several options to consider when choosing the way forward, but each one requires considerable structural change:

1. Life companies with a sufficiently profitable share of the auto-enrolment market – possibly as niche providers to small and medium-sized enterprises (SMEs), for example – should consider outsourcing non-core functions and establish joint ventures and other third-party arrangements in order to improve efficiency and reduce costs.
2. Life companies that find they cannot compete in the auto-enrolment market should consider selling non-core functions and focus on a key strength that has a potential for profitability in the business-to-business (B2B) market. In many cases, that strength will be administration and customer services – the functions many asset managers lack and are seeking through partnership arrangements.
3. Several well-known mid-tier companies will recognise that the key to survival lies in scale. These companies are likely to seek a merger with a stronger parent company.
4. Forward-looking life offices will examine potential business lines outside of the workplace pensions market and focus on cross-selling protection insurance. This will be on a group basis, where the employer is prepared to foot the bill, and on an individual basis, via the workplace, where the employer offers protection insurance as part of a flexible benefits menu.

Section 2: Challenges and opportunities for life companies in the back books markets

In this section, we set out our findings on the future of the back book markets. (Note 'markets' is plural: there are many more 'back books' than is generally appreciated.) We begin with the investigation into legacy charges, terms and conditions, and then consider potential policy and regulatory reforms, the aims of which are to build DC investor confidence and to address concerns about efficiency, as the market seeks to rectify its poor reputation for 'treating customers fairly' (TCF). We conclude with an overview of the new taxonomy of back books, in which each product is categorised according to the era and the legal and regulatory framework to which it belongs.

2.1 Addressing back book policy charges terms and conditions

The focus on back books, triggered by the Office of Fair Trading and Independent Project Board reports,[132] has directed the industry and media spotlight on the extensive range of legacy companies and legacy systems. The 'original' pensions back book market, which is our main focus, is associated with DC policies sold before 2001. The 1990s signalled the mass transition from the with-profits investment model to the unit-linked investment model for DC pension policies and also for long-term savings products, such as endowment mortgages.[133]

In this period, in addition to growing life company concerns about the long-term liabilities associated with with-profits guarantees, the imminent introduction of stakeholder pension schemes in 2001 brought to an end the widespread practice of multiple-charging. In fact, the writing was already on the wall for multiple-charge policies in 1999, when the then regulator, the Personal Investments Authority (PIA), issued Regulatory Update 64 (RU64), which warned advisers not to sell DC pensions workplace schemes and retail products that had high charges and complex terms and conditions, relative to those in a stakeholder scheme. For reasons that are not entirely clear, mass-market sales of single-premium with-profits bonds continued until about 2005-06. It is likely that a major influence here was the high sales commissions paid by life companies to advisers: 5-7% of the single premium lump sum was typical, which compared very favourably (for commission-based advisers) with commissions paid by asset managers for sales of mutual funds, such as unit trusts and investment trusts.

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132 OFT, Sept. 2013, revised Feb. 2014, Defined Contribution Workplace Pension Market Study, http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505. IPB, Dec. 2014, Defined Contribution Workplace Pensions: The audit of charges and benefits in legacy schemes - A report from the Independent Project Board, https://www.fca.org.uk/your-fca/documents/defined-contribution-workplace-pensions

133 The move away from with-profits pension policies with GARs of around 12% (i.e., an annuity of £12,000 for a fund of £100,000 (twice current rates)) began earlier. Equitable Life stopped sales in 1988 and launched proceedings to enable the company to abandon its guaranteed pay-outs in 1999, but by then the damage was already done. It closed its doors to all new business in December 2000 after failing to find a buyer. For a useful timeline on these and subsequent events, see Financial Adviser, 12 Nov, 2015, p. 4.

The OFT identified £40bn of assets in high-charging pre-2001 contract-based workplace schemes, representing 1.4m customers.[134] We estimate that at least an equivalent sum – and that the true figure could be closer to double this – relates to high-charging pre-2001 retail policies, on account of the common practice of transferring a member to a retail personal pension scheme when the employee changed employment and left the workplace scheme.

In July 2015, HM Treasury (HMT) published a consultation on the subject of charges on pension transfers and on exit penalties.[135] The closing date for responses was 21 October 2015. HMT said it would publish further details towards the end of the year, when the FCA and PRA have also completed their 'comprehensive evidence gathering exercise'. The scope of HMT's consultation is wide and searching. The House of Commons Work and Pensions Select Committee, chaired by Frank Field MP, is also examining the charges, terms and conditions of older policies.

It is to be hoped that these two official investigations, together with the work of the regulators, result in a clear plan for action. One area in particular where the Government should consider delivering a robust plan is where the past collides with the present. This involves addressing the restrictive terms and conditions that are likely to undermine the success of its 'freedom and choice' pension regime, which is predicated on DC savers' ability to access and transfer their pension pots easily and quickly, without excessive exit charges.

2.2 Proposed reforms for the 'original' back book market

The reforms we propose address market behaviour, as well as charges, terms and conditions. For example, we argue that the reputation of back book providers would improve if the market were made more visible to public scrutiny. At present, with the exception of the consolidators,[136] information about back books can be difficult to locate, since they are not necessarily named on the company's main website, but are listed under a separate website address. While the separation of closed and open business might make sense in terms of customer access to information, it also serves to disconnect this important business line from the insurer's public profile and to create an artificial gap between older and newer customers, both of which should feel that they are being treated equally fairly.

For the wider back book market to thrive, there needs to be change at both policy and regulatory level. We propose that the Government and regulators should consider taking the following steps.

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134 Bear in mind that at this time, trust-based schemes were confined to single-employer trusts, which generally were large-scale and offered comparatively low member charges, since the 'provider' was the employer, which was not seeking to make a profit from this core employee benefit.

135 HMT, July 2015, Pension Transfers and Early Exit Charges: Consultation, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/449861/PU1847_Pensions_transfers_v4.pdf

136 Examples of consolidators include Phoenix Group (http://www.thephoenixgroup.com/our-companies.aspx) and Zurich-based Admin Re, Swiss Re's business unit. Admin's parent company is ReAssure (formerly Windsor Life): https://www.reassure.co.uk/Pages/default.aspx. Admin Re operates across European borders and in September 2015, it announced the acquisition of the UK life company Guardian Financial Services for £1.6bn.

2.2.1 Resolve the legacy charge issue

The Government and regulators should provide a clear resolution to the investigation into legacy charges. Despite the likely prudential impact on life companies, we believe that the FCA, first to strongly urge, and then, if necessary, to require providers to address the perceived customer detriment in relation to the charges and the terms and conditions of older policies, including, but not limited to those sold before 2001. At the time of writing this report, the industry was awaiting the delayed final results of the FCA's thematic review of legacy charges, which began in 2014. We will be interested to see what actions are taken as a result of this review.

2.2.2 Ensure TCF applies equally to legacy workplace scheme and retail customers

If the Government and regulators decide that there is inconsistency between the treatment of consumers in legacy workplace pension schemes, which are under review, and consumers with legacy retail pension policies, which are not, they should consider initiating a second investigation into retail back books especially if life companies do not apply the same degree of reform to these policies, as is now required for workplace DC schemes. To date, however, there has been no indication that this is what the Government and regulators intend.

The arguments in favour of including retail customers are clear-cut:

- First, if TCF is to apply to legacy policies, it should apply equally to all customers and should not be dependent on the origins of the policy, which in many cases will have begun with membership of a workplace pension scheme, but was converted to a retail pension policy when the member changed jobs. While the latter problem is generally associated with contract-based schemes, which do not have 'deferred' members, we understand that some trust-based schemes 'sweep up' deferred members annually and convert these memberships into individual contract-based personal pensions. There was evidence of such practices in the OFT report, which found that active member discounts (AMDs), which confer lower charges on active members, but higher charges on leavers (via deferred member penalties or DMPs), were evident in 10,000 schemes, representing £13.4bn AUM.
- Second, we do not accept the argument that, where retail policies were sold via advisers, the customer made an informed choice, because the commission-based system and the assumption that with-profits was the best structure for pension policies created a very biased advice market.

  Moreover, we would not expect mass-market retail customers, who purchased policies in the 1980s and 1990s, to have much if any contact with their original adviser, so they will be 'advice orphans'.

Any argument against this extension of the reforms would be based on precedent, as far as we can see – that is, retail policies were not included in the 2013 OFT review, and therefore were excluded from the Independent Project

Board review.[137] This was because the original context of the OFT investigation was auto-enrolment. While this focus on workplace schemes was understandable, in the context of the Government's flagship new private-sector pension system, to ignore retail policyholders would be seriously remiss.

From our interviews with providers that manage back books, we expect behaviour to differ in relation to this important point. Some providers will apply the same revised charges, terms and conditions to legacy retail policyholders as they do to members of legacy workplace schemes. Others will resist, due to concerns about the impact on profits and on shareholder support.

2.2.3 A de minimis for the return of fund to customers with smaller policies

The Government and regulators should consider practical solutions to the difficulties of managing smaller policies, where annual administration costs are material relative to the pot size. One option would be for the FCA to introduce a de minimis, whereby providers can release funds to pensions and long-term savings customers. For the former, it would be necessary to change the legislation to allow for this process where policyholders are under the age of 55, which currently is the minimum age for access. Given the difficulties and the cost of communicating the option to customers, life companies would need a regulatory 'amnesty', under which they would have the right to undertake a blanket communications exercise, to return funds to customers that requested the value of their policy in cash and also to send cheques to policyholders who do not respond. This last point is important because life companies told us that communication exercises with legacy policyholders are rarely fruitful.

With this in mind we make the following proposals:

- The FCA should consider introducing a facility to make automatic transfers – i.e., without individual customer consent – to the life company's own modern products or to an aggregator. This would mirror the process under Part VII transfers permitted under the Financial Services and Markets Act 2000 and allow firms to transfer business when merging, provided that the impact on members is independently assessed and a court approves the transfer.
- The FCA should consider introducing the facility to issue automatic refunds – again without requiring individual customer consent.

In relation to workplace schemes, the ABI appears to be thinking along similar lines:[138]

> *Giving pension providers a legislative mandate to act in the collective best interests of savers will put all contract-based scheme members on an equal footing with members of trust-based schemes; trustees currently have much more discretion to take actions that they believe are in the best interests of scheme members.*

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137 OFT, Sept. 2013, revised Feb. 2014, Defined Contribution Workplace Pension Market Study, 2014 http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505. IPB, Dec. 2014, Defined Contribution Workplace Pensions: The audit of charges and benefits in legacy schemes - A report from the Independent Project Board, https://www.fca.org.uk/your-fca/documents/defined-contribution-workplace-pensions

138 ABI blog by Yvonne Braun, Director, Long Term Savings Policy, Feb. 2015, http://blog.abi.org.uk/2015/02/legacy-pensions-tackling-the-problem-head-on

This could be achieved by allowing without-consent transfers on the basis that three broad conditions have been met:

1. *The provider's IGC establishes that the scheme does not offer value for money for members and changes are required;*
2. *The provider demonstrates to the satisfaction of the IGC that there is no practicable alternative to a transfer; and*
3. *It is independently established that the benefits and fund characteristics in the new scheme are broadly equal to those in existing scheme.*

An important point the ABI made, and with which we agree, is that there is no single solution that will benefit all policyholders equally:

As the IPB [Independent Projects Board] set out, changes that benefit one saver may disadvantage another. This means IGCs may need to make tough decisions about what is in the best interests of the majority of scheme members collectively, rather than individually.

In other words, there is a persuasive argument in favour of taking action that represent 'the greatest good for the greatest number'.[139]

In considering these proposals, the Government and the FCA should bear in mind the fact that pension customers age 55+ can take their policy values as cash, but might lose out if the cash value includes fixed exit penalties, discretionary market value adjustments (MVAs), and/or does not take into account valuable guarantees that are only triggered at the maturity date. HMT's July 2015 consultation on pension transfers and legacy policies appears to exclude any prospect of imposing significant changes to the way that these legacy charges, terms and conditions apply.

2.3 Increased capital requirements under Solvency II

We set out briefly the provisions of Solvency II in the summary of reforms earlier in this report. Here we look at the potential impact more closely.

Life companies and analysts remain uncertain about the full extent of the impact of SII, but it seems clear that the additional capital requirements will trigger a review of capital-intensive business lines, such as annuities and with-profits policies with significant guarantees attached – a review that we understand is already underway, due, at least in part, to the persistently low interest-rate environment.[140] Unit-linked business and protection insurance are considered 'capital-light' by comparison.

Interviewees said that the biggest issue with SII is the uncertainty it brings to the market in the short term. Life companies will not find out until December 2015 if their internal models for capital reserving have been approved, which includes the treatment of 'transitional assets', or assets related to run-off business, which

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139 The phrase 'the greatest good for the greatest number' is attributed to Jeremy Bentham (1748-1832), the founder of Utilitarianism.

140 See, for example, The Actuary, Aug. 2015, pp. 26-27. Leading the way, by Simon Woods, partner at EY; See also http://uk.milliman.com/insight/2014/Capital-management-in-a-Solvency-II-world/ and http://www.solvencyiiwire.com/solvency-ii-update-2015-sponsors-feature/1582669

might or might not be counted as an asset class on the balance sheet. If transitional assets are not included on the balance sheet, this could affect the life company's ability to pay dividends.[141]

One aspect of SII will have particular significance for the back book market. By 1 July 2015, life companies had to request permission from the PRA to use the 'Matching Adjustment' (MA) reserving methodology. MA provisions give insurers relief for holding certain long-term assets that match the cash-flows of a designated portfolio of life or annuity insurance and reinsurance obligations. It does so by allowing an adjustment to the discount rate at which the firm is required to value the cash flows of its insurance/reinsurance obligations in order to determine the amount of technical provisions it is required to hold to cover them. As a minimum, the PRA has said that it expects firms to demonstrate that separate processes will be in place relating to: accounting systems; investment policy and mandates; processes and controls, including controls to ensure that assets within the portfolio will not be used to cover losses arising elsewhere; governance; and management information.[142]

We understand that if an insurer secures MA status, it can hold lower reserves. Interviewees who had studied the legislation said that where a life company does not secure MA status, it is likely to sell its back books to those that do have this status, in order 'to relieve the inefficiencies in capital' and 'to offload unwanted risks' (in an interviewee's words) that are already under strain following the FCA's additional requirements for legacy books that are formally closed to new business. A key issue for MA is that SII favours certain asset classes over others. As a result, some businesses may have to restructure their capital investment in business lines: for example, it is not yet clear if equity release mortgages are permissible life company capital investments under MA status.

The FCA already requires higher levels of capital reserves when a legacy book is formally closed for business. Interviewees said that if an insurer achieves MA, it can hold lower reserves, and might become a buyer of back books from life companies that do not achieve MA status and which might feel the need to 'relieve the inefficiencies in in capital'.

A further but related issue for the life sector is the potential introduction of stress-testing by the Bank of England, as part of its programme for dealing with financial institutions that have the potential to create systemic risks that could de-stabilise the entire financial system, as happened with the banks in the Global Financial Crisis 2007-09. We understand that the regulatory intention is to prevent a repeat of the failure of AIG in 2008. If introduced, this measure could trigger an increase in capital reserving and, in turn, prompt life companies to take a more risk-averse approach to many of their business lines.[143] The stress-testing may apply to nine of the world's biggest insurers, including the UK's Aviva

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141 This problem also arose in the banking sector under Basel III.

142 See https://www.ashurst.com/doc.aspx?id_Content=11470, http://www.bankofengland.co.uk/pra/Documents/about/praletter280315.pdf, and https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii-technical-information/risk-free-interest-rate-term-structures. For analysis, see, for example, http://uk.milliman.com/insight/2015/Stepping-stones-to-ORSA-Looking-beyond-the-preparatory-phase-of-Solvency-II/.

143 See, for example, FT March 17 2015. http://www.ft.com/cms/s/0/1940e7dc-ccd4-11e4-b252-00144feab7de.html?ftcamp=crm/email/_2015___03___20150317__/emailalerts/Keyword_alert/product&siteedition=uk#axzz3UiiZq295

and Prudential.[144] Overseas-headquartered insurers that operate in the UK include Germany's Allianz and New York-based MetLife could also be covered. If the stress-testing goes ahead, as seems likely, these companies will be required to increase the amount of capital they must hold as a cushion against unexpected losses by 10% on average we were told.

Depending on the outcome of these developments, for some providers' back books might continue to represent a profitable business line, even if customer charges are reduced and restrictive terms and conditions relaxed – either on a voluntary or prescriptive basis (both options are set out in HMT's consultation paper). For others, the combination of reduced profits and increased capital reserving might mean that the back books no longer represent a profitable core business and instead act as a drag on investment in new business development.

One final factor that will influence a life company's decision to hold or sell back books is its ability to attract and retain with-profits experts. The with-profits market is vast, but it has a limited remaining life-span, which means that the smarter newly-trained actuaries are likely to eschew a career in this line of business.

2.4 A changing market for buyers and sellers of back books

Our research reveals that a back book is not necessarily an old book or a closed book, and that there is a clear synergy in managing the back books of both the DC and the DB segments of business. Insurers that recognise this reality have the opportunity to make profitable purchases over the next five years or so. The research indicates that the market in back books is on the cusp of a period of major expansion and restructuring. There are several reasons for this, including the pressure on certain life companies to sell legacy books – and possibly complete brands – due to the increased capital requirements under SII.

At the same time that increased transactions in older legacy books take place, we expect to see more recent books of life company pensions business to be offered for sale, due to the anticipated consolidation in the auto-enrolment market we discussed in Section 1. A parallel increase in de-risking transactions in the DB pension scheme market will see further transfers of DB liabilities from the corporate balance sheets of sponsoring employers to the balance sheets of life company BPA buy-out specialists. BPA books of business represent the back books of employers' closed DB schemes and there are interesting parallels between this and the retail annuity back book market, among others. Completing the line-up in this new market will be back books of equity release policies. We expect the number and value of transactions in this business line to be small for some while, but to increase as equity release becomes a mainstream product in the retirement-income market as private-sector workers with small DC pots look to their home to support their retirement standard of living.

Participation in the broader market for back books will not be limited to traditional life companies, but will include mono-line insurers in the retail and bulk annuity business, and also other types of financial institutions, such as large UK and overseas DB pension schemes, for which an investment in certain types of back books will represent a hedge against longevity liabilities. Purchases on the part of DB schemes increasingly will be cross-border.

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144 FT, 5 Oct. 2015. http://www.ft.com/cms/s/0/4e44e49c-6a90-11e5-8608-a0853fb4e1fe.html?ftcamp=crm/email/follow/author/Q0ItMDAwMTA5MA==-QXV0aG9ycw==/product#axzz3qG5JMxRJ

To succeed in the back book market requires significant investment, since the technology and platforms associated with older books will need to be updated to improve efficiency and customer services. For open life companies, this means that the back books will require the same commitment to resources, governance and TCF principles that are applied in the acquisition of new business in the auto-enrolment accumulation and decumulation markets. In other words, the decision on the part of open life companies to participate in the back book market will change from passive – where ownership of back books has been organic (due to changes in regulation or demand, for example) and/or a result of mergers and acquisitions – to a proactive strategy predicated on the ability to extract value, while at the same time demonstrably treating customers fairly.

Back book markets in future will include:

- Mutual society with-profits businesses. In March 2014, the FCA published 'Response to CP12/38 – Mutuality and With-Profit Funds: A way forward'. The report confirmed mutual societies can apply to the FCA for permission to divide their common funds, so that they can separate older and less profitable with-profits business from the more profitable unit-linked business – the market in which some mutuals believe their future lies. We expect some mutuals to take this decision and sell their closed with-profits books to free up capital to invest in the on-going unit-linked business. Although most mutuals are small, in terms of AUM, the shedding of with-profits businesses will be seen as a significant move within the industry, since the sharing of risk and reward between the firm and customer-members, has been the hallmark of this business model. In future, it is likely that mutuals that remain independent may look and behave more like proprietary life companies.
- Single-employer trust-based DC schemes. We expect single-employer schemes to move to an outsourced, multi-trust auto-enrolment scheme, once employers have transferred their DB pension scheme liabilities to a BPA insurer – a process that is likely to occur within the next 10-15 years in the majority of cases. This will be an opportunity for employers to dismantle their trustee infrastructure, which at present they use for both the closed DB scheme and the open DC scheme. The trend may take place earlier where the DC scheme includes a large number of ex-employees – as is likely to occur where, pre-auto-enrolment, only a small percentage of employees voluntarily joined. Under the above circumstances, it is not yet known if employers will transfer their single-trust DC assets to a multi-trust provider or if they will look for a third-party provider to manage the run-off as a separate arrangement. Much will depend on the wording of the DC trust deed and rules.
- Group DC 2000-2012. Many of the workplace DC schemes sold after the turn of the century (that is, after the RU64 and stakeholder watershed) and before the start of auto-enrolment in 2012 are likely to be uncompetitive compared with the new large-scale multi-trust auto-enrolment schemes. Some will have been replaced when the employer introduced auto-enrolment; others will be replaced when the employer reaches the third anniversary of their staging date. Unless the employer and new provider arrange a block transfer of members, which will be difficult under a contract-based scheme, these older DC schemes will form legacy books of business.
- Auto-enrolment schemes sold between 2012 and 2018. We expect several mid-tier life companies to pull out of the auto-enrolment market when the selling frenzy is over in 2018 and companies have time to assess their market share. The same applies to the majority of the 50 master trust providers.

TPR has conferred 'master trust assurance' status on only five schemes to date: NEST, NOW Pensions, SEI Master Trust, The People's Pension, and Welplan.[145] The implication is that schemes not on the list might not be suitable for auto-enrolment purposes. TPR says: 'If you run a master trust pension scheme, we expect you to obtain independent master trust assurance to help you demonstrate high quality governance and administration standards'. We expect most of the master trusts to consider a merger or to close and sell their business.

- Retail annuity books. There is a clear synergy between managing retail annuity books and the pensioner sections of institutional BPAs. BPAs represent the 'back books' of sponsoring employers of DB schemes that are able to transfer some or all of the scheme's liability from the corporate balance sheet to an insurance company. While it is not unusual for annuity books to change hands between multi-line life companies, as firms restructure,[146] Zurich's 2015 sale of its retail annuity book to Rothesay Life, a major mono-line life company in the BPA market, demonstrates this synergy between what hitherto have been classed as two separate markets for retail DC and institutional DB business.

  It is not yet clear to us whether the specialist (mono-line) BPA market would also consider buying mature books of legacy with-profits pension policies that have guaranteed annuity rates (GARs), but we were told that there is synergy in the management of closed books in run-off and BPAs.

- BPA buy-outs. This is the biggest growth area for back books and represents the transfer of the liabilities of closed DB schemes to insurance companies. The Pension Protection Fund (PPF) is the national compensation scheme, established by the Government under the Pensions Act 2004, to accept the schemes of qualifying insolvent employers, where the DB scheme's assets cannot secure a BPA buy-out that offers at least the equivalent of PPF compensation levels. Since 2005, when the PPF opened its doors to business, more than 700 closed DB schemes have entered the compensation scheme. In most cases, the employer had become insolvent and the scheme was underfunded relative to the PPF compensation levels.

  If the funding level is above the PPF level (this situation is known as PPF+), the trustees are required to arrange a BPA buy-out with an insurance company. Today between 20% and 40% of the 6000 schemes in the PPF Index are underfunded and the sponsor's covenant is weak. For most of these schemes, the DB deficit is significant relative to market capitalisation (quoted companies) or relative to the enterprise value (privately-owned companies). Over the next 10 years, we believe many more PPF+ BPA buy-outs will be negotiated.

- Equity release. As this market develops and matures, we expect to see new entrants and books of business exchanging hands.[147] As with the (proposed) secondary market in annuities, we expect some consolidators to develop commoditised funds of equity release policies, which will create a new asset class that will be of interest to insurance companies and DB schemes.

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145 The master trust assurance framework provides an independent review against an industry-wide benchmark of quality, http://www.thepensionsregulator.gov.uk/trustees/master-trust-assurance.aspx#s19297

146 In September 2015, press reports said that Aegon was considering the sale of its annuity business as part of its intention to restructure. See, for example, http://citywire.co.uk/new-model-adviser/news/aegon-annuity-business-on-the-block/a841298. In March 2015, Equitable Life agreed to sell its annuity business to Canada Life. http://www.equitable.co.uk/media/41574/equitable-life-and-canada-life-press-release-3-march-2015-finalb.pdf

147 L&G recently entered the equity release market with the acquisition of Newlife Home Finance. It said an estimated £14bn of equity release transactions has been completed over the last two decades, http://www.professionaladviser.com/professional-adviser/news/2397881/l-g-posts-10-profit-growth-as-retirement-profits-up-38

Conclusion

This report makes clear that the traditional life company business model has become anachronistic as a result of market developments and, in particular, the new auto-enrolment and 'freedom and choice' DC pension regimes for the private sector. It is likely to become obsolete if the Government introduces further tax changes that convert the pension tax regime – a regime on which, arguably, the success of life companies to date has been predicated – to that of the long-term savings tax regime of ISAs.

It would be fruitless for financial institutions in the DC pensions market to strive to maintain the archaic distinctions between insurance-based and investment-based providers, between advice and so-called 'non-advice' distribution channels, and, in the decumulation market, the distinction between workplace and retail.

We hope that the issues raised in this report will form the basis for an open debate about the DC provider's business model of the future – with reference to traditional life companies and the new provider-challengers. The research indicates that the new business model will be based on specialist distributors that rely on a combination of joint ventures and outsourcing arrangements to deliver excellence across all the component parts of DC pension schemes and plans – for new business and back books alike. We look forward to this industry debate and to the Government's and regulators' response to the challenges we have raised.

Appendices

Glossary of terms[148]

Accumulation: In *defined contribution (DC)* workplace pension schemes and individual plans, this refers to the period of pension contributions and investment. See *decumulation*.

Active member: A member of a DC scheme who is working for the sponsoring employer. See also *deferred member*.

Active member discount (AMD): A lower *annual management charge* that applies to active members of a scheme, which is increased when they leave employment. AMDs will be banned from April 2016. See *deferred member penalty*.

Additional voluntary contribution (AVC): A type of individual DC pension policy, used to top up a workplace pension scheme (usually *defined benefit*).

Alternative asset class: A collective term used to describe asset classes that generally are illiquid, such as commodities, hedge funds, infrastructure, private equity, and real estate, among others.

Annual management charge (AMC): The charge deducted from member funds, which covers disclosed investment costs and administration, among other items. The AMC is regarded as an incomplete disclosure measure. The *total expense ratio* is more comprehensive, but is still not complete, nor is *ongoing charges*. There is growing pressure for asset managers to disclose all fund costs such as *transaction costs* and the costs of sub-funds.

Annuity: A lifetime annuity – the most common in the UK – is an insurance policy that that pays out immediately on purchase and guarantees the income for life in return for the DC pension fund (the insurance premium). The purchaser is described as an annuitant. See *deferred annuity* and *bulk purchase annuity*.

Annuity rate: The income the insurance company guarantees to pay per month or per annum in return for the lump sum. It can also be expressed as a percentage yield.

Auto-enrolment: The system of pension scheme provision for all employers, which mainly affects the private sector and which is being phased in between October 2012 and 2018. Employers and qualifying employees ('eligible jobholders' are those aged between 22 and the state pension age, earning at least £10,000 per annum in 2015-16) must make minimum contributions based on *band earnings*. Employees have the right to opt out. Qualifying auto-enrolment schemes do not have to be DC, but, in practice, the majority will adopt this structure. Qualifying schemes must offer a default fund for members who do not wish to make their own investment decisions. Pre-existing workplace schemes can continue to be used if they offer at least the equivalent benefits of a qualifying scheme. This means that, in practice, some employers will retain a more generous pre-auto-enrolment scheme for employees who joined under the voluntary system, and use a new qualifying scheme for auto-enrolment purposes.

148 Sources include previous Pensions Institute reports, the DC Investment Forum, the DWP, the FCA, the Financial Times Lexicon, and the OFT.

Back book: Also known as legacy business, this is a block of older policies and contracts that were sold at a particular period in time. See also *closed book*. Products in back books usually are no longer sold, for example, where they are replaced with modern products with different charges, terms, conditions, and investment strategies. A product can become dated and replaced, due to policy and regulatory change, among other factors.

Band earnings: Under auto-enrolment, by 2018, the annual minimum contribution for all qualifying workers will be 8% (comprising 4% from the employee, 3% from the employer, and 1% in tax relief), based on band earnings of £5,668- £42,385 in 2015-16. The contribution requirements are being phased in, starting with a minimum of 2% of qualifying earnings, of which the employer must pay a minimum of 1%.

Bonus: The annual and final (discretionary) amount added to a *with-profits* policy to reflect the actuarially smoothed investment performance of the fund.

Bulk purchase annuity (BPA): A single transaction that involves the transfer of *defined benefit* pension scheme liabilities from the sponsoring employer's corporate balance sheet to the BPA *life company*. Pension scheme trustees pay a premium (cash) and in exchange the insurer writes an *annuity* contract that pays the retirement income of a large chunk of a scheme's members. The BPA might cover only the pensioner section of members, or it might cover the whole scheme, including pensioners, active members (who still work for the employer), if relevant, and deferred members (who no longer work for the employer, but have yet to reach the *normal retirement age* to qualify for the pension). By arranging the BPA, the trustees offload all of the schemes risks, including investment, inflation and longevity risks.

Bundled scheme: A DC scheme where the provider is responsible for both the asset management and administration functions. An alternative description is vertical integration.

Closed book: Also known as a closed life fund, this term is used as a synonym for *back book* to describe the position where a life company no longer actively sells products based on its with-profits fund. Technically, 'closed' refers to a back book that has been closed formally under the Financial Conduct Authority's (FCA's) rules, which means that additional protections are put in place (e.g. capital requirements) in order to protect policyholders.

Commission: Until the implementation of the *Retail Distribution Review* (RDR) in January 2013, many intermediaries that sold pension schemes to employers – e.g. corporate advisers – were remunerated by the scheme provider in the form of sales commission, the cost of which was incorporated into the scheme member's *annual management charge*. In principle, from this date, commission was banned for sales of investment products and replaced by an explicit advice fee, but, for a short while, intermediaries that sold auto-enrolment schemes could receive a *consultancy charge* from providers, which was very similar to the commission-style form of remuneration.

Composite insurer: A company that has a life and pensions business (a life company) and a general insurance business (e.g., protection insurance, car and home insurance).

Consultancy charge: Between January and September 2013, many auto-enrolment scheme providers offered a consultancy charge to intermediaries instead of *commission*, which was banned from January 2013 under the *Retail Distribution Review*. The Government banned the consultancy charge in

September 2013, as it was concerned that the deduction of the charge from member contributions would undermine auto-enrolment, especially for lower earners and frequent job changers. If a scheme had already been sold under this arrangement, it could remain in place. The final ban on the charge is expected to come into force in April 2016. Even then, the Government might permit it to continue under certain circumstances. Details will be announced in 2016.

Consumer Price Index (CPI): This index, calculated and published monthly by the Office for National Statistics (ONS), measures changes in the price (i.e. inflation or deflation) of a basket of a representative sample consumer goods and services. Since December 2003, the Government has used the CPI as its main measure of inflation in the economy, rather than the *Retail Prices Index* (RPI). The CPI is calculated as the geometric average price of a basket of 700 different goods and services. This contrasts with the RPI which takes the arithmetic average of a different basket of goods and services. Because of the different ways of calculating average prices, CPI inflation is generally 1% p.a. lower than RPI inflation.

Contract-based DC: DC schemes can be established under contract or trust law. In a contract-based scheme, the contract is between the member and the provider, for example, a life company. Contract-based DC schemes and plans are regulated by the Financial Conduct Authority (FCA). See also *trust-based DC*.

Corporate adviser: The distinction between employee benefits consultants and corporate advisers is blurred. Historically it denoted the remuneration basis (fees or commission respectively), but it also denotes the target market, which, for corporate advisers, tends to be smaller and medium-sized employers, whereas for consultants, this tends to be medium-to-large employers.

Decreasing life assurance policy: A *life assurance policy* that reduces in value over the predetermined number of years (the term). Often used to support a repayment mortgage, where the size of the debt reduces over the mortgage term, or with a savings plan used to pay off a mortgage at the end of the term.

Decumulation: The process whereby the DC fund built up during the accumulation stage is drawn as cash or in the form of regular income via an *annuity* or *income drawdown*. Until April 2014, most DC savers were required to buy an annuity. From April 2015, under 'freedom and choice', DC savers can make unlimited withdrawals from their fund (subject to product or scheme rules). These withdrawals are subject to the individual's marginal rate of income tax, with the exception of the 25% tax-free lump sum.

Default fund: In a DC scheme, this is the multi-asset fund designated to receive the contributions of members who do not make an investment choice. Under auto-enrolment, an estimated 90% of members rely on this fund.

Deferred annuity: An *annuity* which begins payments at a predetermined date in the future.

Deferred member: The description applied to members of DC schemes who leave the sponsoring employer's company. In a *trust-based* scheme, membership can continue and so former employees continue to be the responsibility of the scheme trustees. In a *contract-based* scheme, the contract would usually be reclassified as an individual *personal pension*, so the individual is no longer a member of the previous employer's scheme.

Deferred member penalty (DMP): An increased annual management charge applied when a member leaves a scheme where an *active member discount* (AMD) is used. AMDs are banned from April 2016.

Defined benefit (DB): Members' pensions are linked to salary (e.g., final salary or now more commonly earnings averaged over the period of membership). The sponsoring employer is ultimately responsible for meeting the liability if the scheme is underfunded. Most DB schemes in the private sector are closed and have been replaced with defined contribution schemes.

Defined contribution (DC): In DC, the member's pension is based mainly on the level of contributions invested, the charges deducted, and investment returns. There is no guaranteed pension linked to salary, as is the case in a *defined benefit* scheme. Therefore the investment and longevity risks, among others, fall solely on the individual members.

Embedded value: The value to equity shareholders of the net assets and expected future profits of a life company.

Endowment (regular premium): A *with-profits* investment policy combined with *decreasing life assurance*. In the case of a mortgage endowment, for example, on the early death of the policyholder, the combination of the fund value and the life assurance would be sufficient to repay the mortgage debt.

Employee benefit consultant (EBC): The distinction between EBCs and *corporate advisers* is historic and generally denoted the remuneration basis. EBCs generally target the larger employers (DB and DC) and trustees. They might also act as a *fiduciary manager* of their own DC scheme.

Executive pension plan (EPP): An older-style defined contribution policy established by employers to provide pensions for key employees, e.g., senior managers and directors.

Fiduciary manager: With reference to DC schemes, this is where an asset manager or *EBC* offers a full asset management service for the default fund, drawing on third-party asset manager funds (and sometimes their own funds) for each asset class. The role is broadly equivalent to that of a chief investment officer. Where an EBC offers its own scheme, it would manage the administration (in-house or, more likely, via third-party arrangements, including life office platforms).

Financial Reporting Council (FRC): The FRC promotes high standards of *corporate governance* through the UK Corporate Governance Code for quoted companies. It sets standards for corporate reporting, audit and actuarial practice, and monitors and enforces accounting and auditing standards. In addition, the FRC oversees the regulation of the actuarial profession and the professional accountancy bodies.

Free-standing AVC (FSAVC): An older type of individual pension plan used to top-up a workplace DC scheme. Generally these would be held in back books, as the product is dated.

Governance: A generic term used to describe the responsibilities – set out as best-practice rules and processes – of an individual or body in charge of protecting the assets and/or interests of stakeholders, for example shareholders and employees, in the case of a listed company, and members and their beneficiaries, in the case of a pension scheme. Directors of quoted companies in the UK have to comply with the UK Corporate Governance Code, or explain to investors why they are non-compliant.

Group personal pension (GPP): A contract-based workplace pension scheme. In effect a grouping of individual *personal pension* plans but with pricing to reflect the group nature of the arrangement.

Guaranteed annuity rate (GAR): A predetermined *annuity*-conversion rate attached to a with-profits pension policy, which guarantees the rate, e.g., a 10%

of fund annual income per £1,000 of the accumulated fund, irrespective of the prevailing gilt yield at the time of the annuity purchase.

Income drawdown: At retirement, instead of purchasing an *annuity*, the member draws a regular income directly from the fund, which is subject to income tax, apart from the tax-free cash lump sum.

Liabilities: Obligations under law or regulation. In the case of a defined benefit pension scheme, the sponsoring employer is responsible for meeting any shortfall in the value of the fund and in the assets needed to pay future benefits to members, as they are set out in the scheme's trust deed and rules.

Life assurance: An insurance policy that pays out on the death of the insured. See *term assurance*, decreasing term assurance and *whole of life*.

Life company: Life companies (also known as life and pensions companies) and general insurance companies are financial institutions set up to sell life and pension products and general insurance products, respectively. (*Composite* insurers offer life, pensions and general insurance products through different arms of the business.) These companies are highly regulated and their accounting rules are highly specialised. Company valuations require calculations of *embedded value* in order to determine what can be taken as profit for distribution to shareholders, in the case of companies, and to members, in the case of *mutual societies*. In particular, there are specific regulatory requirements in relation to capital adequacy – that is, the reserves a life company must hold in order to back its guarantees to policyholders. In the UK, life companies are regulated for prudential purposes (i.e., to determine the soundness of the business) by the Prudential Regulatory Authority (PRA) and for conduct of business purposes by the Financial Conduct Authority (FCA).

Lifetime allowance (LTA): The LTA limits the amount of pension benefit that can be drawn from pension schemes – whether in the form of lump sums or retirement income – before an additional tax is imposed. The LTA was introduced in 2006 as a cap of £1.5m on an individual's total pension fund value. It increased each year to 2010 (£1.8m) and then reduced. In the 2015-16 tax year, the LTA is £1.25m, reducing to £1m from April 2016.

Mass market: An imprecise term, but used in this report to refer to average earners, who do not have significant sources of wealth. Their investible ('spare') savings and investments outside of their DC pension are likely to be less than about £30,000 at present, unless the individual has received a substantial bequest.

Master trust: A *trust-based* DC workplace pension scheme that can accommodate multiple non-related employers. The trustee board might be wholly independent of the scheme provider or might include provider representation.

Mid-tier life company: An imprecise term, but used in this report to refer to medium-sized *life companies* that historically have relied on paying sales commission to advisers to distribute pension schemes and plans. Mid-tier life companies may provide *bundled* workplace schemes and retail products, but do not necessarily excel across the key component functions, such as asset management and administration.

Money's worth: A measure of the value for money of an *annuity* based on the conversion rate between, say, £1000 of the defined contribution fund at retirement and the annual income the insurer will pay for life in exchange. The money's worth will be less than 100% to allow for provider operating costs and profit.

Mutual society: A life and pensions organisation that is owned by its members, rather than by shareholders, as is the case with a quoted (proprietary) life company.

Normal retirement age (NRA): In an employer-sponsored pension scheme, this is the age at which benefits are paid in full.

Personal pension plan (PPP): An individual (retail) DC pension plan, introduced in 1988 to replace the *retirement annuity contract*. A personal pension could be used to contract-out of the state earnings-related pension scheme (SERPS), in return for which the individual would receive a rebate of national insurance contributions (NICs).

Platform: With reference to DC schemes, this is the life office IT 'engine', which manages the day-to-day running of a range of functions including asset management, administration (e.g., of contributions), and compliance. It might also include member communication and documentation.

Quantitative easing (QE): A form of monetary policy where a Central Bank – in the UK, the Bank of England – creates new money electronically to buy financial assets, like government bonds. QE aims to increase private-sector spending in the economy in response to a financial crisis.

Retail Distribution Review (RDR): The RDR came into effect on 1 January 2013. It banned adviser commission for new sales of investment products, including pension schemes and plans. From this date onwards, all advice relating to the sale of new investment products was supposed to be fee-based, but the *consultancy charge* was used to get round the commission ban until September 2013.

Retail Price Index (RPI): Similar to the *Consumer Price Index*, but the basket of goods and services includes more items, e.g., mortgage interest payments and other housing costs. RPI usually is about 1% higher than CPI.

Retirement annuity contract (RAC): An early type of individual pension policy, which was replaced by the personal pension in 1988.

Section 179 (s179): One of several funding and valuation measures used to calculate the funding position of a *defined benefit* pension scheme. The s179 valuation (s179 of the Pensions Act 2004) is a useful benchmark for the funding position of underfunded closed DB schemes, i.e., where the fund is worth less than the *liabilities* and there is a deficit. This is the main measure used by the Pensions Regulator (TPR) and the Pension Protection Fund (PPF – the compensation scheme for DB members) in their joint annual publication, *The Purple Book*, which examines the risks that the 6,000+ schemes in the PPF Index face. Broadly, s179 represents the cost of PPF compensation, if a qualifying scheme were to enter the PPF in the event of a sponsor's insolvency. S179 is also known as the PPF level of funding, or just 'PPF'.

Section 32 buy-out bond (s32): With reference to Section 32 of the Finance Act 1981, this is an older-style *deferred annuity* contract that was used, at times, for transfer purposes if a member left a *defined benefit* scheme. It was also used to secure members' benefits if a DB scheme was wound up (closed down).

Self-invested personal pension (SIPP): An individual pension plan that offers a wider investment choice than a *personal pension*, which is limited to funds only. A SIPP, which is a type of personal pension, can be used to invest directly in equities and property, for example, although the actual choice of investments will depend on the providers' plan rules. SIPPs can be sold by life companies but also by asset managers and firms of advisers.

Single premium bond: A fixed-term savings plan (typically 5 or 10 years). Single premium bonds based on *with-profits* investment funds represented a major market in the 1990s and up to about 2005-06. Most policies are now in *back books*.

Solvency II: A major review of the capital adequacy regime – i.e., capital requirements and risk management – for the European Union insurance industry. The regulation comes into force in January 2016.

Staging date (auto-enrolment): This is the date at which employers' new duties under *auto-enrolment* become obligatory. The date falls between October 2012 and April 2018, starting with the largest employers and ending with the smallest, based on the size of the employer's pay-as-you-earn (PAYE) scheme.

Term assurance: A *life assurance* policy that pays out on the death of the insured if he or she dies during the term of the contract.

Total expense ratio (TER): The TER is a more comprehensive measure of the member's total annual cost than the *annual management charge* (AMC), but is still not complete. It includes the AMC and fees for a range of services including legal, administration, audit, marketing, directors, and regulatory costs. There is growing pressure on schemes to reveal all fund costs, including *transaction costs* and the cost of sub-funds.

Transaction costs: Costs that are incurred as a consequence of dealing in assets. These include bid-offer spreads, transaction costs of underlying (sub) funds, profits from stock lending retained by fund managers, interest on cash balances retained by fund managers, and FX spreads on currency hedging, among others.

Treating customers fairly (TCF): A regulatory principle that all regulated financial services firms must protect the best interests of all customers.

Trust-based DC: Schemes set up under trust law where the trustees are the legal owners of the assets on behalf of members and have a fiduciary duty to act in members' best interests. These schemes are regulated by The Pensions Regulator (TPR).

Unit-linked policy: A *life company* policy (or wrapper) used to hold one or more funds for the purpose of saving for retirement, for example. Unlike with-profits funds, there is no actuarial smoothing of returns and so the unit value directly reflects the performance of the underlying fund.

Value for money (VfM): In relation to auto-enrolment schemes, VfM for members denotes the optimal combination of scheme costs and design – including governance, the investment strategy for the *default fund*, and administration – sustainable over the accumulation and decumulation periods.

With-profits fund: The fund invests in a range of assets, including equities, bonds and cash (and sometime property). The asset mix will depend on the maturity of the fund, e.g., where there is a high proportion of policies that are due to pay out shortly, the asset mix will be more conservative and hold a higher proportion of bonds and cash. The value of the policyholder's policy is not directly linked to the value of the fund because returns are subject to actuarial smoothing in order to reduce volatility (put simply, some of the profits are held back in good years in order to maintain a steady return in the years when performance is poor). The policy value builds up through 'bonuses'. To the basic value of the policy (the 'sum assured') are added regular (annual or 'reversionary') bonuses. The rate of regular bonuses is not guaranteed in advance, but, once added, cannot be removed from the policy. There may also be a discretionary terminal bonus added when the policy matures (reaches the end of its term), which is usually based on more recent performance. A common feature of older with-profits pension policies is the *guaranteed annuity rate* (GAR), which usually is worth far more than the prevailing (current) rates on offer.

Whole of life policy: A combination of savings (typically *with-profits* in the pre-2001 era) and *life assurance*. The policy pays out on the death of the policyholder, whenever this occurs, which means that there is always a death benefit (unlike *term assurance*, which only pays out if the policyholder dies during the term covered).

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Sponsor Statement

The life and pensions industry is undergoing a period of unprecedented change. New policy and regulation has impacted the shape and scope of the defined contribution (DC) market, providing both opportunities and challenges to the life and pensions market. We will see yet more changes. The introduction of auto-enrolment has brought in powerful challengers into the UK market; the full impact of the new DC pension tax regime – or pension freedoms – is yet to be known, but we have seen a steep decline in the number of annuities purchased to date.

It is therefore far from clear what the market of the future will look like from the perspective of the industry as a whole, for the individual providers and for our customers.

Phoenix Group commissioned the Pensions Institute to write this report, which combines academic rigour with a thorough understanding of the market in practice. We believe that it is important to have an independent view of the impact of the challenges the life industry is facing, and what the industry needs to do to meet them. As the UK's leading consolidator of closed life funds, we believe that Phoenix has a key role to play in supporting our customers through these changes.

This study is timely. From UK to European policy reform, it is clear that the traditional life company business model must continue to adapt and, whilst we do not claim that the report covers every aspect of the market, it should help the industry engage with the reforms and equip itself with a clearer understanding of the rapidly changing market.

The views contained in this report are those of the Pensions Institute. We hope that the report will act as a catalyst for discussion and debate not only around the future direction of the UK life industry but also around the role that life companies have played in the UK's economy and how they need to adapt if they are to continue to play a key role.

The findings should be of interest to life companies, asset managers, policymakers, regulators, investors and a range of other key stakeholders. It sheds some much needed light on the challenges in the new DC pension back book markets, along with offering proposed solutions for the business model of the future and regulation and management of back books.

I would like to thank Dr Debbie Harrison and Dr David Blake personally for the huge commitment they have both made to the development of this report, along with the contribution from organisations and expert colleagues.

We look forward to hearing your views.

Clive Bannister
Phoenix Group Chief Executive

Pensions Institute

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- to undertake high quality research in all fields related to pensions
- to communicate the results of that research to the academic and practitioner community
- to establish an international network of pensions researchers from a variety of disciplines
- to provide expert independent advice to the pensions industry and Government.

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