Financial Services Authority

Financing the future: mind the gap!

The implications of an ageing population – key findings and proposed actions

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Acknowledgements

This report is part of an ongoing programme of work assessing the implications of an ageing population. This has drawn on contributions from across the FSA under the direction of David Baker, Marcus Price and Sarah Smith and has been led by Oliver Page. The report was edited by David Baker and Marcus Price.

In undertaking this work, we acknowledge the valuable contributions made by various government departments, trade bodies, financial services providers and consumer groups, which have helped to inform this work.

1 Executive summary

1.1 The FSA has been examining the issues for consumers arising from changes in life expectancy, changes in lifestyle and the shift in provision of retirement income from the State and employers to individuals. It has also considered the potential risks and opportunities this poses for firms. The research focuses particularly on the market for retirement products and the vulnerability of consumers in this market.

1.2 We have taken into account the broader environment, including changes in the UK's demographics, the rapid growth in the market for decumulation[1] products (e.g. annuities) and the growing emphasis on individual consumers providing for their own retirement. Increasing life expectancy, coupled with good health and mobility for many people well into their 80s is a very welcome development. But, it is a comparatively recent phenomenon and some of its implications are not yet fully appreciated, either by those at the point of retirement or younger generations.

1.3 In this paper, we set out the areas we have identified where we may be able to intervene to help ensure that consumers and financial services providers are better prepared for the reality of an ageing population. In addition, our work has highlighted aspects on which other stakeholders may need to consider actions of their own to ensure that they and consumers are better equipped to deal effectively with the implications of the ageing population. These stakeholders include both the financial services industry and the government.

1.4 In making our recommendations to external stakeholders, we have considered the broader programmes of work and reviews that are presently being undertaken. Our report does not attempt to summarise all of this, but has referenced some other work programmes and initiatives in order to illustrate and support our own work.

1 The term 'decumulation' refers to the process through which wealth accumulated throughout an individual's lifetime through savings and investment products, for example, can be used to meet consumers' needs in retirement, such as providing an income stream (e.g. an annuity) or to meet the cost of long-term care (e.g. long-term care insurance products).

1.5 We are aiming to help deliver two specific changes over the medium term as a result of the actions proposed:

- Consumers will be better equipped to make informed decisions when planning for retirement, at retirement and in retirement.
- The industry will embrace the opportunities ahead, but also consider its responsibilities in managing the risks to consumers, as well as to itself, when manufacturing and selling innovative retirement products.

1.6 We have identified a programme of action to achieve these changes. For consumers, we highlight:

- How different age groups are facing very different types of risks when planning for retirement (page 16). These result from different experiences and assumptions about housing, other assets and debt and different expectations about pensions.
- A lack of awareness regarding consumers' increasing exposure to investment risk and the probability of living longer (or 'longevity risk'), both in the accumulation and decumulation phases of life (page 20). Our research suggests that people in their 20s and 30s are particularly vulnerable to the risks of inadequate financial planning and, therefore, the risk of not saving enough for retirement. They will need to be more self-reliant than generations before them.
- How consumers in their 60s and 70s are particularly exposed to risks arising from not understanding their choices (page 26). In particular, we emphasise the lack of understanding about some core retirement products. We are concerned that too many people are making crucial, often irreversible, decisions at retirement that may affect their standard of living for many years ahead. This issue arises from the wide range and complexity of the options open to consumers and the limited extent of advice and generic information available to them about the main retirement products.

1.7 The ageing of the UK's population, and the increasing responsibility falling to individuals to ensure they have adequate retirement provision, represents a significant change to the environment in which the financial services industry operates. There are a number of very real opportunities for the industry to develop innovative and flexible products to meet changing needs:

- There are challenges in developing products to meet the needs of the younger consumer, to help them manage and plan their finances over the longer term (e.g. competing demands on their financial resources from credit card/student debt, as well as saving for a mortgage).

- The 'in retirement' market is likely to grow rapidly over the next three decades given the growing numbers of elderly people with increasing levels of self provision, demanding greater flexibility with their financial arrangements in retirement.

1.8 Alongside the opportunities that exist for the financial services industry there are also potential risks to firms when embracing the challenges that an ageing population presents. In particular, we highlight:

- The need for the financial services industry to price long-term annuity and equity release products correctly (page 35). Given the scale of the risk involved, any potential mis-management or mis-pricing of this longevity and long-term investment risk could pose a threat to firms' solvency.
- The limited availability of generic advice for the 'in retirement' market, which means consumers are unaware of their choices (page 36).
- How firms that are manufacturing and selling products that effectively transfer longevity or investment risk to consumers inappropriately, may face heightened risk associated with selling these products (page 39). This may arise if they do not ensure that consumers are made aware of the nature and extent of the risks they are taking on. The risk of mis-selling is compounded by gaps in basic advice and comparative information to assist consumers to make more informed choices.
- The potential for commission bias that exists in the sale of income withdrawal products and some concerns about the quality of post-sale ongoing advice for these products (page 41).

1.9 To address these issues, we have set out a six point plan, focussing on some areas of action for the FSA and some proposals for others, including the financial services industry and the government, to consider. Co-operation amongst key stakeholders is most likely to lead to success.

6 Point Plan

- **Encourage retirement planning and provide consumers with the tools to plan, particularly younger consumers.** We plan to deliver a programme of consumer education from young consumers through to retirees targeting the right messages at the right consumers at the right time. For example, we are developing an interactive fact-find which will help consumers understand their financial planning needs.
- **Raise consumers' understanding of the risks associated with increasing exposure to investment risk and inadequate savings levels.** As part of this strategy, we are encouraging the government to look at ways to help and make it easier for employers to give employees information on the need for planning and saving for retirement. We are also encouraging the industry to develop longer-term relationships with consumers saving for retirement, which should serve consumers better as their product needs and circumstances change with age.

- **Equip older consumers with the right questions to ask and relevant information to increase their understanding of the core decumulation products.** We are working alongside the industry and the government to increase older consumers' understanding of annuities, income withdrawal and equity release. In addition, we have now consulted on revisions to the necessary rules and guidance to make consumers more aware of their options and what they are buying; for example, on their right to shop around for annuities.
- **Ensure that firms take full account of the implications for themselves arising from the growth in the market for retirement products.** For example, we will scrutinise the way the financial services industry manages the increasing burden of longevity risk, focusing particularly on the pricing of annuity business on their balance sheets.
- **Ensure firms respond appropriately to the risks to consumers when developing and marketing new and innovative products, particularly annuities and equity release.** For example, we will consider the extent to which longevity risk is being transferred from firms' balance sheets to consumers and where there may be increased potential for mis-selling. More broadly, we plan to carry out themed supervision work to examine the adequacy of the information disclosed to consumers when selling decumulation products.
- **Encourage financial advisors to take account of the changing needs of consumers, particularly the different wealth and debt profiles across different age groups.** We will particularly focus on the advice process for decumulation products. For example, we plan to review the adequacy of qualifications and ongoing competency of advisors who sell retirement products; particularly the more complex products. Finally, we will also consider more closely the quality of audit controls existing in firms to ensure a high standard of service is delivered in the sales process.

2 Introduction

2.1 Our *'New Regulator for the New Millennium'* strategy document, launched in January 2000, set out the approach which we would adopt in the future. *'Building the New Regulator, Progress Report 2'* of February 2002 updated that approach and confirmed the commitment to re-balance regulation towards more thematic work. This included carrying out a number of different theme projects every year, with a focus on consumer-orientated and industry-wide issues.

2.2 In 2000 pilot themed reviews were launched in areas such as e-commerce, treating retail customers fairly after the point of sale and money laundering. At our Annual Open Meeting in July 2001, Howard Davies launched two themed reviews for 2001/02:

- *The Implications of an Ageing Population for the FSA.*
- *Harnessing Market Forces.*

2.3 This report presents the key findings and proposed actions arising from our work on the implications of an ageing population.

2.4 We have set ourselves a number of objectives in this work, namely to:

- Consider the implications of increasing life expectancy for consumers' financial needs and examine the implications for firms and consumers.
- Identify potential risks to our objectives[1] from particular products, associated with changing demand and changing products arising from the ageing of the population.
- Identify areas where our resources or interventions may be required to help to ensure that consumers and financial services providers are preparing for an ageing population.

1 The FSA's statutory objectives are to maintain market confidence, promote public awareness, protect consumers and reduce financial crime. A description of each of these objectives is set out in *'The New Regulator for the New Millennium'*, FSA, January 2000.

2.5 To help deliver these objectives, we have published original research[2] examining how consumers plan for retirement and their attitudes to key decisions, products and advice. We have also collaborated with the Bank of England to investigate the possible long-term effects on the UK's economy of changes in the age structure of the population.

2.6 This report sets out the key findings and proposed actions arising from our work on the implications of an ageing population. The focus is on areas of potential risk and opportunity for both providers and consumers of financial services. We make a number of key recommendations for stakeholders arising from issues connected with accumulating wealth (e.g. patterns of savings, barriers to saving) and with decumulation products, particularly issues arising from the welcome innovation in the annuities, income withdrawal and lifetime mortgage[3] markets.

2.7 However, this report does not attempt to describe the wide range of initiatives that are already being undertaken by ourselves and sits alongside the consultation on polarisation[4] and our work on the disclosure regime, for example. In addition, we have not referenced many of the initiatives being undertaken by the government – particularly the Department of Work & Pensions (DWP) and Inland Revenue – or the industry, including the Association of British Insurers (ABI), in the areas we have identified. This report focuses on where there are possible gaps in that work and where, in our view, more needs to be done to address these.

2 '*The impact of an ageing population on the FSA*', FSA Consumer Research 10, January 2002.

3 Lifetime mortgage is a mortgage aimed at older consumers that provides a lump sum and/or income, and is designed to be repaid on the borrower's death, or earlier if they move into residential care or sheltered accommodation. Interest may be paid monthly or rolled up and repaid with the capital.

4 '*Reforming Polarisation: Making the market work for consumers*', FSA Consultation Paper 121, January 2002.

3 Setting the scene

3.1 This section sets the scene with a discussion of three key areas:

- The key demographic changes that define an ageing population.
- The possibility of a significant impact on the economy which, in turn, would have a wide-ranging effect on consumers and the financial services industry.
- The growing responsibility on consumers to provide for their own retirement income, recognising that consumers are not homogenous, with sub-groups facing very different risks and opportunities.

(a) Demographic changes

3.2 The age profile of the UK's population is gradually rising, with a greater proportion of older people resulting from:

- The ageing of two 'baby boom' generations (from the mid-1940s and, more significantly, the 1960s), which is increasing the number of older people and retirees in the population.
- Declining fertility, which is resulting in fewer young people as a proportion of the total population.
- Improvements in mortality, particularly for older people, which is resulting in people living longer.

3.3 As a result, the average age of the population is expected to rise from 38.6 years in 1998 to 41.9 years by 2021. Further:

- By 2025, there will be only two employed people for each retired/inactive person over 50 years old.[1]

1 Assuming current working practices – such as the retirement age – remain constant.

- The UK's population is expected to grow by 4.4m to 64m over the next 25 years. Although the number of people aged 16-50 is projected to fall by 1.5m, those aged >50 years are forecast to increase by over 6m.
- By 2030, nearly 30% of the population will be aged over 60 (an increase of around 20% on today).[2]
- Life expectancy for men and women at birth is projected to increase from 45 and 49 years respectively in 1901 to 80 and 84 years in 2011.[3]

3.4 Not only is an ageing population leading to an increase in the total number of older people and retirees, but this population is also living longer. This means that individuals will have to support themselves by making their pensions go further, increasing their savings and/or extending their working lives.

(b) Macro-economic implications

3.5 These demographic trends may well have a significant impact upon the UK macro-economy. For example:

- There may be an impact upon asset prices resulting from large numbers of older consumers running down their portfolios of wealth to provide an income in retirement (i.e. decumulating wealth).
- GDP growth could be affected by declining consumption levels, resulting from a smaller economically active population.

3.6 As part of our work on exploring the implications of an ageing population, we have collaborated with the Bank of England to investigate the macro-economic implications, including the prospective long-term effects on growth, savings and capital investment.

3.7 This work highlights four main conclusions:

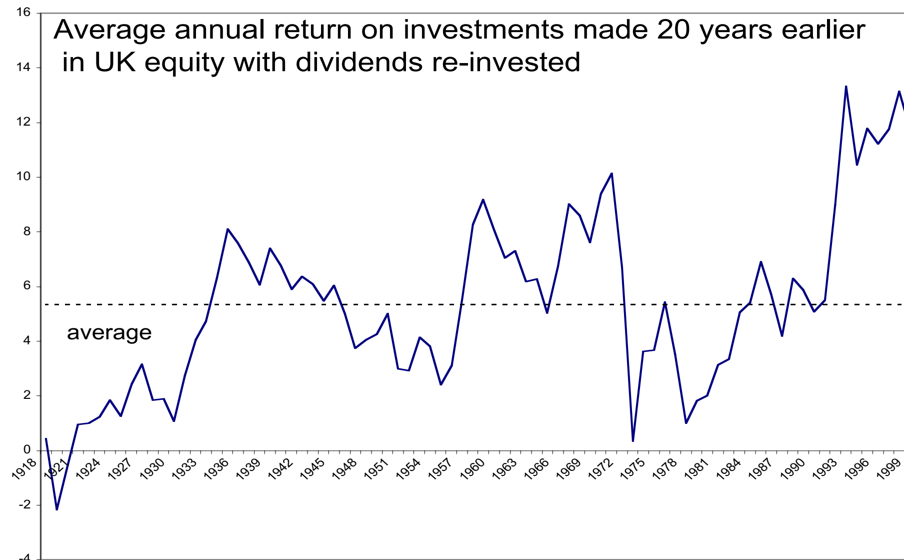
- First, the UK growth rate could fall in the long term as a result of a slowing in labour supply consistent with an ageing population. However, using even relatively cautious assumptions about technological progress and capital accumulation, aggregate living standards (as measured by GDP per head) are likely to double over the next 50 years.

2 *'Government Actuary's Department 1998 population projections'*.

3 Expectations of future lifetime for cohorts, taking into account future improvements in mortality, based on mortality rates assumed in central GAD projections (source: *'Government Actuary's Department 1998 population projections'*).

- Second, fears that retirement of the 'baby boom' generations will lead to a sharp downturn in asset prices appear misplaced. This is because the effect of population ageing on the rate of return on asset holding is likely to be small, especially when set alongside the general level of volatility in asset returns (see Figure 1 below).

Figure 1: Historical volatility of asset returns



- Third, and less reassuring, is the fact that any adverse effects of demographic change are most likely to be felt in old age. This is because one of the effects of people living longer is that they have to spread their lifetime income over more years of life, implying a need for more saving when working. This implies a greater need for more informed financial planning.

- Fourth, as the population ages with more people reliant on private pensions, there is more exposure to the effects of financial shocks. For example, consumers with defined contribution pension schemes will be exposed to the risk associated with volatility in asset prices/investment returns, as well as the risk of living longer then they have provided for (i.e. longevity risk). One impact of this may be that individual consumers have to consider more conservative assumptions about asset returns and greater diversification of their asset portfolios in planning their finances.

(c) Consumers – times of change

3.8 The demographic changes outlined above are set within a context of broader changes, including:

- The declining coverage of occupational/defined benefit schemes.

- The government's target of increasing the share of pensions provided privately from 40% to 60% by 2050.

- A decline in the level of the state retirement pension relative to earnings.[4]
- Product innovation resulting in more complex products leading to some consumers bearing more investment risk.

3.9 A further factor is consumer attitudes to planning for retirement.[5] These suggest that consumers are not responding to the changing risks they face and may suffer detriment as a result.

3.10 The impact of an ageing population will be felt in different ways by different consumers. The reason for this is that the experience and needs of consumers in planning their finances varies across generations and depends on a number of factors, such as:

- Trends in pension provision (e.g. rights typically established under occupational state pension schemes vary between generations) and varying attitudes towards retirement provision (e.g. State vs. individual responsibility).
- Levels of debt (e.g. credit card, mortgage and student debt).
- Savings behaviour (e.g. holdings of PEPs/ISAs and other investments, including housing equity).

3.11 So, the risks facing consumers depend on their experiences of these factors. For example:

- The current generation of older retirees is often characterised by relatively low levels of financial wealth and many who are dependent upon income-related benefits.
- The recently retired have been described as a "golden generation" benefiting from the growth in defined benefit occupational pension schemes and higher levels of home ownership.
- Future retirees will face greater uncertainty about their level of retirement income, following the shift towards defined contribution pension schemes and, for example, possibly lower levels of home ownership.

4 Excluding the impact of the Minimum Income Guarantee and the Pension Credit.

5 '*The impact of an ageing population on the FSA*', FSA Consumer Research 10, January 2002.

3.12 These age-related wealth characteristics are outlined in the following table:

AGE	FINANCIAL CHARACTERISTICS
70s	There are many in this age group, particularly older women, who have no financial wealth at all. Some have benefited from the growth in occupational pensions, but there is considerable inequality in incomes. More than 40% of those aged 75+ receive some income-related benefits from the government. For many in this generation, their most significant asset is their house, with more than half owning their house outright.
60s	Many in this generation benefited from the growth in occupational pension schemes and this has driven up pensioner incomes. While some may have taken out a personal pension, this is not a major component of their retirement income. Levels of home-ownership and equity ownership are higher for this generation than among the older generation. A significant number bought PEPs and with-profits/ income bonds in the late 1990s, possibly using funds from an occupational pension lump sum.
50s – the post-war baby boomers	There is likely to be a further increase in pensioner income as this group moves into retirement. The majority will have belonged to an occupational pension scheme. Women in this group are also more likely to have a pension in their own right (state and occupational pension), further increasing household incomes. Many will get some income from a personal pension – roughly a quarter took out a personal pension when they were introduced. Levels of home-ownership and equity ownership are even higher than among the previous group. Nearly one-quarter of this group have invested in a PEP or unit trust.
40s	The financial position of this group is likely to reflect the beginning of the shift from defined benefit to defined contribution pension schemes. The number of people with a private pension is higher than in previous generations, but there is likely to be greater uncertainty about how much pension income they will get from personal pensions and defined contribution occupational schemes. So, it is not certain that, as pensioners, this group will enjoy a higher income than its predecessors. Many may be thinking about making additional contributions as they get nearer retirement. Levels of home-ownership are slightly higher than among the previous generation and many bought PEPs/ Unit trusts in the late 1990s, which may provide additional wealth for retirement.
30s – the 1960s baby boomers	The shift to defined contribution schemes is even greater for this group. Again, levels of private pension coverage will be fairly high since many took out personal pensions when they were introduced. But there may be some concern about how much people have been contributing. Levels of home-ownership are still fairly high, but there is some indication that people in this group postponing home ownership compared with earlier

	generations. There has been some increase in levels of equity ownership, but far less than for the older generations. This may change as this group gets older and approaches retirement.
20s	Levels of asset ownership among this group seem to be somewhat lower than for earlier generations. Coverage of occupational pensions and personal pensions is lower than for previous generations of 20-year olds. The evidence also shows that they are less likely to own their own home and less likely even to have a savings account. There has been some increase in share-ownership when compared to previous generations of 20 year olds, but this increase has been at a slower pace than among older age groups. There is also a legacy of student debt, because of less state provision.

3.13 Different generations plan for retirement on the basis of quite different experiences of pensions and other assets, and face different sets of risks as a result. The response of ourselves and other stakeholders to these risks, and the strategies developed to mitigate them, must take account of these differences if they are to be effective.

4 Outcomes & risks

4.1 Reviewing the implications of an ageing population, we have identified a number of risks that pose a threat to our statutory objectives. These relate broadly to two areas:

- Consumers are not properly recognising the implications for their retirement planning, particularly the savings rates they need to sustain to provide for an adequate retirement income. Neither are they well prepared for the financial decisions they need to take at, and in, retirement.
- Low levels of consumer understanding and access to advice compound the risks to firms caused by increasing longevity and the rapidly changing market for decumulation products.

4.2 These risks are outlined below in more detail, together with a means of addressing them. In particular, we propose to adopt a number of measures, as well as making recommendations for consideration by other key stakeholders, including the government. In addressing these risks, we are aiming to help achieve two outcomes:

- Consumers are better equipped to make informed decisions when planning for, at, and in, retirement (see A below).
- The industry embraces the opportunities ahead, but also considers its responsibilities in managing the risks to consumers, as well as to itself, when manufacturing and selling innovative retirement products (see B below).

A. Consumers are better equipped to make informed decisions when planning for, at, and in, retirement

Summary

Our research and analysis has highlighted three core risks to achieving this outcome:

- **Consumers of all ages do not adequately plan for retirement.** However, this is a concern particularly for younger consumers in their 20s and 30s because they need to be financially more self-reliant than older generations when they reach retirement. If they fail to start planning for retirement when they are young, they may find the realities of their retirement income far below their expectations based on the experience of previous generations.
- **Consumers are not saving enough for retirement and are unaware of the increasing exposure to investment risk.** There are some important age group differences to consider here. For example, consumers in their 20s-30s face greater challenges with lower savings, less housing equity and pension provision and greater uncertainty/exposure to future investment returns than previous generations. Consumers in their 40s and some in their 50s are more likely to have a combination of defined benefit and contribution pension schemes and substantial housing equity compared to younger age groups. However, they have less time to save than younger people and their pension provision is exposed to investment returns, unlike many of their parents who have benefited from the security associated with defined benefit pensions.
- **Consumers do not understand their choices associated with specific retirement products.** This is particularly a concern for consumers in their 60s and 70s who are in or nearing retirement, because the range and complexity of decumulation products is increasing. These consumers are making decisions that may affect the rest of their lives – such as how comfortable their retirement will be – and they may not be easy to reverse.

To mitigate these risks, we propose a three point strategy to:

- Encourage retirement planning and provide younger consumers, in particular, with the tools to plan.
- Raise understanding of all consumers of the risks associated with increasing exposure to investment risk and inadequate savings levels.
- Equip consumers who are approaching or in retirement with the right questions to ask and relevant information to increase their understanding of the core decumulation products.

Risk 1: Consumers do not adequately plan for retirement

4.3 Our research into consumer attitudes towards retirement and financial planning more generally[1] suggests that relatively few people actively plan their retirement:

1 *'The impact of an ageing population on the FSA'*, FSA Consumer Research 10, January 2002.

- Consumers do not focus on retirement until about ten years beforehand when they try to make additional savings and accumulate as much wealth as possible. They tend to leave key decisions about lump sums and additional financial products to be bought until two years either side of retirement.

- Few consumers actively plan for retirement, even amongst those who take early retirement. Yet whilst consumers are living longer, many hope to retire early, implying a shorter period of time through which to build wealth to support them through a lengthened retirement. In practice, one implication of the ageing population is likely to be some increase in the average age of retirement.

- Older consumers, in particular, are more willing to rely on State or occupational pensions than younger people, who are having to accept more responsibility for securing their own financial provision for retirement.

- There may be a large proportion of women aged over 40 years who tend to rely on their spouses for long-term financial planning, exposing them to considerable risk in the event of divorce or bereavement.

4.4 The following remarks are typical of those made by consumers during our research[2] about attitudes towards planning for retirement:

"When I was younger I didn't actually plan for my retirement, I didn't work for a company that had a pension scheme. I was married and it just didn't cross my mind that I was going to need a pension or that I wasn't going to be looked after." (pre-retired)

"I didn't plan anything…you thought that if you paid your stamp, then that was your pension." (pre-retired)

"I think it's the men who think about pensions more." (pre-retired)

Proposed remedies

4.5 Strategies are required to encourage consumers to plan for retirement and to provide them with the tools they will need to do this.

4.6 The lack of retirement planning does not appear to be confined to any particular age category. But, today's 20-30 year olds are likely to be most affected by changes in the pension market, State provision, the delay in home ownership and rising levels of debt, for example. In addition, younger consumers have the greatest opportunity to benefit from better retirement

2 *'The impact of an ageing population on the FSA'*, FSA Consumer Research 10, January 2002.

planning, as they have longer to change behaviour and provide for their retirement.

4.7 However, the objective of all these strategies should be to encourage as many consumers as possible to:

- Plan actively for retirement.
- Question whether their retirement provisions are adequate.
- Make extra provision, where appropriate, as soon as they can.

4.8 We have set out below messages for ourselves, the government and industry to tackle these issues.

The FSA

4.9 We are already implementing strategies to raise the general level of awareness and understanding about financial planning, particularly amongst younger consumers. These measures include:

- An interactive financial planning tool has been available both on our website and CD-ROM since autumn 2001.
- *'It's your business'* pack on financial planning for small business owners and employees was launched in October 2001.
- We launched an information pack in January 2002 entitled *'Piling on the pounds'* to help women understand the importance of making provision for themselves and to give them the tools to tackle long-term financial issues such as saving for retirement.
- We launched a resource pack in January 2002 entitled *'Make the most of it'* which was sent to all UK secondary schools in support of the Citizenship framework, which becomes a statutory part of the National Curriculum from September 2002. The pack includes modules on planning for the future and making personal finance choices.

4.10 There is more to be done in this area. We are aiming to develop a strategy to target key messages to all consumers about the benefits of actively planning for their financial futures, particularly for retirement, and the risks of not doing so. However, for retirement planning in particular, the role of other relevant stakeholders (e.g. trade bodies, employers and consumer groups) is important and we will collaborate with them to ensure that the messages are effectively delivered and result in tangible improvements.

4.11 Finally, by the end of 2002, we will start work on the development of a generic interactive fact-find that will help inexperienced consumers to understand their financial planning needs at different life stages. It is intended

to be usable both directly by consumers and with intermediaries and should help people make more effective use of financial advice.

The government

4.12 The government already has in place a pension education campaign dedicated to raising general awareness of the need to plan their retirement and ensure they have made adequate provision. The campaign includes a range of simple, impartial guides providing information on pensions options. However, more work could be done in the area of targeting key messages about financial planning and retirement choices, especially to those groups with poor access to generic information or advice. There will be a need for specific messages and strategies for dealing with vulnerable consumers, including those with low incomes. The need for advice and information on financial planning is as high, if not higher, for these consumers, given the complexity of the interaction between rights to benefits, tax limits and savings.

4.13 From April 2003, consumers with money purchase occupational/personal/ stakeholder pensions will be given a Statutory Money Purchase Illustration every year. This will show an illustration of their pension at retirement in real value terms. There is a need for general information material to accompany such statements, explaining the implications of the pension illustrations and the risks of not adequately planning for retirement. There is anecdotal evidence that consumers are most susceptible to such messages and prompts at key stages in their lives and the SMPIs may be an effective call for action.

The industry/firms

4.14 The financial services industry has a key role to play in encouraging consumers to plan for retirement. The industry's distribution and customer contact channels could be used to distribute generic retirement information targeted at key ages and stages of life, reinforcing the messages being delivered by our own education and information strategies.

4.15 The ABI are already undertaking a number of initiatives with the industry in this area, including:

- Researching what employers currently offer and could offer to their workers in the future by way of advice and information on savings and retirement.
- The ABI is exploring whether decision trees and information can be developed to help the mass market identify an appropriate annuity rate for them and to help them shop around.

Risk 2: Consumers are not saving enough for retirement and are unaware of the implications of increasing exposure to investment risk

4.16 There are a number of trends that suggest that many consumers are not saving enough for their retirement and are unaware of the risks of increasing exposure to investment risk:

- Many consumers are not adjusting their saving behaviour to reflect the increased responsibility on individuals to provide for their own income in retirement. For example, looking at people who actually have pension contracts, the proportion of male employees aged between 18-24 years in full-time employment with an occupational pension fell from 35% in 1992 to 20% in 1998. For full-time male employees, aged over 55 years, comparable figures fell from 68% to 55%. For the younger group, the proportion with a personal pension fell from 23% to 10% over the period and for the over 55's it fell from 22% to 19%.[3]
- In addition, there is an increasing body of evidence that many consumers are not saving enough to provide an adequate level of retirement income. For example, 43% of annuity purchases are for less than £10,000.[4] Yet £10,000 will give an income stream of just £700-£800 a year on current annuity rates.[5] Of course, some consumers may have a number of pension funds, or additional sources of income that will increase the amount they have for retirement. But, for others, this will not be the case. In total, one estimate puts the 'savings gap' at £27bn a year, which would require an increase of about 54% in the amount currently being saved.[6]
- Our own research suggests that understanding about pensions is low; for example, many consumers with money purchase contracts did not know that they would have to buy an annuity.
- The trend away from occupational defined benefit pension schemes continues and could be hastened by changes in longevity risk and stock market volatility and made more transparent by changes in accounting standards (e.g. FRS 17[7]).

4.17 The primary issue for consumers is to understand the implications of these trends and the risks they are likely to face as a consequence.

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3 *'General Household Survey'*.

4 Stark, J & Curry, C, *'Reforming annuities: big bang or softly, softly?'*, ABI Insurance Trends, January 2002.

5 Based on a single life annuity for a 65 year old man/woman and excluding any state pension entitlements or other income.

6 *'The future regulation of UK savings and investment: targeting the savings gap'*, Oliver, Wyman and Company for the ABI, 2001. The 'savings gap is defined as the difference between the amount currently being saved and the amount that needs to be saved in order to secure an acceptable retirement income for all UK citizens.

7 *'Financial Reporting Standard 17 – Retirement Benefits'*. FRS 17 sets out the accounting treatment for retirement benefits such as pensions and medical care during retirement. It replaces SSAP 24 *'Accounting for pension costs'* and UITF Abstract 6 *'Accounting for post-retirement benefits and other pensions'*.

4.18 Our research indicates a need to:

- Encourage consumers to question how much they need to save for retirement and be more proactive in planning for their retirement. At present, saving for retirement tends to be equated with simply having a pension and very little thought is being given to levels of contributions. For example, in research undertaken by the DWP, fewer than 30% of consumers aged 25-34 years had given a lot of thought to their retirement income.[8]
- Encourage people to review – and increase – their level of pension contributions on a more regular basis, rather than ten years or so before retirement, as currently appears typical.
- Tailor different messages to younger and older consumers (to start saving at least small amounts at an early age, and then to review their savings and long-term needs and increase their contributions where appropriate) and, possibly, target these on trigger events, such as marriage or divorce, when consumers seem readier to take action.
- Balance the current message that you're never too young to think about saving for retirement with a message that you're (almost) never too old.
- Educate consumers to understand how their pension will provide them with an income.
- Increase consumer understanding of personal/stakeholder pensions – particularly their link to the stock market and the nature of returns to defined contribution pension schemes more generally. Consumers are often unaware of the risks to which they are exposed.

4.19 From our consumer research, the following is typical of consumers' responses to questions about saving for retirement:

"If I had my time again I would have made better provision" (retired)[9]

Proposed remedies

4.20 Although the financial impact of insufficient saving for retirement is ultimately the same for everyone, there are some groups of consumers for which the risk of this happening is significantly higher. In particular, consumers in their 40s and 50s are more likely to be affected by the shift from defined benefit to defined contribution pension schemes in the near future. They have less time to save and may not appreciate that the value of their pension provision is exposed to investment returns and to the risk attaching to those returns.

8 DWP Research Report.

9 '*The impact of an ageing population on the FSA*', FSA Consumer Research 10, January 2002.

4.21 Remedies need to be focused on enabling consumers to make more informed choices about their retirement provision. Nevertheless, there is no effective one-size-fits-all approach, as consumers do not have the same needs and will not be able to provide for their own retirement in the same way. For example, there are some people for whom saving for retirement is either unaffordable or – even as an informed and considered choice – a very low priority.

The FSA

4.22 It is not our role to tell people how much they need to save for retirement. However, our consumer protection and public awareness remit gives us a responsibility to help consumers understand the risks and implications of the decisions they make about their financial futures.

4.23 Consequently, we are reviewing our approach to these issues so that we can get messages to consumers more effectively. As an example of this, we plan to develop a further programme of education and consumer education tools. This will cover the life of a consumer from childhood, through adulthood to old age, to help consumers make better informed investment and savings decisions. This work has already begun with the publication in January 2002 of the first in a series of consumer information booklets on retirement entitled '*FSA guide to saving for retirement – start to save*'. The next steps will be:

- The publication of the second *'FSA guide to saving for retirement – reviewing your plans'* which is being released alongside this report and which will be a particular benefit to those consumers who are already making provision for their retirement.
- We are also planning to begin the testing of interactive decision trees by March 2003 and to illustrate the effect on pension income arising from different contributions, which will complement Statutory Money Purchase Illustrations (SMPIs) that are due to come into effect from April 2003.
- We are in discussion with the ABI and the DWP about the possibility of collaboration on a pension calculator (see below).

4.24 A key element in designing an education programme to improve consumers' financial understanding is to set out a clear picture of consumer understanding, attitudes and behaviour and how these interact in the area of personal finance. We are building up a body of research in this area designed to help us develop effective information, generic advice and education materials. The results of the ageing research[10] are helping us to develop our own consumer educational materials and target our communication to consumers more effectively.

10 *'The impact of an ageing population on the FSA'*, FSA Consumer Research 10, January 2002.

4.25 We recognise that advisors can play an important role in encouraging people to save by giving them advice. It has been argued[11] that a lack of revenue and escalating costs of regulation restrict advisors from undertaking the persuader role for low to middle income groups. We are currently looking at the regulation of advice as part of our review of the polarisation regime (FSA Consultation Paper 121) and are looking to remove unnecessary cost and complexity barriers to the provision of advice.

4.26 We are consulting on adjustments to the rules on pension projections for personal pensions (including stakeholder pensions) to promote consistency with the DWP's format for Statutory Money Purchase Illustrations (SMPIs), which through recent government legislation, will become compulsory from April 2003. We are also collaborating with the government and the industry to develop the format of SMPIs. About nine million consumers will, for the first time, have a yearly statement in real terms of what they might get as a pension and this could act as a powerful incentive to review their levels of saving. This will be similar to information members of final salary schemes currently receive. We are currently consulting on changes to our rules governing pension projections[12] to mesh with the government's initiative.

The government

4.27 The government has recently set up three reviews, led by Mr Alan Pickering, the Inland Revenue and Mr Ron Sandler, to examine different aspects of pension provision.[13] These are looking at:

- Simplifying the regulatory regime for private pensions.
- Simplifying the taxation of occupational pensions, reducing administrative burdens and making pension provision easier to understand.
- The operation of the market for long-term retail savings, including personal pensions.

4.28 These reviews are intended to produce proposals to encourage pension saving, reduce burdens on employers and providers, and help to ensure consumers are well served by the long-term savings market. The aim of this work is to reduce complex regulation, improve information and education and consider where the government and employers might take steps to encourage employees to save towards their own retirement.

4.29 With SMPIs being considered, it is timely for the government to co-ordinate the development of an integrated strategy to remind consumers of the risks of

11 *'The future regulation of UK savings & investments: targeting the savings gap'*, Oliver, Wyman and Company for the ABI, 2001.

12 *'Pensions Projections'*, FSA Consultation Paper, April 2002.

13 *'Economic and Fiscal Strategy Report'*, Budget Report, Her Majesty's Treasury, April 2002.

inadequate retirement provision. Employers, consumer groups and other key stakeholders should all contribute to this work.

4.30 We recently published a guide for employers[14] on how they can give employees pensions information that is consistent with the requirements of the Financial Services and Markets Act. It also explains where they can get help and independent information. We will continue to work closely with the government and other stakeholders on all these issues, particularly as the results of the government's reviews are published.

4.31 Alongside the steps we have taken, and the further initiatives we plan in pursuit of our objectives of improved consumer understanding, the government could also have a key role to play in educating consumers directly. The Foresight Ageing Population Panel[15] has recommended the government consider giving the public more information on how pension contributions might translate into final pension income in retirement, or even suggest benchmark saving levels. This would complement the pension projections and SMPIs already being developed and our own stakeholder pension tables which are published as part of our decision trees. Our research suggests that this is the point on which consumers would like most guidance.

4.32 It is clear from our research that the tax and benefit system can blur incentives to saving for retirement. Potential barriers may come from the complexity of the income tax system as it affects different forms of pensions saving. For example, for consumers over 50 with only modest accrued pension rights and limited income, the promise of means-tested benefits to top up the lowest pensions incomes needs to be taken into account in some consumers' decisions.

4.33 Income-related benefits are good for targeting resources on the most needy pensioners. Our consumer research showed that people felt that, under the current system, some that have worked and provided for themselves were being penalised. From 2003, the Pension Credit will alleviate the worst elements of this savings trap – those who have saved will be better off in retirement than if they had saved nothing. Under the current arrangements, Income Support benefit is withdrawn at the rate of £1 for every £1 of private saving held. This contrasts with the position under Pensions Credit where single people whose income on retirement lies between £78-£134 (£124-£200 for couples) will receive £0.60 in the pound, up to a maximum of £13.80 (£18,60 for couples). However, the implied 40% deduction rate will inevitably be a disincentive to save for some now at work. This could apply to 40% of all pensioners when it is introduced and it effectively reduces the net rate of return to saving.[16] For people at work, clear that their prospective retirement income is likely to lie in

14 *'Helping your employees with their pension options – a guide for employers offering stakeholder pensions or group personal pensions'*, FSA, April 2002.

15 *'The Age Shift: Priorities for action'*, Foresight Ageing Population Panel, May 2000.

16 *'A commentary on the Pension Credit proposals'*, Pension Provision Group, March 2001.

the relevant range, there is certainly a case for considering saving through an alternative tax efficient savings vehicle, rather than a pensions contract.

4.34 However, particularly for younger employees, there is a further factor that affects decisions about saving for retirement. Through the span of five or six Parliaments – which is the kind of time-scale relevant to pension planning – government policy is subject to unpredictable change. For example, policy on taxation, social security benefits and related issues, such as long-term care, could change significantly. At one level, this is in itself a reason for consumers to prefer to make their own provisions. These can offer more certainty then reliance on State provision, whether provided on a universal or means-tested basis. But, that point aside, the more well-founded certainty there can be about the long-term settlement on pensions and associated public policy, the more confident consumers can be in making their plans and the more savings for retirement will be encouraged. It is difficult to conceive of cross-party consensus on such policies enduring through decades. But – though it is not a matter for us – there would be advantage in encouraging an institutional framework to promote a consensus and enduring stability in public policy. If successful, the recent initiative to set up the Pensions Policy Institute to foster clear analysis and debate of pensions policy for the long-term could prove a useful development.

The industry/firms

4.35 The financial services industry has a key role to play in promoting consumers' understanding of greater self-reliance in retirement provision. This is an important aspect of ensuring consumers are given appropriate advice and purchase suitable products. There is also an element of self-interest for providers and intermediaries as improved consumer understanding should lead to greater levels of trust and increasing business for firms.

4.36 The ABI are currently consumer testing a pension calculator which would help consumers answer the questions "How much might I get from a given level of savings?" and "How much would I need to save to get a particular level of retirement income?". Depending on the outcome of consumer testing, they are in discussion with the FSA and DWP about how to develop this model further and promote it more widely.

4.37 The introduction of stakeholder pensions and the requirement on employers[17] to designate a stakeholder provider opens up the possibility for more workplace marketing of pensions. At work, advice and information are reinforced by more general discussions and peer group effects. So, the workplace can be a very effective channel for getting messages to consumers

17 With five or more employees and no existing occupational pension, or group personal pension scheme with 3% employer contribution.

and should be exploited wherever possible. We have recently published guidance for employers offering SHPs and Group Personal Pension schemes on how they can help their employees without needing authorisation or breaching the perimeter requirements of the Financial Services and Markets Act.[18]

4.38 There is an ongoing challenge to the industry as a whole to maximise the lifetime value of their customer base and to develop long-term relationships with consumers saving for retirement. There may also be a role for firms to help them build up their retirement savings over time. There is some evidence of short-termism currently; younger consumers are regarded as less attractive than older ones. This is because their current levels of wealth are lower even though, over the longer term, their total levels of wealth can be expected to grow.

4.39 The industry is taking the lead in consulting on the development of a standard format for Statutory Money Purchase Illustrations (SMPIs) – in collaboration with us and other key stakeholders. They are proceeding to design and test SMPIs and back-up materials, in time for implementation from April 2003.

Risk 3: Consumers do not understand their choices associated with specific retirement products

4.40 Given consumers' low levels of understanding about their options at retirement, moves to greater flexibility and choice of products – although desirable – need to be accompanied by clear information. This should set out the potential benefits and risks of different options. For example, there is a core set of risks associated with decumulation products that consumers in their 50s, 60s and 70s – approaching or in retirement and faced with these products – need to understand.

"I've got little pots of money and feel it's coming to the time to get it sorted" (pre-retired)[19]

4.41 The risk of consumers not understanding their choices at retirement is particularly a concern for those people approaching retirement who are making key decisions that will affect the rest of their lives, such as how comfortable their retirement will be. This risk can be compounded by the complexity of some decumulation products and the wide choice available.

4.42 The focus of the strategies dealing with this risk should be targeted at allowing these older consumers to make informed choices. They need to

18 '*Helping your employees with their pension options – a guide for employers offering stakeholder pensions or group personal pensions*', FSA, April 2002.

19 '*The impact of an ageing population on the FSA*', FSA Consumer Research 10, January 2002.

know the right questions to ask and have relevant information to make informed choices.

4.43 The following sections analyse the issues in relation to some of the main product types currently available; annuities, income withdrawal and equity release.

a) Lack of understanding on annuities

4.44 The Inland Revenue/Department of Work and Pensions have recently consulted on how the annuities market could be made more flexible and competitive in the interests of people who use annuities to turn pension savings into retirement income.[20] With greater flexibility there would sometimes come greater complexity. The biggest concern is that consumer understanding of annuities is very low currently and that people do not fully understand the risks of the decisions they are taking. Our research shows that many people with personal pensions are not even aware that they need to buy an annuity, let alone the choice available to them from an increasingly complex product range:

- There is little awareness of the open market option (the fact that you can buy an annuity from a different provider to the one through which a pension fund has been built up, and so, take advantage of potentially better annuity rates by shopping around). Our research shows that almost two-thirds of consumers buy their annuity from the provider of their personal pension. Shopping around different providers could mean consumers gain as much as 35% in their pension income.
- Generally, consumers wrongly equate the fall in rates in recent years to a fall in the value of annuities. Annuity rates have fallen in line with the yields on gilts and other bonds, reflecting lower expectations of future inflation. Although a purchaser gets a lower annuity rate than a decade ago, the value is expected to be eroded less by inflation. Annuity rates have also fallen due to improved longevity, but this implies no loss of value-for-money for the typical consumer.
- People heavily discount the future, overwhelmingly choosing level over index-linked annuities or single life over joint life annuities. In many cases, these choices may be perfectly rational, but the potential concern is that people do not fully understand the risks in the decisions they are taking. For example, someone retiring in their 60s might live for another 30 years and, even if inflation is only 2.5% a year, this would mean the value of their level annuity more than halving, which may contribute to financial difficulties.

20 *'Modernising Annuities'*, Inland Revenue/Department of Work and Pensions, February 2002.

- Some consumers are not getting the best annuity rate available, as they often fail to buy an impaired life annuity when they are eligible. One estimate suggests that impaired life annuities could account for as little as 3% of the annuity market, whilst as many as 40% of retirees could be eligible for an impaired annuity, which would give them a higher income in retirement.

Proposed remedies

The FSA

4.45 We suggest a minimum set of messages/issues that consumers need to understand when buying an annuity:

- What an annuity is and what your options are.
- A conventional annuity provides a greater level of certainty in income than can be expected from other types of annuities and from Income Withdrawal, although this certainty has an associated cost.
- Open market option:
  - you have the right to shop around
  - it is quite easy to shop around
  - shopping around can make a large difference to the amount of annuity
- Even low levels of inflation can, through time, radically affect your standard of living if your retirement income is fixed in money terms.
- Before buying a single life annuity, consider what will happen to your spouse after your death.
- Some consumers could increase their income with an impaired life annuity.

4.46 These messages are being incorporated in our consumer literature as it is updated. As part of this work, we will promote these to ensure that consistent messages are adopted as part of consumer literature produced by the industry.

4.47 On 29 April 2002, we announced new rules and guidance on disclosure concerning surrendering an endowment policy and buying an annuity, following Consultation Paper 106.[21] The new requirements will come into force in September 2002. For example, these will require firms to make consumers aware of the "open market" option four months before their retirement, with a reminder at least six weeks before retirement, and

21 *'Disclosure: trading an endowment policy and buying a pension annuity'*, FSA Consultation Paper 106, August 2001.

whenever a consumer requests a quote to take benefits from a pension. We do not have powers to make equivalent rules to cover occupational pension schemes, although we have encouraged the DWP and OPRA to consider whether occupational pension scheme trustees might be subject to similar standards.

4.48 As well as disclosing the OMO to consumers, we are also preparing a general information factsheet on annuities for publication by September 2002 which will be widely available to consumers. Under our new guidance, firms are encouraged to provide this factsheet when informing consumers of their rights to shop around for an annuity.

The government

4.49 To have maximum impact, it would be desirable for the government to adopt a similar set of messages for consumers to help increase the general level of awareness of annuities.

4.50 Our work suggests that government could usefully encourage greater innovation in annuity products by enabling consumers to change the terms of their annuity after they have bought it (for example, to change from a level to an indexed annuity or from a single life to a joint life annuity perhaps to reflect a change in personal circumstances). However, there are a number of factors that would need to be considered in increasing flexibility along these lines, including increasing complexity of the product. We welcome the steps that are already being taken to encourage innovation,[22] such as developing limited period annuities, although this could be taken further to explore annuities with some element of capital protection or 'money back', for example.

The industry/firms

4.51 Alongside compliance with our revised rules and guidance on disclosure of the open market option, firms generally need to consider improving their consumer literature to get across better the messages outlined above. Consumers' understanding of annuities is not helped by the legalistic and jargon-filled material which some firms supply.

4.52 The ABI are already undertaking a number of initiatives with the industry in this area:

- The *'Raising Standards Scheme'*, which is a voluntary initiative applying to long-term savings and protection products which meet standards

22 *'Modernising Annuities'*, Inland Revenue/Department of Work and Pensions, February 2002.

relating to clarity, comparability of information, appropriateness of the products purchased and customer service.

- The *'Pension Maturities Statement of Good Practice'* recommends that ABI members spell out to consumers their right to shop around for an annuity, the benefits of the open market option and sets standards in the timing and terminology of correspondence with consumers.

b) Lack of understanding on income withdrawal

4.53 Some consumers are opting for income withdrawal products because they believe that annuity rates will improve either "because they are low at the moment" or "because they are better when you are older". These beliefs are sometimes based on an impression of past annuity rates rather than a considered view of a low inflation environment or the likely net impact of mortality factors. Against this background, it is not certain that all consumers who buy income withdrawal are making an informed decision. Our concerns are that:

- Many consumers who have undertaken income withdrawal do not always understand that they will still need to buy an annuity in the future.
- Equally, many do not know how they will decide when to buy an annuity – a decision which should be based on a combination of fund values, annuity rates, mortality drag[23] and a view of future investment prospects and the value of the death benefits.
- Consequently, consumers do not understand the investment judgement inherent in income withdrawal or how it will be fulfilled. In fact, the objective has to be to achieve enough growth to buy (at an unspecified time in the future, but not later than age 75) the annuity that would have been available at the outset, while providing a regular income and compensating for the effects of charges and mortality drag.
- Some individuals do not realise that they can take the tax-free cash from the pension, without having to buy an income withdrawal product, if instead they buy an immediate annuity with the remaining 75% of the fund.

23 By delaying the purchase of an annuity, individuals are subject to what is called 'mortality drag'. The mortality drag is the additional rate of return that the investments left in the pension fund would have to generate above the return on an annuity, in order for income withdrawal to provide the same income as an annuity. It arises because annuitants who live for a long period of time are, in effect, subsidised by annuitants who die early, whereas consumers using income withdrawal do not benefit from this cross-subsidy.

Proposed remedies

The FSA, government, industry/firms and consumer groups

4.54 We suggest a minimum set of messages/issues that consumers need to understand when buying income withdrawal products:

- The effect of 'mortality drag' caused by delayed annuity purchase.
- The Inland Revenue restrictions on their tax position generating an inheritable asset.
- The rate of fund growth required to match the overall value offered by the alternative of immediate annuitisation.
- The factors they need to take into account when making decisions about annuity purchase and asset allocation later in the life of the product.

4.55 These messages are being reflected in our consumer literature as it is updated. In addition, we plan to encourage their consistent explanation in consumer literature produced by the industry.

c) Lack of understanding on equity release

4.56 Our concern is that consumers may not fully understand some of the complexities and risks with these products (including both lifetime mortgages and home reversions[24]). Whilst the market is still small compared to other decumulation products, such as annuities, equity release products could develop into a significant market given the growth in housing equity and the increasing burden of self-provision in retirement. Equity release may be a rational choice for some consumers to provide an additional source of income in retirement or a lump sum (e.g. to pay for long-term care or to top-up a pension income).

4.57 In particular, consumers do not understand:

- **The possibility of negative equity with a lifetime mortgage –** some lenders offer 'no negative equity' guarantees to mitigate this risk.
- **The rate of increase of lifetime mortgage debt where interest is rolled up –** even at current low interest rates, the sum owed could double in around ten years where interest rolls up. This can affect the consumer's freedom to move home at a later date, quite apart from limiting the amount the consumer may wish to leave to their beneficiaries.

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24 'Home reversion' is a method of releasing equity for older consumers, where a consumer sells all or part of their property to a reversion company (at a discount) in return for a lump sum / income and ability to remain in the property on a lifelong lease. At present, home reversions are not expected to fall under the mortgage regulation regime. 'Lifetime mortgage' is a mortgage aimed at older consumers that provides a lump sum and/or income, and is designed to be repaid on the borrower's death, or earlier if they move into residential care or sheltered accommodation. Interest may be paid monthly or rolled up and repaid with the capital.

- **The impact on estate –** a full home reversion means that the property belongs to the reversion company and the consumer can leave none of the value to his/her beneficiaries. A partial reversion allows the consumer to bequeath part of the value. A lifetime mortgage has to be repaid on death (or earlier if the individual moves into care or sheltered accommodation), again limiting the size of the estate. Of course, this could help reduce inheritance tax liability, although it may not necessarily be the best way of achieving this.
- **Tax and benefit implications –** the particular effects will depend on the type of lifetime mortgage or reversion. For example, where the proceeds are invested in an annuity, the income will affect the individual's eligibility for means-tested benefits (such as Pension Credit) and part of the income will be taxable.
- **Restrictions on others moving in (e.g. a carer or new partner) –** because providers need to calculate figures based on the consumer's age, life expectancy etc., a new resident with occupation rights could result in risks for the provider in terms of their expected return. So, most include a provision in the contract limiting other people moving in. Consumers need to understand any such restrictions in making their plans for future care, for example.
- **Limits on access to additional funds –** for reversion contracts, it is important that consumers are aware that a full reversion means that any current or future equity in the property no longer belongs to them. As far as lifetime mortgages are concerned, lenders usually advance quite conservative amounts, especially where interest rolls up. In addition, access to further funds may be limited, especially during any period where property values are falling. Most lenders will require a first charge over the property, and it is unlikely in the current market that consumers would find a lender willing to lend on a second charge basis.
- **Repair clauses –** most providers require consumers to repair and maintain the property, and many reserve the right to enter the property and carry out essential repairs if not attended to by the consumer. Whilst this is usually a condition of a mainstream mortgage contract, it is important that consumers are aware of their responsibilities.

Proposed remedies

The FSA, governments, industry/firms and consumer groups

4.58 Again we suggest a minimum set of messages/issues that consumers need to understand and be made aware of when purchasing equity release products:

- Is there some other way of accessing funds or increasing income, which might be better for their particular needs? Trading down may be an option – avoiding the need for a lifetime mortgage or reversion. However, if income is a problem, are they claiming all benefits to which they may be entitled?
- Is the information on the product clearly presented – do they know exactly what they are getting?
- What are the benefits of the product – apart from the monetary benefits, are there additional incentives and guarantees that safeguard their position (for example, a no-negative equity guarantee on a mortgage)?
- What are the risks – for example, how will a lifetime mortgage or reversion affect their tax and benefit position? Can they repay the mortgage if they choose to – or will early repayment charges apply? Alternatively, will there be access to further funds later if needed? What about the size of possible debt as interest is rolled up which could affect the size of their inheritable estate?
- Shopping around – it is important to compare products to find the one that best suits their needs.
- Involving the family – consumers may choose not to do so, but it may be helpful, so that later on there is no confusion about what has been done.

4.59 We will give these messages to consumers and we will seek to ensure that consistent messages are delivered in consumer literature produced by the industry as well.

4.60 We published proposals for a tailored disclosure regime for lifetime mortgages in Consultation Paper 98.[25] Following the decision by HM Treasury that the FSA would have responsibility for regulating mortgage advice, we are reviewing these proposals to take account of our new responsibilities. However, it is still our intention to develop a tailored regime for these products, to make sure consumers are aware of the risks.

4.61 In addition, we are developing a booklet on lifetime mortgages and reversions to help increase consumer understanding of equity release products, to be available when the regulation of mortgages takes effect.

25 *'The Draft Mortgage Sourcebook, including Policy Statement on CP70'*, FSA Consultation Paper 98, June 2001.

B. The industry embraces the opportunities ahead, but also considers its responsibilities in managing the risks to consumers, as well as to itself, when manufacturing and selling innovative retirement products

Summary

The changing operating environment and rapid growth in the decumulation product market are creating opportunities for firms. The opportunities arise out of the increasing size of the market, as well as the need for firms to develop new and innovative products to give consumers an income in retirement. For example, they need to design flexible annuity products to meet the changing needs of a population that is facing more years in retirement.

However, there are risks as well. The rapid growth in the decumulation market makes the impact of the risks associated with risk mis-management and mis-selling more significant. Our work has highlighted a number of concerns that stem from the availability and quality of advice, particularly in the retirement market:

- **The growth and potential mis-management of longevity risk poses a threat to firms' solvency.**
- **Generic advice for the 'in retirement' market, in particular, is limited, leaving consumers who are approaching or already in retirement unaware of their choices and they may suffer detriment as a result.**
- **Gaps in basic advice and comparative information mean consumers may be unable to make informed choices.**
- **The quality of post-sale, ongoing advice for income withdrawal products is uncertain.**

In addressing such risks, it is important that:

- Firms take full account of the implications for themselves arising from the growth in the market for retirement products.
- Firms respond appropriately to the risks to consumers when developing and marketing new and innovative products, particularly annuities and equity release.
- Advisors take account of the changing needs of consumers, particularly the different wealth and debt profiles across different age groups.

Risk 1: The growth and potential mis-management of longevity risk poses a threat to firms' solvency

4.62 There are clear opportunities for firms, in terms of the likely growth in demand for decumulation products and an increasing volume of product sales. However, there are also two potential sources of risk that might arise from the growth in the retirement market and from longevity risk:

- **Mis-pricing risk –** annuities are presently the only major source of longevity risk arising from decumulation products in balance sheets, given the current small size of the long term care insurance and lifetime mortgage markets. The key risk to providers is one of mis-pricing of annuities. If the pricing is wrong, this might not be known for decades as it will take time for mortality experience and investment returns to play out.
- **Mis-selling risk –** new types of products are likely to grow, including those engineered to meet firms' risk management aims and to take some of the burden of longevity risk from firms' balance sheets and onto the consumer. In some cases, it may be appropriate for consumers to take on more of this risk in order to benefit from potentially greater rewards, although there may be increasing pressure to sell such products to consumers when the consumer may not understand their characteristics. This poses the potential for mis-selling risk for firms involved.

Proposed remedies

4.63 There are a number of steps that firms need to consider in addressing these risks. Firms should already be managing effectively the risk that they carry on their balance sheets and adopting sound risk management principles, but they should also take account of the risks, as well as benefits, arising from developing and marketing innovative products to consumers.

The FSA

4.64 Of the financial institutions, insurance companies have the greatest exposure to annuities; this area is already a core focus of our supervision. Although there has been increasing activity in recent years, with mergers and acquisitions between banks and insurance entities, banks' exposures are still relatively low and unlikely to threaten solvency. Nevertheless, the nature of bank exposure to longevity risk will continue to be monitored in the future, as any further consolidation between the bank and insurance industry takes place.

4.65 The total industry annuity liability in with-profits funds is likely to be below 50%, compared with 75% in 1985. This has implications for both policyholders and shareholders, as the former now take relatively less and the

latter relatively more of the exposure to longevity risk than was the case as recently as 15 years ago. The extent of policyholders' and indeed, corporate exposure to longevity risk will continue to be monitored to increase our understanding of where the potential burden of risk will lay.

4.66 A better understanding of how new decumulation products balance performance and longevity risk will help us in our work. It will also help us set our prudential supervision, public awareness and market confidence agendas.

The industry/firms

4.67 Firms should ensure their systems and controls and risk management techniques are adequate to monitor their exposure to longevity risk. These will be subject to review by the FSA as part of our supervision programme.

4.68 Firms need to be fully aware of the risks when selling the more complex retirement products and should have strategies to monitor and manage potential mis-selling risk, particularly when selling complex products to vulnerable consumers and when developing products to transfer balance sheet risks to consumers.

4.69 These issues arise because the market for financial services products for retirement is a complex one and is characterised by consumers in retirement who are amongst some of the most vulnerable. So providers and advisors need to exercise caution in determining the suitability of products and making sales. There are already regulatory rules and guidance imposed on disclosure and Know Your Customer requirements. However, the task of understanding the needs of consumers is arguably greater with older consumers where there may be physical or mental impairment and, in some cases, this involves consultation with family members and legal advisors on sensitive issues.

Risk 2: Generic advice for the 'in retirement' market is limited, leaving consumers unaware of their choices

4.70 As discussed above, there are significant opportunities for the financial services industry associated with the likely increase in the number of retirees in an ageing population. About 30% of the population will be over 60 by 2030 and will need advice and information to help them manage their portfolio of wealth to provide an income in retirement. The importance of financial self-provision is also growing.

4.71 However, the 'in retirement' advice market is currently undeveloped. There appears to be very little general decumulation advice encompassing the full range of consumer needs through retirement and the range of products they might consider during their retirement.

4.72 Added to that, our research[26] showed that consumers tended to make use of advisors at retirement and make their key financial decisions in the two or three years either side of their retirement. Subsequently, consumers do not tend to review their financial arrangements.

4.73 More generally, there is a concern that consumers are not getting access to the right kind of financial advice, which might help them in planning for, and in, retirement. There may be a number of reasons for this. For example:

- The way consumers pay for advice may well be a factor; in other words, commission-based fees may not adequately incentivise firms to offer generic information/advice.
- Even if this type of advice were more available/affordable, consumers generally do not appear to regard this as a general planning tool to help them decide how to use a portfolio to generate an income in retirement. Rather, consumers tend to use advice to help them buy a specific product.

Proposed remedies

4.74 The strategy for dealing with the issues arising from the growth in demand for advice and information in retirement needs to be broadly based. The industry should see the beneficial self-interest in providing high quality advice to the growing ‘in retirement’ market. Barriers to the provision of generic information need to be addressed and targeted effort is needed to educate consumers about the benefits of seeking advice on how to get the best value and flexibility as they run down their portfolio of wealth.

The FSA

4.75 We are already looking at the investment advice market as part of consulting on CP121[27] generally and believe there may be a number of failings. For example, the current fee/payment structure may encourage advisors to sell products even where suitability may be uncertain. We are consulting on proposals to address these issues, in the context of polarisation reform, including separating the cost of advice (and marketing) from the cost of the product and the possible development of a two-tier advice market. These proposals may make advice cheaper and accessible to more people and may also stimulate the growth of the generic advice / information sector for elderly consumers as for others.

4.76 Commission structures have been identified as a potential barrier to developing long-term relationships, particularly in retirement. With accumulation products, advisors should have an incentive to nurture their

26 ‘*The impact of an ageing population on the FSA*’, FSA Consumer Research 10, January 2002.

27 ‘*Reforming Polarisation: Marking the market work for consumers*’, FSA Consultation Paper 121, January 2002.

existing customers and encourage them to increase their level of saving over time. Commissions may provide less incentive for portfolio management. In particular, neither up-front nor trail commissions provide much of an incentive for advisors to build long-term relationships with consumers in the management of a declining portfolio.

4.77 We are planning to review commission structures in a sample of key firms by December 2002 to explore whether they create disincentives to developing long-term relationships between consumers and firms and to investigate the causes and extent of bias. As appropriate, we will follow this up with the use of supervisory tools to address any concerns. This might include either a firm-specific or industry-wide response.

4.78 We are developing and consumer testing a factsheet targeted at consumers approaching retirement, when they are most likely to be receptive to relevant help and information. We have had discussions with the DWP about including the information in this factsheet in their pre-retirement pack. This pack goes to all adults with State pensions in the months before they reach the statutory retirement date. By December 2002, we also plan to investigate what other basic information should be available to consumers covering the range of financial issues they might think about in retirement.

4.79 We already require that firms send out statements for income withdrawal products once a year. These statements suggest that the consumer should take advice.[28] There is, however, scope to extend this to empower the consumer further in seeking the advice he/she needs. For example, the statement could specify what questions a consumer would need to consider in each year of their retirement. Then, by disclosing the amount of trail commission being paid each year, they could be encouraged to seek expert help on answering these questions. We will consider these options by August 2002, and assess whether this approach could be extended to other products that require continuing advice; helping the consumer to make better decisions.

The industry/firms

4.80 The industry may consider how best to foster the 'in retirement' market, for example by providing a range of generic advice and information to build consumer understanding. An opportunity may exist to promote the development of a market for fixed-fee advice. For example, consumers could pay a set price for advice about a specific issue from a 'menu' of options available, so encouraging consumers to see advice as a general planning tool. Such a 'menu' might include financial advice on generic issues around retirement, marriage, starting a family, inheritance and tax-planning etc. The advantage of providing such generic advice is that the cost is likely to be lower

28 FSA Conduct of Business Sourcebook: Rule 6.4.12(2).

than specific advice. It could also benefit both provider and consumer in establishing a relationship, building trust and identifying further opportunities for more specific advice.

4.81 In delivering advice, advisors need to focus on the specifics of shifting patters of wealth and debt across different generations, including both the level and type of savings. For example, the fact that housing equity is a growing proportion of total household wealth should be considered.

Risk 3: The lack of understanding about specific decumulation products is accompanied by gaps in basic advice and comparative information to assist consumers make more informed choices

4.82 There is likely to be a significant increase in the opportunities for firms as the market for decumulation products expands:

- It has been predicted that the market for pension annuities – measured according to the money value of new annuity business – will grow at around 20% or more a year.[29] Over ten years, such growth would mean an increase of more than 500% in nominal terms – almost 400% in real terms.[30]
- The market for income withdrawal[31] is already significant, not only in terms of the annual flow of £2.2bn taken into it, but also the 90,000 consumers who currently hold this product.
- The market for lifetime mortgage products has potential for considerable growth because of high and growing levels of home-ownership among the retired. This will bring new providers into the market, and almost certainly encourage more intermediaries to offer these products. A recent report from the Institute of Actuaries estimates the current potential market for lifetime mortgages at around £100 billion in total, equivalent to a 20-fold increase from current levels.[32]

4.83 Product innovation in these markets to generate long-term income from accumulated wealth can bring real solutions to the needs of a growing number of retirees. The growth in the value of core decumulation product markets reflects, in part, a market responsive to consumers' needs. However, alongside these opportunities are the risks from limited consumer understanding of retirement options and specific products.

29 For example, Wadsworth, Findlater & Boardman, *'Reinventing annuities'*, Staple Inn Actuarial Society 2001.

30 Assuming inflation at 2.5% a year.

31 Income withdrawal is a product that allows consumers to defer the purchase of an annuity and to take an income directly from the pension fund.

32 The Actuarial Profession, *'Report on Equity Release Mechanisms'*, January 2001.

4.84 In particular, many of the products targeted at the retirement market, particularly decumulation products, are complex and require advice and high levels of consumer understanding. For example, when should you buy an annuity with an income withdrawal product? Selling these products requires advisors to have not only detailed understanding in very technical areas, but also a wide knowledge. For example, determining the suitability of a long-term care insurance product requires proper understanding of the interaction with income-related benefits, the tax system and of age-related health issues. While there are advisors who specialise in each of these areas, the supply of good advice on a much-increased scale may be problematic.

Proposed remedies

The FSA

4.85 Additional rules on disclosure have been applied to a limited number of products, including income withdrawal, because of their additional complexity. There may be some benefit in extending these rules to include investment-based annuities and Long-Term Care Insurance (LTCI) policies;[33] we are already considering a tailored disclosure regime for equity release products. We will review a number of providers to assess the adequacy of current disclosure practices during 2002 and follow up on the results in 2003. We will also be consulting on an appropriate regulatory regime for LTCI, once HM Treasury has commenced its consultation on the required amendment of the Regulated Activities Order.

4.86 Given the newness of many products for older consumers, advisors may lack detailed knowledge and expertise. Training requirements of advisors need to reflect the changing emphasis on managing a declining portfolio and know your customer (KYC) needs of the old and very old. So, we plan to consult on proposed changes to training requirements by September 2002, to reflect the increasing importance of decumulation knowledge and to instigate a training regime that updates and re-tests advisors' knowledge in these highly complex areas. These changes will come into effect by 2004. To complement this work, we will review the role of specialist exams for advisors as a pre-requisite to selling certain products, such as specialist annuities, draw down and LTCI products. In addition, training and competency requirements in relation to lifetime mortgages will be considered in our consultation papers as the mortgage regulation regime develops.

4.87 The main decumulation products have not yet been included in our comparative information tables. We are working towards including annuities by March 2003 and, by December 2002, will consider whether to extend them to include additional decumulation products, possible candidates include

33 FSA will be consulting later this year on the appropriate regulatory regime for LTCI which is to become a regulated activity.

on income withdrawal products, lifetime mortgages and LTCI. The aim would be to help consumers shop around and find good value products.

The government

4.88 At this stage, the government is not proposing to introduce product standards for decumulation products and has recently explicitly ruled them out in the case of LTCI. Product standards are not a substitute for advice, but they can help in the development of a simplified advice regime. In a relatively new market, standards can help to signal to consumers basic and/or reasonable value products, but setting standards can risk hampering innovation and reducing competition. As the market for decumulation products develops, the government needs to keep under review the case for setting product standards or benchmarks.

4.89 Similarly, there is a case for the government keeping the scope of regulation under review, particularly the markets for equity release and related products.

The industry/firms

4.90 The income withdrawal market has demonstrated that product providers can gain market share by giving good technical support to IFAs. This is not a new concept as seminars run by product providers and supported by broker consultants have long been used by providers to raise awareness of their products and the benefits they can deliver. Firms should consider the scope to use such means to help IFAs provide better advice and promote confidence in the market. Firms should, where necessary, strengthen their own training and development programmes to ensure that staff in contact with consumers have up to date and relevant knowledge of the products they are selling. This is particularly relevant for the decumulation market where some of the products are extremely complex.

4.91 Firms are already expected to keep their disclosure (e.g. KFDs) practices/materials under review to ensure that they are up to date. They must also provide full and clear explanations of the nature and risk of the products being sold to reflect, for example, product innovation or changes in Inland Revenue rules.

Risk 4: There is a potential for significant commission bias in the sale of income withdrawal products and there are concerns about the quality of post-sale ongoing advice for this product

4.92 There has been significant growth in the market for income withdrawal products, despite the complexity of these products and the problem of ‘mortality drag’. Although the growth in the market may have been driven by

death benefits, one reason could be the comparatively high level of commission available to intermediaries on this product. There are two points at which high commissions could give rise to biased advice:

- The first is in advising a consumer to use their pension plan to produce capital or income as opposed to borrowing, selling shares or units, or taking money off deposit. The concern arises because there is no commission for advising a client to raise money from such alternatives, so a commission-based advisor clearly has an incentive to recommend income withdrawal products.
- The second is in advising withdrawal over other options which give access to tax-free cash, such as taking an immediate annuity. The commission from an income withdrawal contract will usually exceed that from a conventional annuity.

Proposed remedies

The FSA

4.93 We are already working on proposals[34] to consider whether to introduce rules and guidance to require firms to distinguish the cost of the advice from the cost of the product. This will help consumers understand the value and cost of the advice that they have/will receive, and encourage them to understand that they may be able to seek advice on an ongoing basis. Improved point of sale disclosure may also be used to empower consumers to ask the right questions to decide whether they should vest their pension and what product may be the best for them.

4.94 Even the consumer who seeks advice after the point of sale may not receive the service he/she needs. So, we plan to investigate strategies in a dialogue with the industry to stimulate the availability and quality of advice for income withdrawal and, in particular, when to buy an annuity. Specifically:

- **Guidance on critical yields –** the decision to take an annuity, either at inception or later in the contract, will depend on the investor's needs. However, for some commentators,[35] the key first stage in assessing the risk and reward is a "critical yield" analysis.[36] We are intending to review offering guidance on critical yields by December 2002.
- **Annual reviews –** linked to the need to assess the yield is the need to meet it. There is no obligation on firms to recommend an asset allocation that would meet the yield or on maintaining the portfolio to take account of the changing needs for growth, income or volatility. We intend to

34 '*Reforming Polarisation: Making the market work for consumers*', FSA Consultation Paper 121, January 2002.

35 '*Retirement planning in the current legislative framework*', Chartered Insurance Institute Research Report, 2000.

36 The critical yield calculation is an attempt to show the investment returns required from a pension fund withdrawal arrangement to match the income that could have been provided by a traditional annuity.

re-evaluate the training of advisors on giving advice post-sale, and using improvements to annual review letters to stimulate consumers to seek advice.

4.95 We will review of a number of key firms in this market to test the extent of commission bias and mitigating controls and will take remedial measures if appropriate.

The industry/firms

4.96 Firms need to have appropriate systems and controls in place to identify, monitor and mitigate potential sources of commission bias.

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