

# Article

## A broad brush approach

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On the 10 March 2010 the Financial Services Authority (FSA) published its Financial Risk Outlook (FRO) outlining the main risks and issues affecting firms, markets and consumers.

The FSA highlighted some of the topical risks and issues that they believe must be considered by firms and consumers for investment and decumulation products. One area of concern highlighted is the increasing demand for products which allow decumulation of capital. The concern seems to stem from research suggesting that this is an area where consumer financial capability is low.

Interestingly, the FSA makes the rather bold statement that an annuity will be the most appropriate option for many consumers. The argument presented is that people approaching retirement may be more susceptible to sales of Unsecured Pension (USP) because annuity rates are lower and could generate an income below consumers' expectations. The FSA believe that these factors create the conditions for potential mis-selling of products which generate higher fees or commissions than annuities, even when annuities would be more appropriate for consumers.

To summarise, the FSA outlined the key messages for firms and consumers.

### Key messages for firms

- Firms should recognise that consumers' investment needs and attitudes to risk may have changed given the economic climate. Firms need to satisfy themselves that their systems for assessing consumers' attitudes to risk are fit for purpose given these likely changes in risk appetite. Firms should also ensure that their assessment of the appropriate target market for new and existing products is updated.
- Both providers and distributors of products need to provide clear and transparent information to consumers regarding the extent of capital protection, circumstances in which it would not apply and the cost of the product. They should also make it clear what protection the product offers under the Financial Services Compensation Scheme (FSCS).
- Firms providing income drawdown, or advising on it, should bear in mind that this product is unlikely to be appropriate for consumers with pension pots under £100,000.

### Key messages for consumers

- Consumers should check that they understand the risks to their investments as well as the potential benefits, particularly if they feel that their desire to take risks with their money has changed.
- Consumers approaching retirement should be aware that if their pension pot is under £100,000, income drawdown is unlikely to be the most appropriate option. Consumers who do purchase income drawdown products need to ensure that their financial position is reviewed regularly.

### Regulatory Pressure

For advisers, the regulatory guidance for USP goes back many years and was outlined in PIA Updates 55 (August 1998) and 67 (June 1999). PIA Update 67 summarised the outcome of themed visits to determine how income withdrawal was being sold. To quote the update, the findings did not conclude that there was a systematic failure to give suitable advice. However, due to poor record keeping no definite conclusions could be reached on whether or not:

- firms were providing an adequate explanation to investors of the inherent risks of opting for income withdrawal rather than a guaranteed annuity or the other options available.
- the advice given by firms on pension fund withdrawal business complied with the standards set out in the PIA's Rules.
- those advising on pension fund withdrawals had sufficient awareness and understanding of this type of business to ensure that suitable advice was given.

In terms of risks to the investor, it was concluded that the risks of this environment were often described in a superficial manner and in terms that the investor would not have been likely to understand. The risk warnings that need to be

included in suitability reports have been identified and highlighted many times over recent years:

- High Income Withdrawals may not be sustainable during the deferral period.
- Taking income withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is taken. This could result in a lower income when the annuity is eventually purchased.
- The investment returns achieved may be less than those shown in the illustrations.
- Annuity rates may be at a worse level when the annuity purchase takes place.

It is a little worrying that little has been said about the risks involved in the annuity purchase decision. It is true that an annuity will be appropriate for many pension investors but it is not without risk. Growth in the USP market has been fuelled by the many investors who do not like the thought of risking all of their capital with a single decision. In the past many annuities have been bought on a non escalating basis which introduces inflation risk. The underlying annuity rates available can vary significantly over any given year. Pressure on capital within a business can affect pricing policy. Also, changes in demographics and gilt rates will affect the rates available. There are a wide variety of annuity products now available. When reading the FSA report, I can't help but think that it is dangerous to make broad brush generalisations when referring to issues of client suitability.

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Please note this document is intended for trade and national press individuals.

#### Notes for Editors

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