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Creating a secondary annuity market

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Creating a secondary annuity market

Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

March 2015

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Foreword

Last year this government announced the most fundamental changes to how people access their pensions in nearly a century. Restrictions on individuals who had worked hard and saved for their retirement were removed, giving them the freedom and choice to get the deal that was right for them. These changes built on reforms that introduced the new state pension, which will provide a simple, firm foundation for saving.

People approaching retirement will be able to take full advantage of these freedoms from 6 April this year. We have drastically simplified the tax rules to give people access to their pension savings – and removed altogether the restriction on people's ability to draw down from their defined contribution pots after age 55. The industry is responding by developing innovative new products to cater for the decisions people are making when they are able to choose how to use their pension savings. And we have introduced Pension Wise, the new guidance service to help people understand the pension freedoms and which option best fits their circumstances and goals.

However, people who have already bought an annuity are still effectively locked in to the old system and do not have the option to exit from these arrangements. In this government's view, there is no reason to prevent retirees who have already purchased an annuity from selling their right to future income streams for an upfront cash sum if it is right for them. So from next year, we will remove the tax restrictions on people seeking to assign their annuity income to firms wishing to purchase it. Individuals will be able to take the proceeds of their assignment and save or spend them as they see fit, taxed only at their marginal rate.

The government believes that for most people, keeping their annuity income will be the right decision – allowing them a stable and guaranteed retirement income. But individuals' needs vary greatly and it is not for the State to determine how they use their income. So for instance, those looking to exchange some of their retirement income to pay off debts, or help their children or grandchildren get a step up in life, should be able to do so if they can find a willing buyer.

We believe it is important that people are in a position to make an informed decision. So the government will work with the Financial Conduct Authority to consult on how best to support people's choices through consumer protection, and protect those who are most vulnerable.

As with last year's reforms, the government is removing barriers and challenging industry to create a market that allows individuals the choice to spend their pension savings flexibly. I encourage you to respond to this consultation on how we implement the reforms.

George Osborne
Chancellor of the Exchequer

March 2015

Steve Webb
Minister for Pensions

March 2015

1 Introduction

1.1 Since the early 1920s, individuals have had limited choice in how and when to access their pension savings. The government announced reforms in Budget 2014 to increase radically the choice and flexibility available to individuals when they come to access their defined contribution pension fund.[1]

1.2 While those retiring after 6 April 2015 will benefit from these reforms, those who retired before then and bought an annuity with funds from their defined contribution pension scheme remain effectively "locked" into that choice through a tax charge of up to 55% (or 70% in some cases) if they were to reassign their annuity. For the vast majority of people, continuing with their existing annuity will be the right choice. Annuities provide a regular guaranteed income for life and many people will continue to value the security they provide. However, there is no reason why the government should impose barriers that prevent individuals from being free to make their own choice about what to do with their annuity rights, purchased with money they have saved throughout their working life.

1.3 The government wants to give increased flexibility to current pension annuity holders. The government therefore proposes to remove the tax barriers which currently deter existing annuity holders from using the value of their annuity flexibly – so that they can assign their income stream to a third party in return for a lump sum. This lump sum could then be taken directly or used to buy an alternative retirement income product[2] where it can be drawn down over a number of years, and would be taxed in the same way as those taking their pension after April 2015.

1.4 . The changes aim, by April 2016, to give those with existing annuities greater flexibility, in line with those who will be taking their pension flexibly after April 2015.

1.5 The government's main reforms will be to:

- **Change the tax treatment in relation to annuity holders wishing to realise the value of their annuities.** This will include the removal of the "unauthorised payment" tax charge of up to 55% (or even 70%) that deters annuity holders from assigning their annuity. Individuals will, upon agreement with their annuity provider, have the opportunity to assign their annuity to a third party in return for a lump sum. Individuals can take this lump sum directly, or transfer the lump sum to an alternative retirement income product, drawing income down over a number of years and being taxed at their marginal rate.
- **Work with the Financial Conduct Authority (FCA) to ensure appropriate consumer protection is in place for annuity holders as they consider their options.** This may include the provision of guidance to annuity holders or the requirement to seek advice so they are in a position to consider fully the impact of their decision and ensure they are receiving a competitive price.

1.6 The government thereby intends to create the conditions for a secondary market in annuities to develop, in which third parties – which could include asset managers, pension funds, insurers

[1] Throughout this document, the term "defined contribution" should be taken to mean both money purchase and cash balance savings as those terms are defined for tax purposes in section 152 Finance Act 2004 (meaning of "arrangement").

[2] The reforms to have effect from 6 April 2015 introduced flexi-access drawdown funds, a type of pension fund where people can take as much or as little from their pension as suits them, and introduced greater scope for payments under pension annuities to increase and decrease (now commonly referred to as flexible annuities). Both of these products will become available from 6 April 15.

and intermediaries – are assigned the rights to annuity holders' income streams in return for a lump sum.

1.7 This approach fully recognises the contractual agreements between the annuity holder and the annuity provider, and does not interfere with those contracts. Instead, where annuity providers agree, it allows the annuity holder to access the value of their assets where they can find a willing buyer. The annuity provider would continue to hold the underlying assets and pay the annuity income to the third party for the lifetime of the annuity holder.

1.8 This document sets out the government's proposed approach to ensure people obtain the right support and guidance to make decisions that best suit their personal circumstances. It also provides a high level overview of how the market may develop when the legislative barriers are removed and appropriate consumer protection is in place.

1.9 These changes will have implications for a wide range of parties with an interest in annuities, including the pensions industry, providers of retirement income products, consumer groups, employers and individuals themselves. The government is therefore keen to hear from all stakeholders as part of the consultation process.

2 A new secondary market for annuities

2.1 The government believes that in response to its reforms, annuity providers, third party purchasers, and intermediaries will allow a strong market for secondary annuities to develop. This market will allow annuity holders to assign to a third party the right to their annuity payments in return for a lump sum, which can be taken directly or used to purchase a flexi-access drawdown fund or a flexible annuity.

Consumer demand

2.2 Estimates show that, before the reforms announced in Budget 2014, approximately 75% of people who reached retirement with defined contribution pension savings used them to buy an annuity.[1] Take-up rates of annuities were 38% lower between Quarter 1 and Quarter 2 2014 after the announcement abolishing the effective requirement to take out an annuity.[2]

2.3 The most recent figures on annuities from 2013 suggest that there are six million annuities in payment, paying out approximately £13.3 billion a year.[3] Given that some people will hold more than one annuity, it is estimated that up to five million individuals are in receipt of these payments.

2.4 The government expects that for most of these existing annuity holders, continuing to hold the annuity and receiving a regular income will be the right decision, given the lifetime certainty and security that annuities provide. But this may not be the case for everyone. Individuals may want to assign their annuity in order to, for example:

- free up the value from one of a number of retirement income streams, where the other income is sufficient to cover daily needs
- provide a lump sum for relatives or dependants
- meet a particular financial need or goal, such as paying down debt
- respond to a change in circumstances or
- purchase a more flexible pension income product instead

2.5 Annuity holder demand will also be highly dependent on the price they can obtain for assigning their annuity income. Whilst there may be high levels of consumer interest, the price individuals can obtain will reflect various factors – including the level of the annuity payments, the customer's health and age, buyer profit margin and buyer costs – all of which could reduce the attractiveness of assigning their annuity.

2.6 Support that will be provided to individuals to ensure they can make an informed choice is described in Chapter 4.

[1] HMRC analysis of ONS Wealth and Assets Survey and Association of British Insurers Data

[2] Association of British Insurers, UK Insurance, Key Facts, 2014f

[3] Association of British Insurers, UK Insurance, Key Facts, 2014f

Box 2.A: Sample case studies

How the new system will affect you will depend on your individual circumstances, including whether you have an income from other sources. The case studies below seek to demonstrate the tax implications of some of the potential options that are proposed in these reforms. These examples are for illustrative purposes only, and do not assess whether or not assigning the annuity payments or the method of receiving payment would be appropriate. They are not indicative of what people should expect to receive when assigning their annuity payments, which will depend on a number of factors such as how the market develops and individual circumstances.

Case A

Ms A is 68 and has company pension income of £20,000 per year, an annuity paying £1,500 per year, and a State Pension paying £6,000 per year. She decides to assign the rights of the smaller annuity for a lump sum of £19,000 in 2016-17 and puts this amount into a flexi-access drawdown fund. Her total income for that year is £26,000. She pays no tax on the first £10,800 as part of her personal allowance, and so pays 20% tax on the remaining £15,200.

If Ms A took the entire £19,000 from the sale of her annuity as one lump sum, her total income for the year would be £45,000. She would still pay no tax on the first £10,800, but now would pay 20% tax on the next £31,900, and 40% tax on the remaining £2,300.

Case B

Mr B is 69 and has a £7,500 per year income from his State Pension. He has two annuities, one paying £10,000 a year, and the other £5,000 a year. He decides to assign the rights to the smaller of the two for a lump sum for £59,000 in 2016-17. He places this money into a flexi-access drawdown account and draws down £20,000 in 2016-17 to pay for improvements to his house. This means his total income that year is £37,500. He pays no tax on £10,800 as part of his personal allowance, and pays 20% tax on the remaining £26,700. He accesses the remaining £39,000 from the flexi-access drawdown fund as needed.

Investor demand

2.7 As an asset for an investor, an annuity income stream has some advantages and disadvantages. It will offer a fixed or predictable level of income which will be particularly attractive to investors given potential difficulties in finding investments with low counterparty risk. On the other hand, the duration of the income, and therefore the total value of the asset, will depend on the lifetime of the original annuity holder. In other words, the buyer will take on a mortality risk – the risk that the original annuity holder, and potentially a dependant, will live for a shorter period than expected.

2.8 Clearly, this creates a significant uncertainty for the investor. Investors could potentially partially mitigate this by:

- individually underwriting each annuity they buy
- buying in sufficient numbers that this risk is aggregated and/or

- offsetting the mortality risk in a portfolio of annuities by matching it against longevity risk

2.9 The government expects that obtaining the right to annuity payments could therefore be attractive for a number of different types of investors, such as insurance providers and pension funds. For example, insurers could be well placed as buyers given their underwriting capacity and expertise. This asset could potentially be of interest to institutional investors looking for a partial hedge against the longevity risk they already hold, although longevity and mortality risks would not be matched perfectly for these providers – in part due to the risk of adverse selection, with people in poorer health potentially more likely to want to assign their annuity income. The government recognises, however, that the modelling and measurement of longevity basis risk is an area where the industry is still developing its thinking.

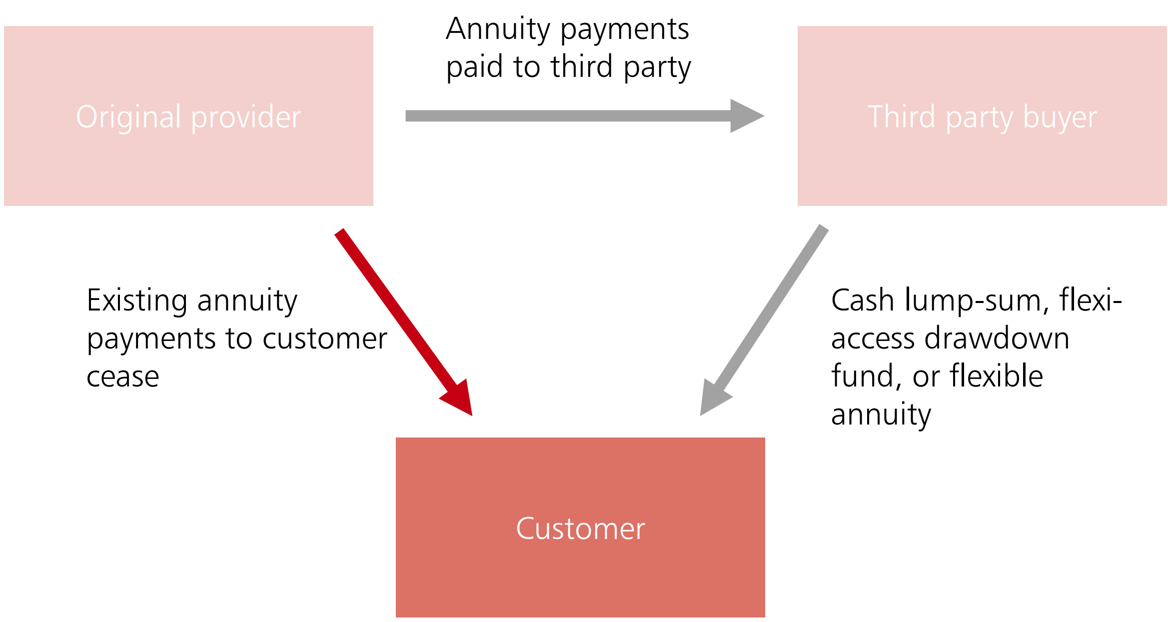
2.10 Depending on how the market develops, many institutional investors may only want to purchase in bulk and there may therefore be a need for intermediaries to enter the market in order to purchase individual annuities, repackage them, and sell them on to the end investor.

2.11 The government does not consider annuity income purchased on the secondary market to be an appropriate investment for retail investors owing to the complexity and difficulty in determining a fair price, and proposes to restrict the categories of persons able to undertake this activity. Beyond this, the government is keen that a range of corporate entities are able to purchase annuity income if they wish, for example companies, investment funds and partnerships, and welcomes views on what entities should be permitted. As discussed in chapter 3, which sets out the tax implications of the reforms, some restrictions may be necessary to mitigate the risk of tax avoidance.

How the market will operate

2.12 The development of a secondary annuities market would allow annuity holders to assign to a third party the right to their annuity payments in return for a lump sum, or to purchase a flexi-access drawdown fund or a flexible annuity. The third party would, in return for providing this lump sum or funds to purchase an alternative product, receive what would have been the customer’s annuity income for the lifetime of the annuity holder. Figure 2.A demonstrates how the government envisages that the transaction would work. While the third party buyer could itself provide a flexi-access drawdown fund or flexible annuity in which the lump sum would be invested, the third party buyer could equally release the customer’s funds directly to another party to purchase an alternative pension income product at the customer’s request. Figure 2.A is a simplified model. In practice, third parties may well include funds that purchase through intermediaries.

Figure 2.A: Secondary annuities market



Source: HMT

2.13 Third party buyers will offer a price to consumers for the assignment of their annuity income which, as in any market, will be based on various factors, including their estimate of the actuarial value of the annuity, transaction costs and a profit margin. For example, costs may include obtaining and assessing information on the consumer's circumstances. Buyers are also likely to take account of the inherent uncertainty as to how much the annuity will pay out in practice (given the unpredictability of individual longevity). The costs faced by the buyer and the profit margin they would reasonably seek to earn will reduce the price people can obtain for their annuity, which may make it less attractive to some consumers.

2.14 One factor that could affect the value of the annuity payments to the third party is the risk of the annuity provider defaulting on payments. Consumers are protected from this risk by the Financial Services Compensation Scheme (FSCS), which guarantees to cover part of the losses an annuity holder makes as a result of their provider defaulting.[4] There may be scope for this protection to continue following assignment within the existing rules.

Purchases by the original annuity provider

2.15 The changes outlined in this consultation will allow the annuity holder (with the consent of the annuity provider) to access the value of their annuity where they can find a willing third party buyer, with the annuity provider continuing to pay the annuity to the buyer for the duration of the annuity holder's lifetime. Allowing individuals to agree with their original annuity provider to access the value of their annuity by terminating their annuity contract, or 'buy back', is not currently being considered as part of these changes for two reasons:

- **Impact upon annuity providers and funds.** Even though there would not be a requirement for the annuity provider to purchase its own annuity, the government recognises that providers could come under significant public pressure to do so. If demand was very high, and the provider felt obliged by public pressure to meet that demand, they may need to sell their illiquid asset holdings at short notice, undermining

[4] The FSCS covers 90% of losses to annuity holders in the event of an annuity provider failing to meet its obligations.

their value. This could be also detrimental to a provider's solvency and make it more vulnerable to other risks crystallising.

For example, if such pressure forced a change in annuity investment strategy away from illiquid assets, this would reduce the returns for new annuity holders and would affect the regulatory treatment of in-force business. In particular, the amount of matching adjustment that firms could assume would potentially reduce.[5] This would have a detrimental effect on firms' solvency.

- **Consumer protection.** Allowing annuity providers to 'buy back' their annuity could also result in some consumers falsely believing that they can only use these new freedoms through their existing annuity provider. While this could be partially overcome through clear guidance, this 'captive market' could prevent individuals from shopping around to get the best deal, and reduce the incentive on providers to offer the best price.

2.16 The government does recognise there are some potential benefits of allowing annuity holders to access the value of their annuity by agreeing to terminate their annuity contract with their original provider, including:

- annuity providers already have a transactional relationship with their annuity holders, as well as access to key information. This may act to reduce some of the transaction costs that third party buyers would incur, such as obtaining information on the customer and the annuity payments – this could be passed on to the annuity holder through a higher lump sum; and

- annuity providers could reduce cost (and risk) by commuting the annuity, rather than continuing to pay it for the lifetime of the original annuity holder. In this way, a commuted annuity would result in a reduction of the provider's liability rather than an asset to be set against the liability. It would also avoid the risk of overpayment beyond the lifetime of the annuity holder. The provider may therefore be in a position in some cases to offer a better price to the consumer than other purchasers.

2.17 The government believes that the risks of allowing 'buy back' outweigh the benefits, and therefore does not intend to permit it at this stage. However, it welcomes views on the potential risks and benefits of allowing 'buy back'.

Operational considerations

2.18 The government's preferred approach set out in this consultation is to remove the barriers to the creation of a secondary market – and allow annuity providers and potential buyers to develop the market and its operations, rather than to dictate a rigid mechanism. However, there are a number of challenges that the government is aware of that firms would need to consider as part of developing their strategies, including two set out below.

2.19 **Ceasing payments.** Currently, annuity providers cease payments on an annuity either when notified by an estate executor or administrator, or by the bank account into which payments are made being closed. In practice, providers also have fail-safe checks, for example by accessing the register of births, marriages and deaths.

2.20 If the annuity income stream has been assigned to a third party buyer so the original annuity holder no longer receives any payments, there is a risk that the annuity provider will not now know when to stop payments – and continue to pay the annuity payments for longer than

[5] The matching adjustment (MA) is an adjustment to the risk-free interest rate term structure used to calculate the best estimate of a portfolio of eligible insurance obligations under Solvency II. Its use is subject to prior supervisory approval where certain eligibility criteria are met.

it should have to, with no incentive on the original annuity holder's estate to notify the annuity provider.

2.21 A number of alternative approaches might address this issue. These include:

- annuity providers may require, as a condition of the annuity assignment, the annuity holder puts in place arrangements to instruct the executor of their estate to notify the annuity provider upon their death
- annuity providers and third parties may agree on a maximum age, beyond which they agree the payments will cease unless recent contact with the original annuity holder can be demonstrated
- annuity providers may decide to pay a nominal amount to the original annuity holder on a semi-regular basis as a way to be informed of their death, or at least trigger further investigation

2.22 One further option would be for the government to establish a central 'death register' which third party buyers and original annuity providers could access to confirm whether an individual has passed away. However, the government does not believe this would be a proportionate response due to the complexity and expense of setting up such a register for what the government anticipates will be a relatively niche market.

2.23 **Annuity provider costs.** Annuity providers are under no obligation to consent to the assignment of annuity payments. But if providers agree to do so, they will incur costs in assigning income payments to a third party. These include the administration of redirecting payments to implement the assignment and the implementation of consumer protection measures. While annuity providers may absorb some of these costs, they may wish to recoup other costs in return for permitting annuity assignment.

2.24 In most markets it is reasonable for parties to a transaction to agree on a mutually acceptable fee, but there is a risk in this market that the original annuity provider can obtain an unfairly high fee because it essentially has 'veto' power over the transaction. That is, it can prevent the whole transaction going ahead if it so chooses, as the customer is unable to unilaterally decide to 'shop around' for an alternative as they could in most markets. Therefore original annuity providers could be in a position to charge an unfairly high price, to the detriment of consumers. The government proposes to work with the FCA to monitor the fees and charges imposed by annuity providers and, if necessary, work together to address any problems in line with the FCA's powers and objectives for securing consumer protection and promoting effective competition.

Scope of changes

2.25 The government is proposing that only annuities in the name of the annuity holder and held outside an occupational pension scheme are within the scope of these new freedoms.

2.26 Where an annuity is bought by the trustee of an occupational pension scheme as an asset of the scheme, this may be in reference to the life of an individual member of the scheme, but the product and the entitlement to the payments go to the scheme. In this case the annuity is a general scheme asset, despite the annuity being based on a specific retiree's life. This is an important distinction as where a scheme asset is involved, reassigning the income stream has an effect not just on the named person in the annuity contract but the economic health of the entire pension scheme. For this reason, the government is not proposing allowing such annuities to be assigned.

2.27 With regards to joint annuities, where more than one person is named, it will be for the annuity provider to decide whether and what confirmation is needed from secondary beneficiaries. In many instances, the government expects it will be appropriate for all parties to consent to the assignment in order to protect the rights of secondary beneficiaries. This is set out in further detail in Chapter 4.

2.28 Annuity holders who are unsure as to the type of annuity they hold should contact their annuity provider.

The government welcomes views on how it envisages the secondary annuities market working, and its proposed approach on the scope of these reforms.

More specifically, the government welcomes views on the following questions:

1. In what circumstances do you think it would be appropriate to assign one's rights to their annuity income?

2. Do you agree with the government's proposed approach of allowing a wide range of corporate entities to purchase annuity income in order to allow a wide market to develop, whilst restricting retail investment due to the complexity of the product? What entities should be permitted and not permitted to purchase annuity income and why?

3. Do you agree that the government should not allow annuity holders to access the value of their annuity by agreeing to terminate their annuity contract with their existing annuity provider ('buy back')? If you think 'buy back' should be permitted, how should the risks set out in Chapter 2 be managed?

4. Do you agree that the solution to the death notification issue is best resolved by market participants? Is there more the government should be doing to help address this issue?

5. Do you agree with the proposed approach of the government working with the FCA regarding the fees and charges imposed by annuity providers?

6. Do you agree that the scope of this measure should be annuities in the name of the annuity holder and held outside an occupational pension scheme?

7. Are there any other types of products to which it would it be appropriate for the government to extend these reforms?

3 Legislative changes

3.1 The key legislative barriers that currently deter individuals from assigning their annuity to a third party are the pension tax rules. Under current tax legislation, if an individual assigns their annuity to another party, any proceeds they receive from the assignment are subject to the "unauthorised payment" tax charges, which are normally 55%, but can be up to 70% in some circumstances. The current tax rules also require that the annuity must be payable for life[1] and that payments under annuities bought before 6 April 2015 may not reduce other than in prescribed circumstances.[2] This legislation was designed to ensure that individuals who purchase an annuity receive a steady income for life. However, it also effectively locks annuity holders into their existing contract, and in some cases may be reflected in the standard contractual terms of the annuity. Additionally some secondary pensions legislation might need amending to ensure that annuities purchased by or on behalf of individual scheme members are capable of assignment.

3.2 To allow individuals to assign their annuity, the government proposes to remove these tax charges. Instead of being taxed at up to 55% (or more), individuals who choose to assign their annuity to a third party will be taxed on the payment they receive in return at their marginal rate of tax.

3.3 The government proposes that under the new tax rules, individuals should have three options:

a) **Lump sum cash payment.** Individuals will be able to receive a lump sum cash payment in return for assigning the rights to their annuity payments to a third party buyer. The whole amount received will be subject to income tax at their marginal rate. We propose that tax will be deducted at source through Pay-As-You-Earn (PAYE).

b) **Flexi-access drawdown fund**. Individuals will be able to arrange for any funds released from the assignment of their annuity to be paid by the buyer into a flexi-access drawdown fund. This flexi-access drawdown fund could be provided by the third party buyer, or an alternative provider. The proceeds transferred into the flexi-access drawdown fund by the buyer would not be subject to income tax on transfer, would not be eligible for pensions tax relief, would not count towards an individual's annual or lifetime allowance, and would not trigger entitlement to a tax-free lump sum. Individuals would be able to draw down from this fund as they wish over time, with amounts drawn down subject to income tax at their marginal rate. We propose that tax will be deducted at source through PAYE.

c) **Flexible annuity.** Individuals will be able to arrange for the proceeds of the assignment to be used to purchase a flexible annuity. Again, this flexible annuity could be provided by the third party buyer, or an alternative provider. As above, proceeds used to purchase the flexible annuity would not be subject to income tax, would not be eligible for tax relief, would not count towards an individual's annual allowance, and would not trigger entitlement to a tax-free lump sum. We propose that tax will be deducted at source through PAYE, as usual for pension annuities.

[1] Other than certain short term annuities, payable for up to 5 years.

[2] The Taxation of Pensions Act 2014 allows payments from annuities purchased after 6 April 2015 to decrease.

£10,000 annual allowance

3.4 From 6 April 2015, individuals who access their pension savings flexibly will be subject to an annual allowance of £10,000 which will apply to their defined contribution pension savings. This is to prevent individuals from gaining an unintended tax advantage by diverting their current income into their pension, in order to reduce their tax liability.

3.5 To ensure consistency of treatment, the government proposes to apply the £10,000 annual allowance to individuals who assign their annuity to a third party. This will apply in the following circumstances:

- for individuals who receive their payment in the form of a cash lump sum, this will apply from the date that they receive the cash payment

- for individuals who use their payment to reinvest in a flexi-access drawdown fund, this will apply from the date that they first draw down from this fund

- for individuals who use their payment to purchase a flexible annuity, this will apply when the first payment is made under the flexible annuity

Tax treatment on death

3.6 As part of the reforms announced at Budget 2014, the government made several changes to the tax treatment of pensions on death in the Taxation of Pensions Act 2014 and by changes to pension legislation in the Pension Schemes Act 2015. The government also announced changes to the tax treatment of annuities on death which it will introduce in the Finance Bill 2015.

3.7 The government proposes to treat individuals who have assigned their annuity income to a third party in line with these changes. This will mean that for:

- Individuals who receive a cash lump sum payment in return for assigning their annuity, any money remaining from that lump sum will form part of their estate upon death. Gifts made during their lifetime will be subject to the usual tax rules on such gifts;

- Individuals who put the funds into a flexi-access drawdown fund, the funds will be treated in line with the new rules for drawdown. This means that where that individual dies below age 75 with unused funds held in a flexi-access drawdown fund, they will be able to pass these free of income tax to any beneficiary who is an individual. Where an individual dies having reached the age of 75 with unused funds held in a flexi-access drawdown fund, they will be able to pass these to any beneficiary, who will then be able to draw down on these, or buy an annuity – in each case liable to income tax at their marginal rate on the payments; and

- Individuals who use the funds to purchase a flexible annuity, payments under the contract in respect of a dependant, nominee or successor will be free of income tax where the original annuity holder dies below age 75, and will be taxable as pension income if the original annuity holder dies after this age.

Information obligations

3.8 Allowing individuals to assign their annuity to a third party presents unique arrangements that would not necessarily be addressed by current information obligations for registered pension schemes.

3.9 The government is therefore considering new obligations that may be needed to ensure that information is provided to individuals once they have flexibly accessed their annuity and are subject to the £10,000 annual allowance limit, and whether further information obligations may be needed more widely given the different relationships under this proposed change. Respondents' views on proportionate approaches are welcomed.

Treatment of the annuity after sale

3.10 Once the annuity has been assigned, it is proposed that the annuity payments will no longer be treated as pension income in the hands of a buyer. Instead, it is anticipated that the annuity payments will be treated as trading income or miscellaneous income for tax purposes depending on the business activities of the recipient. Alternatively, in the hands of a registered pension scheme, payments will be exempt from tax in so far as the payments represent income from an investment. However, the government recognises that the exact tax treatment of an annuity purchase will depend on the specific circumstances of the buyer and therefore welcomes views from interested parties on the tax treatment that should apply in different situations.

Avoidance

3.11 Whilst the vast majority of people will use the freedom to assign their annuity to a third party in an entirely legitimate way, there may be a small minority who will attempt to use it as a means to avoid paying their fair share of tax. The government takes a strong stance against tax avoidance and is committed to delivering a system that deters and prevents such behaviour. The final legislation is therefore likely to include provisions to protect against tax avoidance. These provisions might, for example, ensure that an assignment will trigger an unauthorised payment charge where the assignment is made between connected persons, or is made to a registered pension scheme with less than a certain number of members.

The government welcomes views on how it proposes to change the tax rules relating to the assignment of annuity payments. In particular, the government would welcome views on the following:

8. Do you agree that the design of the system outlined in Chapter 3 achieves parity between those who will be able to access their pension flexibly and those who will be able to access their annuity flexibly? Are there any other tax rules which the Government would need to apply to individuals who had assigned their annuity income?

9. How should the government strike an appropriate balance between countering tax avoidance and allowing a market to develop?

4 Consumer protection

4.1 The changes set out in previous chapters will offer more choice and greater flexibility for annuity holders. The government wants to ensure consumers are empowered and equipped to make the most of their assets, and to make decisions that best suit their personal circumstances and risk appetite for the duration of their retirement. It is also important that consumers who do want access to the value of their annuity have a choice of buyers to give them the best opportunity to get a competitive price.

4.2 In coming to a decision to assign their annuity to a third party, individuals will have to take into account a wide range of factors. These include their health, their current financial needs, what other income they will receive, their saved wealth and their aspirations for future needs. Individuals will also have to consider dependants' needs – both now and in the future – and the implications for their own future welfare and social care needs.

4.3 Judging the value of an annuity in payment is particularly difficult and complex and subject to behavioural biases. Individuals are likely to find valuing their annuity difficult for a number of reasons:

- accurate calculation of the net present value of an annuity is relatively complex – and beyond the capability of most consumers if they do not have access to expert help
- many people apply a high effective discount rate; with a strong preference for payment now over future payments
- people consistently underestimate their own predicted life expectancy, leading to the risk that they will have too little saved for future needs. Conversely, people in poor health may feel under pressure to assign their annuity payments in order to pass on money to relatives

4.4 Individuals who have bought their annuity recently may assume that a fair rate will be close to the purchase price minus any payments. However, they are less likely to be able to properly consider legitimate changes in value caused by changing economic circumstances (such as interest rates, or returns on investment), or deterioration in health. They may also find it difficult to determine what level of fee is reasonable for a purchaser to seek to compensate for their costs and risks. All of these could result in a material difference between the price paid for an annuity and the value the individual can now obtain for it.

4.5 The government will work with the FCA to ensure that safeguards are in place so that people have the information they need to decide whether they want to assign their annuity to a third party. The safeguards will have to balance the challenges of protecting consumers – including those who are vulnerable or suffering from ill health – without making costs so high that they prevent a market from growing, or imposing disproportionate costs on providers or people looking to assign their annuity to a third party.

4.6 Drawing from the approach taken by the government and the FCA to help consumers understand and navigate the new range of options when accessing their pension following the Budget 2014 reforms, the government is considering a number of potential safeguards: a requirement to take financial advice; an offer of guidance; and regulatory interventions such as risk warnings.

4.7 It is likely that some of these safeguards will be for the government to implement, such as measures requiring legislation. And certain aspects of the package of measures may be implemented by the FCA, in line with its statutory objectives to protect consumers and promote effective competition. The government is not formally consulting over these measures at this stage, nor should the measures below be regarded as an exhaustive list, though the government welcomes initial views on these and other potential interventions. The government will work with the FCA to produce proposals for consultation in due course.

Helping annuity holders understand their choices

4.8 **Regulated advice.** There is a strong case for requiring annuity holders to take financial advice from an Independent Financial Advisor, with a requirement for annuity providers to check this before they enable the annuity to be assigned. This mirrors the requirements now in place for when people convert from a defined benefit to a defined contribution based pension during their accumulation phase, where the value of the pension is above £30,000.

4.9 Regulated advice would ensure that individuals receive help tailored to their circumstances and a recommendation on whether assigning their annuity to a third party would be in their best interests. People would still be at liberty to choose not to accept a recommendation.

4.10 Regulated advice can be expensive, as individuals could have to pay several hundred pounds or more, which might be a significant proportion of the value of their annuity. However, following on from the FCA's recent clarification of rules around simplified advice and new business models for online and telephone advice, there are new, expanded opportunities for the advice sector to meet the growing demand for advice on pension issues; the government believes that this could be a potential new market for advisors.

4.11 This requirement could be restricted to those looking to assign annuities that are valued above a given threshold (bringing the requirement into line with the conversion from a defined benefit scheme). A means of approximating the value of the annuity in advance of advice would be needed under this approach. Consideration would also need to be given to what support is provided to those with annuities valued below this threshold.

4.12 **Free and impartial tailored guidance.** This might be an important universal offer to complement other safeguards. The government is therefore considering whether to introduce legislation to extend the remit of Pension Wise, the new guidance service to help people understand the pension freedoms being introduced on 6 April and choose the option that fits their circumstances and goals. Whilst extending the scope of Pension Wise is one option, guidance could also be offered, either through the annuity provider or independent and impartial third parties.

4.13 **Risk warnings.** The FCA is placing a requirement upon pension firms to provide customers seeking to access their pension with a risk warning setting out the potential risks of different options, based upon a consumer's health and circumstances. This so-called 'second line of defence' could be introduced as a requirement upon the original annuity provider to protect their customers looking to assign their annuity income to a third party, with annuity providers being required to provide warnings of the risks and factors consumers should be considering when making this decision.

4.14 Risk warnings could be standardised, and would ensure that all annuity holders received basic information. Potentially warnings could be given in writing or by phone. However, this may well not be sufficient by itself given the impact of the decision and the vulnerability of some consumers.

Preventing aggressive practices

4.15 The government considers it important that promotional material is clear, fair and not misleading, and that people do not feel forced into a decision. Those looking to buy annuity income streams from consumers will already be governed by legislation which protects consumers from misleading or aggressive commercial practices. In addition, sales of regulated financial products are already subject to such requirements through the Financial Promotions Order and FCA rules. There is a strong case for extending this principle to those offering to buy annuity income streams. It will be important to ensure that these reforms are delivered in a way that prevents and tackles scamming. The government will continue to work with regulators, industry and consumer groups to provide appropriate protection for consumers.

Ensuring a competitive price

4.16 Individuals will find it difficult to determine what a fair value for an annuity might be, and are therefore potentially vulnerable to purchasers offering an unfairly low price. Conversely, it is possible that consumers are unrealistic about the value they would expect to receive, which could restrict market take-up. Purchasers will also be wary about consumers having greater knowledge about their life expectancy, and potentially offering too high a price – so they may price this risk in. For some people, the annuity could be worth very little, for example an annuity that has been in payment for a long time. To support consumers, there therefore needs to be a means of helping them determine a fair value for their annuity.

4.17 **Requirement on annuity providers to offer a benchmark "selling price".** This price would give an individual a ballpark figure for comparison. The challenge would be to ensure a meaningful estimate at reasonable cost. A generic table approach, for example based on age and a few health questions, would be relatively inexpensive. However, such an approach could prove inaccurate for some customers. A tailored approach which considered the customer's circumstances in more detail would provide a more accurate figure, but would require more extensive underwriting, leading to expense that would ultimately have to be passed on to the end consumer. Furthermore, this potentially imposes risk on the annuity provider if their benchmark subsequently proves too low.

4.18 **Requirement on individuals to obtain a number of quotes.** Shopping around for the best deal is important in any financial transaction, and especially in this context. Individuals looking to assign their annuity to a third party should be required to confirm to the annuity provider that they have received a minimum number of quotes before the provider can consent to the assignment. It will be important that the information quoted is provided in a way that is easy for the individual to understand and to compare with other offers.

Protecting dependants

4.19 Many people will hold annuities that contain rights for more than one party to receive an income. Most typically, they include the rights for a dependant to receive an income after the principal holder's death. This may also include the commuted value of a guarantee period or the continuation of the original annuity for a guaranteed period.

4.20 Beneficiaries of contracts are generally protected by third party rights legislation which restricts the ability of the contracting parties to reduce or sign away their rights without their consent, though this legislation allows parties to "contract out" of these protections, and in many cases these statutory rights are dis-applied by the terms and conditions of annuity contracts.

4.21 Annuity providers will want to ensure that the rights of dependants are appropriately protected, not only for the benefit of those beneficiaries, but also in order to minimise the risk of legal action at a future stage. Where contractually appropriate, one approach would be to obtain the written consent of any dependants before rights under an annuity can be assigned, and once any issues surrounding such circumstances as pension sharing upon divorce have been addressed. The government believes it most likely that annuity providers will adopt this approach.

4.22 The government has also considered whether it is possible for only the rights of the primary annuity holder to be assigned, but the rights of the dependant to remain in place, so that payments revert to that dependant upon the passing away of the primary annuity holder. However, it may well prove costly and difficult contractually to separate out these rights.

Protecting social care and welfare claimants and the taxpayer

4.23 A proportion of those eligible to assign their annuity may also be in receipt of means-tested welfare benefits, social care support, or council tax reductions. Analysis of administrative and survey data suggests that around 13% of annuities are paid out to those in receipt of means-tested benefits, primarily Pension Credit and Housing Benefit.[1] For social care, modelling using survey data estimates that around 15% of those receiving state support with their social care currently have annuities.

4.24 The means tests for welfare, social care and council tax reductions take into account levels of income and capital. Based on the current rules, where an individual decides to assign their annuity to a third party, thereby exchanging income for capital, this may change the level of support they are entitled to through these mechanisms, and the deprivation of income or capital rules would apply.

4.25 The government wants individuals using these new freedoms to understand what this might mean should they need support in the future and if they are already accessing support. This will be particularly important in light of the wider reforms to how people pay for social care that will come into force in April 2016.[2]

4.26 The government therefore wants to consider carefully how to explain the interaction between annuity income, capital, and deprivation rules in the welfare, social care and council tax reduction systems to those who are considering assigning their annuity to a third party. The government will consider how best to support these decisions through the development of an appropriate consumer protection regime for the assignment of annuities and would welcome views on this point.

4.27 In order to protect the taxpayer, the government does not intend to compensate individuals through welfare for any loss of income resulting from assigning their annuity to a third party and would therefore like to consider whether those receiving means-tested benefits should be able to do so.

[1] DWP analysis based on the Family Resources Survey 2012/13 and the Annual Survey of Hours and Earnings 2011.

[2] From April 2016 people will be protected from the risk of catastrophic care costs through the introduction of a lifetime cap on the amount they are asked to contribute towards their care costs set at £72,000 and an increase in the level of assets someone can hold and still qualify for state support towards residential care costs.

Equality impact

4.28 Under the Equality Act 2010, when exercising its functions, the government has an ongoing legal duty to pay due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation and other prohibited conduct under the Equality Act 2010
- advance equality of opportunity between different groups of persons who share a protected characteristic and those who do not
- foster good relations between different groups

4.29 The payment of 'due regard' needs to be considered in light of the nine protected characteristics:

- race
- sexual orientation
- marriage/civil partnership
- sex
- religion or belief
- gender reassignment
- disability
- age
- pregnancy/maternity

4.30 The likely age and demographics of consumers of these transactions, and the fact that dependants of those assigning the annuity products are disproportionately likely to be women, means that this policy has the potential to impact those with protected characteristics. The likely demographics of annuities' consumers or their dependants may also include those with disabilities or those suffering from mental or other physical illness.

4.31 The policy options have been designed to include appropriate consumer protection to mitigate potentially adverse impacts on protected groups. The potential equality implications of the reforms have been considered regularly as the policy has developed. The public sector equality duty is an ongoing duty and the equality implications of decisions affecting the reform programme continue to be kept under review.

4.32 The government would like to invite further comments and suggestions in relation to the possible equality implications of these proposals, and whether any particular implications need to be captured as part of the government's ongoing equality analysis.

The government welcomes views on how it proposes to ensure consumers are appropriately informed when making decisions relating to the assignment of their annuity income. In particular, the government welcomes views on the following questions:

10. What consumer safeguards are appropriate – is guidance sufficient or is a requirement to seek advice necessary? Should the safeguards vary depending on the value of the annuity?

11. What is the best way to implement these safeguards? Should the safeguards include expansion of the remit of Pension Wise?

12. Should the costs of any advice or guidance be borne by the annuity holder (mirroring the arrangements for conversion from a defined benefit scheme)? If not, what arrangements are appropriate?

13. Do you agree that the government should introduce a requirement on individuals to obtain a number of quotes? How else should the government best promote effective competition to ensure consumers obtain a competitive price?

14. Does the government's approach sufficiently protect the rights of dependants upon assignment? If not, what further steps should the government take?

    - Should the government or FCA issue guidance to annuity providers about protection for dependants?

    - Are there particular classes of beneficiary which require special consideration, for example minors or following a divorce or dissolution of a civil partnership?

    - Are there specific equality impacts that should be considered in this context?

15. Should the government permit the principal annuity holder's income to be assigned while dependants retain their own income stream? Should the decision on whether to do so be left to the discretion of the parties to the transaction?

16. How can the proposed consumer protections for the assignment of annuities ensure that any impact on means-tested entitlement is understood by those deciding whether to assign their annuity income?

17. Should those on means-tested benefits be able to assign their annuity income?

18. What are the likely impacts of the government's proposals on groups with protected characteristics? Please provide any examples, case studies, research or other types of evidence to support your views.

5 How to respond to this consultation

5.1 This consultation is available at www.gov.uk/government/publications.

5.2 The government welcomes responses to the questions raised in this consultation; these are summarised in Annex A.

5.3 Responses to this consultation should be received by 18 June 2015. Please ensure that responses are sent in before the closing date. The government cannot guarantee that responses received after this date will be considered.

5.4 Responses to this consultation should be sent to:

Annuity Consultation
Insurance and UK Regulatory Authorities Team
HM Treasury
Horse Guards Road
London
SW1A 2HQ

Alternatively, please send responses by e-mail to
Annuity.Consultation2015@hmtreasury.gsi.gov.uk

5.5 When responding, please state whether you are doing so as an individual or on behalf of an organisation.

Consultation process

5.6 This consultation is being run in accordance with the Code of Practice on Consultation, and will be run for the full 12 week period.

Confidentiality

5.7 Information provided in response to this consultation, including personal information, may be published on disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1988 (DPA) and the Environmental Information Regulations 2004.

5.8 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

5.9 HM Treasury will process your personal data in accordance with the Data Protection Act and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A Summary of questions

A.1 In addition to addressing the specific questions set out in this annex, respondents are encouraged in their responses to add any additional information they feel is relevant to this consultation.

A new secondary market for annuities (Chapter 2)

A.2 The government welcomes views on how it envisages the secondary annuities market working, and its proposed approach on the scope of these reforms.

1. In what circumstances do you think it would be appropriate to assign one's rights to their annuity income?

2. Do you agree with the government's proposed approach of allowing a wide range of corporate entities to purchase annuity income in order to allow a wide market to develop, whilst restricting retail investment due to the complexity of the product? What entities should be permitted and not permitted to purchase annuity income and why?

3. Do you agree that the government should not allow annuity holders to access the value of their annuity by agreeing to terminate their annuity contract with their existing annuity provider ('buy back')? If you think 'buy back' should be permitted, how should the risks set out in Chapter 2 be managed?

4. Do you agree that the solution to the death notification issue is best resolved by market participants? Is there more the government should be doing to help address this issue?

5. Do you agree with the proposed approach of the government working with the FCA regarding the fees and charges imposed by annuity providers?

6. Do you agree that the scope of this measure should be annuities in the name of the annuity holder and held outside an occupational pension scheme?

7. Are there any other types of products to which it would it be appropriate for the government to extend these reforms?

Legislative changes (Chapter 3)

A.3 The government welcomes views on how it proposes to change the tax rules relating to the assignment of annuity payments.

8. Do you agree that the design of the system outlined in Chapter 3 achieves parity between those who will be able to access their pension flexibly and those who will be able to access their annuity flexibly? Are there any other tax rules which the Government would need to apply to individuals who had assigned their annuity income?

9. How should the government strike an appropriate balance between countering tax avoidance and allowing a market to develop?

Consumer protection (Chapter 4)

A.4 The government welcomes views on how it proposes to ensure consumers are appropriately informed when making decisions relating to the assignment of their annuity income.

10. What consumer safeguards are appropriate – is guidance sufficient or is a requirement to seek advice necessary? Should the safeguards vary depending on the value of the annuity?

11. What is the best way to implement these safeguards? Should the safeguards include expansion of the remit of Pension Wise?

12. Should the costs of any advice or guidance be borne by the annuity holder (mirroring the arrangements for conversion from a defined benefit scheme)? If not, what arrangements are appropriate?

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14. Does the government's approach sufficiently protect the rights of dependants upon assignment? If not, what further steps should the government take?

    - Should the government or FCA issue guidance to annuity providers about protection for dependants?

    - Are there particular classes of beneficiary which require special consideration, for example minors or following a divorce or dissolution of a civil partnership?

    - Are there specific equality impacts that should be considered in this context?

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16. How can the proposed consumer protections for the assignment of annuities ensure that any impact on means-tested entitlement is understood by those deciding whether to assign their annuity income?

17. Should those on means-tested benefits be able to assign their annuity income?

18. What are the likely impacts of the government's proposals on groups with protected characteristics? Please provide any examples, case studies, research or other types of evidence to support your views.

HM Treasury contacts

This document can be downloaded from www.gov.uk

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