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Financial Services Authority

Disclosure: Trading an endowment policy and buying a pension annuity

August 2001



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Annex A: Extract from PIA Regulatory Update 85: Traded
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The Financial Services Authority invites comments on this consultation paper. Could these please be sent to us by Wednesday 31 October 2001.

You can send your response by electronic submission using the form on the FSA's website (at www.fsa.gov.uk/pubs/cp/cp106_response.html), by e-mail or in writing to –

Malcolm Easton
Conduct of Business Standards
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Telephone: 0207 676 5696

Fax: 0207 676 9717

E-mail: cp106@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Summary

- 1.1 The purpose of this consultation paper is to set out proposals which would require the disclosure of information to consumers in two specific contexts –
 - holders of life policies (e.g. traditional with-profits) who seek information on surrender value, must be made aware that they may be able to sell their policy as an alternative
 - policyholders of individual personal pensions must, at the appropriate time before their retirement, be informed of the fact that their annuity may be purchased from a life office other than their present pension provider.
- 1.2 Setting down requirements for the provision of this information to consumers will serve to meet FSA's statutory objectives by improving consumer understanding and facilitating competition amongst product providers. The proposals are intended to achieve *certainty* that the disclosures will be made and *consistency* that the information will be given to consumers in broadly the same way.

Traded endowment policies

- 1.3 There is nothing new about selling a life policy and assigning all rights of ownership to a third party. However, over the last 10 years or so, this market has grown considerably and has become a good deal more sophisticated.
- 1.4 We, and many others, continue to stress the need for consumers to look upon a life policy as a long term investment, the full benefits of which can only be realised if it is held to maturity. However, it is a simple fact of life that, in some cases, unexpected circumstances arise and make it no longer sensible for the consumer to sustain his or her investment in a life policy and prompt a decision to realise its value.
- 1.5 In March 2001, PIA issued guidance (Regulatory Update 85) in which it asked provider firms to take steps to ensure that policyholders considering the

surrender of a life policy were informed that they may be able to trade that policy instead.

- 1.6 The rules we propose to make are limited to giving effect in FSA rules to the PIA guidance already in place.

Open market option for annuities

- 1.7 We acknowledge that some policyholders may choose to purchase their annuity from their existing pension provider, perhaps because they want to continue a relationship through their retirement. However, it seems to us inherently undesirable that anyone should do so simply out of inertia or in ignorance of the fact they have a choice. Given the very significant differences that can exist between annuity rates offered and the “no going back” nature of the decision to be taken, we have concluded that there are grounds for the regulator to put a minimum disclosure standard in place.
- 1.8 In considering the scope as well as the content of any rules we might make to achieve this outcome, we have been mindful of the steps the industry is taking to improve the quality of information given to policyholders when buying their annuities and when it is most timely for that information to be given.
- 1.9 The ABI has published a Statement of Good Practice¹ on recommended minimum standards for handling pensions on maturity, from issue of the claim notification to purchase of the annuity/drawdown. We welcome this initiative.

1 *Pension Maturities Statement of Good Practice* August 2001

2 Introduction

- 2.1 It is a generally accepted feature of good business practice, which we seek to reinforce through regulation, that consumers should be aware of, and understand, the main options they have when buying a financial services product. It is particularly relevant to ensure that options available to the consumer are adequately disclosed where a choice, once made, cannot be changed. These options can be explained in point of sale documentation (such as key features), in product literature or as part of the advisory process, whether one-off or continuing.
- 2.2 In general, standards of disclosure by product providers have improved markedly in recent years. However, in some instances there is a lack of certainty and/or consistency about what information needs to be disclosed, when it should be disclosed and how it should be disclosed. To the extent that there is failure to disclose information which could generally be held to be beneficial to the consumer, or that the quality (in terms of, for example, visibility and transparency) of the disclosure could generally be held to be less than adequate, there is a risk of consumer detriment. Where that risk exists and cannot otherwise be mitigated, it is reasonable for the regulator to set minimum standards through its rules.
- 2.3 The purpose of this consultation paper is to set out proposals for the disclosure of information in two such instances –
 - holders of life policies (e.g. traditional with-profits) who seek information on surrender value, must be made aware that they may be able to sell their policy as an alternative
 - policyholders of individual personal pensions must, at the appropriate time before their retirement, be informed that their annuity may be purchased from a life office other than their present pension provider.

3 Background and objectives

- 3.1 The aim of the proposals set out in this consultation paper is to achieve *certainty* that the disclosures will be made and *consistency* that the information will be given to consumers in broadly the same way.

Traded endowment policies

- 3.2 There is nothing new about selling a life policy and assigning all rights of ownership to a third party. But, over the last 10 years or so this market has grown considerably and has become a good deal more sophisticated.
- 3.3 We, and many others, continue to stress the need for consumers to look upon a life policy as a long term investment the full benefits of which can only be realised if it is held to maturity. However, it is a simple fact of life that, in some cases, unexpected circumstances arise and make it no longer sensible for the consumer to sustain his or her investment in a life policy and prompt a decision to realise its value.
- 3.4 Policyholders may believe that the only way forward is to surrender the policy and take the cash. No one may have explained the alternatives, at least one of which may prove a better fit with the policyholder's financial needs. It is, therefore, at this point that policyholders need to be told what their other options are –
- to make the policy paid up where there is no need to realise a cash sum
 - to use the policy as security for a loan
 - to trade the policy in the expectation that this will generate a higher cash return.
- 3.5 In all cases it will be important to emphasise the potential benefit to the policyholder of taking advice before deciding what would be the best thing to do in the light of existing circumstances and the outlook for the future.

- 3.6 We would not expect any policyholder to be advised to surrender or sell a policy as anything but a last resort. However, if at the end of the day, that is his or her decision, that decision will have been taken on an informed basis.
- 3.7 Where the policyholder has decided to explore the trading option, interest is likely to focus on –
- understanding the benefits and the risks
 - understanding the process
 - ensuring that the sale is completed and the money is paid.
- 3.8 Unless policyholders are already aware of the trading option and how to go about it (for example, directly with a market maker), they are likely to get in touch with the issuing life office or an independent financial adviser. In the latter case, the policyholder can expect to be advised of all the options, including whether trading is a possibility and, if so, whether it would be the best option to take.
- 3.9 It is where policyholders approach the issuing life office direct with, perhaps, a direction to surrender, that they are at greatest risk of losing out through ignorance or lack of understanding of the alternatives. Historically, some life offices have been reluctant to accept responsibility for informing such policyholders about the alternatives to surrendering a policy. They have not, for example, considered it to be their responsibility to tell policyholders how to dispose of their policy and have been reluctant to get involved in the additional administrative effort in being a party to the sale of a policy.
- 3.10 In March 2001, PIA issued guidance (Regulatory Update 85) – copy at Annex A - in which it asked provider firms to take steps to ensure that policyholders considering the surrender of a life policy were informed that they may be able to trade that policy instead. The Regulatory Update noted that the FSA planned to consult at a later date about the introduction of rules to the same effect.
- 3.11 The rules we propose to make (see Chapter 3 and Annex B) would simply give continuing effect in FSA rules to the PIA guidance already in place. We are aware that there may be wider issues about the operation and implications of the traded endowment market that may need to be considered in due course (for example, how the interests of buyers and sellers interact, how policies are priced and the potential effect on surrender values). However, at this stage our focus is on carrying forward the requirement that policyholders be informed of the option to trade their policy.
- 3.12 We will wish to be satisfied that firms have put the necessary management systems in place to meet the new disclosure requirement, including review of

the effect of the rule on their handling of surrender enquiries and their outcomes. We will also wish to be satisfied that firms have amended their literature accordingly.

Q1: Do you have any comments on the desirability or otherwise of the FSA enshrining in its rules the existing guidance issued by PIA?

Q2: Are there grounds for the FSA to review the traded endowment market in more depth? If so, what is the evidence for those grounds, and what are the areas and issues on which you would expect the FSA to focus future work?

Open market option for annuities

- 3.13 The main issue here is whether more should be done to bring to the attention of those approaching their retirement date the fact that they may purchase their annuity from a life office other than the pension provider holding their fund.
- 3.14 Pension providers are already under an obligation, under the Personal Pension Schemes (Disclosure of Information) Regulations 1987 (SI 1987 No 1110) and Section 634(1) of the Income and Corporation Taxes Act 1988 (“ICTA’88”), to inform policyholders no less than 4 months, but no more than 6 months, before their retirement date of various options they have in connection with their annuity purchase. However, this does not include a specific obligation on firms to inform policyholders that they have the right to shop around for the best annuity rate to maximise their retirement income.
- 3.15 We acknowledge that some policyholders may choose to purchase their annuity from their existing pension provider, perhaps because they want to continue a relationship through their retirement. However, it seems to us inherently undesirable that anyone should do so simply out of inertia or ignorance of the choice they have. Given the very significant differences that can exist between annuity rates offered and the “no going back” nature of the decision to be taken, we have concluded – taking account of any extra costs for product providers - that there are grounds for the regulator to put a minimum disclosure standard in place.
- 3.16 In considering the scope, as well as the content, of any rules we might make to achieve this outcome, we have been mindful of the steps the industry is taking to improve the quality of information given to policyholders when buying their annuities and when it is most timely for that information to be given. We know that some firms have long been open with their policyholders that they can, and indeed should, shop around to get the best deal.

- 3.17 The ABI has published a statement of good practice² (“the ABI Statement”) on recommended minimum standards for handling pensions on maturity, from issue of the claim notification to purchase of the annuity/drawdown. The scope of the ABI Statement covers personal pension schemes (including retirement annuity contracts, i.e. “section 226” contracts where an open market option is available under the contract terms), free standing additional voluntary contribution schemes and “section 32” buy-out policies approved under Section 32 of the Finance Act 1981 (now incorporated in Chapter I Part XIV of ICTA 1988).
- 3.18 We welcome this initiative which seeks to achieve consistency in the approach taken by providers for the benefit of the individual customer. However, this initiative does not entirely replace the need for the regulator to introduce some rules to achieve a consistent approach to the provision of a basic, yet crucial piece of information. Not least, the ABI Statement does not cover all product providers.
- 3.19 The FSA does not have powers to make equivalent rules to cover occupational pension schemes. For occupational pensions schemes, current Department for Work and Pensions (“DWP”) Regulations³ mirror those for members of personal pension schemes and are enforced by the Occupational Pensions Regulatory Authority (“Opra”).
- 3.20 Whilst trustees of some occupational schemes may ensure that their scheme members are advised of the option to shop around before they decide from whom to buy an annuity, this outcome cannot be taken for granted. The ideal would be *certainty* and *consistency* across all schemes regardless of the form of governance or type of pension. We understand that the ABI intends to discuss with DWP and Opra ways in which the ABI Statement could be adopted by occupational pension scheme trustees. Amendment of the DWP Regulations themselves would be a matter for government.
- 3.21 By introducing the proposed FSA rule we would expect to bring about a reduction in the risk of consumers taking decisions in ignorance of their right to shop around for the best annuity deal. Through our continuing supervision, the FSA will look to check that firms have put the necessary systems in place, and made the necessary changes to their literature to ensure that the required information is given and followed through as appropriate.

Q3: Do you agree that it would be appropriate for the FSA to introduce rules requiring firms to inform prospective annuitants that they can shop around for the best annuity deal?

Q4: Do you agree that it is important for members of occupational pension schemes to have the benefit of this same disclosure requirement? If so, do you have any comments on how this might be achieved?

2 Pension Maturities Statement of Good Practice August 2001

3 Occupational Pension Scheme (Disclosure of Information) Regulations 1996 (SI 1996/1655) and Personal and Occupational Pension Schemes (Protected Rights) Regulations 1996 (SI 1996/1537)

4 Proposals

Traded endowment policies

- 4.1 We propose that all life offices should be required to have arrangements in place to inform policyholders that, subject to eligibility and market demand, their policy may be traded instead of surrendered. Annex B sets out the details of the changes we propose to make under our general rule making power (sections 138 and 157 of the FSMA).
- 4.2 There are a number of criteria which indicate whether a policy can be traded. These are not new and some firms already inform policyholders that they may trade their policy on the basis of them. We would not expect firms to have to carry out significant and costly analysis of the traded endowment market to identify which policies may be traded, as a consequence of our proposals.
- 4.3 But firms will need to be aware, in general terms, of what is being traded so that they can deal with some of the more straightforward questions policyholders may ask. For example, currently secondary market makers are generally willing to buy traditional with-profits policies (in particular, endowments) which have been in force for at least 5 years and which have a minimum surrender value of £1000. But the market may change and firms will need to be generally aware when it does and what the implications are.
- 4.4 The proposed disclosure rule neither promotes nor supports the secondary market as such. There is no implication that firms are required to tell policyholders about the secondary market, other than to make them aware that it exists and how they might use it instead of surrendering their policy. Of course, if firms want to tell their policyholders more about the market and to guide them towards and through it, they will continue to be free to do so.
- 4.5 An alternative for the FSA might have been to require life offices to tell all policyholders who are surrendering their life policy (excluding a personal pension policy) that there is an alternative market where they might be able to trade their policy.

- 4.6 This option would mean that firms would not have a duty to assess whether their policies were of a type that could be traded in the secondary market. We consider that the cost to firms of judging whether a policy was likely to be tradable would not be significant. However, many policyholders with, for example, a unit linked contract, where there is very little secondary market activity, would have their expectations raised for no reason and would waste their time in trying to identify whether their policy was tradable. There would also be costs to firms who had to deal with continuing enquiries from such policyholders. Our conclusion is that this alternative would be more costly than what we have proposed and would offer little or no additional benefits to policyholders. We have not therefore taken this option any further.
- 4.7 Alternatively, we could have adopted a more definitive view on what types of policy are tradable and only require disclosure when a policy of that type was surrendered. For example, we could say that all traditional with-profit policies should be considered as tradable. However, the market might change. Indeed, already there appears to be some interest in unitised with-profits policies. We therefore concluded that any regulatory requirements should be flexible enough to allow for market developments. It would also have meant that we would have to make prescriptive rules which would require rules changes and consultation. We take the view that the person best placed to judge whether a particular type of policy is tradable in principle and to tell the policyholder, is the life office itself.
- Q5: Do you agree with our conclusion not to require life offices to tell all policyholders, regardless of the type of policy held, who are about to surrender their policy, about the secondary market?
- Q6: Do you agree that the basic disclosure requirement we have proposed would be a sensible and proportionate response to the need policyholders have for information about all of the alternatives to surrendering a life policy?

Open market option for annuities

- 4.8 In line with our aim to ensure that customers are treated fairly after the point of sale we want to ensure that there is a minimum standard across the industry to inform all policyholders, at a given time, of their right to shop around to get the best annuity deal on offer. We do not propose to prescribe how this is done and how it is followed through. That will be for firms to decide.
- 4.9 We propose that all firms which offer individual pension contracts should inform policyholders no later than 4 months prior to their planned retirement date (i.e. the target date agreed by the policyholder at the start of the policy)

that they have the right to shop around for the best pension annuity deal. In addition, a reminder of this fact must be made at least 6 weeks prior to their retirement date and whenever a quote to take benefits is requested outside of these dates. Annex B sets out the details of the changes we propose to make under our general rule making power (sections 138 and 157 of the FSMA).

4.10 Included within the scope of an individual pension contract will be –

- personal pension contracts
- stakeholder pension contracts
- free standing additional voluntary contribution contracts
- retirement annuity contracts i.e. section 226 contracts (where an open market option is available under the contract terms)
- “section 32” buy-out policies approved under section 32 of the Finance Act 1981 (now incorporated in Chapter I Part XIV of ICTA 88) – where an open market option is available under the contract terms.

4.11 We would expect the disclosure to comprise -

- an explanation of the open market option, including the fact that there is not necessarily one “best” company or product for all individuals in all circumstances
- that by shopping around policyholders may get a better deal and the importance of this to their standard of living in retirement
- a brief explanation of how to make use of this option, including the desirability of taking independent financial advice.

Q7: Do you agree that this is the information policyholders need to know and which it would be reasonable to require to be given to them?

5 Compatibility with the FSA's general duties under the Financial Services and Markets Act 2000 ("the FSMA")

Introduction

- 5.1 The purpose of this section is to give a statement of our reasons for concluding that the rules and guidance for inclusion in the Conduct of Business Sourcebook are compatible with our general duties under section 2 of the FSMA. The requirement for this statement is set out in sections 155(2)(c) and 157(3) of the FSMA. The analysis in respect of cost benefit issues (as required by section 155(2)(a) and 157(3) of the FSMA) is set out in Annex C.

FSA's statutory objectives

- 5.2 Three of our objectives are relevant to the disclosure requirements set out for discussion in this consultation paper: securing the appropriate degree of protection for consumers, promoting public understanding of the financial system and maintaining market confidence.

(i) Consumer protection

- 5.3 In some cases consumers may have subsequent decisions which they may or will need to make after having bought a product – possibly some years on from the date of the original purchase. They are deserving of the same care and attention from the firm and/or their adviser that they received when the initial sale was made. Our proposals will help to bring this about.
- 5.4 We are required to take four criteria into account in meeting this objective:
- (a) **The differing degrees of risk involved in different kinds of investment or other transactions.**
- 5.5 In the case of either trading an endowment policy or buying an annuity, consumers are dependent on being informed of all the alternatives when there

are choices to be made and the consequences of each of them. What is particularly important in the case of these two types of transaction is that these may well be lifetime decisions which there will be little or no opportunity to change. Our proposals will help to ensure that there are certain minimum standards of disclosure designed to ensure that consumers are told about all their options.

(b) The differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity.

5.6 It can be expected that, in some cases, consumers will be in a position to inform themselves about alternative courses of action, have the confidence to pursue them and to know when and how they have secured the best deal. However, most consumers are more likely to need to be told and then to be given sufficient information (and in some cases advised) about how to pursue the alternatives and how to know when they have succeeded in securing a better deal.

5.7 The first step towards achieving this outcome is to ensure that the alternative courses of action are disclosed in the first instance. If they are not, the consumer is likely to remain at a disadvantage. Appropriate and timely disclosure is what we seek to ensure.

(c) The need consumers may have for advice and accurate information.

5.8 In many cases, the need for advice and information does not cease once the purchase has been made. It can be a continuing process. In the case of some products, it is necessary for consumers to make further decisions. What is particularly important, in the case of trading an endowment policy or buying an annuity, is that these circumstances are likely to arise only rarely for any individual consumer and include decisions which they may have little or no opportunity to change subsequently. There is therefore little or no scope to learn from experience or to “get it right next time”.

5.9 Normally, the provider firm is able to give the information more cost-effectively than anyone else. It does not seem reasonable to put the onus on consumers to work out that there are questions they need to ask, from whom and when. The proposals set out in this consultation paper are designed to help ensure consumers get the information they need, when they need it and in a form that they can understand.

(d) The general principle that consumers should take responsibility for their decisions.

5.10 Having been given appropriate information (and advice where the consumer seeks it) the responsibility passes to the consumer to take the decision he or she considers to be most appropriate.

(ii) Public awareness

- 5.11 Our public awareness objective includes two particular aspects -
- (a) **Promoting awareness of the benefits and risks associated with different kinds of investment and other financial dealings.**
- 5.12 Decisions on whether to surrender or trade a life policy or whether to buy a pension annuity from an existing pension provider or elsewhere can leave a lot of consumers significantly better or worse off. It is important that consumers have the information necessary to be aware that they have choices and that they should consider taking advice about the benefits and risks of those choices.
- (b) **The provision of appropriate information and advice.**
- 5.13 When and where information is disclosed is critical to its ultimate usefulness. So, for example, there is little point in telling policyholders that there was an alternative after they have complained about the return on a surrendered life policy. This information should be provided when they are thinking of surrendering their policy. Similarly, there is no point in annuitants being told that better annuity rates were available once the post-purchase cooling-off period has been passed. This information needs to be made available in good time before their retirement date so that they can do something about it.
- 5.14 There is also little point in adopting an approach of informing all policyholders that their policy may be tradable when in fact many policies would not be accepted by the market traders.
- 5.15 We consider that the proposals set out in this consultation paper achieve a sensible balance between the commercial considerations of firms and the desirability of consumers getting as good a deal as possible.
- 5.16 In addition to requiring provider firms to give the consumer information about buying an annuity, we also cover the issue in our consumer publications. For example, the “FSA Guide to Annuities and Income Drawdown” emphasises the importance of shopping around before buying a pension annuity.

(iii) Market confidence

- 5.17 Our proposals to require the provision of further information to consumers should make consumers more aware of the markets for trading endowment policies and for buying retirement annuities. This should lead to greater consumer confidence to make the most of their options.

(iv) Reduction of financial crime

- 5.18 We do not consider our proposals would have any material impact on this objective.

Matters to which the FSA must have regard when carrying out its general functions

5.19 Section 2(3) of the FSMA requires the FSA to have regard to certain principles when carrying out its general functions.

(i) The need to use its resources in the most efficient and economic way.

5.20 We have kept the proposed rules as simple and few as possible which should, in turn, make it more straightforward to judge compliance with them. In the case of buying an annuity, we have taken into account standards the industry has itself put in place and tried to ensure that there is consistency in the provision of information to policyholders. The rules will also support the consumer guidance we have already put in place.

(ii) The responsibility of those who manage the affairs of authorised persons.

5.21 It is the responsibility of firms to ensure that their customers, once they have bought a product, are kept informed about relevant issues in respect of it. They need to have the people and systems in place to bring this about. So, for example, as soon as they receive an enquiry about surrendering a policy, the policyholder should be informed of the alternative courses of action. Similarly, a policyholder approaching retirement should be informed of the option to shop around for the best annuity deal.

(iii) The principle that a burden or restriction which is imposed on a person or on the carrying out of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

5.22 We have carried out a cost benefit analysis of our proposed rules in accordance with section 155(2)(a) of the FSMA. This analysis is at Annex C.

5.23 In the case of traded life policies, in pure monetary terms the total benefits to policyholders who gain as a result of our proposals is expected to be broadly equal to the total costs to other policyholders. However, to the extent that some of the existing profits from the surrender of life policies go to shareholders rather than policyholders, the actual cost to existing policyholders may be somewhat less than the gain to policyholders who surrender. We consider that our proposals will result in a market which is more transparent and fairer to policyholders in general.

- (iv) The desirability of facilitating innovation connected with regulated activities.**
- 5.24 By prompting consumers to consider shopping around our proposals should tend to encourage market innovations. The proposed rules are sufficiently flexible to ensure that they do not hinder innovation.
- (v) The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom.**
- 5.25 Our proposals have no direct international implications.
- (vi) The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions.**
- 5.26 Our proposals can be expected to have a positive impact on competition. In respect of trading endowment policies, competitive pressure may increase surrender values. It will enhance the transparency of the market. In respect of buying an annuity, competitive pressures may encourage firms to offer better annuity rates – and those who do not really want the business to say so rather than simply offer uncompetitive rates to an unsuspecting consumer.
- (vii) The desirability of facilitating competition between those who are subject to any form of regulation by the Authority.**
- 5.27 Our proposals can be expected to enhance competition between market makers and between life offices and market makers in the case of trading endowments. In the case of buying an annuity, they can be expected to enhance competition between firms offering this line of business. In both cases, enhanced consumer awareness and more shopping around to get the best deal will encourage firms to acknowledge that consumers expect to get the best deal the market can offer.

Acting in a way most appropriate to meeting the statutory objectives

- 5.28 Our proposals do not break new regulatory ground. They simply require firms to tell their customers the full extent of what they can do in the two sets of circumstances. We believe that in both cases we have combined our rule-making power with our consumer education work in the most appropriate way.

Q8: Bearing in mind the economic costs and benefits, do you agree that our proposals would produce a more transparent and fairer market and that this justifies the proposals?

Q9: Do you have any other comments on this section?

6 Summary of questions

Background and objectives

(i) Traded endowment policies

Q1: Do you have any comments on the desirability or otherwise of the FSA enshrining in its rules the existing guidance issued by PIA?

Q2: Are there grounds for the FSA to review the traded endowment market in more depth? If so, what is the evidence for those grounds, and what are the areas and issues on which you would expect the FSA to focus future work?

(ii) Open market option for annuities

Q3: Do you agree that it would be appropriate for the FSA to introduce rules requiring firms to inform prospective annuitants that they can shop around for the best annuity deal?

Q4: Do you agree that it is important for members of occupational pension schemes to have the benefit of this same disclosure requirement? If so, do you have any comments on how this might be achieved?

Proposals

(i) Traded endowment policies

Q5: Do you agree with our conclusion not to require life offices to tell all policyholders, regardless of the type of policy held, who are about to surrender their policy, about the secondary market?

Q6: Do you agree that the basic disclosure requirement we have proposed would be a sensible and proportionate response to the need policyholders have for information about all of the alternatives to surrendering a life policy?

(ii) Open market option for annuities

Q7: Do you agree that that this is the information policyholders need to know and which it would be reasonable to require to be given to them?

Compatibility with the FSA's general duties under the Financial Services and Markets Act 2000

Q8: Bearing in mind the economic costs and benefits, do you agree that our proposals would produce a more transparent and fairer market and that this justifies the proposals?

Q9: Do you have any other comments on this section?

Extract from PIA Regulatory Update 85 – Traded Endowment Policies

REGULATORY UPDATE 85

March 2001

Traded Endowment Policies

Product provider firms only

The purpose of this Update is to ask provider firms to take steps to ensure that policyholders considering surrender of a life policy are informed that they may be able to trade that policy instead.

- Some with-profits policies (normally only those that have been in force for at least 5 years) may be traded rather than surrendered. Where this is the case, the policyholder can often expect to get a better cash value for the policy than if it had been surrendered. PIA is of the view that policyholders should not surrender policies without being aware that they may have the option to trade them instead.
- As a matter of principle, it is important that policyholders are always made aware of the financial consequences of surrendering a life policy, an investment that is designed to be held through to maturity.
- Provider firms are reminded of the guidance given in RU81 on the need for customers to be made aware of the consequences of surrendering a life policy and the help and support they might reasonably expect to get from firms in understanding this. Where a customer remains minded to surrender his or her policy, it is just as important that he or she be informed that surrender is not the only way forward and that one of the alternatives, which is to trade the policy, may net them a higher cash sum.
- PIA does not have the powers under the Financial Services Act 1986 to place a specific duty on life offices to inform their policyholders that they may trade their policies rather than surrender them. However, it considers that it is reasonable for policyholders to expect to be informed that, provided their policy is eligible for trading, this option is open to them.
- Some provider firms, of course, already provide this information. Where this is not the case, PIA would ask those firms to take steps to ensure that this information is made available to their policyholders. Precisely when and how this is done is for firms to decide. Clearly, the latest possible time is when firms become aware of the intention to surrender - although even if the information has been given in earlier literature it would still seem appropriate to repeat it. It would not be reasonable to expect policyholders to have to rely on

information given when they took out the policy, because of the time that will likely have elapsed before they wish to surrender the policy.

- IFAs are already subject to a Recommendation (Adopted FIMBRA Rules Appendix F6 Note F7) that, when being asked to arrange surrender of a with profits policy, they should, where appropriate, advise that it may be possible to obtain a higher cash value through trading.
- In the case of friendly societies, policyholders will also need to be made aware of any membership considerations which may affect the ease with which a policy can be reassigned.
- PIA understands that the FSA plans to consult later this year on rules and guidance relating to the surrender of life policies and the alternatives available to policyholders.

PROPOSED RULES AND GUIDANCE

Proposed amendment to the existing rule

Application

6.1.1R

COB 6.1 to 6.5 apply to a *firm*:

- (5) which is a *long-term insurer* which receives a request from a *private customer* for a quotation for a surrender value of a *life policy*.
- (6) which receives a request from a *private customer* for a retirement quotation in respect of a *personal pension scheme, stakeholder pension scheme* or *free standing additional voluntary contribution* contract it provides.

Proposed new rules

Life policies: requests for quotations for surrender values

6.5.50R

When a *long-term insurer* receives a request for a quotation for the *surrender value* of a *life policy* which may be traded on an existing secondary market for *life policies*, it must, before or when providing the quotation, make the policyholder aware of:

- (1) the fact that, as an alternative to surrendering to the *long-term insurer*, the *life policy* may be traded on that secondary market;
- (2) the fact that there may be financial benefits in trading the *life policy* when compared to surrendering it to the *long-term insurer*; and

(3) how the policyholder may trade the *life policy* on the secondary market should he decide to do so.

6.5.51G (1) When complying with COB 6.5.50R, a *long-term insurer* could identify whether the policy is tradable by obtaining information from a trade association or other body which holds information on the relevant secondary market.

(2) *Long-term insurers* may wish to include this information with the information on the other options available to policyholders, which may for example include informing the policyholder where advice may be obtained before surrendering, making the policy paid up or taking a loan against the policy.

Open market option

6.5.52R When a member of a *personal pension scheme*, a *stakeholder pension scheme* or the holder of a *free standing additional voluntary contribution* contract is nearing his intended retirement, the *firm* which is the provider of that scheme or contract must:

(1) when there is a request for a retirement quotation more than four months before his intended retirement date;

(2) at least four months before the policyholder's intended retirement date, and then again, at least six weeks before his stated retirement date;

provide the policyholder with an explanation:

(a) of the *open market option*;

(b) of any financial benefits of making use of this option when compared with taking a pensions annuity with that *firm*; and

(c) how the policyholder may make use of the *open market option* should he decide to do so.

6.5.53G

In complying with COB 6.5.52R, a *firm* could include:

(1) an explanation of what the *open market option* is;

(2) the fact that companies offer different annuity rates, so there is not necessarily one "best" company for all circumstances or at all times;

(3) that by shopping around the policyholder may get a better deal and end up purchasing a higher pension income for his retirement; and

(4) a brief explanation of how to make use of this option, for example a general suggestion to seek professional advice.

Cost benefit analysis

- C.1 Sections 155 and 157 of the FSMA require the FSA to undertake a cost benefit analysis (“analysis”) of its proposed rules or proposed general guidance on rules and to publish the results. Under section 155(8), a cost benefit analysis is not required if the costs arising from the proposed rule would be no more than the costs arising from the existing requirement or if any cost increase would be of minimal significance.
- C.2 This analysis covers firms’ compliance costs, our direct costs (i.e. costs borne initially by the FSA) and the costs and benefits to consumers. We have carried out separate analyses on our proposals for disclosure of the availability of the traded endowment market and the open market option.

Traded endowments

- C.3 The proposed rule will give effect to the guidance contained in PIA Regulatory Update 85. We have set out the analysis of the requirement for life offices to disclose the existence of a secondary market to life policyholders only where they are of the opinion that there is likely to be a secondary market for that type of policy.

i) Compliance costs

- C.4 We estimate that around 50 life offices offer, or have offered, traditional with-profits policies which, in principle, are of interest to the secondary market. From information provided by the Association of Policy Market Makers (“APMM”), we estimate that the total surrender value of tradable contracts which are traded or surrendered amounts to around £1 billion each year, of which we estimate around half by value (i.e. £500 million) is currently traded.
- C.5 We estimate that around half of these life offices (i.e. 25) already have documented procedures in place (or are in the process of putting procedures in place) to make some level of disclosure of the secondary market to with-profits

policyholders who have asked to surrender their policies. There may be some new costs to these firms as they will need to review procedures to ensure that they are consistent with the rules. **We consider that these costs will be minimal but we would welcome comments from firms who are in this position.**

- C.6 Therefore, our estimates of the additional costs of the proposed disclosure requirement have been based on the other 25 life offices who do not currently disclose the traded alternative and will therefore need to alter their current procedures.
- C.7 One of the costs to these firms will be in identifying which of their policies are tradable. However, we consider that many of these firms will already have a general understanding of the traded endowment market and be able to identify which of their policies are tradable without incurring significant new costs. **We do not consider that any additional costs in identifying whether policies are tradable will be significant. Firms may wish to comment on this assumption.**
- C.8 Possible other new costs to firms will arise from putting new procedures in place, preparing new consumer literature and additional postage costs. The figures are set out in Table 1. **We estimate that there may be a one-off cost of around £165,000 and continuing costs of around £125,000 a year.**

Table 1: Estimate of firms’ costs of providing the information to policyholders

Compliance activity	One-off costs	Continuing annual costs
Identification (of whether a policy is tradable)	Negligible	Negligible
Development*(of procedures and literature)	£165,000	Negligible
Printing**	–	£125,000
Postage	negligible	negligible
Total	£165,000	£125,000

* We have assumed that each of the 25 firms will need to spend 15 days on development work using staff whose annual costs including all overheads amount to £100,000 a year.

** This is based on an estimate of 50,000 surrenders a year, i.e. “untraded” market of £500 million a year divided by the estimated average surrender value of £10,000, scaled up since firms may have numerous enquiries compared with actual surrenders, many of which do not turn into actual surrenders. We have assumed that 250,000 copies a year will be needed between the 25 firms, and a unit printing cost of 50 pence.

ii) Direct costs

- C.9 We estimate a one-off cost to the FSA of around £10,000 and negligible continuing costs.

iii) Costs and benefits to policyholders

- C.10 When considering the costs and benefits to policyholders, we have based our analysis on three types of affected policyholder: those who would stay invested in the with-profits fund and neither surrender nor trade their policy; those who would trade their policy but who would have surrendered it if our proposals were not implemented; and those who would have traded their policy anyway.
- C.11 To the extent that policyholders trade rather than surrender, there is a cost to those policyholders who remain invested in the with-profits fund until their policies mature. This is because, in the long run, such policyholders may receive lower bonuses as any surrender profits that normally benefit the with-profits fund will be lower than they would otherwise have been. However, since current surrender profits may, in part, benefit shareholders and future policyholders, the effect of any reduction in surrender profits might not flow through fully or immediately to current policyholders. The actual cost to continuing policyholders is difficult to quantify without detailed industry information but we have assumed that, in the long term, it should be broadly equal to the benefit to policyholders who, as a result of our proposals, would trade rather than surrender. In fact, to the extent that some of the existing profits on surrender go to shareholders rather than policyholders the actual cost will be somewhat less than assumed. **We invite comments from firms on the costs to continuing investors in the with-profits fund.**
- C.12 Table 2 sets out the estimated potential monetary benefit to policyholders, both existing and new, who trade their policies. It compares the increased activity in the market that might be expected as a result of our proposals against the base case of the current market size, where policyholders who trade benefit by about £60 million a year. The table also sets out the possible effect on these policyholders if prices in the secondary market fall as a result of a higher number of policies being traded.
- C.13 The APM estimate that policyholders who trade rather than surrender currently get an average increase of around 12% on the surrender value.
- C.14 We estimate that the 25 life offices who already make some form of disclosure of the traded endowment market account for around two thirds of policyholders with tradable policies. In these offices, of the policyholders who wish to discontinue their policy, around two thirds trade rather than

surrender their policy. The total monetary benefit from trading rather than surrendering is around £60 million.

Table 2: Estimated changes in proceeds to customers who sell rather than surrender

These figures show the differences in relation to the base case (where policyholders who trade benefit by about £60 million a year).

Potential size of traded market	No change in price (i.e. average 12% above surrender value)	Reduction of 2% in price (i.e. 10% above surrender value)
No change to market size Current size - £500 million each year	Base case (consumers benefit by about £60 million each year)	-£10 million
Increase of 25% (i.e. additional trading each year) - £125 million	£15 million	£2.5 million
Increase of 50% (i.e. additional trading each year) - £250 million	£30 million	£15 million

- C.15 Should the additional disclosure to policyholders of the other 25 life offices result in only one third of their eligible policyholders trading rather than surrendering, the market would increase from £500 million to £625 million. It would also mean that policyholders new to the traded market would gain by around £15 million (i.e. increasing the overall gain to policyholders who trade from £60 million to £75 million).
- C.16 It is possible that the increase in volume of business in the secondary market could lead to a reduction in the percentage difference between a policy's traded value and its surrender value. As an illustration, if the price fell by 2% (i.e. the gain over surrender value is 10% rather than 12%), the gain to the market overall would be £2.5 million (i.e. increasing the overall gain to policyholders who trade from £60 million to £62.5 million).
- C.17 The £62.5 million overall gain to policyholders would be made up of two components –
- existing policyholders who would have traded anyway, who would receive £50 million more than the surrender value (although this will have been reduced by £10 million from £60 million as a result of the fall in price paid).
 - policyholders new to the traded market, who would still gain £12.5 million compared with surrendering their policy.
- C.18 There may be a cost to policyholders who trade rather than surrender as those who trade may suffer a delay, typically some weeks, before getting their money, whereas they would have got it more quickly had they

surrendered. But we consider that any such cost is insignificant relative to the difference between the traded value and the surrender value and have not considered it further in this analysis.

- C.19 The proposals may also have an impact upon the wider market by encouraging life offices to increase their surrender values to better match the asset value of the policy, thereby reducing the benefits of trading but creating a benefit for those who surrender. **We have not attempted to presume the reaction from life offices but would welcome comments on this subject.**

Open market option

- C.20 This analysis is of the proposed requirement on firms who offer individual pension contracts to disclose that the open market option exists, its benefits to the policyholder and what the policyholder needs to do next.
- C.21 The data used in this analysis relating to pension annuity sales in 2000 comes from new business data published by the ABI –
- cost of annuities purchased in the year 2000: £5.7 billion
 - number of contracts written: 250,000
 - average policy size: £23,000.

(i) Compliance costs

- C.22 Our proposal to require the open market option to be disclosed builds on existing legislative requirements and the industry guidance published by the ABI on handling pension maturities. Firms are already under a statutory obligation to disclose the options available to policyholders before retirement. However, the Regulations do not specify those obligations at a sufficient level of detail to ensure that the open market option is one of them.
- C.23 Acknowledging that the purchase of an annuity is one of the most important decisions many prospective retirees have to take, the ABI has put some guidance in place. On the assumption that ABI member firms will put this guidance into practice, **we have concluded that there will not be any significant additional costs to ABI member firms as a result of our proposed rule requiring disclosure of the open market option.**
- C.24 Only a few pension providers are not members of the ABI. Of these firms, those which do not have a life office within their corporate group would

already disclose the open market option as this is the only possible outlet that their policyholders have to buy an annuity.

- C.25 The only group of firms to whom there may be some additional costs are those which are not members of the ABI which offer individual pension contracts and which do have an associated life office to which the annuity business could default. We understand there are around 6 such firms. We estimate that the additional costs of the requirement to disclose the open market option will arise from a one-off systems cost of around £40,000 (assuming that each firm requires 15 man hours for preparation, analysis, programming and testing and has to bear staff costs of the staff concerned, including all overheads, of around £100,000 per year). We estimate that the cost of incorporating the requirement in product literature will be minimal.
- C.26 We estimate that there will be negligible on-going cost for maintaining systems and procedures given that the new disclosure requirements will be added to existing procedures and communications to policyholders.

(ii) Direct costs

- C.27 We estimate that there will be a one-off cost of around £10,000. This is based on the need to carry out an initial survey of firms and analysis of information supplied requiring 22 man days of a supervision officer and half of one day of a Departmental head (at an assumed daily cost, including overheads, of £435 and £1000, respectively).
- C.28 We estimate that continuing supervisory costs will be negligible.

(iii) Benefits to policyholders

- C.29 This analysis does not take into account the fact that someone will eventually have to pay for the higher annuity rates obtained by better informed consumers. It is likely that ultimately, it will be a combination of shareholders and other policyholders, in particular future policyholders, who will pay for the higher rates.
- C.30 We cannot predict whether disclosure of the open market option will change policyholders' behaviour. However, we can calculate the numbers of policyholders who would need to change their behaviour to achieve a monetary benefit. On this basis we can then take a view on whether it is reasonable to conclude that this number of policyholders would in fact change their behaviour.
- C.31 At the time of preparing this analysis, the difference between the best rates in the market and other firms actively competing for annuity business was around 10%. The full difference between the best and worst rates in the market is likely to be much greater than this because firms not actively

competing for annuity business have no incentive to offer good rates.

Looking at the handful of firms who will be affected by our proposals, if we assume that each policyholder achieved only a 3% uplift in their annuity rate, then after only 70 policyholders had done so, each with an average pension fund of £23,000, both the industry and the FSA's own costs would have been covered by the benefit to these policyholders.

- C.32 We consider that it is not unreasonable to expect that at least this number of policyholders will shop around for the best annuity rate as a result of their being told of their right to do so. We have therefore concluded that the benefits to policyholders outweigh any additional costs.**

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7676 1000 Fax: +44 (0)20 7676 1099
Website: <http://www.fsa.gov.uk>

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