ANNUITISATION PROCESS AND CONSUMER DETRIMENT

AN INITIAL INVESTIGATION OF ISSUES

Final Paper

Financial Services Consumer Panel

Jackie Wells & Mary Gostelow

August 2010

Foreword from the chairman of the Financial Services Consumer Panel

Annuities play a central role in securing income for many people in later life. Moreover, the trend away from defined benefit occupational pensions means that more people will need to buy annuities in the future. In May 2009, the Consumer Panel commissioned an independent consultant, Jackie Wells, to conduct further research into annuities in late Spring 2010, following up on the research she had done for the Panel in 2009 (http://www.fs-cp.org.uk/publications/pdf/fscp_laterlife0609.pdf). The core objective of the research was to review the process of annuitisation and to recommend a small set of implementable solutions which would address issues of consumer detriment. The recommendations would be supported by an initial analysis of consumer detriment arising from the current annuitisation process and international comparisons and subsequently by a programme of original research.

This presentation was made to the Panel in August 2010 and represents the initial phase of work to identify and quantify consumer detriment in the pension annuity market. The presentation was prepared at a time when the Government initiated consultation on the requirement to buy an annuity or alternatively secured pension at age 75.

The Panel decided not to proceed at present with the second stage, having regard to the findings reported here, the Government's review of annuitisation and the pressure of business arising from the Government's proposals for regulatory reform. Nevertheless, the Panel is satisfied that the attached represents a broad summary of the current annuities market and many of the areas of detriment that exist. The Panel will consequently be using this research in its discussions of the annuities market with key stakeholders. The Panel would like to thank Jackie and Mary for their work in producing this piece.

The presentation highlights some key conclusions about the nature and scale of consumer detriment relating to annuities . Of particular interest to the Panel are what the presentation says about the Open Market Option (OMO) and the value for money associated with annuities. The estimates indicate that there is significant detriment associated with the lack of shopping around which is seen as too complex by many (30% of annuitants do not use the OMO or shop around at all), particularly those with smaller funds. Research suggests that one in five may not get the best annuity rate, with average detriment of £200pa in reduced income.

Perhaps of greater significance is the failure to get what might be the most appropriate type of annuity. The point is made in the presentation that the perceived poor value of annuities may lead to poor choices. Failure to get the right product for the individual consumer's circumstances would seem to be a difficult barrier to overcome. While advice services such as CFEB and TPAS work hard to educate, the innate complexity of annuities – issues such as longevity and inflation can be difficult for consumers to comprehend – means that finding ways of better informing consumers needs to be a priority for Government and regulators alike.

The conclusion that the Panel draws from the presentation is that the biggest issue to consider is not the decumulation phase but instead the process of accumulation. Small pension pots leave consumers with little choice at the point of annuitisation – the fixed cost of providing annuities for small pots and the rules on triviality mean that the current situation is problematic. Unless ways are found to stimulate more saving during working life then the switch from Defined Benefits to Defined Contributions pensions arrangements will result in increased numbers of retirees with small pots who will enjoy smaller rewards than in the past from their pension savings.

Adam Phillips

October 2010

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EXECUTIVE SUMMARY

Executive summary

Introduction

This paper was initially commissioned by the Financial Services Consumer Panel (FSCP) to identify ways in which the annuity (or retirement income) process could be improved to address consumer detriment and improve consumer outcomes. This paper represents the first phase of work to map the market and to identify and quantify consumer detriment.

This paper draws on a wide range of secondary resources, initial informal discussions with the ABI, a limited number of industry participants and a meeting with Oxford Economics. The UK annuity market is analysed and comparisons are made with five selected international countries. Consumer detriment is defined and the value of detriment is quantified where possible.

Annuity market map

Consumers continue to have a poor understanding of annuities and of the risks associated with different types of retirement income products. This may lead to poor consumer choices.

Based on number of members of DC schemes and personal pensions, the market for annuities should grow substantially in 10 - 15 years but will depend upon the numbers choosing annuities over other retirement income products. Average pension pot sizes will increase which could reduce detriment as more see the value of shopping around and more consumers are attractive to intermediaries. However, without an improvement in consumer understanding or engagement, the scale of detriment also rise.

Industry research indicates that consumer awareness of annuitisation and the need to shop around is improving but around one third still do not engage with the process and may be put off by the perceived complexity and limited benefits of the process. The majority of annuitants do seek formal advice but the cost and complexity of advice precludes those with small pots. This problem is likely to increase once the Retail Distribution Review (RDR) is implemented, particularly if, as expected, the number of advisers falls and the cost of advice becomes more transparent to consumers and/or the cost of advice rises.

There is evidence of innovation in the annuity market with new products developed to address consumer concerns, more widely available generic information and the emergence of portals for financial advisers. However, consumer access to online quotation and comparative websites for annuity quotes is still limited.

Executive summary

International comparisons (Australia, Chile, Singapore, Sweden and USA)

Approaches to providing for retirement income range from compulsory annuitisation (e.g. Chile) through qualified annuitisation (e.g. UK) to voluntary annuitisation (e.g. USA). However, in countries where voluntary annuitisation exists, Governments are increasingly concerned about an individual's ability to secure a lifetime retirement income as evidenced by recent consultations and reviews in the USA and Australia and by changes made in Chile and Singapore to make annuitisation more attractive.

Where annuity markets exist, they tend to be concentrated with individuals having a limited choice of annuity provider. However, no evidence was found to indicate that this contributes to consumer detriment internationally. Like the UK, where annuities are purchased, consumers tend to favour immediate annuities with level payments.

Consumer detriment

Consumer detriment is not always easy to measure but can arise where: the market is inefficient; poor advice prevails; consumers do not get the best rates or fail to get the right product; the pension provider fails to transfer funds in a timely manner; where consumers are left with an inability to access their funds due to regulatory restrictions. Our analysis suggests that:

- While there is no current evidence of oligopolistic powers, the annuity market is consolidating and there is a need to review whether this remains the case. There remain some market concerns about providers taking advantage of weak consumer power by not providing competitive internal rates, no published data was found to substantiate or quantify claims. Those with small stranded pension pots continue to suffer loss as a result of market inefficiencies.
- Whilst FOS cases of poor advice on decumulation produces have risen in recent years, the numbers remain very low.
- Approximately one in five annuity buyers fail to get the best annuity rate. On average these individuals suffer detriment to the value of around £200pa (in reduced income). Over a typical lifetime, an annuitant might have gained an additional £3000 from shopping around for a better rate. Estimates suggest that detriment can be valued at between £8 million to £17 million per year (as modelled in this paper) or £280 million over the lifetime of the annual cohort of annuitants.
- Individuals sometimes fail to get **the right product** for their circumstances. However, we have not been able to quantify the scale of detriment since the decision is strongly influenced by personal circumstances and preferences. Research suggests that around one quarter of annuitants do not appear to make an informed choice and may be subject to detriment as a result.

Executive summary

Conclusions, barriers and solutions

Based on the findings of this initial investigation, this paper concludes that the following issues prevent consumers in achieving better outcomes:

- Shopping around is seen to be complex, costly and of little benefit to those with smaller funds and results in reduced income in retirement;
- Market consolidation is limiting choice of annuity provider and may lead to imbalance in provider power and further consumer detriment;
- Lack of consumer understanding of products and risks (longevity, inflation, etc) could lead to uninformed choices and decisions;
- Small pots / stranded pots leave consumers with little choice;
- Perceived poor value of annuities may be leading to poor choices / may lead to poor choices in future as choice of alternatives widens.

An initial analysis of the barriers and potential solutions to these issues is presented in the table overleaf. The solutions have not been analysed for the effect that they have on detriment or the costs of implementation. This was to have been the second phase of the project but, in response to the Government's current consultation on the requirement to annuitise by age 75 (ends September 2010) and revised FSCP priorities, this initial analysis of the annuitisation process will not be developed further at this time.

Dependent on the changes that the Government makes following its consultation, this initial analysis of the barriers and potential solutions for the annuitisation process will provide a framework for the future, to develop more detailed solutions that can be discussed, challenged and evaluated with key market stakeholders.

Executive summary

Barriers and solutions to the annuitisation process – initial analysis

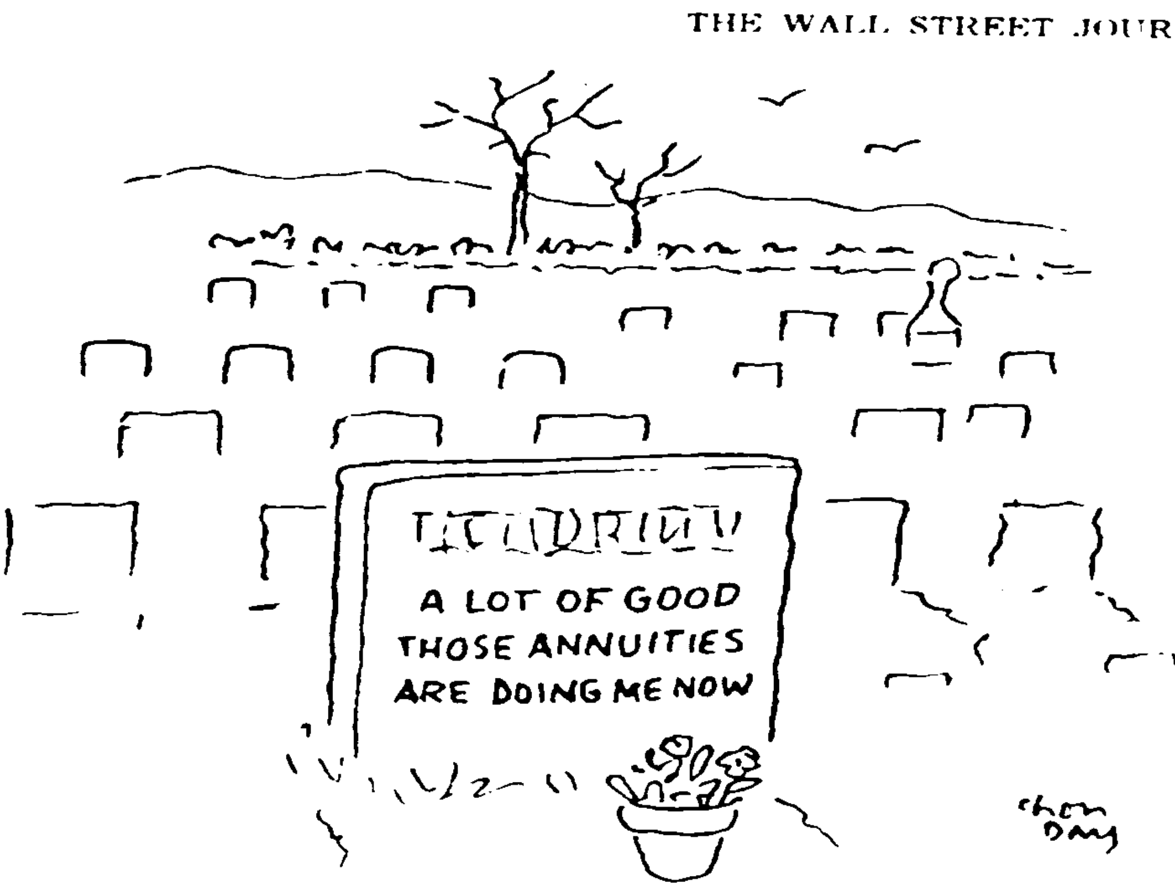
Problems	Barriers	Potential solutions
• Shopping around seen to be complex, costly and of little benefit to those with smaller funds and results in reduced income in retirement.	• Consumer understanding of benefits • Full advice process is highly regulated and costly; • Supply of advisers limited; • Benefits not fully highlighted.	• Consumer portals / comparisons; • Simplified advice process; • Increase trivial commutation; • Specialised advisers; • Scenarios highlighting impact over lifetime • Mandate advice (and fund it).
• Market consolidation is limiting choice of annuity provider and may lead to imbalance in provider power and further consumer detriment.	• Solvency requirements; • Low return on capital in UK life market; • Low margins on many UK products (in part due to regulatory interventions); • Higher margins on alternatives to annuities.	• Ensure Solvency II does not make UK even less attractive a base for life companies; • Remove barriers to selling higher margin products; • Increase competition on higher margin products or regulate charges.
• Lack of consumer understanding of products and risks (longevity, inflation etc) could lead to uninformed choices and decisions.	• Inherent complexity; • Lack of consumer oriented information.	• Remove choice from the consumer / impose solutions; • Consumer education; • Mandate advice (and fund it); • Use scenarios to educate.
• Small pots / Stranded pots leave consumers with little choice.	• Fixed costs of providing annuities to small pots; • Trivial commutation rules.	• Change rules; • Improve communication; • Mandate provision for small pots; • Reduce costs for providers; • Increase trivial commutation.
• Perceived poor value of annuities may be leading to poor choices / may lead to poor choices in future as choice of alternatives widens.	• Gap between perception and reality; • Lack of consumer and media understanding; • Poor risk profiling by providers / advisers.	• Tracking of value of annuities; • Improve consumer communication; • Clear and accurate comparisons of alternatives; • Mandate advice; • Improve quality of advice.

INTRODUCTION

Introduction

- This paper presents the findings from an initial investigation of issues relating to the annuitisation process and consumer detriment for the Financial Services Consumer Panel. Work was conducted in response to the Panel's brief for a review of the annuitisation process to identify ways in which the process could be improved for consumers.
- The findings and conclusions are based on extensive desk research, initial informal discussions with the ABI and a limited number of industry participants and a meeting with Oxford Economics (who modelled the impact of improved shopping around for the Pension Income Choice Association).
- The original objectives of the project were to:
  - Recommend a small set of implementable (but potentially radical) solutions for the panel to take forward with the FSA, industry, Government and/or other regulators, supported by a robust analysis of:
    - The consumer detriment arising from the current annuitisation process;
    - The strengths and weaknesses of initiatives recently implemented in the UK, those currently being debated in the UK or those implemented in other countries;
    - A range of solutions for addressing consumer detriment which are defined and then tested with a range of industry participants;
    - The impact of the solutions tested on consumers, industry, regulators and government.
- This paper addresses the first two of these points and includes an initial analysis of the barriers and potential solutions to the issues identified.
- Since the commencement of this project the government announced and is currently conducting a consultation on the requirement to annuitise by age 75 (ends September 2010) . This, coupled with the FSCP's revised priorities, means that this initial analysis of the annuitisation process will not be developed further at this time.

MYTHS AND LEGENDS


THE WALL STREET JOURNAL
A LOT OF GOOD
THOSE ANNUITIES
ARE DOING ME NOW

Myths and legends

- *"Annuities would be better value if they paid your estate back the unused value on your death"*
  - If insurance companies paid back the 'unused' funds annuity rates would be much lower for those choosing this option and risk sharing could be reduced (there could be more selection against the insurance company). Should these products prove successful (which is perhaps questionable given the current apparent preference for maximising income today), cross-subsidies in the annuity market could be reduced. This combined with increasing selection against the insurance company would lead to reduced annuity rates for all.
- *"Insurance companies profit from those customers who die early"*
  - Annuities are priced assuming average mortality with a distribution of longevity around the average. So, if some people die early their 'unused' funds contribute towards the annuity of those who die later. Only if an unexpectedly high proportion of annuitants die earlier than expected do insurers 'profit' from early death. If longevity trends started to reverse, this could, in theory, happen if the market ceased to be competitive.
- *"Falling annuity rates mean people are getting poor value"*
  - Rates fall for two main reasons: people are living longer which means that the money has to stretch for longer; the rates of return on the assets backing annuities are falling (and look likely to stay low). Various reports suggest that annuity prices accurately track bond yields (and deliver better value than investing in those assets directly – Watson report).
- *"People would get more money overall if they purchased an inflation-linked annuity"*
  - This only holds true if inflation-linked annuities are well-priced and people live long enough. However, research suggests that insurers find them difficult to match with equivalent assets and that, on a measure of Money's Worth*, they offer poorer value for money than level annuities or fixed rate increasing annuities.
- *"Everyone would be better off being able to control their own money in retirement"*
  - Without annuities, people would have no means of insuring against living too long. Some would therefore run out of money, particularly if markets turned against them or if they live a long time (Corrigan & Matterson, 2010).
- *"If people understood the impact of inflation, they would choose an inflation-linked annuity"*
  - Some might well do so but research suggests that most people when faced with a choice of more money today or more money tomorrow, choose the former.

Quotes are summaries of views expressed in various media articles. Analysis is authors own.

* Money's Worth is a measure of value for money used in the DWP assessment of the annuity market conducted by Cannon & Tonks (2009)

Myths and legends - alternatives to annuities

- **Retirement income decisions always involve trade-off: income today v income tomorrow, income v bequest, certainty v potential for growth, having enough income today v protecting family. Decisions on which route to adopt are fraught with complexity, present different risks and opportunities, are limited to the majority of retirees who have less than £100,000, and are often based on very personal preferences or circumstances.**
- All retirement income products expose the customer to risk. There are essentially three different groups of retirement income product (but with considerable variation within the groups). A simplistic comparison of products available to age 75 reveals that:
  - **Lifetime annuities** expose customers to risk of not maximising the value of their pension and to the potential to far exceed the value of their pension. If they die young, they don't get their full value back. If they live a long time, they get better value. The same is true of DB pensions and state pensions. DB pensions, state pensions and annuities all have the same inherent cross-subsidy and largely remove the risk of living too long and investment risk but do not provide for bequests (unless a guaranteed period has been selected on an annuity and/or spouses pension is available).
  - **Fixed term annuities / variable annuities / investment linked annuities** typically provide flexibility and varied degrees of exposure to investment growth / loss and to changes in future annuity rates and provide for the potential of leaving a bequest (which will all be taxed). At the time of purchase, many of these products will provide a lower starting income than a lifetime annuity. By the time the individual comes to purchase a lifetime annuity, rates may have moved against or for the individual. The retiree may have a greater prospect of getting enhanced annuity rates by that time but rates may also have moved against the individual. Although these products may typically guarantee a maturity value, that maturity value may not buy the same level of income at the end of the fixed term (so income in later retirement may be lower in real or even nominal terms). Most of these products have a reduced element of cross-subsidy which means that the individual is bearing more of the risk of living too long in the form of a reduced income / higher charges. Buyers of these products may require more costly advice than lifetime annuitants and they are only likely to be suitable for those with significant funds. (Some websites that promote fixed term / variable annuities still do not highlight the risks to which consumers are exposed – others have improved since the Later Life Scoping Project report, June 2009.)

Myths and legends - alternatives to annuities

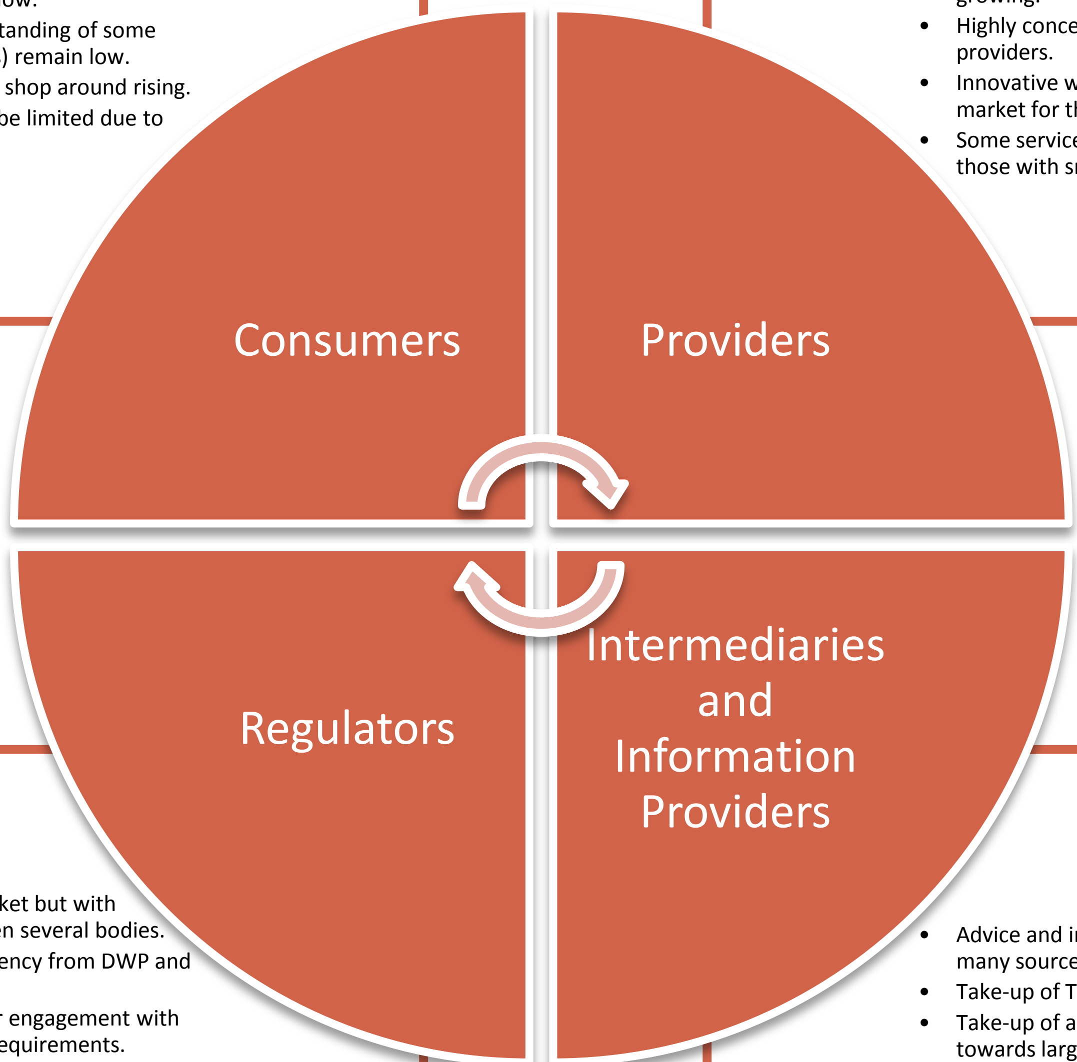
- **Income drawdown** (or just managing your retirement investments yourself) satisfies the bequest motive (unless funds run out) and expose customers to investment risk which can have either a positive or negative impact compared to a lifetime annuity. Corrigan & Matterson modelling (2010) suggests that at a lower level of annual income (£5,500 compared to £7,700) from income drawdown, retirees have a 50% chance of running out of money in year 26 of retirement (age 86 if retire at age 60) and have a 10% chance of running out in year 15 (age 75 if retire at age 60) but a 10% chance of running out in year 51 (age 111 if retire at 60). Only suitable for those with significant funds. Buyers of these products may require more costly advice than lifetime annuitants.
- Since completing the central research for this project, HM Treasury has announced a review of the requirement to annuitise at age 75. One of the consequences of this change could be increased complexity for retirees in the UK.

ANNUITY MARKET MAP

Annuity market map – summary of UK market

- Growing number of annuitants.
- Average funds remain low.
- Awareness and understanding of some issues (choice and risks) remain low.
- Awareness of ability to shop around rising.
- For many, choices will be limited due to small fund sizes.

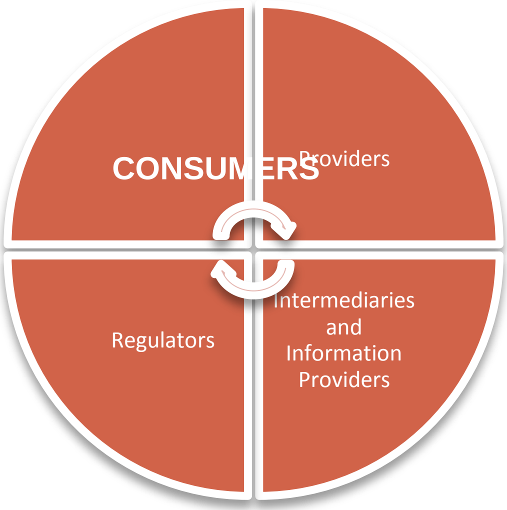
- Largest annuity market in world and growing.
- Highly concentrated among few providers.
- Innovative within highly regulated market for those with larger pots.
- Some service innovation evident for those with smaller pots.



- A highly regulated market but with regulation split between several bodies.
- Focus on market efficiency from DWP and HMT.
- FSA focus on consumer engagement with process and solvency requirements.
- Many influencers are shaping regulation of market.

- Advice and information available from many sources.
- Take-up of TPAS information growing.
- Take-up of advice high but skewed towards larger pots.
- Cost of advice reduces advice availability for those with small pots.

Annuity market map - consumers



- Approximately 500,000 converting pension accumulation to decumulation products each year (based on ABI new business data).
- Some may have already converted some funds earlier, some may be annuitising following a period of income drawdown.
- Based on TPR research (2009) we estimate that 92% of annuitants are from contract based schemes (8% from trust based). Actions of ABI members are therefore critical to consumer outcomes.
- Most people take out an annuity between the ages of 59 – 62 years and so will not typically have access to their state pension (ABI 2002). Women are more likely than men to take annuities earlier. Less than 5% of retirees wait until their 70s to take income with two clear ‘spikes’ at age 60 and 65 years.
- However, growing signs that more people working later in life and more people expecting to work later (ONS,2009, Aegon 2008).
- Aviva research (2010) shows that average retiree’s pension pot is £27207 with each person taking an average lump sum of 15% (£4,338). The average value of men’s pension pots is £29,600 and women’s is £21,825 (26% lower).
- People worry most about running out of money in retirement and then about ending up relying on the state (Aegon). Not being able to pass on money to family much lower down the list of concerns.

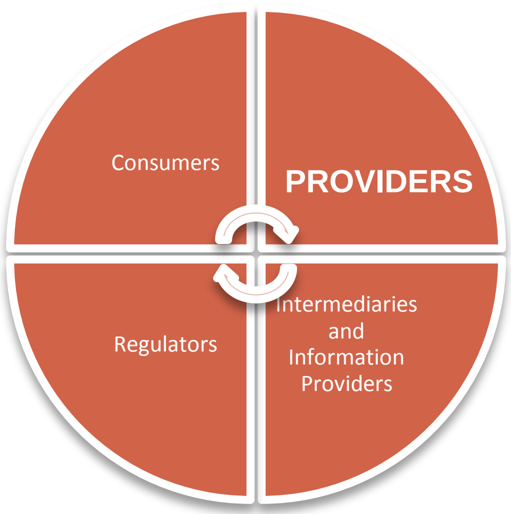
Attitudes to annuities

- General media attitude is that annuities are a “bad deal” (reflected in some attitudes of some consumers) due to perceived:
  - Lack of flexibility (once and for all decision);
  - Poor value for money (insurance company profits);
  - Inability/restrictions on bequests .
- 42% of older consumers (Aviva) have no idea what an annuity is and lack understanding of how it operates as an income generator. Some evidence of increased awareness / understanding (authors comparison of research studies 2002 – 2009).
- OECD research (Brown 2009) concludes that consumer dislike of annuities arises because they are “ill-informed, financially unsophisticated”.

Buying behaviour

- ABI research (2008) found that 85% of customers purchase a single life level annuity at a rate of at least 95% of the highest external rate (may be partly due to low pension pot):
  - About 40% exercise their OMO and switch (rising);
  - Among remainder approx half shop around but do not switch;
  - Limited ability to shop around if pension pot small (<£10k).
- AEGON research (2009) and DWP (2008) found consumers apparently lacked awareness of alternatives to annuities.
- Barriers to shopping around include perception that switching will be complex and time-consuming (DWP).
- However, FSA CPOS research suggests 80% get advice on decumulation products (72% IFF Research for ABI).

Annuity market map - providers



- UK annuity market largest in world and growing – competes with drawdown market which includes fund management industry.
- Estimated annuity market value of £11bn (ABI new business), of which:
  - Value of variable annuity sales in 2009, £1.1bn;
  - Enhanced annuity sales in 2008, £1.4bn;
  - Almost 30% of annuity sales less than £10k.
- High market concentration – top 10 firms represent 90% market share. However, Cannon & Tonks (2009) found no evidence of monopoly power when reviewing the market.
- Fewer than 20 firms are writing new business:
  - Majority of firms only provide annuities to existing customers (AgeUK estimate two thirds);
  - Standard Life and Legal &General (L&G) will provide OMO of £10k but others have higher limits;
  - Increasing number of smaller pension providers now thought to be 'white labelling annuity business through major annuity providers. Some moving to a panel approach (eg Aviva).

Key players

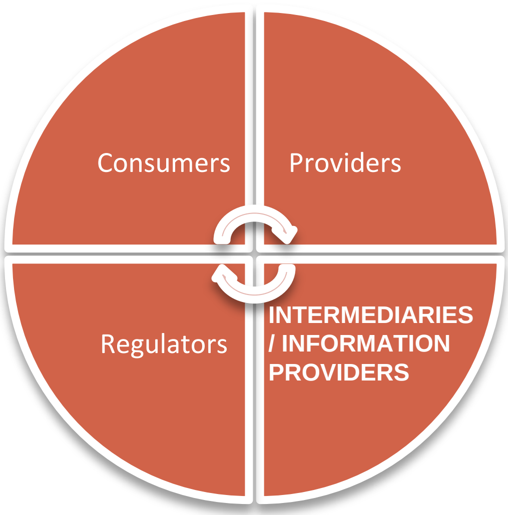
- Limited number of major players: Aviva, Aegon, Canada Life, L&G, Prudential (estimated 21% market share) consistently in top five;
  - Axa, Friends Provident, Scottish Widows, Standard Life; less competitive;
  - Not all providers appear on FSA comparison site.
- 6 main players in enhanced annuity market including MGM Advantage and Partnership (latter has developed a portal for small funds). LV= - 2nd largest enhanced annuity provider. Just Retirement - year on year enhanced sales £238.6m end Mar 2010, 87% increase on year (£587.9m end Mar 2010, 47% increase over previous year, all annuity sales).
- Minor players characterised by more specialist offerings e.g. enhanced annuities or specific target markets e.g. farmers, construction industry.
- Signs of further consolidation of industry with several annuity players named as take-over prospects.
- Market large enough for presence of annuity administrators such as Xaffinity.

Developments

- Market has innovated through development of alternative annuity products but has been constrained by a highly regulated environment:
  - Development of investment linked annuities;
  - Variable annuities / fixed term annuities present new opportunities and risks;
  - Drawdown a relatively young market with much lesser concentration of players.
- Providers have sought to address consumer issues in response to government, regulatory and consumer body pressures:
- Speed of annuitisation through Options programme (Origo system);
- Information provided near retirement and encouragement to shop around (best practice guides).
- Solvency II requirements impact remains uncertain but could cause further downward movement in annuity prices.

Analysis of providers drawn from variety of media articles and reports

Annuity market map – intermediaries and information providers



- IFAs dominate sales of OMO annuities though direct sales are growing slowly and majority still purchased from pension provider (ABI).
- 95% of enhanced annuity sales are reported to be through IFAs (Trott 2009).
- Range of online annuity brokers and comparison sites, such as Annuity Direct now available.
- Only 11% of IFAs have CII J05 qualification to sell / give advice on annuity/ retirement income decisions (Snapshot survey)
- IFAs tend to be wary of alternatives to standard annuities (Datamonitor 2009).
- New portals emerging which provide access for IFAs to give annuity rates for smaller pots.
- Age UK plans to enter market to support those with small pots (press release).
- FSA comparison website still excludes several mainstream providers.

Access to information

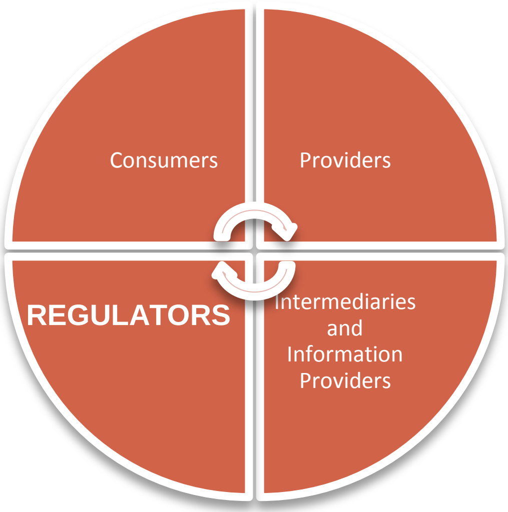
- Among consumers there is a general lack of awareness of where to obtain financial advice on retirement income:
  - Most people will still look to IFA for advice, even if not confident that advice is independent;
  - Company information is cited as another useful source.
- TPAS has an online planner to help people choose the right annuity and reports significant increase in usage in 2010.
- Consumers may access a number of online quotation and comparative websites for annuity rates but these have limitations:
  - No consumer portals currently available that enable full comparisons or trade-off analysis;
  - Not all systems list all providers;
  - Few enable generic quotes without inputting personal details;
  - Typical rather than specialist rates may only be shown.

Selling annuities

- Typical IFA commission for selling annuities is 1% - 3% (Aegon).
- Variable annuity commission typically higher and drawdown can be higher still.
- Costs of giving advice on annuities typically exceed the commission available from the many small pots. Many intermediaries reported not interested unless pot exceeds £30,000 which will generate £300 or more.
- Aegon estimate average cost of £733 (but advice skewed to those with more complex arrangements). Implies that pots below £73,300 not profitable for IFAs. Recent blogs suggest figures of between £500 - £800.
- Growth of brokerage services such as Annuity Clearing House provide IFAs with more cost efficient method of annuity selection.

Analysis drawn from variety of media articles web sites and reports

Annuity market map - regulators



FSA (Financial Services Authority)

- Independent body responsible for regulating the financial services industry in the UK. Regulates marketing, sales and advice, prudential regulation of annuity providers and consumer education.
- Focus of regulatory concerns and developments relating to annuities has included:
    - The implementation of OMO among providers (clarity of communication);
    - Disclosure as part of annuity process;
    - Rules for advice and supervision of advice firms;
    - Tracking consumer awareness of and engagement with OMO;
    - Tracking provider and adviser activity in alternative markets (drawdown, variable annuities);
    - Promoting increased consumer awareness of options at retirement and provision of guidance;
    - Setting rules and supervision of solvency requirements (ICA and Solvency II).

Government

- HMT concerned with efficiency of OMO process and annuity choices. Works closely with HMRC on taxation aspects of product legislation.
- HMRC regulate the types of pension annuity and alternatives available in the UK and currently reviewing issue of stranded pots (see details later in pack).
- DWP focus on pensioner income and product regulation in pensions market and supports TPAS (The Pensions Advisory Service). Has focused on money's worth of annuities.

TPR (The Pensions Regulator)

- Risk based regulator established in 2005 to regulate private sector work-based pension schemes. Regulates some of the schemes that provide funds for annuities.
- Wide range of regulatory powers including imposition of penalties for non-compliance.
- Sets same requirements for OMO as contract based providers but some occupational schemes may choose the annuity provider for the scheme member.

INTERNATIONAL COMPARISONS

International comparisons - summary

- Worldwide, approaches to providing for retirement income vary. Some countries have compulsory annuitisation (Chile, Sweden, UK (qualified) and from 2013, Singapore), while others ,such as Australia and USA do not.
- Given consumer dislike of annuities, unsurprisingly, levels of annuitisation are highest where there is an element of compulsion (Chile, UK).
- Though various types of annuities are available, consumers tend to favour immediate annuities with level payments. The exception is Chile, where only inflation linked annuities are available.
- Lump sums are generally available but with restrictions (heavy restrictions in Chile and Singapore). In the US, this is the only available option for some 401(k) and DC plans.
- Annuity markets tend to be concentrated. No evidence was found to indicate that this contributed to consumer detriment. Other than Chile and UK, individuals have limited choice of annuity provider. In both countries, financial advisers are a main source of information and purchase. Chile's mandatory quotation system (SCOMP) has not completely removed the need for advice.
- Increasing government concerns about the individual's ability to provide a lifetime retirement income evident. Available information indicates that average pension pots are not high. Support for change can be seen in some countries:
  - Recent changes have been made in Chile and Singapore to make annuitisation more attractive through the use of a combination of immediate and deferred annuities which go some way to alleviate an individual's concerns about the ability to leave bequests;
  - Henry Review of Australia's Tax System (May 2010) highlighted the lack of life annuity products and the need for government support to develop these. The Review Panel was "not convinced that the purchase of such products should be made compulsory" at this time;
  - USA's Labour and Treasury departments have finished consulting (3 May 2010) on what, if any rules and regulation changes are required. Awaiting further analysis and output.

International comparisons

	Australia	Chile	Singapore	Sweden	UK	USA
Compulsory annuitisation	• No.	• Yes.	• No, but from 2013 will be compulsory.	• Yes.	• Qualified compulsion.	• No.
Level of annuitisation	• Low, estimate less than 10%.	• High, estimate around 70%.	• Low.	• Lifetime annuities low, estimate less than 30%.	• High.	• Low.
Annuity market concentration/ competition	• High level in immediate annuities market.	• Highly competitive. • In 2008, 18 life insurers offered annuities. Offers thin intermediation and relatively low returns on equity.	• No information readily available. • Private sector expected to contract with CPF responsible for annuity provision.	• High concentration - Market dominated by 7 of over 40 insurers.	• High market concentration.	• Limited competition.
Types of annuity available	• Various, but little demand for annuities with longevity insurance. • Term and allocated (up to 25 year term) annuities available.	• Since 2004, option of combination of a fixed real annuity (restrictions apply) and either a phased withdrawal or a temporary withdrawal phased with a deferred annuity. • Deferred annuities are usually for 1 year .	• Non-participating annuity – a nominal fixed amount each period or Participating annuity-includes a non-guaranteed bonus dependent on investment performance of insurer.	• Life annuities in occupational plans are either traditional 'guarantee and bonus' type or the unit linked accounts. In latter, investment and longevity risk remain with individual.	• Various - immediate most prevalent. Enhanced annuities increasing. Deferred , and impaired annuities also available. • Variable annuities impacted by market volatility .	• Various – immediate most prevalent. • Variable annuities increasingly popular. • Impaired life available but not widespread. • Fixed annuities are deferred annuities which may be taken as life annuity, term certain annuity or a lump sum.

International comparisons

	Australia	Chile	Singapore	Sweden	UK	USA
Lump sum available	• About 55% of pension savings taken as lump sum (2008).	• Lump sums allowed with restrictions. Few workers do this and sums are small.	• Lump sum only available to purchase life annuity.	• Lump sums not allowed.	• Up to 25% may be taken tax-free. • 15% lump sum taken on average (AEGON).	• Lump sum only option for 28% 401(k) plans and 30% of all DC plans.
Average pension pot	• Information not found.	• No data published on size of pension pot.	• Fund small as can be used to finance housing. • Fund minimum sum introduced - by age 55, S$94,600 in 2006 rising to S$120,000 in 2013.	• Information not found.	• Average retiree's pension pot is • £27, 207 (Aviva research, 2010).	• In 2007, $137,430 avg, $76,946 median in 401(k) balances among 401(k) participants.
OMO or equivalent	• Market too small.	• Mandatory use of quotation system encourages people to shop around.	• 9 providers available in 2007. • With CPF now responsible for provision of annuities, little choice expected in future	• Little individual choice of annuity provider. Often determined in the collective labour agreement	• Estimated two thirds shop around of which one third use OMO	• Within DC plan employer must select annuity provider
Comparison data easily available	• Market too small.	• Anonymous bids via SCOMP, an on-line offer and quotation system. Cost efficient, especially for small pots.	• Prices and structures of annuity products available on internet.	• Information not found.	• Prices available on internet but these are often standard rates. • Easy access to comparative data limited.	• Prices and structures of annuity products available on internet. Limited in how it deals with longevity risk.

International comparisons

	Australia	Chile	Singapore	Sweden	UK	USA
Use of intermediaries	• Market too small.	• Independent brokers account for 40% of sales. Agents and employees, 60%. • Commissions capped at 2.5%. • Advisers subject to strict eligibility criteria.	• Information not found.	• Available information indicates that customer deals direct with company.	• IFAs are the main source used for the purchase of annuities. Direct business is growing. • Typical commission is 1% to 1.5%. Usually higher for variable annuities.	• Insurance agents may be independent or work for a company. • Commission varies according to product sold. Can be as low as 1% but deferred annuities average 6%.
What happens with pension savings	• 42% taken as allocated annuities. 2% term annuities, 61 life annuities and 56% lump sum (2008).	• Over 70% annuitise. If not, a reserve must be set aside to fund pension annuity equal to at least 30% of programmed withdrawals until retiree is well into their 90s . In effect, the reserve finances a deferred lifetime annuity for individual.	• If annuity not purchased, minimum sum may be withdrawn for deposit at bank or left with CPF to earn nominal interest rate 4%. • Bank deposit or CPF funds at retirement pay monthly until funds are exhausted.	• In occupational plans, extensive use of 5 / 10 year annuities.	• Alternatives to annuitisation are income drawdown and ASP (Alternatively Secured Pension). This is often described as a more limited form of income drawdown.	• Most funds rolled over into IRA. 1995-2000, only 23% of DC participants with choice at retirement chose annuity.

International comparisons

	Australia	Chile	Singapore	Sweden	UK	USA
Recent changes/ Proposed changes	• Henry Review of Australia's Future Tax System (2010) highlighted the lack of life annuity products and the need for gov support to develop these. • Not convinced of the need for introduction of compulsory purchase of life annuity products.	• In 2008, conditions on taking a partial lump sum were tighten. This had the effect of substantially educing early retirement .and making annuities more attractive than phased withdrawals.	• Compulsory annuitisation from 2013 for those 35 yrs with S$44,000 or more pension account. Required to purchase term annuity starting at retirement age together with a deferred annuity that commences at end of term period. Pays out at same level. Limited flexibility but allows for retirement income and bequest.	• None found.	• Annuitisation by age 77 rather than 75 years. • Consultation on removing the requirement to annuitise by age 75 taking place. Ends Sep 2010.	• Labour and Treasury departments have finished consultation (May 2010) to determine whether, if and how rule or regulation changes should be made to facilitate access to, or use of arrangements to provide a lifetime stream of retirement income. • Awaiting further analysis and output.

CONSUMER DETRIMENT

Consumer detriment – summary

Market inefficiencies

- Market remains moderately concentrated but concern about oligopolistic power if consolidation and white-labelling continues.
- Inefficiencies caused by consumer inertia being reduced by emphasis on shopping around but concerns remain about those with smaller pots.

Poor advice

- Rise in FOS complaints on annuities / income drawdown but no data to scale detriment.

Getting the best rate:

- Research suggests that majority of annuitants are getting the best rate, either by switching, the trustees of their scheme selecting the best provider or from their existing provider. However, shopping around may be over-stated since it includes those buying from an occupational DC scheme. Minority likely to be getting the best rate by chance rather than by shopping around.
- Detriment exists where barriers exist for shopping around or switching when to do so would achieve a better rate (including an enhanced rate). Concentrated among those with smaller pots for whom advice may be inaccessible, unaffordable or intimidating.
- Estimates of detriment suggest that scale is in order of £8million - £17million per year, although some consumers may lose some of the uplift in state benefits which further reduces the detriment. Equates to approximately £200 per year per annuitant or a 3% uplift.

Getting the right product

- Decisions on single v joint life, fixed v increasing income and guaranteed periods are all strongly influenced by personal circumstances and preferences and cannot be generalised or quantified.
- All research suggests that consumers value more money today than more money tomorrow regardless of the risks and impact. May also suggest that, given advice and access to alternatives, they would continue to opt for annuities v alternatives.
- Around ¼ of annuitants do not appear to make an informed choice and may be suffering detriment as a result. It is not at all clear that, given information, they would change their behaviour but emphasis on showing the impact of decisions through scenarios remains important.

Stranded pots

- No data available to quantify this detriment but for an individual the loss of benefit triggered by the tax charge can be significant. HMRC review may reduce or remove detriment experienced.

Classification of consumer detriment - definition

Consumer detriment analysis has identified three categories (first of these explored in most detail but equivocal detriment also covered in passing):

- Unequivocal detriment exists (but not always easy to measure) where:
  - Market is inefficient and delivering poor value **– market inefficiencies;**
  - Individuals get **poor advice;**
  - Individual could benefit from better standard or enhanced rates on open market but not able to engage in process (due to lack of awareness or access to advice) – **getting the best rate**;
  - Individual failed to protect income (through joint life, not protecting against inflation) but would have done so if able to engage in process – **getting the right type of product**;
  - Time delays in transfers result in lost months income – **time delays;**
  - Individual unable to annuitise / commute due to small pots – **stranded pots.**

- Equivocal (and hard to measure) detriment where:
  - Could benefit from better rates - able but not willing to engage in process;
  - Could benefit from better rates but preference for status quo of current provider;
  - Failed to protect income but preference for more income today than protection;
  - Purchase an annuity but fail to understand full implications (eg loss of ability to bequeath).

- No detriment where:
  - Decision is fully informed (debatable whether decision has to be fully informed on both parts where in a couple);
  - Hindsight suggests that annuity was / was not the best option (eg decided to take drawdown but stock market crashes and run out of income or even where annuity rates improve after purchase);
  - Markets change leading to a change in rates for some cohorts of annuitants;
  - Perceived loss is due to fundamental nature of product (eg lack of transferability).

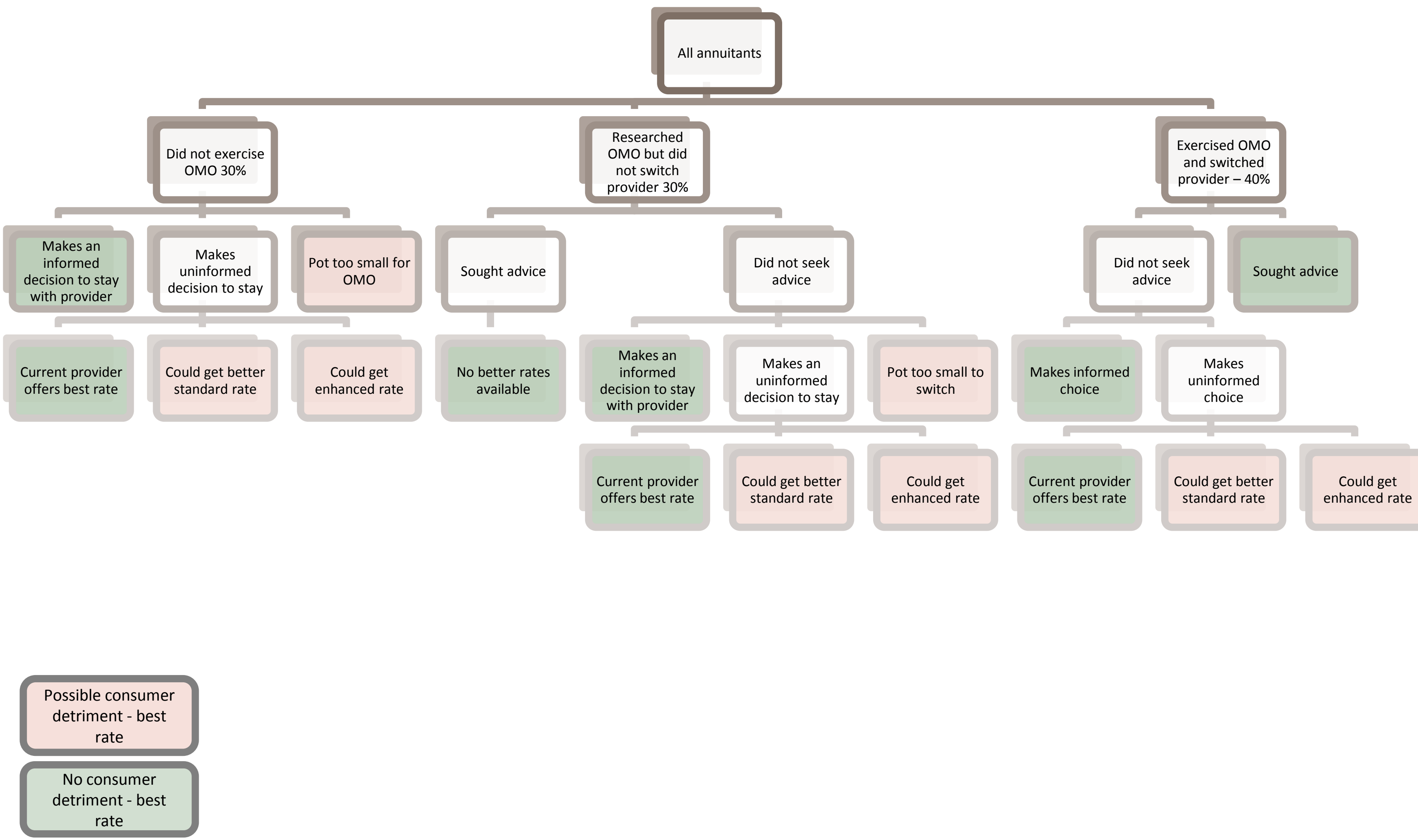
Market inefficiency

- Detriment can arise if the annuity market is not efficient and delivering 'money's worth' to the consumer. This could occur where:
  - Market consolidation presents players with oligopolistic powers, in which case all buyers could be affected (although oligopolies can also be fiercely competitive); or
  - Where providers (or some providers) do not price accurately for longevity (because of over-prudence in assumptions), in which case all buyers or some buyers could be affected; or
  - Where providers cannot match their liabilities with appropriate products, in which case all buyers could be affected; or
  - Where certain consumer segments do not shop around, in which case, some consumers may suffer; or
  - Where the market cannot deliver products at a profit for certain segments of the market, in which case, some consumers may suffer.
- **Oligopoly** - research conducted by DWP, FSA and ABI shows consistently that the annuity market is not sufficiently concentrated to give rise to concerns about oligopolistic powers and that annuity rates have broadly tracked the performance of their underlying assets (bond yields). However:
  - Much of the data is in need of updating; and
  - The trend in concentration is upwards as providers consolidate and others move out of the market
  - There is a case for regular monitoring.
- **Longevity –** industry mortality data is now collated and analysed centrally (by CMI), individual companies will take a view on their own position (which will be influenced by the markets in which they operate as well as their own view on mortality). DWP research suggests that money's worth could be affected by different assumptions but found no evidence that it had been (although data on mortality for annuitants remains imperfect).
- **Matching** - annuity rates respond to longevity and bond yields (when an insurer sells an annuity, it needs to buy bonds to secure the future payments to the annuitant). An increase in demand for bonds will reduce the yield (because the price that has to be paid for the bond rises). This in turn reduces income for new annuitants (but not existing ones) – this is said to have occurred during the recent Government measures of quantitative easing. Whilst market forces do not give rise to consumer detriment, they can result in consumers achieving very different outcomes depending upon the timing of their purchase. Academic research (Blake 2009) has also pointed to need for government to issue longevity bonds to provide longevity 'insurance' for the industry.
- **Weak consumers** – companies could (and, it is claimed, some still do) take advantage of consumer inertia by providing low internal annuity rates. This aspect of detriment has been reduced by ABI and FSA initiatives and by the advent of white-labelling. ABI research suggests that internal rates may have improved and that majority are close to the better external rates. No analysis found of the percentage with low internal rates who do shop around.
- **Imperfect market** – current market behaviour suggests that some providers are unable to supply annuities profitably for pots of less than £10,000 but that a market does exist (perhaps with oligopolistic powers). The position is however, more marked for very small pots of less than £2,000 (see stranded pots analysis).

Poor advice

- Whilst media attention is focused on perceptions of annuities being poor, very little evidence that consumers are dissatisfied with decision to buy annuity over alternatives. In part due to:
  - Alternatives not meeting consumer needs for maximising income today and removing risk of income falling;
  - Complexity of alternatives and difficulty in assessing risks;
  - Lack of availability for those with smaller pots;
  - Lack of consumer awareness of alternatives.
- Number of complaints to FOS is one indicator of poor advice:
  - Number of complaints about annuities rose by 60% in 2008/09 to 611 but remains small in comparison to other product areas (no details available from FOS on nature of complaints);
  - Number of complaints on income drawdown rose to 130 (from 88).
- All FOS case studies on decumulation relate to variable annuities and drawdown (and the unexpected falls in value / income).
- No data available to assess scale of consumer detriment as a result of poor advice on retirement income but detriment may change as alternatives become more widely available .

Consumer detriment model - getting the best rate



Consumer detriment – getting the best rate

- This element of the analysis of detriment only models detriment which may arise because individuals do not get the best rate on offer. Other forms of detriment that may arise due to buying the wrong type of annuity or failure to consolidate are considered separately.

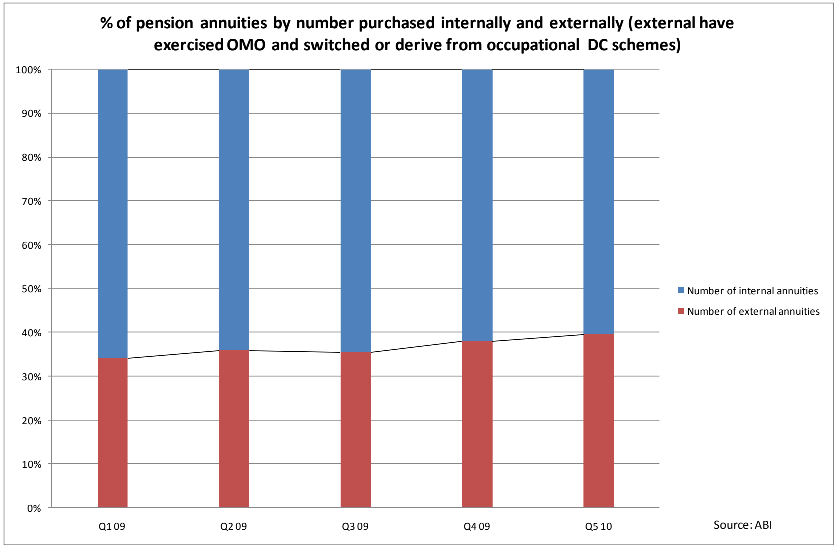
- Among those who exercise their open market option:
  - Those who also took advice considered not to suffer detriment. Assumes that they consolidate pensions where possible, take an informed decision on which type of annuity to purchase and get best rate in market for that type of annuity;
  - Those who exercise without advice:
    - May make an informed decision, in which case no detriment is assumed, or
    - May suffer detriment through an ill-informed decision on best rate.
- Among those who researched alternatives but stayed with their existing provider:
  - Considered not to suffer detriment where took advice or where did not take advice but made an informed decision (except where very small pots prevent annuitisation – Age UK stranded pots);
  - May have suffered detriment where decision to stay not based on sound information. Some could have achieved a better rate on open market / through enhanced rates;
  - Could be argued to have suffered detriment because pot not large enough to transfer (although difficult to argue in a private sector annuity market where providers able to select business).
- Among those who did not exercise option at all:
  - Do not suffer detriment where rate is the best available anyway;
  - Do not suffer detriment where make an informed choice to stay with current provider. No data on how many do this. Informed choice may be based on a strong preference for brand;
  - May suffer detriment where information unavailable or inaccessible to make informed decision and where better rates available elsewhere;
  - Suffer detriment where pot too small to annuitise at all.

Getting the best rate

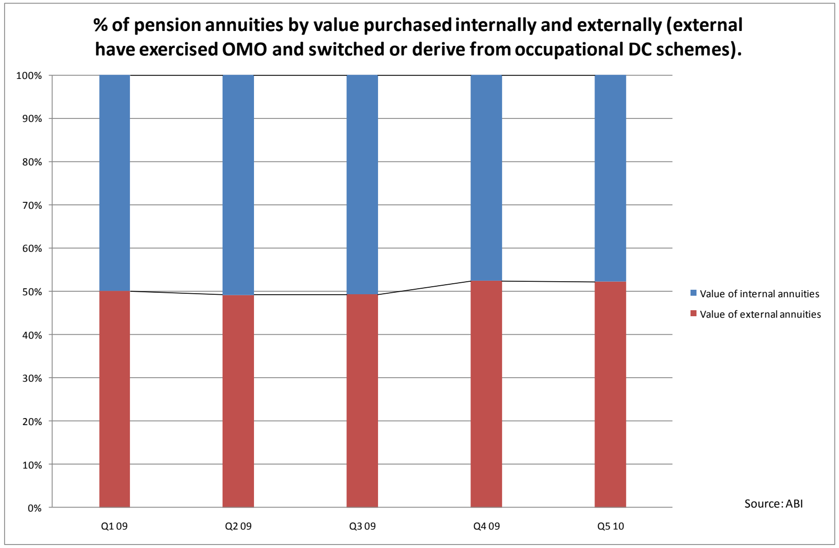
Latest ABI data shows an upward trend in percentage of annuity business that is being written on external rates:

- Up from 33% in 2006 to 40% in Q1 2010. Suggests that more are shopping around and finding better rates. Average annuity pot bought externally appears to be falling, suggesting that more annuitants with smaller pots may be shopping around and moving (although there could be other drivers behind this statistic). Possibility that ABI data may overstate shopping around, since all annuities purchased by Occupational DC count as 'external' when in fact the annuity may be the trustees choice (no research available on occupational DC).
- Among the 40% who shop around and switch:
    - We have assumed 75% take advice - CPOS and IFF research but could be higher;
    - Of remainder, we have assumed that 80% make an informed choice on best rate (they have done their homework);
    - Leaves 20% of 25% who may not have made an informed choice and may not have the best rate (eg missed out on enhanced rate).
- Of the remainder, around half shop-around but stay with their existing provider (FSA and ABI/IFF research):
    - Of these around half stay with their existing provider because the rates are as good as elsewhere (IFF research). May have access to guaranteed rates that are better than market, internal rates may be better than market;
    - 12% stay because advised to do so (which may be because of rate or other factors);
    - 16% said difference did not justify switching;
    - 25% gave no specific reason - some may simply have preferred to stay with existing provider, some may have found switching too much trouble, some may have felt that they had left it too late.
- Of those who neither shop around or move provider:
    - Some will have best rate available (we have assumed half – same as those who shop around and stay);
    - We assume that the remainder may achieve a better rate elsewhere (although in practice, some will have pots too small to move).

Percentage switched by number



Percentage switched by value



Modelling value of detriment – getting the best rate

- On basis of assumptions outlined above:
    - 81% of annuitants (91% by value) do not suffer detriment in terms of getting the best rate. Similar to ABI estimate of 85% within 5% of best rate in 2006;
    - 19% (9% of the value) may suffer detriment, rising to 50% among those who do not shop around at all;
    - However, even within 19%, not always clear that they would move provider if offered slightly higher annuity. For example, pride, embarrassment or fear may prevent someone seeking out an enhanced annuity;
    - Some of those suffering detriment may have pots too small to move (perhaps as many as 50-70%). However, we have included their detriment in the model.
- Having established the number who may suffer detriment, then need to consider by how much. This will depend upon:
    - The differential between their current provider and standard market rates;
    - The proportion that qualify for an enhanced annuity.
- On standard rates several research documents (ABI, FSA and Oxford Economics) point towards a skewed distribution of rates:
    - Small number of companies with poor rates;
    - Larger number of companies with better rates;
    - Median is closer to higher rates than lower;
    - This means that gap between average and highest is narrower than the overall gap might suggest.
- Position may be more or less skewed if take account of the weighting of annuitants across providers. Possible that most personal pension annuitants are with the larger companies who are active in the annuity market - this would mean that even higher proportion of annuitants would be likely to get a good /best rate from their existing provider.
- Position is also complicated by differentials between companies' internal rates offered to their personal pension customers and external rates offered to others. Internal rates are typically higher, although some companies do not differentiate and rates are not published.

Enhanced annuity rates

- Partnership /MGM Advantage assert that 40% of annuitants could achieve enhanced rates (assertion has not been validated).
- Towers Perrin report that 30% of OMO switches are to enhanced rates which either suggests that 10% of switchers could get enhanced but not doing so or that 40% is overstated . We assume that 20% of those who may suffer detriment in this group could achieve an enhanced annuity;
- We assume that half of those who research but don't switch have been offered enhanced or equivalent and of remainder, 40% of the remainder could have achieved enhanced rates;
- We assume that 40% of those who do not shop around at the moment could achieve enhanced rates by doing so (although some may achieve this with their current provider).
- It is worth noting that if more consumers gain enhanced rates, the cross-subsidy is reduced and rates for others will fall.

Value of detriment

- We assume an uplift of between 4% and 5% for those not suffering detriment who could benefit from improved standard rates (based on ABI analysis of the difference between average internal rates and highest OMO rates). We assume an uplift of 22% for those who could achieve an enhanced annuity (based on an MGM Advantage press release).
- Our model suggests that the annual detriment suffered is:
    - Approximately **£17 million** in annual income (although some will be lost to pension credit reduction). (Falls to £8m if remove those estimated to have pots of <£10,000). **£280 million approximate lifetime detriment**;
    - An average **of £200 per year per annuitant** or (if live for average of 17 years, over **£3000 over the lifetime**);
    - A **3% uplift in gross income** overall (9% for those who do not currently shop around) but potentially less when pension credit factored in.
- This compares to the Oxford Economics estimate of reduced net income for PICA of £14 million or £169 per year, which takes account of loss of pension credit and assumes that those with pots of <£10,000 cannot benefit from OMO. We have not undertaken a thorough comparison of the models and our model is more simplistic than the PICA model. However, we believe that the PICA model overstates detriment – e.g. all of those who do not switch are considered eligible for higher rates, even though a significant proportion are likely to get the best rate from their existing provider.

Getting the 'right' type of annuity - joint v single life

- It remains the case that the majority of annuities sold are based on male lives and single life, suggesting that many couples risk the prospect of a lower income for the (typically) female spouse on the death of the husband. There has been widespread concern that couples may not be making an informed choice.
- No significant body of work has been found which seeks to quantify detriment in this area. The main reason for this is likely to be that the decision is a very personal one and can be affected by a number of issues, including:
    - Preference for higher income today than tomorrow – several research studies confirm a strong consumer preference for more today than more later;
    - The age differential between partners (if partner is much younger this will affect rates and reduce income substantially);
    - Holdings of other assets (those with other financial assets or property may prefer to use those assets to support the remaining partner);
    - The existence of other support (some individuals may receive considerable support from other family members);
    - Pension status of partner (partners with their own pension pots may prefer to annuitise separately);
    - Working status of partner and expected retirement date (some partners may prefer to continue working into later years others may wish to retire close to time of partner);
    - Level of income and proximity to receiving pension credit (for many, it may appear more beneficial (and rational) for the remaining partner to receive pension credit than to reduce annuity income today). This raises the question about whether the Exchequer and taxpayers would be better off insisting on joint-life annuities;
    - Many changes can take place in retirement. Individuals can divorce, remarry, marry for the first time. None of these can be anticipated, although divorce laws will provide some protection.
- It is likely that those who seek advice or make an informed decision (63%) have considered this issue and have consciously decided that a single life annuity suits their circumstances:
    - DWP qualitative research (2008) suggests that married participants were generally aware that they could choose between joint and single lives. Consensus research for ABI confirms that all but one interviewed chose a single life over a joint life – preferring more money today or saw their pension pot as their personal asset, not a joint asset;
    - Those who seek advice should have been advised on the risks of taking a single life annuity;
    - Those who use on-line information services have the risks highlighted.
- Among 37% who appear not to make an informed decision, some will be single and research suggests that faced with choice, most of those in a couple would still opt for single life, for reasons outlined above. Detriment therefore very hard to measure as it will depend upon personal preferences. Nevertheless, it is important that the benefits of joint life are brought to the attention of couples (see barriers and solutions later in this paper).

Getting the ‘right’ type of annuity - fixed v increasing income

- Most annuities (around 87%) are sold at a level income throughout the term (no recent ABI data available at time of writing). This provides for a higher income at the time of purchase but exposes the individual to the effects of inflation which will devalue the nominal amount over the years (the extent of this will vary with inflation levels).
- Again, no significant body of work has been found which seeks to quantify detriment in this area. The main reason for this is likely to be that the decision is largely dictated by personal preference:
    - Inflation is uncertain and in times of low inflation, people are particularly prone to underestimate its effect;
    - Preference for higher income today than tomorrow – several research studies confirm a strong consumer preference for more today than more later;
    - Expectations of healthy living beyond retirement – people expect health to decline and income needs to fall with health (whereas in practice they can rise for some);
    - Life expectancy – those who do not expect to live beyond average life expectancy will perceive that they will not get their money’s worth (it can take many years for inflation-linked annuities to exceed level annuities);
    - Inflation is uncertain and insurers cannot fully protect themselves from risk which is reflected in a poorer returns;
    - Holdings of other assets (those with other financial assets or property may feel that these provide protection against inflation);
    - Working status of self / partner and expected retirement date (some may continue to earn an income which provides some inflation protection).
- It is likely that those who seek advice or make an informed decision (63%) have considered this issue and have consciously decided that a level annuity suits their circumstances:
    - DWP qualitative research (2008) suggests that awareness of the ability to get an increasing annuity was quite high but that when aware, most preferred a higher initial income today. ABI research (2005) suggested that people recognised the importance of protecting against inflation but did not recognise that this would mean a lower income today. ABI research (2009) suggested that people are not prepared to take the risk that they may never benefit from higher income later in life;
    - Those who seek advice should have been advised on the risks of taking a level annuity;
    - Those who use on-line information services should have been shown the effect.
- Among 37% who appear not to make an informed decision, research suggests that faced with choice, most would still opt for level income, for reasons outlined above. Detriment is therefore very hard to measure as it will depend upon personal preferences. Nevertheless, it is important that the effect of inflation is brought to the attention of annuitants (see barriers and solutions later in this paper).

Getting the 'right' type of annuity - guaranteed period / value protection

- Most annuities (around 70%) are sold with no guaranteed period (no recent ABI data available at time of writing). This provides for a higher income at the time of purchase but does not provide for any benefits to be paid to the individual's estate/family in the event of early death.
- Again, no significant body of work has been found which seeks to quantify detriment in this area. The main reason for this is likely to be that the decision is largely dictated by personal preference:
    - Maximising income today more important than providing for bequests;
    - Whether need to provide for family / partners in the event of death;
    - Life expectancy – those who DO expect to live beyond average life expectancy will perceive that they will not get their money's worth;
    - Holdings of other assets (those with other financial assets or property may not feel the need to buy the guarantee).
- It is likely that those who seek advice or make an informed decision (63%) have considered this issue and have consciously decided that no guarantee suits their circumstances:
    - Those who seek advice should have been advised on the impact of guarantees;
    - Those who use on-line information services should have been shown the effect;
    - ABI research suggests that given the choice, 80% opt to maximise income rather than pay for an inheritance benefit.
- Among 37% who appear not to make an informed decision, research suggests that faced with choice, most would still opt for no guaranteed period, for reasons outlined above. Detriment is therefore very hard to measure as it will depend upon personal preferences. Nevertheless, it is important that the effect of guarantees is brought to the attention of annuitants (see barriers and solutions later in this paper).

Stranded pots

- Age UK has highlighted the detriment suffered by those who have 'stranded pots'. These are individuals who:
  - Have personal pension pots that are too small to annuitise with their existing provider (or potentially too small to move from occupational scheme into open market – although such sums are more likely to be capable of commuting as a lump sum) AND
  - Do not qualify for trivial commutation (typically they have a total pot that exceeds £17,500 limit and the smaller amount is in a personal pension OR they may have missed the 12 month deadline) AND
  - Cannot consolidate their pot with other pension provision (occupational scheme is unlikely or unable to accept personal pension funds as transfers in).
- Only option open to individuals is to take an unauthorised lump sum and take 25% as a tax-free lump sum and pay tax of 55% on the remainder. By way of example, an individual with £800 personal pension pot that they cannot move can take £200 tax free and will pay £330 tax on the remainder (rather than £120 if he was taxed at basic rate). Their 'detriment' is £150 (£680 received if basic rate, £530 received if 55% tax).
- No data published to date that shows how many of these individuals there are in the market but likely to be a small number (for every 1000 that exist with stranded pot of £800, aggregate detriment would be £150,000).
- Government reluctant to allow small pot (<£2,000) commutation due to ability to split personal pensions into different policies and by-pass rules. However, original 2010 budget announced that HMRC will consult on the matter.

Timing of annuitisation

- Timing is largely dictated by the individual's chosen 'normal retirement date' (NRA) if saving in personal pension OR employers default retirement age (DRA). Taking benefits before these dates requires consumer to be aware and active. Most communication arrives around NRA or DRA. Difficult for providers / schemes to know personal circumstances that may dictate taking pension early.
- Timing of annuitisation can lead to differences in income in retirement. Differences emerge in the main due to changes in individual circumstances and movements in annuity rates. Neither set of changes can be predicted with any certainty and no research exists on whether timing of annuitisation leads to consumer detriment.
- A decision to defer can turn out to be a good one or a bad one and will depend on:
  - What happens to the individual's health or family circumstances;
  - What happens to the deferred fund in the meantime - it could fall or rise in value;
  - What happens to other savings or investments;
  - What happens to annuity rates – they may fall or rise.
- Research (DWP 2008) suggests that many people are aware of the ability to defer annuitisation. Some anecdotal evidence that poor perceptions may lead to people failing to buy annuities.
- Manypeople who annuitise may have little choice when they do so:
  - Those taking early retirement (either voluntarily or forcibly) may have no other source of regular income (they are unlikely to have a state pension, may not qualify for a other state benefits and may not be able to get work);
  - Those retiring at a planned date may also have little choice but to take annuity at time of retirement given small pots;
  - Most people are retiring with small pension funds.
- However, some evidence emerging (ONS 2009) that more are working beyond state pension age and that option to defer may be taken by more people. Decision to take early may be less familiar which may give rise to loss (no data available to quantify).
- Government announcement of the review of the default retirement age, proposals to further increase the state pension age , and plans to remove age 75 compulsion could also influence future timing of annuitisation.

CONCLUSIONS, BARRIERS AND SOLUTIONS

Conclusions, barriers and solutions

Myths and legends

- Perceptions of annuities are strongly influenced by media headlines and are, in some cases, ill-informed. In particular, lack of understanding of pooling of risk leads to perceptions of poor value. Understanding of the risks associated with alternatives is also poor (across media, consumers and some intermediaries).
- No evidence however that those who buy annuities are dissatisfied. Concerns about running out of money in retirement appear to be more important to consumers in shaping decisions than leaving money to dependents.

Consumers

- Growing number of individuals will have to take the decision either because of shift to DC or as a result of the Government's commitment to auto-enrolment. Market could quadruple in size in 10-15 years time.
- Most people need to annuitise when they give up work because they have little other income or savings on which to rely (and may not even have a state pension at the time) and because they are not in a position to risk falls in income.
- Early signs that consumer awareness of annuitisation and need to shop around improving. Also signs that focus on OMO is leading to improvements in rates overall (as internal rates increasingly have to compete and white-labelling is introduced).
- Majority of annuitants do consider alternative providers and majority do seek formal advice. Majority of these will make an informed decision which may or may not involve choosing the best rate or moving away from a level annuity.
- However, significant minority (around a third) do not engage with the process and may be put off by the perceived complexity and perceived limited benefit.
- Concern is growing about how to deliver value to those with small pots, particularly those with stranded pots of personal pensions that they cannot consolidate or commute.

Providers and intermediaries

- Market consolidation may shortly be reaching a position where concentration of market power is of concern.
- Costs of advice preclude those with small pots and problem will get bigger once RDR implemented.
- However, market has innovated and many previous areas of concern are being addressed:
    - New products have been developed to address consumer concerns but take-up remains limited;
    - Generic information widely available but rate comparisons remain limited to those who are seeking advice;
    - New portals emerging and likely to be only a matter of time before some become more consumer facing.

Conclusions, barriers and solutions

- Based on the findings of this initial investigation, this paper concludes that the following issues prevent consumers in achieving better outcomes:
  - Shopping around is seen to be complex, costly and of little benefit to those with smaller funds and results in reduced income in retirement;
  - Market consolidation is limiting choice of annuity provider and may lead to imbalance in provider power and further consumer detriment;
  - Lack of consumer understanding of products and risks (longevity, inflation, etc) could lead to uninformed choices and decisions;
  - Small pots / stranded pots leave consumers with little choice;
  - Perceived poor value of annuities may be leading to poor choices / may lead to poor choices in future as choice of alternatives widens.
- An initial analysis of the barriers and potential solutions to these issues is presented in the table overleaf.
- In response to the Government's current consultation on the requirement to annuitise by age 75 (ends September 2010) and revised FSCP priorities, this initial analysis of the annuitisation process will not be developed further at this time.
- Dependent on the changes that the Government makes following its consultation, this initial analysis of the barriers and potential solutions for the annuitisation process will provide a framework for the future, to develop more detailed solutions that can be discussed, challenged and evaluated with key market stakeholders.

Conclusions, barriers and solutions

Barriers and solutions to the annuitisation process – initial analysis

Problems	Barriers	Potential solutions
• Shopping around seen to be complex, costly and of little benefit to those with smaller funds and results in reduced income in retirement.	• Full advice process is highly regulated ; • Supply of advisers limited; • Benefits not fully highlighted.	• Increase trivial commutation; • Simplified advice process; • Specialised advisers with restricted qualifications; • Consumer portals / comparisons; • Scenarios highlighting impact over lifetime • Mandate advice (and fund it).
• Market consolidation is limiting choice of annuity provider and may lead to imbalance in provider power and further consumer detriment.	• Solvency requirements; • Low return on capital in UK life market; • Low margins on many UK products (in part due to regulatory interventions); • Higher margins on alternatives to annuities.	• Ensure Solvency II does not make UK even less attractive a base for life companies; • Remove barriers to selling higher margin products; • Increase competition on higher margin products or regulate charges.
• Lack of consumer understanding of products and risks (longevity, inflation etc) could lead to uninformed choices and decisions.	• Inherent complexity; • Lack of consumer oriented information.	• Remove choice from the consumer / impose solutions; • Consumer education; • Mandate advice (and fund it); • Use scenarios to educate.
• Small pots / Stranded pots leave consumers with little choice.	• Fixed costs of providing annuities to small pots; • Trivial commutation rules.	• Change rules; • Improve communication; • Mandate provision for small pots; • Reduce costs for providers; • Increase trivial commutation.
• Perceived poor value of annuities may be leading to poor choices / may lead to poor choices in future as choice of alternatives widens.	• Gap between perception and reality; • Lack of consumer and media understanding; • Poor risk profiling by providers / advisers.	• Tracking of value of annuities; • Improve consumer communication; • Clear and accurate comparisons of alternatives; • Mandate advice; • Improve quality of advice.

APPENDICES

Glossary

- ABI – Association of British Insurers
- ASP – Alternatively Secured Pensions
- CII – Chartered Insurance Institute
- CMI – Continuous Mortality Investigation
- CPF – Central Provident Fund
- CPOS – Consumer Purchasing and Outcomes Survey
- DB – Defined Benefit
- DC – Defined Contribution
- DRA – Default Retirement Age
- DWP – Department for Work and Pensions
- FOS – Financial Ombudsman Service
- FSCP – Financial Services Consumer Panel
- HMRC – HM Revenue & Customs
- HMT – HM Treasury
- ICA – International Compliance Association
- IFA – Independent Financial Adviser
- IRA – Individual Retirement Account
- NEST – National Employment Savings Trust
- NRA – Normal Retirement Age
- OECD – Organisation for Economic Co-Operation and Development
- OMO - Open Market Option
- ONS – Office of National Statistics
- PICA – Pension Income Choice Association
- RDR – Retail Distribution Review
- SCOMP – Sistema de Consultas y Ofertas de Montos de Pension
- TPAS – The Pensions Advisory Service
- TPR – The Pension Regulator

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