

Secondary Annuity Market – Consultation Paper (CP16/12)

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In March 2015, the Government announced it was consulting on extending pension freedoms to individuals with an annuity already in payment, allowing them to sell their annuity income without the tax restrictions that currently apply. The Government published its response to this consultation in December 2015 and confirmed that the tax changes would come into effect from April 2017.

The changes would allow consumers to receive the proceeds of their annuity as a taxable lump sum, invest the proceeds in a drawdown fund or purchase a flexible annuity with the proceeds.

In April 2016, the Treasury announced its intention to create three new regulated activities for the secondary annuity market:

- Buying annuity incomes;
- Buying back annuity incomes; and
- Acting as a market intermediary.

Companies will need to obtain the relevant regulatory permission to partake in these actions, and CP16/12 seeks views on the Financial Conduct Authority's (FCA) proposed rules and guidance on the secondary annuity market.

The closing date for responses is **Tuesday 21 June 2016**. The consultation period is one month less than the usual three months to allow final rules to be issued earlier and to give firms more time to prepare. The FCA will consider the feedback it receives and intends to issue a Policy Statement containing its final rules and guidance later in the year.

OVERVIEW

The FCA believes that there is a significant risk of poor outcomes for consumers in the secondary annuity market, due to the older and hence more vulnerable nature of many of the consumers, and the complexity in understanding how annuity products are valued.

The FCA has identified a number of risks in the secondary annuity market for sellers of annuities. Some of the main risks include longevity, obtaining the best value for money, the vulnerability of the consumers, competition in the market and misleading practices. The proposed rules are designed to help alleviate the risks listed.

Contrary to the Treasury's March 2015 paper, *Creating a secondary annuity market*, it now appears that firms will be able to buy back annuities that they have sold. It is unclear how the Treasury's initial concerns have been addressed, namely that high demand for buy backs may mean that the provider sells illiquid asset holdings at short notice for a low price, and hence may compromise their solvency, and it may reduce consumers shopping around to obtain the best price for their annuity. There are also other implications whose impact is unclear, such as the effect on a firm's matching adjustment, the treatment of existing annuity reinsurance and that the firm buying back the annuity may have extra medical information on the consumer.

The Government announced in its December 2015 consultation response that it would legislate to provide a number of protections for sellers in the secondary annuity market. These include requiring sellers with an income stream above a certain threshold to seek financial advice and introducing dedicated regulatory activities for the secondary annuity market. The proposals in CP16/12 are designed to introduce additional levels of protection for the sellers of secondary annuities. The proposals are divided into the following sections:

- Disclosures;
- Presentation of offers;
- Restrictions on charging;
- Compensation and prudential arrangements; and
- Other regulatory requirements.

DISCLOSURES

This section covers the information that the FCA proposes sellers should be given before proceeding to sell their annuity.

Risk warnings

It is proposed that firms must deliver risk warnings to the seller on the possible consequences of selling the annuity as early as possible in proceedings, in either a durable medium (as defined by the FCA Handbook), or in verbal communication with the material sent in a durable medium afterwards. A firm must not proceed with a sale until it is satisfied that all risk warnings have been issued, and the consumer has acknowledged the receipt of this information.

The risk warnings to be communicated to the annuity seller cover:

- The risk of running out of money in retirement;
- Tax;
- Welfare benefits;
- Contingent beneficiaries;
- Price;
- Debt advice;
- Investment charges; and
- Investment scams.

Firms will be able, but not required, to use the exact wording as stated by the FCA if they wish, and should consider whether some risk warnings should be emphasised more than others for particular consumers.

Advice and guidance requirements

The FCA proposes to make rules requiring that, upon first contact with an adviser, all sellers should:

- Be informed of the legal requirement to take advice under certain circumstances;
- Be given a recommendation to take advice even if they are not legally required to;
- Be given a recommendation to take the Pension Wise guidance; and
- Be given a recommendation to shop around for the best possible value for their annuity income.

The Government will determine the threshold used to establish whether the seller is required to take advice. The FCA will establish rules to require the annuity provider to check that the compulsory

advice has been taken, and receive confirmation of this in a durable medium. However, the rules will not require any firm that is not giving advice, including annuity providers, to advise the seller on the suitability of the sale.

Contingent beneficiary consent requirements

The FCA proposes to introduce a rule requiring annuity providers to have received consent from any contingent beneficiaries, who could potentially have an entitlement under the annuity contract, before they facilitate any assignment or buy back. Contingent beneficiaries should be brought into the decision as soon as possible so the rules would require firms to highlight this to sellers.

The legal position for annuity providers under this circumstance, would depend on the specifics of the annuity contract. In seeking consent from contingent beneficiaries before the sale of the annuity, firms would avoid later claims and increase transparency in market practices.

One area of ambiguity here is what happens if the contingent beneficiary is a child and hence isn't legally able to exercise their power of attorney over their finances. Under this circumstance, parents are likely to be the legal guardians, however this may pose a conflict of interest if the parent is selling their annuity.

Disclosure to other costs

At first contact, it is suggested that firms will be required to inform the seller of the types of costs likely to be involved in the sale, including reasonable estimates of their size. In addition, firms should be required to inform the seller that an annuity provider may cover its reasonable costs, either directly or indirectly, from the seller.

Although the FCA is requiring that costs should be disclosed, there are questions over what happens if these costs are higher than anticipated, which will have an impact on which quote offers the best value for money. This may not be material if the differences are small, but costs may reasonably be significantly more than expected and it is currently unclear what the outcome would be in such a scenario.

Panel disclosure

The FCA suggests that brokers and adviser-brokers (adviser-brokers give a personal recommendation to the seller which brokers do not) should be transparent about the size of their panel (number of buyers) and whether they have any commercial relationships with the buyers on the panel. These disclosures should be highlighted to the seller on initial contact with the broker and should help sellers to compare brokers more easily.

PRESENTATION OF OFFERS

Quote presentation

The FCA aims for consumers to readily understand the value of the annuity they are hoping to sell, and to receive quotes that are directly comparable. Hence all (both indicative and final) quotes are to be presented in a standardised format in pound sterling terms as a one-off lump sum. All quotes should be net of any buyer charges (or estimated charges if they are not known at the time), such as medical examinations for example. A footnote is required stating that the annuity provider and other parties involved in the transaction may also require payment.

All quotes attained must be presented by the adviser in descending order of the value offered, so advisers are not able to inappropriately highlight any quotes that may benefit them personally.

The FCA's proposed new rules will prevent firms from making the purchase of an annuity from a seller conditional on other events occurring, such as the seller committing to put the proceeds of the sale into one of the firm's other products. However firms will be allowed to promote alternative products to other sellers as potential places for their money to be invested.

Price comparator

The FCA proposes that consumers should be told of the cost of buying an annuity to replace the income they are planning on selling on the open market, to give them a direct comparison of its value and to help them to decide whether to sell the annuity at all, and at what price. This information should be provided to the consumer when a firm presents a seller with a quote for their annuity.

The price comparator could be reversed to look at the size of the lump sum required to attain a certain level of income. The FCA comments that these tools and IT solutions are already available to firms,

so may be a suitable way of providing the price comparator. The quote for the annuity income and the price comparator should be presented to the consumer in a standardised format in a durable medium.

The price comparator quote should use the same medical information as the quote for the secondary annuity. If there is no quote available on the primary market for a comparable annuity, then firms should do their best to find a quote which is as close as possible to the cost of replacing the annuity income.

Under these circumstances, situations could arise where the price comparator is not directly comparable with the quote, due to differences in the simplifying assumptions made. The impact could end up being material, and it is currently unclear how these differences would be presented to consumers.

The FCA proposes that the proposed rules enforcing price comparators will not apply to annuitants over the age of 90, due to the low number of insurers willing to offer annuities to the very elderly.

Cancellation period

Annuity sales will be subject to the Distance Marketing of Consumer Financial Services Directive 2002/65/EC (DMD), meaning the seller will have 14 days to withdraw from the contract.

It is expected that this will be implemented as a pre-contract right to withdraw for a period of 14 days prior to a sale being processed, due to the difficulty of reversing an annuity sale. During this 'stop period', neither the firm nor the seller would be able to proceed with the sale.

RESTRICTIONS ON CHARGING

Broker incentives and charging

To avoid conflicts of interest, rules are proposed to prevent brokers from receiving commission set by buyers, and prevent buyers from offering commissions to the market.

Brokers will be expected to set their charging structures and apply those structures across the whole market. The FCA's proposed rules will stipulate that any broker charges should be paid upfront, though it would be acceptable for any pre-arranged broker fees to be taken from the proceeds of the annuity sale.

Annuity provider costs

To ensure annuity providers do not place unreasonable financial barriers on consumers to prevent them from selling their annuity income, a rule is proposed stating that annuity providers can only cover reasonable costs when moving the annuity income into another third party name, or for the tasks when buying back the annuity. These costs could consist of general administration, or checks on advice requirements or contingent beneficiaries' permissions as mentioned earlier. Providers must disclose any charges they are recovering to the seller.

Although quotes must be provided net of the costs in buying the lump sum, the costs of selling the annuity will not be included in this figure. The FCA intends to allow annuity providers to make their own decisions as to how much these costs should be and when they should be incurred. By not including this information as part of the quote, consumers could be misled as to which quote is offering the best value for money.

COMPENSATION AND PRUDENTIAL ARRANGEMENTS

Financial Ombudsman Service protection

The FCA intends for consumers in the secondary annuity market to have the same access to the ombudsman service as they do for other designated investment business, so will amend definitions relevant to those rules accordingly. This service provides a mechanism for settling disputes between customers and regulated firms.

Consequently annuity sellers and contingent beneficiaries could use the ombudsman service for complaints against firms in the sale of annuity income. However, annuity buyers would generally not be eligible to use the ombudsman service for complaints against the annuity provider or broker, because of restrictions on the size of entities allowed to take complaints to the service.

Financial Services Compensation Scheme (FSCS) protection

The FCA intends for consumers in the secondary annuity market to have the same access to the FSCS as they do for other designated investment business, so as with the ombudsman service, the FCA intends to amend the relevant definitions to this accordingly. The rules covering FSCS

compensation are in the Compensation sourcebook (COMP) of the FCA Handbook.

In practice a claim by a seller or contingent beneficiary against firms in the sale of annuity income would come under COMP. A claim by a buyer may also be covered, if the buyer falls within the restrictions of the type of entity that can eligitly claim.

Prudential requirements

The FCA proposes that firms carrying out regulated activity in the secondary annuity market be subject to the same prudential requirements that would apply if they were to carry out the activities today. This covers rules published by the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU), the Prudential sourcebook for Investment Firms (IFPRU), the Interim Prudential sourcebook for Investment Business (IPRU (INV)) or the relevant sections of the PRA Rulebook.

To maintain current approaches, the FCA proposes to apply IPRU (INV) Chapter 13 prudential standards to any firm partaking in regulated activities surrounding the sale of annuity income on the secondary market, as their principal investment business. From 30 June 2016, the new Personal Investment Firm (PIF) rules included within PS 15/28 will replace the current IPRU (INV) Chapter 13 rules, and any relevant definitions intended to capture the new regulated activities will be amended. For firms where the sale of annuity income on the secondary market is not their principle investment business, it is proposed that they will continue to be subject to the prudential sourcebook that is determined by their other investment business activities.

Client asset rules

If a secondary annuity market broker receives money from a buyer that is ultimately destined for the seller, it must be held in line with the FCA's client asset sourcebook (CASS). The FCA does not propose to make any changes to the existing CASS rules.

OTHER REGULATORY REQUIREMENTS

Record keeping requirements

The FCA's general rules on record keeping (SYSC 9.1) require that firms must:

- Arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it; and
- Have appropriate systems and controls in place with regards to the security of those systems.

Mental capacity guidance

Given that the population of those with annuities is inevitably made up of the elderly, the FCA proposes to provide guidance in its Handbook to remind firms of their existing legal obligations with regards to sellers who may be vulnerable due to their mental capacity. The guidance will be similar to that found in the FCA's consumer credit rules (CONC).

Secondary annuity market fees and levies

The FCA are proposing amendments to FEES 4 Annex 1A to incorporate acting as a broker in the secondary annuity market into the definition of fee-block A.13, and buying back annuity incomes into fee-block A.10. The consultation paper sets out a scale of fees which will apply for different levels of authorisation.

Other regulatory requirements

The FCA also highlights the following areas in its consultation paper:

- The FSMA financial promotions regime will apply to all firms in the secondary annuities market, including COBS 4, preventing firms from cold calling consumers about secondary annuity sales;
- The FCA is proposing changes to the Supervision manual (SUP) to capture the new regulated activities; and
- The FCA highlights that firms must continue to ensure that staff are appropriately supervised and competent to carry out the activities.

Regulation of the tertiary market

The term tertiary market refers to situations where the consumer has assigned their annuity income to a firm, and the firm then assigns the annuity income

to a third party. Tertiary markets also refer to the fourth, fifth, sixth etc, re-assignments of the annuity income.

The Government is consulting on changes that would require all buyers of annuity income in the secondary market to be authorised. This would mean that retail investors who are not authorised, would be committing an offence if they invested directly into the secondary market. However, the Government does not currently plan to apply this principle to the tertiary (or higher) markets, meaning investors would be able to invest directly in re-assigned annuity incomes.

The FCA points out the undiversified risk associated with investing in a single, or few, annuities. If buying from an authorised firm that firm will be subject to certain Handbook rules, including the requirements of COBS.

Buyers in the tertiary market (when authorised) do not have to give the protections described above for the secondary market.

CLOSING COMMENTS

The FCA expects an increase of activity in the secondary annuity market for the first two years, which is then expected to decline dramatically in subsequent years before stabilising. HMRC estimates 300,000 of the five million individuals with pension annuities will choose to sell their annuities. This would result in an increased tax revenue of c. £500m in the 2017-18 and 2018-19 tax years, with a reduced tax income of c. £150m in the following tax year and a smaller amount in subsequent years. However, it is difficult to accurately anticipate the volume of consumers who may look to sell their annuities and then there are further challenges in estimating the proportion of consumers who may complete the sale of their annuity after having received quotes.

It is also difficult to estimate the number of firms who are likely to be involved in the secondary annuity market, particularly in light of the PRA's recent indication that such assets may not qualify for the matching adjustment. Based on the FCA's meetings with the industry ahead of the consultation paper, it is anticipated that there may be 7-10 direct buyers of annuities and approximately 30 annuity providers not involved in buy back, though these figures are subject to change.

CONTACT

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