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Pensions Institute

THE MEANING OF LIFE 2

The UK life company business model in the context of dramatic changes to the political landscape and the investment and private-sector pensions market

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

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November 2017

The meaning of life 2: The UK life company business model in the context of dramatic changes to the political landscape and the investment and private-sector pensions market

Published November 2017

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106 Bunhill Row
London
EC1Y 8TZ
www.pensions-institute.org

ISSN: 1367-580X

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Rajiv Jaitly is managing partner of Jaitly LLP which is a global alternatives risk consultancy specialising in fund operational due diligence, operational and business risk and corporate governance. He has specialist experience in pension fund regulation, investment operational risk, insolvency problems and corporate governance as a non-executive director of a number of organisations. He has worked with The Pensions Regulator in the UK. He was a member of the UK Office of Fair Trading's expert panel for its September 2013 market study on defined contribution pensions in the UK. He was commissioned to write a report for the Financial Services Consumer Panel on fund costs and their implications for consumers which was published in 2014. He is a Chartered Accountant and Licensed Insolvency Practitioner, a Fellow of the Chartered Institute of Securities and Investment and a Fellow of the Association of Business Recovery Professionals. He has disclosed that he has a holding of 290 shares in the sponsor of this report (Phoenix Group) within an investment savings account, that he has held since August 2015.

The compilation of this Pensions Institute report was authored by Pádraig Floyd, with Rajiv Jaitly of Jaitly LLP providing some of the initial research material.

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

Available at: www.pensions-institute.org/reports/MeaningOfLife2.pdf

A to Z of key definitions

AA	Annual allowance
ABI	Association of British Insurers
AE	Auto enrolment
AUM	Assets under management
BPA	Bulk purchase annuity
CPI	Consumer Price Index
D2C	Direct to customer
DA	Defined ambition
DB	Defined benefit
DC	Defined contribution
DWP	Department for Work and Pensions
EET	Exempt/exempt/taxed
GMP	Guarantee minimum pension
HMT	Her Majesty's Treasury
ISA	Individual Savings Account
LTA	Lifetime allowance
MPAA	Money purchase annual allowance
NEST	National Employment Savings Trust
NS&I	National Savings & Investments
OECD	Organisation for Economic Cooperation and Development
PHI	Permanent Health Insurance
PPF	Pension Protection Fund
PRA	Prudential Regulation Authority
PSD2	Payment Services Directive 2
RPI	Retail Price Index
SII	Solvency II
TEE	Taxed/exempt/exempt

Foreword

A great deal has happened in the UK investment and pensions market since we published *The Meaning of Life* at the end of 2015. This report *The Meaning of Life 2* provides a timely update on developments since then.

One key issue discussed is the conflicting policy signals coming, on the one hand, from the encouragement to save for retirement (via auto-enrolment) and, on the other hand, the freedom to withdraw funds from age 55 with no obligation to secure a life-long income. The pension reforms introduced in 2015 have had the effect of reducing consumer choice over retirement products – the individual annuity market appears to be dying and there is a dearth of new products that offer both flexibility and guaranteed income. The author talks of a potential 'crisis of provision and consumer protection within the retirement income market', of the freedom and choice reforms offering 'freedoms, but little by way of choice', while making 'decisions more complex'.

The report also finds that the life industry is bifurcating, with one group of companies – with a strong mission or group behind them – retaining the traditional risk-based model, while another has moved to an asset management structure which is less capital intensive (i.e., 'capital-lite') in order to avoid the increased capital costs under Solvency II. But the overall effect of this is to limit choice in the retirement market.

The life companies that remain have switched resources to the bulk purchase annuity (BPA) market where buyouts and buy-ins are helping companies hedge the longevity risk in their pension schemes. But there is a danger that, here to, regulation could restrict the growth of this market. Insurers have turned to reinsurance to lay off risks to their own balance sheet that otherwise require additional Solvency II capital. But the UK regulator is concerned about reinsurance being placed in jurisdictions outside its control.

In short, the author finds that 'regulatory intervention is stifling innovation and interfering with commercial decisions, promoting an imbalance between traditional life and asset management companies, with consequences for consumer protection'.

Consolidation is a key feature of the bifurcation process. The consolidation of life companies was well under way before 2015, but has gathered pace since then. Again this is being driven by what many commentators describe as excessive regulatory burdens at both domestic and EU levels. Mergers are resulting in fewer, larger scale companies, although small efficient providers also have a role to play, according to some commentators.

The author also finds that technology is the key to scalability and that achieving critical mass on platforms is absolutely essential, since the platform world is built on high volume, low cost transactions, but this leaves little by way of profit margin. However, while many institutions have been building platforms – some for a decade or more – few have achieved anything like the critical mass to be profitable. Further, the quality of platform systems is mixed and this raises questions about the value to consumers. At the same time, technology lacks a coherent approach to industry data standards and the report recommends that current programmes, such as the pensions dashboard, should look to include broader technology standards such as those in open banking.

The report's key messages for industry and government are: 1) the retirement journey will turn out to be a rough one for many consumers either because the products that hedge the key risks faced in retirement – especially longevity and inflation risks – are not available or because consumers do not see or are not being advised to see their value; 2) there is no coherence to the government's approach to pension policy in contrast to what is happening in other OECD countries; 3) regulations, although there to protect consumers, are having the effect of impeding both innovation and the risk management practices of insurers; 4) platform technology which should be there to help the retirement journey run smoothly is not yet fit for purpose, despite the huge sums spent on it; and 5) life companies, partly in response to the previous four factors, are both consolidating and moving away from traditional pension business for retail customers, leaving the real prospect that in a few years' time there will be no private sector providers of longevity risk cover, with the state having to bail out those individuals who outlive their pension assets. The consequences for future intergenerational solidarity can only be imagined.

David Blake, Director
Pensions Institute

Preface

This report sets out to update the findings of the November 2015 independent investigation of the UK's life company business model, published by the Pensions Institute in a report entitled *The Meaning of Life*. This update looks at the industry in the context of the dramatic changes to the political landscape in the UK and continuing changes to the investment and private-sector pensions market since 2015.

The intervening two years between these two reports has seen unprecedented change both within the life industry and in wider society. From Brexit to increased pensions freedoms and the implementation of Solvency II, we examine the effects of this change.

In the course of our research, we discovered that the market had indeed begun to develop along the trajectory mapped out in the original report. Further, we identified a number of dynamics that are set to have a profound effect upon the shape of the market over the next few years.

Many of these challenges are as a result of the rapidly changing political and regulatory landscape. Although we have seen little direct impact from the decision made by the UK to leave the European Union, the shadow of Brexit weighs heavily over all areas, while uncertainty about the final outcome of the UK's separation remains.

A significant development has been the further implementation of the auto-enrolment (AE) project, which has given around nine million workers access to pension savings.[1] However, the path of regulation within the retirement income market is at odds with providing steady, dependable income and is wildly divergent from the UK's peers who are experiencing many of the same economic and demographic challenges.

Regulation could stunt the flourishing BPA market

The bulk purchase annuity (BPA) market is flourishing, with high levels of interest from employers/plan sponsors keen to mitigate some or all of their DB pension liabilities. Evidence suggests that pricing has remained extremely competitive, despite uncertainty over Brexit and the increased costs associated with the new Solvency II regime. Volumes of buy-in and buyout contracts for the first half of 2017 have reached £5.1bn, double that of the corresponding time last year.[2]

There is interest from different scheme sizes, too, with Pension Insurance Corporation (PIC) securing a number of smaller buyouts and buy-ins, late in 2016, while Canada Life secured a £250m buy-in with the Cancer Research UK Pension Scheme in February this year.

1 http://www.thepensionsregulator.gov.uk/press/automatic-enrolment-passes-the-eight-million-milestone.aspx

2 https://www.lcp.uk.com/media-centre/press-releases/2017/08/buy-in-and-buy-out-volumes-nearly-double/

We expect reports to show that the second half of 2017 has been very busy – though perhaps not a record year – with the Pearson Pension Plan completing two £600m buy-ins with Aviva and Legal & General in early October. However, commentators assert that there are clear tensions between regulatory scrutiny and commercial decision-making at life companies.

We examine the potential impact of interventions that impinge upon commercial decisions which may limit life companies' ability to service this crucial market.

The perfect storm

Some in the sector argue that the regulatory path within the retirement income market is often at odds with providing steady, dependable income and has diverged from the UK's peers who are experiencing many of the same economic and demographic challenges.

While the project to get UK workers saving for their futures is well advanced, many in the sector argue that these dynamics – regulatory, commercial and behavioural – will combine into a 'perfect storm' that will result in a crisis of provision and consumer protection within the retirement income market.

While few will have any sympathy for life companies in an increasingly Darwinian landscape, the challenges they face look set to leave consumers with less choice and making more sub-optimal decisions than before the pensions freedoms were introduced in 2015.

We indicated in the first *Meaning of Life* report that there was data to show that 90% of auto-enrolment savings would be held as assets under management (AUM) by a select group of financial institutions and over the past two years, the pace of consolidation has increased, with certain high street/household names withdrawing from the market.

As we asserted in 2015, there has been considerable consolidation among life companies with overseas parents. Aegon has sold off an annuity book and AXA and Zurich have all sold off back books and/or moved out of the workplace pension market. Though already a closed book, Abbey Life was also sold by an overseas parent (Deutsche Bank) to a consolidator in 2016. The market anticipates this rate and depth of consolidation to accelerate over the next two years.

A number of market dynamics are combining to exert immense pressure on both institutional and retail pension markets. We believe this is leading to an imminent crisis in the retirement income market.

Consolidation amongst, and regulation of, life companies which choose to maintain a risk-based book of business, such as annuities, are under what many believe to be a disproportionate regulatory burden compared to those moving towards a 'capital-lite' asset management structure.

The shrinking annuity market has reduced the number of players offering annuity policies in the retail market. No longer is this business a core competency, but is rapidly becoming a specialist or niche market.

Since the pensions reforms, few products that bridge the gap between flexibility and guaranteed income have been launched. In fact, most hybrid products have been withdrawn by providers, as they did not attract sufficient business due to the additional cost of the guarantees. Consumers, dissuaded from annuity purchase must rely on income drawdown, traditionally a stopgap product for wealthier individuals or those who refused to buy an annuity under the old regime. However, drawdown remains unproven as an effective product for the mass market and unadvised sales are being reviewed by the FCA.

The FCA has recognised the weaknesses of such reliance and launched a paper on 17 October 2017[3] calling on the industry to design products and adapt their strategies to make their products more appropriate for consumers of all ages, particularly the elderly.

Compiling the report

The initial research for this update took place in May 2017, with interviews taking place over the course of the summer. Abbreviations used are explained in the A to Z of key definitions.

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

We would particularly like to thank the sponsor of this research, Phoenix Group, which is the UK's largest consolidator of closed life and pension funds. The views expressed in the report are those of the author and not necessarily those of the sponsor, which did not seek to influence the research.

The compilation of this Pensions Institute report was authored by Pádraig Floyd, with Rajiv Jaitly of Jaitly LLP providing some of the initial research material.

3 https://www.fca.org.uk/publications/occasional-papers/ageing-population-financial-services

Executive Summary

Key highlights

A combination of both consolidation and divergence in the UK life and pension market is having a major impact upon the future health of the retirement income market.

Those seeking to retain a risk-based model are under increasing regulatory pressure and this has encouraged the adoption of an asset management 'capital-lite' model.

Further tightening of regulation may prevent the risk-based providers from offering other life companies and mature DB schemes a release mechanism from the liabilities they no longer wish to retain on their balance sheets.

The impact of regulation on life companies has therefore been to reduce consumer choice – with fewer drawdown products, hybrids or newer products withdrawn and annuities marginalised since 2015. As a result, the provision of longevity hedging products is an increasingly specialist market.

Though the range of retirement products available to consumers has shrunk, pensions freedoms and choice has made the retirement income environment more complex for consumers. The vast majority do not seek advice which results in sub-optimal decisions and ultimately is detrimental to consumers.

The DC market

- Consolidation of the mastertrust sector is accelerating, though some smaller providers may survive if they can meet the increasing regulatory requirements.
- Pensions freedoms have complicated the personal financial planning process, making advice/guidance a key requirement, which is often not available with smaller pots.
- Insurance companies now favour 'capital-lite' asset management models, but this limits choice in the retirement market as there are fewer insurers operating in this sector.
- The life distribution model may be replaced with direct to consumer products (D2C), but the same problems of technology and scalability will remain.
- Almost half of the UK working population remains without cover from auto-enrolment (AE) and there is a danger the project could lose momentum if the contribution hikes due in 2018 encourage higher opt-out rates.
- Government policy in the retirement income market deviates from that of its peers in other countries and is working against policies, such as auto-enrolment.

Back books

- The regulatory and financial burdens on insurance companies are considered excessive by some commentators, compared with other players operating in the same market, such as asset management companies.
- An appropriate definition of the back book would cover all existing policies – including those not considered 'legacy' that pose risk to the balance sheet of a financial institution.
- Though the regulator is right to be concerned about costs undermining product performance, consolidation has provided neither better products nor more choice. Regulation is working against an efficient market and good consumer choice.

Bulk Purchase Annuities (BPA) – a growing business opportunity

- The BPA market is flourishing and its success is absolutely central to the future health of the life and pensions market. BPA offers life companies and UK businesses an opportunity to restructure their organisations by offloading legacy risk and reducing regulatory cost to their business.
- Many commentators feel life companies in this arena are not playing on a level playing field because of inconsistencies in customer regulation (charges and transparency matters) and prudential regulation (reserving, reinsurance, etc).

Solvency II

- The life company model under Solvency II has encouraged the adoption of a 'capital-lite' asset management structure.
- Regulatory intervention is stifling innovation and interfering with commercial decisions, promoting an imbalance between traditional life companies and asset management businesses, with consequences for consumer protection.
- Despite a focus on scale, there remains a role for small providers that are highly efficient or with strong links to larger groups.
- The Solvency II regime is unlikely to be eased at the point of Brexit – the regulator is expected to mirror a period of continuity and is not anticipated to vary much from any future European model. However, the PRA announced in October 2017 that it would consult on possible reforms to Solvency II in the future.[4]

Reinsurance

- The way reinsurance contracts are placed requires a more collaborative framework between regulators and financial institutions to prevent this developing into a cold war. However, many commentators believe the industry must be the source of innovation, as the PRA does not have the resources to become more proactive in developing regulatory solutions or compromises.

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4 http://www.bankofengland.co.uk/publications/Pages/news/2017/062.aspx

Technology

- Technology is an essential component of the UK retirement market, but its quality varies significantly.
- The effectiveness of new platforms and whether they deliver value for money to customers still needs to be researched.
- Technology has reinforced the demand for simpler products, making a recovery in annuity sales or innovation within the market for risk-hedging products less likely.
- Evidence of innovation by platforms appears limited and there is a need to adopt standards across the industry. For example, the take-up on the opportunities provided by the Open Banking Project[5] has been limited even though it offers an opportunity for a data standard that far exceeds the life and pensions market.

Regulation

- UK Government regulation is seen by many commentators who contributed to the report as moving against the spirit of pension saving. While AE and pensions freedoms give with one hand, the Lifetime Allowance (LTA), the Annual Allowance (AA), the Money Purchase Annual Allowance (MPAA) and taper, take it away with the other. In the last tax year, the sum raised in tax penalties for those breaching the LTA rose to £36m from £20m in the previous year – a rise of 80%.[6]
- These commentators also argue that pensions freedoms and choice was implemented without sufficient infrastructure to provide proper consumer choice and protection in the retirement income market. Drawdown, now the default option, may prove to be unsuitable for many consumers when considered against the quantum of savings/income that can be achieved, income needs in retirement and longevity risk.

A review of the key findings of the first Meaning of Life report

In our 2015 report, we predicted that between 2016 and 2020, DC workplace pension scheme assets under management (AUM) would double from around £280bn to £550bn.

By December 2016, the market had increased to £330bn and that number is expected to increase by £96bn by 2020 if the rate reported by the Office of National Statistics for 2016 continues. This figure does not include the impact of compounding or the increased coverage of auto-enrolment by the end of 2018.

As DB schemes continue to close, a significant portion of these funds will be directed into DC products, both occupational and retail. However, there is a paucity of data concerning the size of the DC pensions market, with none of the regulatory or trade bodies keeping comprehensive records.

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5 https://www.openbanking.org.uk/

6 Data from a freedom of information request by Salisbury House Wealth, https://s-h-w.com/news/

Independent research consultant Spence Johnson indicated early this year that it anticipated the growth rate for DC funds to increase from 12% to 13% and believes this could push the total DC market to £600bn in 2020 and £1 trillion by 2025.[7]

We also indicated in the first *Meaning of Life* report that there was data to show that 90% of auto-enrolment savings would be held as assets under management by a select group of financial institutions.

The pace of consolidation has increased, with certain high street/household names withdrawing from the market. There has been considerable consolidation among life companies with overseas parents. Aegon has sold off an annuity book and AXA, Zurich and Deutsche Bank have all sold off back books and/or moved out of the workplace pension market.

There has been consolidation among some smaller mastertrusts, while the largest providers continue to attract contributions from the AE market. NEST is no longer excluded from transfers in, with the ban being lifted in March 2017.

The market expects the rate and depth of consolidation will accelerate over the next two years.

Conclusions

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

The drivers for these changes continue to be:

1. Annuities are no longer a core focus, following the introduction of pensions freedoms, with many schemes closed to new business and shrinking in size. The low interest rate environment is limiting returns and further impacting the demand for annuities, as prices fall and customers seek alternative forms of investment and sources of income.
2. Increasing focus across the market on 'capital-lite' savings products and income drawdown products.
3. Solvency II impact on the economics of annuity products encouraging only a few specialists to remain in the market.
4. Pensions freedoms are radically changing and structurally shrinking the overall market size.
5. Increased regulatory oversight, including recent FCA reviews, is bringing insurers' practices with respect to back books sharply into focus.
6. Regulators are likely to focus on the application of existing products, such as income drawdown, in terms of suitability and the level of value provided to consumers by platforms. However, there is little to motivate providers to develop new products unless the regulatory environment begins to work in a more cohesive fashion.

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7 Pensions Expert, January 25, 2017: http://www.pensions-expert.com/Comment-Analysis/Data-crunch-How-big-is-the-workplace-DC-market?ct=true

The implications of these drivers therefore are:

1. To benefit from scale; annuities portfolios are being acquired by a small number of specialists.
2. The ability to price on the same/better terms as they have scale allows the participants to achieve return hurdles. A different approach to asset mix allows buyers to take an alternative view on value.
3. To use portfolio acquisitions as an additional line of growth, helping to compensate for the fall in individual annuity volumes.
4. Buyers seeking to mitigate legacy issues through indemnification provisions.

Introduction to the Findings

The main focus of this update remains the defined contribution (DC) market. This includes the back books of the pre-2001 era and the books of more recent workplace schemes and individual plans for the periods of accumulation (contributions) and decumulation (withdrawals of cash and regular retirement income), as well as the performance and implications of auto-enrolment and the rise of mastertrusts.

We also consider the impact on insurance solutions in the defined benefit (DB) pensions market, namely, bulk-purchase annuities (BPAs). In addition, we have included specific sections on market dynamics that are influencing the industry as a whole – Solvency II, reinsurance and the impact of technology.

These life company markets remain vast, but the estimates of aggregate assets under management (AUM) – and aggregate liabilities, where relevant – vary considerably.

New millennium, new regulatory pressures

Since the turn of the century, both the DB and the DC markets have changed beyond recognition. Over the past two years alone, since the first *Meaning of Life* report was written, these have included:

- Continued expansion of AE, so that all employers will be covered by 2018.
- Introduction of flexi-access drawdown with the 2014 Budget and launched in 2015.
- Roll-out of freedom and choice pension reforms in April 2015[8], allowing comprehensive access to and full control by the investor of pension saving after the age of 55.
- Secondary annuity market concept dropped by government after lukewarm response from industry at the end of 2016.
- Money purchase annual allowance (MPAA) introduced in 2015 to limit future pension contributions for those who accessed their pension plans reduced from £10,000 to £4,000 in 2017.
- Lifetime allowance reduced to £1m in 2016-17. Though indexed to CPI from 2018, the limit may be reduced further.
- Introduction of the new, tax efficient savings vehicle, the LISA in April 2017.

8 http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdfhttps://www.pensionsadvisoryservice.org.uk/about-pensions/pension-reform/freedom-and-choice

- **DB**: The widespread trend of closure of schemes (about 87% by number of schemes) appears to have remained the same based on the March 2016 information published by the PPF in its *DB Pensions Landscape Report*[9] and the trend towards the transfer of these liabilities from the employers' corporate balance sheets to the balance sheets of BPA insurers and their reinsurers appears to have continued. This market is relevant to life companies, in their capacity as providers of BPAs and also as third-party asset managers to DB schemes – a business line that had declined as more and more BPAs (largely bond-backed) were transacted.
- **DC**: Change continues apace due to the development of modern mass-market auto-enrolment workplace schemes. These are increasingly dominated by large-scale multi-trust, multi-employer schemes known as mastertrusts under a quasi-compulsory pension system.
- One of the largest of these mastertrusts is NEST[10] the structure developed from the findings of Lord Adair Turner's Pensions Commission.[11]

The Pensions Act 2017[12] received Royal Assent in April 2017 and mastertrusts now experience a much tighter regulatory regime under which member-borne commission payments are banned, early exit charges capped, and authorisation and intervention powers have been awarded to The Pensions Regulator (TPR). Capital adequacy will also become a major consideration by TPR and as a result, it is anticipated there will be considerable, rapid, consolidation of the providers in this market. The Department of Work & Pensions (DWP) has issued consultation[13] on the draft regulations to give effect to these powers.

More freedom, less choice?

The DC market has seen considerable regulatory change in recent years, which has broken the stranglehold insurance companies held over the pensions market, in particular, the workplace pensions market. Insurance companies have moved away from some of their traditional product suites in the retail sector in both accumulation and decumulation products.

The introduction of the lifetime ISA (LISA) from April 2017 reopened the debate as to how UK pension structures and products should be designed. Many commentators believe the new savings products that are exempt from tax provide better certainty than pension products that are subject to the constant tinkering with pensions legislation that has made tax planning near impossible. Whether LISAs will undermine pension saving in the coming years is moot, as few providers – either traditional or challenger – have launched LISAs.

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9 The Pensions Regulator's DB Landscape Report suggests that 85% of DB schemes are closed to new members as it states 15% open to new members but only 12% of DB memberships are active.

10 https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-Corp-SARA_2016_2017,PDF.pdf

11 http://webarchive.nationalarchives.gov.uk/+/http:/www.dwp.gov.uk/publications/dwp/2005/pensionscommreport/main-report.pdf

12 http://www.legislation.gov.uk/ukpga/2017/17/pdfs/ukpga_20170017_en.pdf

13 https://www.gov.uk/government/news/tough-new-regulations-for-master-trusts-proposed-to-boost-consumer-protection

Pensions freedoms have had the effect of greatly undermining the annuities market. By the end of 2016, annuity sales were around 25%[14] of the level before the reforms were introduced. Though this figure has stabilised against income drawdown products, there will always be consumers seeking guarantees over flexibility. Many more will seek to guarantee a portion of their income and retain the rest of their pension within their estates for inheritance and legacy purposes.

However, the annuity market is rapidly becoming a niche sector, operated by a smaller number of specialists. Though annuity rates remain low due to current gilt rates, it remains to be seen whether this will offer the degree of choice consumers had in the past, if and when, the gilt market 'normalises', following the unwinding of quantitative easing.

A new way of life

The changes in the DC market have called into question the fundamental purpose of the traditional UK life company business model. The largest life companies are restructuring in order to compete with a diverse range of challenger-providers. Several of these challengers have already demonstrated the merits of alternative business models in the mastertrust auto-enrolment market and have gained a significant market share at the expense of traditional life companies.

This changing model in the life industry can be seen in the merger of Aberdeen Asset Management and Standard Life, reinforcing their position in the market as an asset manager. It is thought that all or part of the £16bn back book of this business is likely to be up for sale as the century and a half old insurance company is dwarfed by the £357bn of assets under administration in its investment arm. A disposal would likely release capital that could improve the company's balance sheet under Solvency II.

Aegon sold some £9bn of its annuity book in 2016 and analysts suggest that Prudential may be considering the future of its £45bn back book.

As challenger-providers move into the decumulation, or income generating market, the historic distinction between 'retail' and 'workplace' pensions becomes increasingly blurred. Some commentators believe that within five years, some well-known brands will have disappeared after selling off all – or parts of – their back book. Few will exist in their present form.

These books will include pre-2001 life company policies, but also more recent workplace schemes, retail accumulation products, drawdown products, and annuities.

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14 https://www.abi.org.uk/news/news-articles/2017/04/the-new-retirement-market-the-evolution-continues/

Findings in the workplace DC pension scheme market

Summary

- The path of consolidation suggests the vast majority of assets under management will be concentrated in the hands of a few very large 'premier' financial institutions.
- Rapid consolidation is anticipated in the auto-enrolment market, which will dramatically reduce the current number of mastertrust providers.
- Pensions freedoms have undermined long term planning by exposing greater numbers to the risk of sub-optimal choices and penalty taxes.
- This is compounded by a lack of choice in the at-retirement market – the default solution is drawdown, a legacy product designed for those who wished to avoid annuity purchase under the previous regime.
- The arms race to build bigger, better institutions in this increasingly polarised market will see the withdrawal of household names.
- AE's universal reach falls short of its objectives and has yet to be challenged by rising contribution rates.
- Government must coordinate regulation better to avoid the pensions system becoming increasingly ineffective due to the short term requirements for tax revenues.

1. Assets under management

In our 2015 report, we predicted that between 2016 and 2020, DC workplace pension scheme assets under management (AUM) would double from around £280bn to £550bn.

By December 2016, the market had increased to £330bn and that number is expected to increase by £96bn by 2020 if the rate reported by the Office of National Statistics for 2016 continues. This figure does not include the impact of compounding or the increased coverage of auto-enrolment by the end of 2018.

As DB schemes continue to close, a significant portion of these funds will be directed into DC products, both occupational and retail. However, there is a paucity of data concerning the size of the DC pensions market, with none of the regulatory or trade bodies keeping comprehensive records.

Independent research consultant Spence Johnson indicated early this year that it anticipated the growth rate for DC funds to increase from 12% to 13% and believes this could push the total DC market to £600bn in 2020 and £1 trillion by 2025.[15]

15 Pensions Expert, January 25, 2017: http://www.pensions-expert.com/Comment-Analysis/Data-crunch-How-big-is-the-workplace-DC-market?ct=true

2. Mastertrusts

Ever increasing consolidation in the auto-enrolment scheme provider market seems inevitable as the market matures. This must be managed by both the industry and regulators in order to avoid market instability. This consolidation trend will intensify as further reforms – such as those from the legacy policy review – come into force and make legacy business unsustainable for all but the very large and/or very efficient.

The analysis by TPR[16] shows that 50% of the assets are held by 15% of the total mastertrust provider universe and the power to authorise mastertrusts in the Pensions Act 2017 means the barrier to entry will increase as it becomes more difficult to achieve critical mass. Two providers – NEST and The People's Pension (TPP) – have £4bn AUM between them.[17] Though NEST is second in size to TPP, it asset flows have been quite dramatic. In 2016, it doubled its AE AUM from £0.69bn to £1.42bn. By the end of June 2017, this figure has reached £1.88bn.[18]

Rapid consolidation is anticipated for the mastertrust sector, which has already seen some smaller operators absorbed by larger companies, though there are some who believe some smaller, well-capitalised and governed trusts, perhaps with special relationships with their membership, may survive.

3. Long term planning undermined by 'freedoms'

Government intervention in the pensions and ISA markets has created uncertainties for long term planning and there is increasing debate as to whether the introduction of new ISA models is continuing to have a detrimental effect on the pensions market, thus undermining the impact of auto-enrolment.

Analysts suggest that the impact of the NS&I savings bond, LISAs, dividend income relief and abolition of the annuity requirement which has been replaced by income drawdown and its impact on the market are all relevant to whether pension products will continue to attract sufficient commercially viable sales. This has been further undermined by the lifetime allowance being restricted to £1m and possibly reduced in the future; the introduction of the tapered annual allowance which limits pension relief for those on higher incomes and the money purchase annual allowance (MPAA) which restricts the amount of pension contribution that may be made by someone who has crystallised a DC pension fund.

Increasing numbers of consumers at the middle and upper earnings level will reach contribution ceilings and be forced to save into non-pension vehicles. These products will focus on income delivered through tax efficient wrappers and a specialist risk transference industry that will package the residual liabilities of legacy products in a scenario akin to an insurance run-off where residual capital will then require redeploying.

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16 http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf

17 https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-Corp-SARA_2016_2017,PDF.pdf

18 NEST assets membership has reached 4.5m

4. This year's model

In 2015, we identified mid-tier life companies as being most likely to be challenged by the fragmentation and segmentation of the market. However, it has become clear that all life companies have had to adapt to the new environment as reliance on a traditional 'bundled' business model and commission-based intermediaries is no longer possible.

It remains to be seen whether these companies will see their strengths lying within a new asset management style of product provision or more traditional risk-based products. Certainly, protection insurance remains 'under-sold' and may offer an opportunity, particularly in a DC market whose products have no guarantees and are entirely dependent upon investment returns.

Income drawdown, the dominant retirement income product since the introduction of pensions freedoms has yet to be shown to be fit for purpose and non-advised drawdown sales are currently under review by the FCA.

Many commentators are concerned that regulatory reviews will find that many consumers should not have selected income drawdown and this will result in another industry scandal. However, annuities remain unattractively priced, based as they are on the value of gilts. The vilification of annuities by politicians and the media has reinforced a belief that annuities are inherently bad products.

As the government has abandoned the notion of a secondary annuity market, this only throws into sharper relief the need for a suite of products that will release income while protecting individuals from the vagaries of investment markets and longevity risk at a time they are no longer able to generate income from work.

5. It's the end of Life as we know it

Policy and regulatory reforms have broken the near-monopoly of life companies in the DC market for accumulation and decumulation, facilitating the entrance and growth of powerful competitors in the mastertrust market. The impact of Solvency II brings into question the continued use of the life model for delivery of DC products and the asset management model makes much more commercial sense.

The expectation is that the direct-to-customer (D2C) will be the main distribution channel in the auto-enrolment market for smaller employers. Larger employers may consider a switch to D2C in future, once the market has stabilised, in order to save costs. In the UK, NEST, along with a few other mastertrusts is likely to remain the main channel for distribution to small employers, although D2C is likely to play a greater role where the asset manager sells investment products to investors that are sold outside the pensions wrapper and through other tax savings wrappers such as ISAs and LISAs.

The challenges surrounding D2C and to some extent, AE, are inseparable from those challenges facing insurers and their technology infrastructure. Without robust and scalable platforms, economies of scale and flexibility cannot be delivered.

Few – if any – providers have achieved their objectives in platform builds yet, and others have a long way to go. Those who feel they lack a competitive advantage may choose to divest themselves of their back books and either withdraw from pensions products altogether or focus on the new breed approach. This will include very large household names.

6. AE ain't what it's cracked up to be

Auto-enrolment, which will be fully implemented by 2018, is compulsory for all private-sector employers and employees, although the latter have the right to opt-out (the 'soft compulsion' feature that distinguishes auto-enrolment from full compulsion). By August 2017, more than 8.5m workers have been enrolled.[19]

By July 2017, the membership of NEST alone increased to 4.5m members. Only 2.7m NEST members are active as nearly one third change jobs every year and it has an 8% opt-out rate. AUM of NEST stands at £1.88bn.[20]

Auto-enrolment schemes, in particular, are failing to meet employers' requirements: following the introduction of freedom and choice and age discrimination legislation, the DC pension system no longer works as a corporate retirement-management tool. Part of the problem is that it leaves a significant part of the working population as ineligible for auto-enrolment, who will be eligible for employer contributions to LISAs and ISAs which are likely to be more attractive to the wider population of lower paid workers that have low rates of persistency in any one employment role.

Auto-enrolment has also arguably failed half of previously unpensioned private-sector employees. 7.4m workers (around 50%) are not eligible for auto-enrolment, since they are non-eligible job holders, either because of their age or level of earnings, or because they are self-employed are not automatically enrolled so they must make elections to opt-in if certain conditions are met.

This will be addressed to some degree by the planned increases to the National Minimum Wage, which is expected to increase the wages of the lower paid by 40% over the next five years and their pensionable salary by around 80%. However, a structure to include the self-employed within auto-enrolment has yet to be established. An increase in National Insurance Contributions was tabled by the government at the end of 2016, but was rapidly dropped. The industry has proposed a number of models, including a 5% 'tax' upon profits that would be earmarked for pension saving.[21]

7. Government needs to get its Acts together

Pension reforms remain essential but must be implemented in a coherent fashion. For example: there has been some progress such as with the creation of a pensions dashboard (see technology section), further regulatory strengthening, deregulation around annuities and pensions freedoms but more needs to be done for legacy pension policies, annuities and drawdown products. Though some of these are currently under review by the FCA, the fragmented approach adopted by government and regulators has fostered overlaps and inconsistencies and fails to deliver a coherent long-term policy strategy.

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19 http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf

20 https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/news/nest-corporation-publishes-its-annual-reports-and-accounts-2016-17-and-third-master-trust-assurance-report.html

21 One example is the Aviva/Royal London report: https://www.aviva.com/media/upload/AvivaRoyalLondon_Report_30Jun17.pdf

There is also fragmentation and inconsistency between workplace pensions and auto-enrolment, contract-based pensions and other savings products, particularly around consumer protection. The introduction of LISAs has further muddied the waters and raised questions as to whether the structure is a) fit for purpose and b) can deliver a safety net in retirement.

8. The danger of regulatory divergence

The greatest anomaly in social policy surrounding pensions and long term saving is the government's approach to pension pots which was enshrined in freedom and choice. Freedom and choice has certainly offered excellent flexibility for those with life limiting illnesses or those with excess savings who may prefer to pass on their pension pot through their estate. However, it diverges sharply not only from the raft of pensions legislation to date, namely to safeguard a fund to deliver a meaningful income in retirement. Furthermore, it also deviates from the policy objectives of most developed nations facing similar demographic problems among populations which are not prepared to support themselves through an ever-lengthening period of retirement.

As UK consumers reject annuities in favour of drawdown products, the global trend continues towards greater security of income in retirement.

Findings in the back book (legacy policy) market

Summary

- The introduction of the Lifetime ISA (LISA) model could result in the closure of open pension books, even within the AE market, should the EET model be replaced with the ISA's TEE structure.
- Life companies are competing in a market where the different regulatory and compliance requirements and scrutiny create inconsistency between providers of products in the same market.
- Charges are not the only cause of poor value for legacy pots. Sub-optimal decisions to move small pots into less tax efficient structures have been made by people as a consequence of a lack of professional advice and a mistrust of pensions.
- Back books should include all existing policies which pose a risk to a financial institution, including the bulk purchase annuity (BPA) market.
- A lack of with-profits actuaries may not be as alarming as considered in 2015 due to future innovations using non-life product structures. However, the with-profits legacy is huge and will require management for many years to come.

1. LISA threatens open pension books

The November 2015 report predicted a surge in sales of legacy back books, as life companies struggled with reducing member charges and increasing capital requirements under Solvency II, which came into force in January 2016. The introduction of an ISA-type tax model for pensions could lead to the closure of many open books of pension business, including those in the auto-enrolment market.

2. Life companies under pressure

Life companies with back books continue to struggle to deal with unprecedented and inconsistent levels of government scrutiny, regulatory reviews, and consultation processes. Recent reviews by the FCA into the long term annuity market, asset management fees and advice all indicate that the commercial flexibilities that arose from market asymmetry of information previously available are being eroded.

Pressure is intensifying to address high charges, restrictive terms and conditions and suitability under TCF (treating customers fairly) rules. The imposition of the independent governance committees on insurance companies should be reviewed for their effectiveness in delivering 'value for money'.

3. Freedoms produce sub-optimal consumer decisions

Value for money for small legacy pots is undermined by fixed annual administration costs. The FCA's retirement outcomes interim report showed that it has become the norm for pots to be accessed early, with 72% accessed by consumers under 65, mostly as lump sums. More than half (53%) of pots accessed since the freedoms have been fully withdrawn and 90% of these were smaller than £30,000 (60% were smaller than £10,000)[22]. The FCA was confident these funds were not being squandered, as 94% of consumers making full withdrawals had other pensions in addition to the state pension. However, whilst small pots are often being spent, the remainder are being held in less tax efficient vehicles[23], usually provided by their existing provider. Consolidation is not resulting in better outcomes for these consumers. Few take advice when entering drawdown and if they did so, they could potentially make more of their investments.

4. All existing policies are legacy

We suggested that the definition of 'back book' was out of date. In reality, a back book consists of any products that have already been sold that pose risks to an institution through changing economic environments and/or regulatory change. We proposed that it should include private-sector closed DB schemes and bulk purchase annuities. We also believe it should include legacy DC schemes with GMPs and other guarantees. The size of the back book redefined in this way also raises issues of capacity within the market in order to enable the regulators and policy makers to consider the impact given that the market is consolidating into the hands of a few specialist market players.

22 https://www.fca.org.uk/news/press-releases/fca-publishes-interim-findings-study-retirement-income-market

23 https://www.fca.org.uk/publications/market-studies/retirement-outcomes-review

5. DC consolidation will accelerate

More recent DC back books will come to market over the next five years as the mastertrust model overtakes the old life policy structures traditionally used in DC schemes.

Retail annuity books will also be sold, creating the potential for commoditised funds in an alternative asset class.

Mid-sized players such as Canada Life, Phoenix and Scottish Widows are known to be interested in increasing their share of this market. The sale of Zurich's workplace pensions business to Lloyds Bank, the parent of Scottish Widows, shows a broader commitment to achieving scale.

Some life companies currently managing legacy books would prefer to sell them, but either cannot justify the expense or see a short to medium term benefit running them alongside newer structures offering cross-selling opportunities. Others see this benefit as a longer term strategy and are preparing to manage them to run-off.

As previously reported in the first *Meaning of Life* report, equity release is likely to be a 'back book of the future'.

6. You can't get the staff?

Managing a back book requires specialist skills in three main areas: mortality prediction, investment and operational efficiency which can give competitive advantage to an operator in these markets. We reported in 2015 that the market suffers from a skill shortage as it is more than a decade since the with-profits policy was a dominant structure. This is because while the numbers of actuaries has increased by almost 3,000 members since 2014, only about half of the total qualified group is based in the UK.[24]

Despite a lack of actuaries having with-profits experience, commentators do not feel this will necessarily result in a staffing crisis in future years. Most books are in run-off and new products – even those that offer hybrid structures – are expected to be written under asset management savings product structures.

We found that there may be short term staffing shortages in books in run-off, but as these books are increasingly concentrated under the control of specialist consolidators' businesses, this should give some comfort to both regulator and consumer.

These businesses are engaged in the same technology race to streamline their processes in a market that no longer tolerates the margins of the past. If they are to maintain these books – and potentially offer additional products to their customers in the future – their success will be dependent on the client experience.

Actuaries are confident that the quality of actuarial education produces sufficient talent to inform a new generation of innovative long term savings products for when the with-profits products has ceased to exist.

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24 Institute of faculty of actuaries, our members: at a glance 2015 & our members: at a glance 2014

Background to the Findings

Solvency II

- Solvency II has overburdened life companies in terms of regulatory compliance.
- Insurance companies are being asked to hold too much capital and many view the regulator's position on prudence to be unfair, but the Brexit transition period will prevent major reform.
- While scale is the key to success, small, efficient providers also have a role to play.

1. New broom sweeps clean

The Solvency II regime was finally introduced in 2016 and has proved to be a catalyst for change in the UK life industry. It places a far greater burden on those writing risk-based business, and while there have been increasing regulatory costs, the tax benefits derived from the life company structure have also been eroded, making the writing of business far more expensive.

The administrative component of managing life products is no longer a profit centre, but a drain on resources, driving the move towards a technology-based solution. As a result, many traditional life companies have begun to shift their business models towards that of an asset management model.

The 2015 report predicted that legacy back books would surge as life companies struggled to balance reduced member charges and the increased capital requirements under Solvency II with making a profit for their members or shareholders. However, many of the commentators who contributed to this report believe that insurance companies are being asked to hold too much capital in respect of longevity risk, making it almost impossible for the industry to develop new and better products for customers.

It is true that this is but one factor. The continued depression of gilt prices makes it very difficult and expensive for life companies to build guarantees into longevity products. In recent years, consumers have refused to buy certain guarantees or hybrid products due to this increased cost.

2. Regulatory upset

None argue against the need for prudence – it is the watchword of insurers and the basis of the previous regulatory regime. All insurance companies have also accepted the need for allocating more resource to governance under the regime, but there are some areas where some providers feel the asymmetry is 'unfair'. Many criticise the degree of intervention being pursued by the Prudential Regulatory Authority (PRA) and say the structure must change, with the PRA taking a more pragmatic approach to risk.

The application of the risk margin in particular – at several times the size it would have been under the old regime – appears to be arbitrary and is considered to be unjustified by many of the commentators who contributed to this report.

On 25 October 2017, the PRA announced a series of consultation papers[25] to address some of the concerns raised by the industry. The first will address the matching adjustment.[26]

The introduction of the increased risk margin has also made writing annuities – and some forms of whole-of-life protection – much more expensive. Addressing the size of the risk margin would be seen as a major step forward.

3. The Brexit effect

Though some anticipate changes to the Solvency II regime following Brexit, more cynical commentators believe they are unlikely to happen before the Brexit transition is complete, as there is insufficient political will to instruct the PRA to make any major adjustments before the process is completed.

Various commentators have said that two years grossly underestimates the transition period required, with estimates of up to seven years being suggested. If this longer period was to prove to be correct, change is unlikely to happen before the next parliament, and quite possibly it would occur under the subsequent administration.

A week is a long time in politics and few companies will be prepared to stake their business model on what might happen following two general elections. As a result, more life companies are likely to reassess their business model and make the move towards a 'capital-lite', asset management style model and join peers as a 'new breed' financial institution.

This will trigger greater demand for offloading back books to those companies remaining in the risk-based arena – and specialising in managing legacy products – therefore prompting demand for reinsurance of those risks.

4. Bigger not always better

The overarching principle driving the divergence of traditional risk-based life companies and those choosing an asset management structure is to determine which sector best suits the business and then achieve scale. Yet some commentators see a role for smaller, niche providers to not only survive, but prosper in such an environment.

Companies with a strong mission or affinity with a customer group, such as a mutual or collective, may find they have sufficient support to continue serving their traditional customer base. Small and niche, if innovative – or perhaps through the use of a shared value model, such as those used in PHI (permanent health insurance) which reduce premiums for customers achieving health goals – may foster such a connection. As one commentator put it: "It is always better to be small and good, than big and bad". Scale is only part of the process of being successful in this new environment, as the regulatory and technological hurdles get progressively higher.

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25 http://www.bankofengland.co.uk/publications/Pages/news/2017/062.aspx

26 http://www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp2117.aspx

Reinsurance

- Governance costs have increased but have been borne by insurers.
- Mixed views over the PRA's 'unreasonable' position on reinsurance.
- Don't look to the regulator for innovation, warn commentators.

1. Trouble brewing over reinsurance decisions

Insurers operating in the risk-based arena – such as the bulk purchase annuity market – require reinsurance to hedge the risks on their own balance sheet. The implementation of Solvency II has increased governance costs, the cost of capital and levels of reserves required to satisfy the regulator.

Regulators and insurers need to collaborate in the risk-based arena, particularly around the subject of reinsurance. As commercial organisations, insurers will seek the most cost effective deals available and that may lead them to reinsure long term risks such as longevity with organisations domiciled outside the UK and EU.

2. PRA seeks greater regulatory oversight

The PRA has long held concerns about reinsurance being placed in jurisdictions outside its control. In 2017, the regulator invited Legal & General to demonstrate that the governance surrounding its non-EU reinsurance contracts was suitably robust. This has led to concerns that the PRA may seek to intervene further in commercial matters and impede current insurers' ability to write business without clearance from the PRA.

Some commentators pointed out that once Brexit is fully implemented, the UK will be the only market over which the PRA will have jurisdiction and such a limitation on reinsurance would increase both charges and risk.

Others are more conciliatory towards the regulator's position. One commentator said: "If [the PRA is] giving relief in the UK, they won't be happy to see it exchanged for a large pile of capital risk in a jurisdiction it doesn't have any control over. If the PRA is concerned about this, it will increasingly ask insurers to explain their due diligence to make sure the structure will work."

3. Regulator a block to innovation?

The PRA has been criticised as being slow to react to the rapid pace of change and to engage with those it regulates. Some attribute this to being resource-constrained during the implementation of Solvency II, while others see the PRA as lacking the necessary skills to be a proactive regulator once Brexit has been achieved, and in encouraging innovation.

One commentator said: "Regulators are quangos, unelected and given a certain mandate. So it is not in their interest to provide innovation. There's no upside for them."

BPA

- The BPA market is flourishing and broadening in scope.
- Appetite for exposure has spread to deferred members.
- Attractive pricing set to continue.
- Calls for government to look at partial transfers to assist schemes and protect consumers.

1. Harder, better, faster, stronger

If the PRA's position should limit the freedom of insurers to make commercial decisions as to whom they select as reinsurer, this will have implications for the sale of legacy books, but also the flourishing BPA market.

The last 12 months has seen considerable development in this market. Insurers have sought to optimise balance sheets as they seek assets that satisfy both capital requirements and offer sufficiently high yields to keep pricing attractive.

Mid-sized players such as Canada Life, Phoenix and Scottish Widows are known to be interested in increasing their share of this market. The sale of Zurich's workplace pensions business to Lloyds Bank, the parent of Scottish Widows, shows a broader commitment to achieving scale. Specialist providers such as Rothesay and PIC have also emerged over the last ten years.

2. Wider range of deals on offer

The types of deals on offer have also evolved. Three or four years ago, a large deal would have been for liabilities of £1bn or more. Now, those buyouts may be up to as much as £5bn. New players in the market have also stimulated the lower end of the market, with deals being struck for considerably less than was possible before. Pensioners are not the only targets, either, with increased interest for deferred member risk – as part of a full scheme buyout.

Perhaps more surprising is that many commentators believe pricing has not only been stable, but highly attractive. Funding may have improved in many schemes as a result of rising equity markets and the relative value of the pound against the dollar. Pricing has improved to the extent that sponsors have seen a significant shift to within 5% or 10% of the current funding level and taken the decision to commit to ridding themselves of the obligation.

3. BPA and the freedoms effect

Pensions freedoms have had a positive influence on the 'health' of DB schemes, with as many as 80,000 transferred out of their DB scheme in the year to 31 March 2017, according to TPR.[27]

This has improved the funding position of all but the worst funded schemes. It has also encouraged many trustee boards to consider offering transfer values to all members with annual statements and sponsors to pursue enhanced transfer value (ETV) and pension increase exercises (PIE), improving funding levels further.

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27 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/595103/security-and-sustainability-in-defined-benefit-pension-schemes.pdf

There have been calls for the government to further assist DB schemes to allow greater freedoms, by providing partial transfers. These would not only improve funding levels, but many schemes see them as compatible with their remit. A partial transfer would not only allow an individual to benefit from the pensions freedoms, but allow the member to maintain a level of pension within the scheme, ensuring that the customer has some financial security in retirement.

Most commentators believe this positive approach is likely to continue and reject the notion of a "buy now while stocks last" situation. However, they are keen to point out that some of the larger deals struck will be with schemes that have already undertaken a previous buy-in/buyout. They will have been through the process of data cleansing and putting structures in place to facilitate further deals.

The increased use of exclusivity arrangements between a DB scheme and a single or several insurers offers them the opportunity – and time – to find the assets they will need to transact, which has a positive impact upon pricing.

Global reinsurance will maintain demand for longevity risk as current environmental and geopolitical situations mean that the sector continues to move heavily towards mortality risk exposure.

With stability in the market, price is not expected to be the determining factor alone in BPA deals. Some commentators feel insurers are going to have to demonstrate a greater level of value-add, perhaps in terms of service levels with policyholders in the future.

Technology

- Technology the key to scalability.
- Simpler products have been embraced by advisers and consumers, suggesting complex hedging products will continue to struggle in this market.
- Quality of platform systems is mixed and questions are raised as to the value to consumers.
- Technology lacks a coherent approach to industry data standards and current programmes such as the pensions dashboard should look to include broader technology standards such as those demonstrated by the Open Banking project.

1. Managing spiralling costs

Solvency II has increased transparency in the use of capital among life companies, but also made it more expensive to conduct business.

Spiralling costs are not new to life companies in the UK managing legacy business. This is, in part, due to the age of the existing systems used to administer them – many insurers still rely on some mainframe technology first developed in the 1950s – and the cost of maintaining these arcane systems. While proficient at doing the job they were built for, these systems are ill-equipped for the 21st century and integration has been a constant source of frustration for – in some cases – decades.

Life companies – and financial institutions in general – have spent hundreds of millions of pounds on new platforms that allow them to manage their books of business more easily and consequently more efficiently. Where life companies were spending money on reserving for guaranteed products, they have now chosen to build platforms for their new product world.

Simple unitised funds rely more on arithmetic than actuarial science and this has encouraged life companies to abandon older, risk-based products. This, however, has not proved to be a simple way of accumulating assets under management. Achieving critical mass on platforms is absolutely essential – the platform world is built on high volume, low cost transactions, which leaves little by way of margin without scale.

2. The legacy effect

The traditional life model had what one commentator called "a get-out-of-jail-free card", which was the back book. The income generated by legacy products could be used to fund new business ventures – or smooth returns in with-profits products.

Those back books allowed life companies to defer profitability on persistent or 'sticky' life and pensions business for a decade or more. Though commissions have been removed for many products, life companies reliant upon the asset management model must drive business onto platforms and make it profitable as soon as possible.

Though institutions have been building platforms – some for a decade or more – few have achieved anything like critical mass and some are looking at developing a hybrid approach to writing business.

Legacy books which inevitably have a reducing level of profitability will be sold off, while those that offer cross-selling opportunities will be maintained and "re-platformed". This is efficient, but a painful process for those who are unable to make it work effectively.

Aside from the difficulty in making the platform suitable for existing business requirements, there are other dynamics to consider. Transferring legacy business from arcane manual or mainframe structures to a modern online environment simplifies administration, but also makes products more portable. That can significantly impact embedded value, a key measure of value within insurance companies' businesses.

The effect of the freedom and choice reforms has been to switch advisers and their clients onto the simplicity of platform-based products. But these non-pension products do not offer long term security to life companies as they can be easily switched elsewhere. Gone too, is the ability to hedge some of that volatility through the pricing of annuity products.

3. Lack of innovation

Since the reforms, few products that bridge the gap between flexibility and guaranteed income have been launched. In fact, most hybrid products have been withdrawn by providers, as they did not attract sufficient business due to the additional cost of guarantees.

This lack of innovation in the post-retirement market can be attributed as much to access to technology as to the market eschewing annuities in favour of flexibility in terms of drawdown. Many customers want a product with similar characteristics to with-profits, but are not prepared to pay for the guarantees – the same problem facing annuity rates in this "lower for longer" economic environment.

Advisers, too, favour simplicity, convinced they can achieve similar outcomes through using a combination of lifetime – or flexible – annuities and straight forward income drawdown products as they would be sophisticated turnkey solutions if they were appropriately designed.

"It is partly an instinctive rejection of things that look complex because these products are expensive," said one commentator. "While they may do the job they are meant to very well, the downwards pressure on fees makes it difficult for advisers to justify the expense in our return-constrained environment where the client is taking out regular income," said another commentator.

This dynamic makes it difficult for smaller operators, such as mutuals, to justify re-platforming their legacy books for the few basis points they will achieve in returns. Though scale is the ultimate goal, for those who are operating in the mass market.

4. The pace of change

It is often asked whether technology can keep up with industry advancements, but it is perhaps more apposite to consider whether technology is in fact being developed to advance the industry. Platforms, first developed in Australia following a period of intense activity among financial services institutions, were designed to deliver economies of scale and market power to achieve better fund deals with the cost of the platform shared between the provider and the consumer.

The platform market in the UK is founded on the premise that it will deliver better value for all parties, but that has not happened, leading to the FCA launching a review[28] into the market. The question remains as to what a platform is supposed to deliver for a consumer. The self-directed investor is quite a different proposition from the mass market and some think it's highly likely the FCA will question the significant margins achieved by the platform market.

"We are paying a lot of money for what is technically the back-office system of an IFA," said one commentator. "I don't see many consumers getting a huge amount of value from a system that simply makes it easy for the IFA to manage the administration."

28 https://www.fca.org.uk/publications/market-studies/ms17-1-investment-platforms-market-study

5. Platforms under pressure

By improving access, platforms should allow consolidation in what has become a heavily fragmented marketplace. This, too, has not been the experience in the UK market. The Pensions Dashboard, a project started under the aegis of the DWP and other government agencies, will allow a consumer to find all their existing pension products – both occupational and personal – and view them in one place in real time. By providing access to this data, it is hoped that consumers will attach greater value to their pensions, stimulating interest and greater engagement with long term saving.

The Association of British Insurers (ABI), which took the project lead with its membership, has developed a prototype[29] product which commentators have said looks promising. However, it is unlikely to achieve its objectives without universal application and that is unlikely without strong indications, or perhaps even regulation, from the regulator.

The European banking industry is under notice to put its data house in order under the powers derived from Payments Services Directive 2[30]. Under PSD2, banks must develop a data standard that improves customer experiences but also allows swift and secure exchange of data mandated by the consumer at the touch of a button.

The dashboard project has been criticised for taking pensions in isolation and not seeking a more comprehensive solution. Though this was in response to close scrutiny from government agencies, the technology developed by the UK's Open Banking project[31] could help to enhance the functionality and prevent multiple incompatible standards being developed simultaneously.

On 19 October 2017, Guy Opperman, parliamentary under-secretary of state for pensions and financial inclusion confirmed that the DWP was committed to the project and was targeting a 2019 launch.

Regulatory direction

- Pension reforms may have offered freedoms, but little by way of choice.
- The annuity market has been undermined by the freedoms, but the move away from risk-based business is likely to render guaranteed products a niche market.
- The shrinking annuity market has forced most consumers into income drawdown, a product of questionable suitability.

29 https://www.abi.org.uk/products-and-issues/products/pensions/the-pensions-dashboard/

30 https://www.paymentsuk.org.uk/policy/european-developments/payment-services-directive

31 https://www.openbanking.org.uk/

1. Pensions freedoms have limited choice and made decisions more complex

While prudential regulation may be causing both difficulties and concerns for life companies, its evolution is broadly in line with other developed nations. The same cannot be said for regulation in the retail market.

The UK Government has in recent years developed regulation to encourage pensions saving, through strengthening and simplifying the state pension and introducing auto-enrolment which has already increased the number of those saving for a pension by almost nine million.

However, the freedom and choice reforms, though popular for the flexibility they offer individual consumers, cut across and undermine these other policies. Little consideration was given to the existing infrastructure for the transfer of money out of pension savings products into income generation or even into cash.

2. Freedoms punish the prudent

Those who crystallised a pension product have since seen any future pension contributions they might make reduced from £10,000 a year to £4,000, with no guarantee this relief will not be further reduced.

The maintenance of a £1m lifetime allowance (LTA) begun to capture many more individuals than simply wealthy savers who have benefited most from pensions tax relief.

In the last tax year, the sum raised in tax penalties for those breaching the LTA rose to £36m from £20m in the previous year – a rise of 80%.[32] In addition to the taper which has been introduced for high earners on the annual allowance, it appears that maximising tax revenues is the primary goal of these policies.

3. UK policy: dysfunctional and divergent

This places the regulatory direction of pensions and long term savings at odds with the social benefits of removing the elderly from poverty and reducing the burden on the public purse. It also places the UK on a different path from the rest of its peers in the OECD. It is important to note that these are OECD nations, as they are experiencing many of the same demographic structural issues associated with an ageing population that face the UK.

The trend amongst many of these nations is to automatically enrol savers into pension savings vehicles, to encourage savings into pensions by offering tax relief and by extending access to longevity hedging products, such as annuities.

The annuities market, under pressure from low rates due to historically low gilt rates (as a consequence of quantitative easing), has been severely set back by policies designed to generate tax receipts for the Exchequer, such as pensions freedoms.

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32 Data from a freedom of information request by Salisbury House Wealth, https://s-h-w.com/news/

4. End of the road for annuities?

Since the introduction of the freedoms, drawdown has dominated product sales. The number of annuity providers and products has consequently been reduced. This not only reduces choice for consumers today, but some commentators fear it could send the annuity market into terminal decline. If that should happen, there may be no annuity industry in place to satisfy the real need for retirement income guarantees once gilt values return to normal levels.

The government does not seem to have considered the state of the retirement income infrastructure when it implemented these policies. The market, fragmenting – while consolidating – in the wake of economic challenges, regulatory strictures and the costs associated with Solvency II, provided rather patchy coverage for consumers. Though politicians and lobby groups had been calling for innovation in product design, guarantees became more expensive and consumers lost the appetite for paying for them – something many may well regret once they have run out of money a long time before they actually die.

5. One size fits few

Though dominant, drawdown has yet to be shown to be fit for purpose for the mass market, and is currently under review by the FCA. Before the freedoms, it was often viewed as the 'least worst' option by consumers with significant pensions savings who did not want to purchase an annuity.

That does not mean annuities, the dominant form of retirement income vehicle before the freedoms, should necessarily be the default for those retiring in their 60s or even 70s. It is clear that annuity pricing is more favourable if purchased around the age of 80, but this depends upon the ability to make purchasing decisions and access to a secure income in the interim period.

Many commentators are concerned that regulatory reviews will find that many consumers should not have selected drawdown and this will result in another industry scandal. However, annuities remain unattractively priced, based as they are on the value of gilts. The vilification of annuities by politicians and the media has reinforced a belief that annuities are inherently bad products.

Annuities can represent good value for those who require greater security of their income in retirement. Better value is also to be had if the consumer can defer the purchase until a later date, closer to the age of 80. Many legacy products also have valuable benefits such as guaranteed annuity rates which are no longer offered and which would far exceed current market rates.

6. A bleak future

As the government has abandoned the notion of a secondary annuity market, this only throws into sharper relief the need for a suite of products that will release income while protecting individuals from the vagaries of investment markets at a time they are no longer able to generate income.

Commentators told the author that government should seek to avoid implementing single changes or advocating a single product unless it implements a proper degree of “joined-up thinking”. There is never going to be a one size fits all product, so government should stop looking for it, said one commentator, and be satisfied with one that suits 80% of the market.

Others warned of the focus many politicians and policy makers have taken with regard to the other concern facing many consumers – long term care. “There is a belief – one which some have articulated – that insurance will take care of the long term care problem,” said one commentator. Insurance products protect individuals against relatively unlikely but catastrophic situations and that is not necessarily compatible with long term care.

“If you ‘insure’ against something that is pretty likely to happen, that becomes a savings plan, or what we have until now called a pension.”

If pensions are undermined by freedom and choice, then greater focus will fall upon the equity release/lifetime mortgage market.

Conclusions

The past two years of regulatory change and implementation – though not yet fully manifested – will have a wide ranging impact upon the life and pensions sector.

Consolidation

Consolidation of the vast majority of the market under a small number of financial institutions seems irresistible, as more companies decide where their future lies. In the past year, companies such as Aegon have sold off large back books and very recently, Zurich has sold off its workplace pension book to Lloyds, which has increased its interest in the BPA market through its Scottish Widows brand.

Though some smaller providers may survive, increasingly, only large, efficient institutions will persist. Solvency II makes the risk-based market that supported longevity products such as annuities less attractive to providers. Those who remain in the risk-based arena may find their relationship with the PRA become more strained unless providers feel they are able to satisfy regulatory requirements while retaining full commercial control of their business.

Consolidation is a primary driver and involves all providers, who have one form of back book or another – i.e. existing policies which will continue to pose risks to the business and require careful – and regulatory compliant – management. Technology is seen as the key to this transformation, but it is an area of weakness for many financial institutions and particularly for life companies. New platforms remain unproven and concerns have been raised that consumers receive little value for the cost, leaving the industry open to further claims of detriment.

Greater effort should be placed on seeking standardisation across not only life and pensions, but the whole of the financial services market. Integrating with initiatives such as open banking should deliver a structure that can offer more benefit to the end consumer and offer hope of better access to information – guidance, advice – that may result in better decision making in an unadvised/less-advised world, and potentially, better outcomes.

In the DB market, BPA appears to be functioning well and seemingly for the benefit of schemes and its members, but it has been argued that the government might do more to improve funding levels by making partial transfers – that offer consumers flexibility but with the protection of a DB underpin – easier to achieve.

Retirement income market

The reforms of the DC pension market seem to offer greater flexibility to consumers but freedom and choice is limited, unless restricted to the freedom and choice to pay more tax. Annuities, much maligned by politicians and mainstream media have been replaced with income drawdown for the majority of consumers.

However, drawdown was only ever a stopgap measure exploited by those who did not want to be forced to purchase an annuity. As such, it remains to be seen whether it offers either sufficient growth or sufficient protection to the majority of customers who need lifelong income in retirement – although they may not realise it.

It is unlikely the majority of new drawdown policyholders fully understand their purchase choice and this will be tested in the FCA's review of the unadvised drawdown market. Any negative outcomes are likely to exacerbate ill will towards the pensions market.

However, the move towards simpler products does not give much hope for innovation in the retirement income market any time soon. It is often said that consumers want with-profit products, but won't pay for the guarantees, but that may change in the future if gilt markets – and therefore annuity rates – return to some form of normality. However, the move away from life products to an asset management model means there will be fewer providers playing in the risk-based market and so it will be increasingly specialist and niche. This will undoubtedly limit choice.

Regulation

The government must address all these markets – DB, DC, BPA, AE and retirement income – in a more holistic fashion.

Auto-enrolment is yet to become a universal project and if the next stage of increased contributions increases the opt-out rate, there are fears it could result in the AE project losing momentum. This will make pension saving less attractive to those not covered by it now, such as the lower paid and self-employed.

The UK Government's fragmented approach to regulating the pensions landscape is undermining the spirit of pension saving regulation. They give with one hand (AE and pensions freedoms), while taking away with the other (LTA, AA, MPAA and taper).

Freedom and choice lacked the necessary infrastructure to offer proper consumer choice and adequate protection. The default option, drawdown, may yet prove to be inappropriate for many savers and there is growing recognition from the FCA that retired consumers – in particular the elderly – are not being well served by the current market. Though it has called for the industry to step up to this challenge, without a more coherent regulatory approach, financial institutions are unlikely to invest in products that may not be commercially viable.

This piecemeal approach to regulation is undermining the security of the retirement income market and works against the stated aims of pension saving policy. It also neglects the experience of the UK's peers across the OECD, which are steadily moving towards a contributory workplace DC environment that will provide an income in retirement underpinned by some form of drawdown combined with longevity hedging products such as annuities.

To ignore this trend amongst nations that face the same challenges as the UK will result in a crisis in the provision of retirement income and leave many more elderly citizens reliant upon the state in their old age.

The UK Back Book Market updated to 2017

- Aegon:[33]
  - Legacy policies were written under the company's previous brand name, Scottish Equitable.
- Aviva (including Friends Life):[34]
  - CGNU Life
  - Commercial Union
  - Colonial Life
  - Equity & Law
  - Friends Life
  - General Accident Life Assurance
  - Gresham
  - Hamilton Life
  - London & Manchester
  - National Westminster Life
  - Norwich Union
  - Provident Mutual
  - Royal Scottish Assurance
- BlackRock Life Limited:
  - BlackRock
- Canada Life
- Chesnara:[35]
  - Countrywide Assured
  - Save & Prosper Insurance
  - Save & Prosper Pensions
  - Direct Line life Assurance
  - City of Westminster Assurance
- Curtis Banks:
  - Suffolk Life
- Equitable Life Assurance Society
- Fidelity Worldwide Investment

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

34 http://www.aviva.com/investor-relations/institutional-investors/regulatory-returns/

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

- Legal & General
  - Savings Heritage
- LCCG:
  - Aviva Life International
  - AXA Isle of Man
  - Reliance Mutual (Criterion Life Assurance, Family Assurance/Time Assurance, Hearts of Oak Insurance, University Life Assurance Society)
- Mobius Life
- NFU Mutual
- Old Mutual Wealth:
  - UK Heritage
- Phoenix Group (over 100 hundred legacy brands exist within the Phoenix Group but the main life companies are):[36]
  - Phoenix Life Limited
  - Phoenix Life Assurance Limited
  - Abbey Life incl. Hill Samuel Life Assurance and Target Life Assurance
  - AXA Sun Life Direct Limited
  - AXA UK Wealth's Pension & Protection business (now Phoenix Wealth) incl. Winterthur Life UK Holdings
- Prudential:
  - Prudential Assurance Company Limited
- RL360:[37]
  - Friends Provident
- ReAssure:[38]
  - Aegon
  - Aetna
  - Alico
  - Barclays Life
  - Combined Life
  - Continental Life
  - Crown Life
  - GAN

36 For the Phoenix timeline, which gives the full breakdown of acquisitions see: http://www.thephoenixgroup.com/~/media/Files/P/Phoenix-Group-v3/documents/about-us/phoenix-family-tree-30December-2016.pdf

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

38 https://www.reassure.co.uk/customers/pages/welcome

- Gresham
- Grosvenor
- Guardian Financial Services (latest acquisition – see below)
- HSBC Life (UK) Limited
- Lifetime
- National Mutual (Tomorrow)
- New Zealand Life
- NM Pensions Tomorrow
- Reassure UK
- Tyndall Life
- UK Life
- Windsor Life

- Royal London Group:[39]
  - Co-Operative Insurance Company
  - Scottish Life
  - Royal London Plus
  - Royal London (CIS) Limited

- Scottish Friendly Assurance:
  - Marine & General Assurance

- Scottish Widows: Part of the Lloyds Banking Group:[40]
  - Halifax Financial Services[41]
  - Clerical Medical Investment Group[42]

- Standard Life:
  - Annuities Heritage business

- Sun Life Financial of Canada:
  - Sun Life Assurance Company of Canada (UK)

- Wesleyan Assurance Society

- Zurich Insurance:[43]
  - Zurich Assurance Limited
  - Allied Dunbar
  - Eagle Star

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

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

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

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

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

Acknowledgements

In addition to a number of commentators who gave their time to this report anonymously, we would like to formally thank the following organisations for their contributions.

Aon Hewitt

Association of British Insurers

Barnett Waddingham

Capital Cranfield

Deloitte

Hargreaves Lansdown

Ignition House

Just

The Lang Cat

Legal & General

Leeds Business School

OECD

Pension Advisory Service

Pension and Lifetime Savings Association

Pension Protection Fund

Phoenix Group

Reform

Standard Life

Sponsor statement

Over the last few years the UK's life and pensions industry has been undergoing a period of unprecedented change, driven by new policy and regulation as well as shifting demographics. These changes present both opportunities and challenges and, to get a view of what the market of the future would look like, in 2015 we commissioned a report, *The Meaning of Life*.

That report foresaw instability in the industry, with a number of exits from the small and medium-sized mastertrust market, and that by 2020 fewer than ten organisations, including life insurers, would be in the "premier league" of auto-enrolment scheme providers. The report predicted that this premier league would control 90% of total assets under management.

In the two years since this report, we have seen the UK voting to exit the EU, increased pension freedoms and the implementation of Solvency II. Given this constantly shifting landscape, we commissioned this second report, *The Meaning of Life 2* to provide an independent view on whether the predictions are indeed playing out and what other factors might impact the industry and our customers.

The Meaning of Life 2 shows that in just two years, we have seen further consolidation, particularly amongst companies with overseas parents. This consolidation and divergence in the market is having a major impact upon the future health of the retirement income market. From a consumer point of view the range of retirement products available has shrunk, whilst freedom and choice has made the retirement income environment more complex for consumers. However, the majority do not seek advice and this is expected to result in sub-optimal decisions which will ultimately be detrimental to consumers.

This pace of change is unlikely to abate, with the continued pressure from government and regulators, as well as the yet unknown impact of Brexit. What is clear is that the life sector will continue to evolve to react to these challenges, but for that evolution to be successful, clarity of understanding of market conditions, regulatory risk and government policy together with a clear vision for the future is essential.

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

I would like to thank the author Pádraig Floyd and researcher Rajiv Jaitly, as well as Dr David Blake from the Pensions Institute for the commitment they have made to the development of this report, along with the contributions from organisations and individual experts.

We look forward to hearing your views and to being able to debate them with you.

Clive Bannister
Phoenix Group Chief Executive

Pensions Institute

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