The UK Pension Annuities Market: Structure, Trends & Innovation

Introduction and Summary

The annuities market is increasingly important in the UK. It more than tripled in size between 1990 and 2005, and this trend is expected to continue. Annuities are becoming more common as defined contribution (DC) schemes replace defined benefit (DB) schemes. The introduction of Personal Accounts in 2012, a new vehicle for pension saving for people on modest incomes, will increase the size of the annuities market still further.

This paper discusses the legal framework applying to annuities in the UK, the current market structure and developments in innovation. It discusses whether the increase in market size is sustainable and sets out ways in which the UK is helping consumers deal with the complexity and choice in the market.

Pension annuities are also referred to as ‘compulsory annuities’, ‘lifetime annuities’ or simply ‘annuities’. This paper uses the term ‘annuities’ throughout.

Legal framework

The annuities market in the UK is based on the principle that at least 75% of an individual’s accumulated pension savings must be used to generate an income.
The UK pension savings regime operates on the EET (exempt, exempt, taxable) taxation principle. Individual contributions to pensions savings plans (up to the lesser of 100% of earnings or £225,000 per year) receive full tax relief and pension savings grow in a tax-free environment.

When the saver takes the benefits from their pension savings any regular income payments are taxed as earned income. Before the accumulated savings are converted to an income most pensions savings vehicles allow the saver to take a tax-free lump sum of up to 25% of the fund. The remainder must be converted into an income at some point after the age of 50 (rising to 55 in 2010) and before the saver reaches 75.

There is an exception for small funds. An individual holding up to £16,500 (rising to £17,500 in 09-10) in pensions savings, and this may be across a number of funds, can take the entire amount as a cash sum. 25% of this amount is tax-free and the remainder taxed as income.

There are two ways of producing an income from pension savings: income withdrawal (or drawdown) and annuities. Up to the age of 75, individuals may withdraw income from their pension savings, subject to certain annual limits designed to ensure that the fund does not deplete too quickly. Income withdrawal is seen as a specialist product that is only suitable, and often only available, for those with larger pension funds. Most companies that offer drawdown products only do so for those with pension funds in excess of about £90,000. The average pension amount used to buy an annuity in 2007 was £25,500 whereas the average amount used to provide income drawdown was £92,500.

It is often thought that the UK operates a system of compulsory annuitisation. This is not strictly true. In 2006, in response to religious objections to mortality pooling, the Government introduced legislation to allow the use of ‘alternatively secured pensions’, a form of income withdrawal, beyond the age of 75. Any money left in the fund on death may be used to provide a pension income for any dependants, which is taxable as income. If there are no dependants, or the dependant dies with money remaining in the unsecured pension pot, the remaining funds can be paid to a charity or transferred to another member of the scheme, although the latter option is subject to penal tax charges of up to 70 per cent in order to discourage people from using tax-relieved pensions as a means to build up bequests.

There is a requirement under UK legislation that, once in payment, the annual income paid by an annuity should not fall. However there are some exceptions to this rule:

- ***Bridging pensions:*** Pension annuities may reduce their income level once the annuitant becomes entitled to the UK state pension (at present age 60 for women, 65 for men). The level of reduction must not exceed the level of state pension received, so total income must not fall.
- ***Investment-Linked Annuities:*** Some annuities are linked to investments and in such cases where the value of the investments fall so to does the income paid. This sort of annuity is not particularly common in the UK.
- ***Fraud, Criminal Activity or Genuine Error:*** There are provisions to allow annuity income payments to fall where the annuitant is guilty of fraud or criminal activity or the annuity provider has made a genuine error in setting the level of payments. Again these are exceptional circumstances.

Rationale for the UK system

Uncertainty about how long an individual will live poses a problem for him or her. Should the individual conserve money early on in retirement, and risk leaving a large sum to dependants, or enjoy a more comfortable lifestyle and risk running out of money at the point in later life he or she may need to spend more?

People in general have a poor understanding of how long they will live. They are aware of a general upward trend in life expectancy but fail to estimate accurately how this will have an impact on them as individuals. One study[1] has suggested that men in their 60s – when they are most likely to buy an annuity – underestimate their longevity by about three years and women in the same age group underestimate by around four and a half years.

Annuities solve the problem faced by individuals by pooling mortality risk and hence insuring individuals against the very real risk of outliving their pension pot.

In the UK, tax relief on pension saving is generous. This amounted to £18.9 billion net in 2007-08 and it has been estimated that in some cases 60%, or even more, of an individual's pension pot may be funded by the taxpayer.

In return for this taxpayer subsidy, the Government intends that individuals should use their savings to generate an income, so that they neither run out of money and fall back on state benefits, nor leave money in bequests. There is no rationale for the taxpayer to subsidise private inheritance. Requiring people to annuitise or secure an alternative pension by the age of 75 is the chosen mechanism for ensuring the taxpayers' interest is protected.

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[1] *How long do people expect to live? Results and implications.* O'Brien, C, Fenn P, and Diacon S. Centre for Rick and Insurance Studies. University of Nottingham, 2005.

During an individual's early 70s the rates of return required from investments in conventional assets become unrealistically high for a retired person to justify delaying annuitisation. This is because, as an individual ages, the benefits of mortality cross-subsidy decrease. This 'mortality drag' increases with age. Figures from the Government Actuaries Department (GAD) suggest that, on the basis of projected mortality at age 75, men would need to make an investment return of around 3% above gilt yields and women around 2% to make delaying annuitisation worthwhile. This is borne out by consumer behaviour: 95% of people annuitise before the age of 70.

For a further discussion on the UK Government's rationale, see *The Annuities Market*, HM Treasury, 2006.

Regulation

Annuity sales in the UK are overseen by the Financial Services Authority, which ensures that customers are treated fairly and have all aspects of risk and product structure explained to them when they buy an annuity.

Annuities are provided by insurance companies, which have strict capital requirements designed to ensure that they meet their financial obligations. However in the event that such a company was to fail annuitants in the UK are protected by the Financial Services Compensation Scheme (FSCS) which is funded by a levy on the industry and will pay annuitants 100% of the first £2000, plus 90% of the remaining money they should receive.

There is no restriction on the design of products which may be sold, subject to meeting the tax rules. Nor is the price of annuities regulated.

Annuities: some consumer issues

When asked what they want out of a pension, people will generally describe the features of an annuity – simplicity, security and a certain level of regular income, guaranteed until they die[2]. Yet annuities remain unpopular in many countries and in the UK there is pressure from firms and individuals to end the requirement to secure an income from a pension by the age of 75.

One argument advanced against annuities is that any remaining money in the pension pot cannot in general be passed on to heirs on the death of the annuitant. However, this pooling of mortality risk is what makes annuitisation possible – there is in effect a cross subsidy between those who die earlier than the average in the pool and those who die later. The benefit is in ensuring the annuitant has a steady income, no matter how long they may live.

People also cite the lack of flexibility in the UK system. However, there is considerable freedom about when an individual can use their pension pot to generate an income, and the option to take up to a quarter as a lump sum. There is also choice in the type of annuity which may be purchased, including, for example, term annuities or 'value protected' annuities. These have both been allowable under recent tax changes designed to increase flexibility.

[2] *The Pension Annuity Market: Consumer Perceptions.* ABI, 2005.

A reluctance to annuitise may also be caused by individuals' discount rates. In general people tend to place more value on those things where the outcome is in the here and now. Buying an annuity can also be highly complex, and the decision is one-off and irreversible. Individuals perceive the costs of getting the necessary information to be disproportionate. Moreover, surveys of financial capability[3] highlight the fact that many people lack the financial knowledge to make the best decision in the complex annuities market.

Another possible explanation for the unattractiveness of annuities is the presence of adverse selection in the market. In general, people who buy annuities tend to live longer than those who do not. This means that the price appears relatively expensive to the average person. High-risk individuals push up the market price, pricing lower risk individuals out of the market.

Improvements in risk assessment have gone some way towards dealing with the problem of adverse selection. Developments include 'impaired life' annuities for those with pre-existing health problems, and the use of postcode data to determine how much income an individual will receive in retirement. The problem is overcome in the UK market by the existence of almost universal compulsion.

Value for money

Perhaps the most frequently voiced objection is that annuities do not represent good value for money. For individuals who die earlier than the average annuitant, this may be true, but it is a judgement which can only be applied with hindsight, and neglects the intangible benefits of an annuity, particularly peace of mind.

Consumers also argue that annuity rates – the income that can be secured for a given fund size - have fallen, and so therefore the value for money must be declining.

There are a number of factors which determine annuity rates:

- Interest rates. UK price inflation has been low and stable for over a decade. This has kept interest rates low and is the main reason for the decline in rates.
- Annuities are backed with 'safe' investments, typically gilts and corporate bonds. A lower gilt or bond rate mean the annuity provider gets a lower return on the underlying assets and so offers a lower rate. With the number of pensioners increasing, the demand for assets to back long-term liabilities is also increasing, reducing the yields on long bonds and other long-term instruments. This also exerts a downward pressure on annuity rates.
- Longevity is increasing, meaning that annuity providers have to provide an income for a longer period of time, bringing down overall rates.

These factors do not necessarily mean that annuities are poor value for money as individuals with a level (ie not index-linked) annuity will see the real value of their income maintained for longer.

Perhaps the best indicator of value for money is the 'money's worth ratio'. This measures the ratio of the expected income stream from an annuity for an average individual to the size of the pension fund which is used to generate the income. In this way, the price of an annuity can be compared with other assets. If annuities were sold at an 'actuarially fair' price, then the money's worth ratio (MWR) would be 1. As

[3] *Financial Capability: Baseline Survey. Consumer Research paper 47a.* FSA, March 2006.

the insurer needs to cover his administrative costs and make a profit, the MWR will generally be less than 1.

Many studies across different countries have shown that the MWR for annuities is usually in the range 0.85-1.05, with values at the upper end of the range indicating the insurer is actually making a loss. These findings are discussed in Cannon and Tonks' paper on UK pricing.[4]

Cannon and Tonks' evidence suggests that annuities are fairly priced. Although the price may be slightly higher than an actuarially fair price, the mark up is not excessive when compared with other financial services products. An update to the paper is due in February 2009.

The decumulation market in the UK

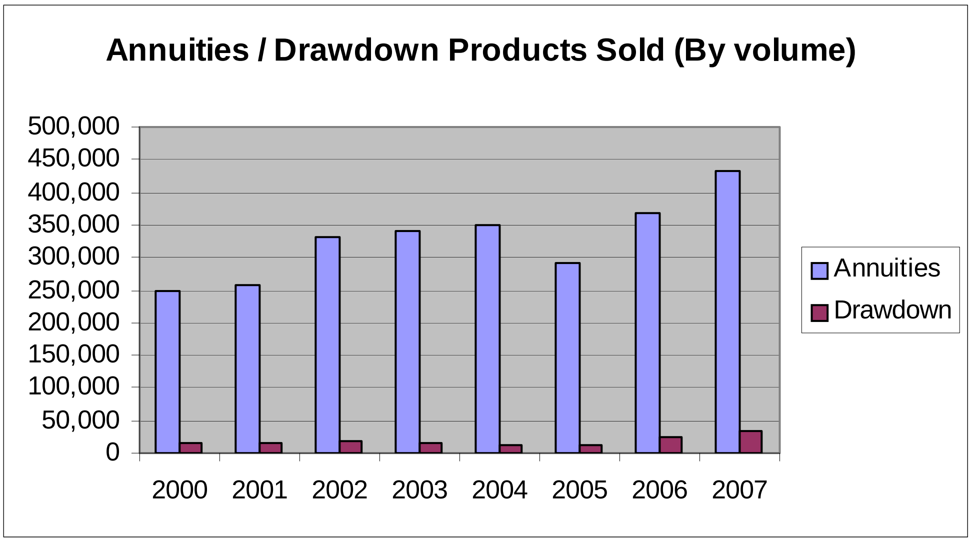
In the UK, annuities and income withdrawal products are provided by insurance companies. There are in the region of 40 companies offering annuities in the UK, with the top 5 companies having around 61% of the market. Many of these companies also offer income drawdown but there are actually more companies in this market. 66 companies offer income drawdown with the top 5 companies in this market having a 66% share of the business.

Many annuity providers will impose a minimum fund value. Not many providers offer an annuity for sums less than £10,000 and even fewer for under £5,000, which is the effective minimum.

Annuities versus income withdrawal

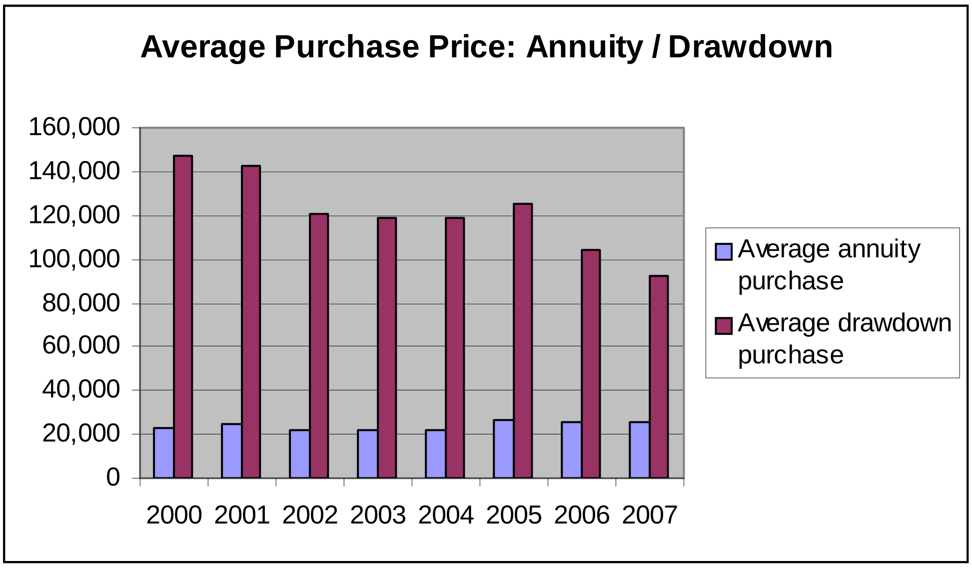
Although there are flexibilities within the system, the majority of pension savers in the UK convert their savings to an income by buying an annuity at the point of retirement. In 2007 around 78% of those taking an income from pension savings did so using an annuity, with around 22% using income drawdown. In that year, 433,000 annuities were sold compared to 33,000 income withdrawal products. This difference is not surprising as drawdown products are inherently more expensive. Up to the age of 75, the member may take up to 120% of the annuity level they would be able to receive on the open market. This limit has to be reviewed every five years to take account of investment performance, with the aim of ensuring that the fund does not run out. These additional active management costs need to be taken into account when deciding whether to go for drawdown and, in practice, it is worth it only for larger funds.

[4] *Survey of Annuity Pricing. DWP Research Paper 318.* Edmund Cannon and Ian Tonks, 2006.



Source: ABI (www.abi.org) Note: This snapshot does not necessarily represent a true market picture, as drawdown products may be converted to an annuity at a later date.

The average purchase price of income withdrawal products is significantly higher than for annuities, although it has been generally falling since 2000, whereas the average annuity purchase price has been increasing. This is, at least in part, due to an increased appeal of income drawdown to a wider section of the market, an increase in the number of providers offering drawdown products and a reduction in the minimum amounts these providers are willing to accept.



Source: ABI (www.abi.org)

Types of annuity

There are many different types of annuity product available in the UK. The market is highly competitive and different products are available to meet the differing needs of individual pension savers.

Single Life: This type of annuity ends when the annuitant dies.

Joint life: This type of annuity provides for a portion of the income to be paid to a dependent on the death of the first annuitant. This will usually be between a half and two-thirds of the original member's pension.

Guaranteed Term Annuity: The annuity will continue to pay an income for a set period (usually five years) even if the annuitant dies during that time. Payment continues for the life or the set term, whichever is later.

Value Protected Annuity: If death occurs after annuity payments have started but before the annuitant reaches age 75 any "unused" pension savings can be returned to the deceased's estate.

Flat Rate (or Level) Annuity: Provides the same amount of income every year, usually payable monthly.

Escalating Annuity: Provides an increasing level of income every year until death. The increase may be in line with the Retail Prices Index (RPI), a fixed rate or the RPI with a maximum cap (known as LPI). The initial income is at a lower rate than the equivalent Flat Rate annuity. It 'catches up' after a number of years and then becomes greater than the equivalent Flat Rate.

Investment-Linked Annuity: Level of income is linked to the performance of an underlying investment. Common types are "with-profits" or "unit-linked".

- ***With-Profits Annuity:*** Income is paid at a basic level, with a bonus based on investment in an insurance company's with-profits fund.

- ***Unit-linked Annuity:*** The pension fund is invested in units in investment funds and income is linked directly to those investments. The choice of funds can vary.

With this type of annuity, income may go down.

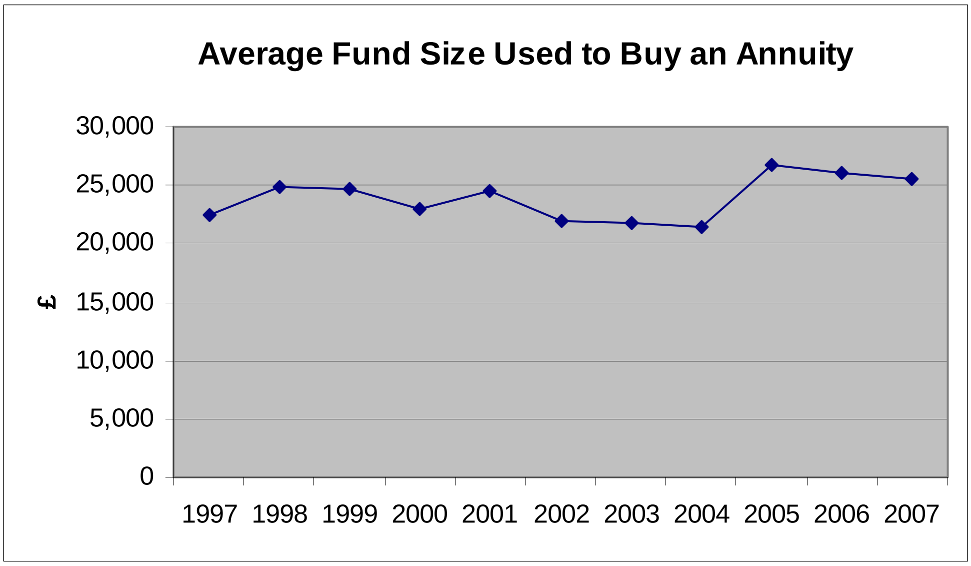
Impaired Life Annuity: The income level is higher than for the equivalent Flat Rate annuity, due to the higher risk of early death from pre-existing medical conditions such as cancer, asthma, diabetes, multiple sclerosis or high blood pressure. Any type of annuity may be sold as 'impaired life'.

Enhanced Annuities: As with impaired life, this type of annuities will pay out more than the equivalent Flat Rate, but in this case based on lifestyle factors such as smoking or obesity.

Factors affecting the level of income an annuitant receives

The amount of annuity received will be dependent on a number of factors. At its most basic the income received will be based on the size of the individual's pension fund, the type of annuity chosen, and the annuity rate currently available.

The size of the pension fund is based on the level of contributions made (including tax relief) plus any investment growth minus charges and any investment losses.



Source: ABI (www.abi.org)

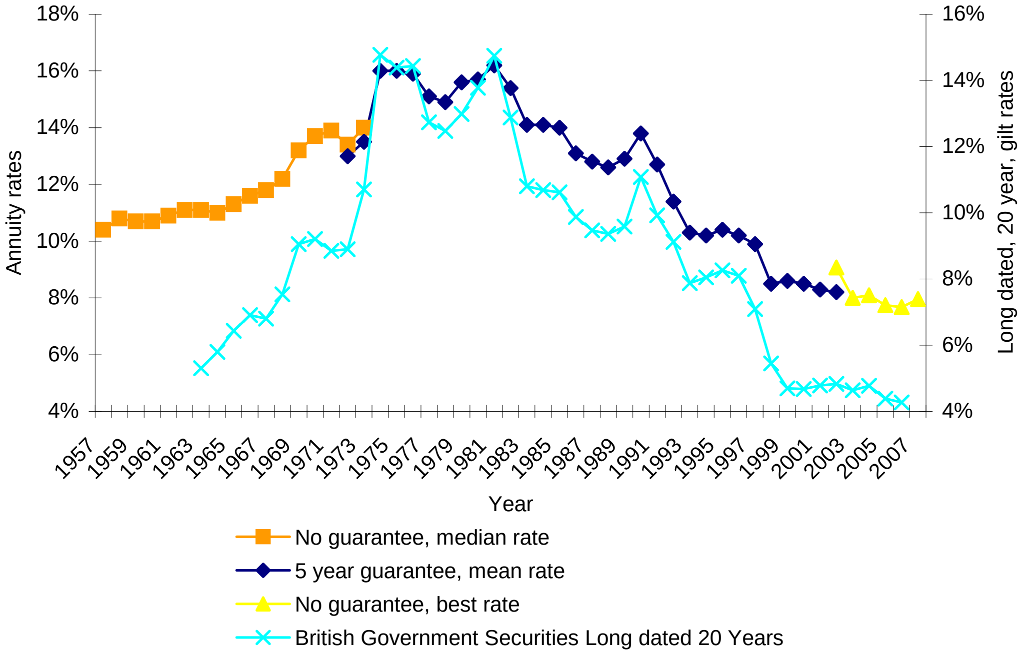
The table above shows the average fund size used to purchase an annuity in the UK 1997-2007. The steep rise in average purchase amount between 2005 and 2006 can be put down to much higher triviality limits introduced in 2006 – this took smaller annuity purchase amounts out of the market thus raising the average purchase price.

The choice of annuity type will determine whether the annuity will rise over time, whether it will continue after the annuitant's death and so on. In general terms the simplest annuity – a single life, flat rate annuity - is the cheapest to buy.

The annuity rate available is more complex and also varies from company to company. However, in general, the annuity rate available will be dependant on two primary factors – interest rates and longevity assumptions.

Interest Rates

Interest rates are important as they indicate the returns that an annuity provider will be able to receive on the money which they use to generate the income (most UK annuity companies invest in long term corporate or government bonds). Generally as interest rates fall pension annuity rates also fall.



Source: ONS 'British Government Securities Long dated 20 year gilt rates' Annuity rates: Annuity Bureau (2002-2006), Pension World (1972-2001) and The policy (1957-1973). Note: Because the type of annuity measured has changed over the years, there are discontinuities in the graph.

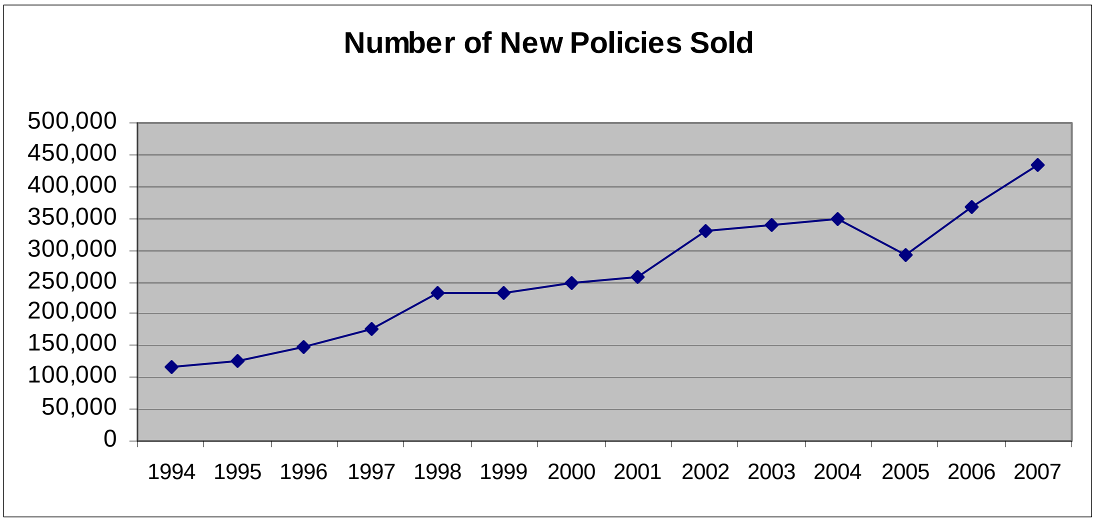
The table above shows UK annuity rates over a 50-year period alongside the yields on 20-year British Government Securities. Annuity rates will tend to be less volatile than interest rates, because they depend on a wider range of factors. It is likely that the gap between annuity rates and gilt rates up to the early 1970s is due to longevity assumptions being much lower than they are today. From 2000 onwards, the gap is more likely to be due to the comparison moving from a mean rate to a best rate, and increased demand for gilts from DB pension schemes, notably in the wake of changes to pensions regulation in 2004.

Longevity Assumptions

Once an annuity comes into payment it must continue to be paid for at least the lifetime of the annuitant, therefore longevity assumptions are extremely important in determining annuity rates. In common with all developed countries, longevity is increasing in the UK, which will have the effect of reducing annuity rates.

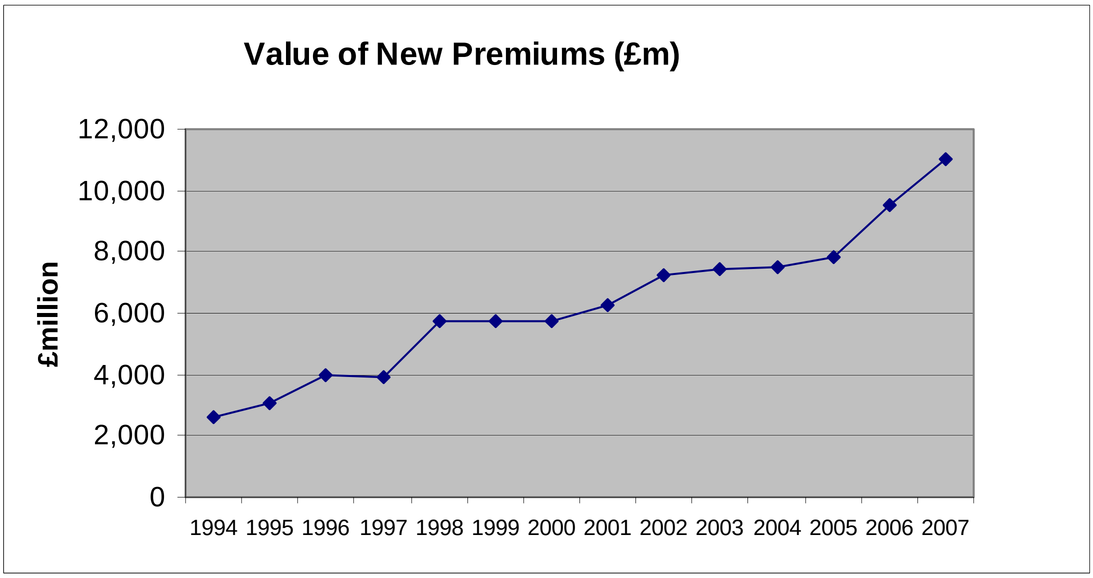
Trends in the UK Annuities Market

<u>Sales Trends</u>



Source: ABI (www.abi.org.uk)

The above graph shows annuity sales in the UK between 1994 and 2007. It shows a general increase in annuity sales year on year. The slight drop in 2005 can most likely be attributed to the changes in pension legislation made under the banner of "pension simplification" in 2006. There is some anecdotal evidence to suggest that a number of people put off taking an annuity at that time, pending introduction of the new rules.



Source: ABI (www.abi.org.uk)

The above graph shows that the total value of annuity sales has also been increasing over the same period and in 2007 total annuity sales were in excess of £11 billion.

Drivers of future trends

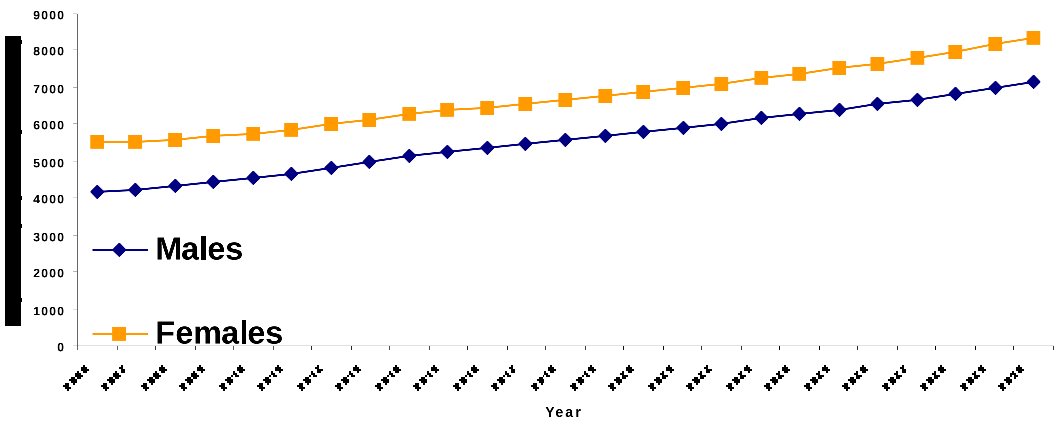
Defined Benefit to Defined Contribution

For a number of years the "traditional" form of UK pension scheme – the defined benefit scheme – has been in decline. Defined benefit schemes, provided by employers, pay scheme members a pension from the scheme itself. Defined benefit schemes make a pension promise to the members and any shortfall must be met by the scheme or the employer. Between 2000 and 2005 an estimated 60% of defined benefit schemes closed to new members. This trend has continued, albeit at a slower pace. In many cases closing defined benefit schemes have been replaced by occupational defined contribution schemes or by defined contribution personal pension plans. These pension schemes are far more likely to result in annuity purchase to provide income.

As time goes by, people will have saved in a defined contribution scheme for longer, so defined contribution retirement funds will be larger as well as more numerous. Reduced management costs, encouraged by the Government's introduction of 'stakeholder' pensions in 2001, will also contribute to larger 'at retirement' funds. Estimates suggest that the annuities market will grow at least by 10% a year over the next 10 years.

A Shifting Demographic

In addition, a general increase in the population of the UK would be expected to increase the number of people saving for an annuity.



Source: Offi ce for National Statistics. Note: Figures are 2006-based principal projected populations at mid-years of males and females aged 65 or over at their last birthday

The graph above shows the UK's population predictions for those age 65 and over through to 2030. An ageing population means pension annuities will be paid for longer, this in turn may result in lower annuity rates. The ABI suggests that the effects of an aging population will increase annuity sales by around 2% each year with the remainder of the increase being due to the increasing percentage of individuals having defined contribution pension savings as opposed to defined benefit.

Personal Accounts

In 2006, the UK Government embarked on a major programme of pensions reform, involving public and private sector schemes. This responded to the recommendations of the Pension Commission (usually known as the "Turner Report"[5]). Among other things, the Pensions Commission found that an estimated seven million people were under-saving for their retirement, and that there was considerable inertia in relation to pension savings.

As part of its response to the Pensions Commission, the UK Government is planning to launch a new retirement savings product known as personal accounts. These savings schemes will be targeted at low to moderate earners (£5,035 to £33,540 in 2005-06 terms) not currently in an occupational pension scheme and will attract compulsory employer contributions. The idea behind personal accounts is that with tax relief and compulsory employer contributions members will be able to make significant pension savings with a fairly low contribution.

The current proposals for personal accounts would produce a 4:3:1 split of contributions with the member paying half, the employer paying 37.5% and tax relief accounting for the additional 12.5%. The introduction of personal accounts will also see the implementation of an "opt out" system whereby employees will automatically be joined to either the personal account scheme or an equivalent employers' scheme unless they actively chose not to join (this is in contrast to the current "opt-in" system whereby the employee must actively chose to join the scheme).

The expectation is that personal accounts will increase pension scheme membership by 6-9 million and, as personal account schemes and the majority of the equivalent employers' schemes will be defined contribution schemes, it is reasonable to assume that this will also increase the number of annuities being purchased.

However, due to the target audience for personal accounts (low to mid earners) it is possible that the number of annuities being purchased may increase but the average purchase price may not grow as fast or may even continue to fall.

Personal Accounts will, however, have a big impact on the overall size of the annuities market. Despite the modest scale of individual pension pots, the personal accounts funds under management will, in time, form a significant portion of total pensions funds under management in the UK. The UK Department for Work and Pensions estimates that personal accounts funds under management will reach between £100-200bn. For comparison, the current largest private sector scheme (British Telecom) has £39bn under management and the largest public sector scheme (Local Government) £120 bn. Around £160bn is currently invested in DC schemes as a whole in the UK.

Annuity Rate Trends

The average annuity rate has been, on average, falling for many years (meaning the annuitant gets less income per £1 of pension saving). This is mainly due to increasing longevity assumptions. However in recent months this annuity rate fall has slowed and even reversed, in September 2008 UK annuity rates reached a 5-year high before beginning to fall again.

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[5] *A New Pension Settlement for the Twenty-First Century. The Second Report of The Pensions Commission.* 2005.

The general expectation is that longevity will continue to increase, although possibly more slowly, and therefore annuity rates will continue to decrease on average. However it is possible that a combination of factors will cause longevity to stabilise (or even decrease slightly) and this will obviously have an impact on the trend in annuity rates.

In addition there are some developments in the pension annuities market which may result in annuity rates for some individuals improving. This is explained further in the 'innovations' section, below.

Sustainability of the annuity market

As the annuities market has grown, questions have been asked over the whether supply will continue to keep pace with demand growth. The key constraint on insurance companies' ability to sell more annuities is the restricted supply of assets available to back the liabilities. There are four main things that insurers look for in a security to back an annuity:

- length – a pool of annuities represents a set of liabilities which can stretch out over forty years. If an insurer purchases a short-term (e.g. 1-5 year) security to back that liability, it must face the risk that interest rates may have fallen by the time the money needs to be reinvested (reinvestment risk). To minimise the amount of reinvestment risk they have to bear, insurers look for long-term securities, in particular long-dated corporate bonds and Gilts.

- security – although at the margins unexpected shifts in pool longevity can affect the total amount insurers pay out, an annuity pool still represents a comparatively certain pool of liabilities. To match this certain set of liabilities requires a relatively secure income stream. This makes equities unattractive. Although they offer plenty of length (they last as long as the company does), they do not offer a certain stream of payments to match the known stream of liabilities. This is why insurers tend to prefer debt instruments, which offer a defined payment stream contingent only on the solvency of the debtor. Lower rated bonds have a much higher probability of default. Although some of this risk can be hedged by holding a diversified portfolio, some of the risk is undiversifiable as it represents the greater vulnerability of lower rated issuers to fluctuations in the market. For example, a AAA issuer is more likely to be able to withstand a recession than a B issuer, so the total payout on a pool of B bonds is more sensitive to (unpredictable) economic fluctuations than the total payout on a pool of AAA bonds. This means that insurers prefer higher rated bonds, or other debt instruments with an equivalent level of certainty.

- Index-linking – inflation linked annuities represent only around 10 per cent of the market. However, to match those liabilities requires index-linked assets. Because of the relative scarcity of index-linked corporate bonds, insurers rely to a large extent on Government issuance. Another option is the purchase of fixed nominal bonds held alongside an inflation swap contract[6], which

[6] A swap is a contract where two parties agree to give each other (swap) a payment or stream of payments. Generally one party will pay a fixed amount and in return the other party will pay an amount contingent on future variations in some economic variable. In the example of an inflation swap, one party generally agrees to make a payment or stream of payments increasing in line with current market expectations of inflation. The other party agrees to make payments increasing in line with observed inflation. The party taking the floating side generally collects some premium in return for bearing the extra risk.

together provide an index-linked income stream. However, these inflation swaps are provided mainly by investment banks and recent concerns over their solvency have reduced the attractiveness of this option.

- yield – subject to the constraints above, insurers of course then look to maximise yield. This leads some insurers to seek out suitable niche instruments. In doing this, insurers can take advantage of the fact that they do not need liquidity. Illiquid assets tend to pay a premium to compensate the holder for not being able reliably to sell the asset quickly and at market price. Because insurers generally do not need to sell assets used to back annuity liabilities (they buy and hold), they can take the illiquidity premium without incurring the associated costs.

The ability of the annuities market to keep pace with future demand growth will therefore depend significantly on the supply in the capital markets of highly-rated long-term bonds and gilts. At this stage there are good reasons to believe that supply will keep pace. One of the main factors driving the increase in annuity demand is the increasing take-up of DC pensions. This in turn is driven almost entirely by the drop-off in DB pension provision by employers. DB pension schemes are among the biggest investors in the types of bonds annuity companies need to back their liabilities. The long-term slowing in the creation of new DB liabilities will eventually reduce demand from DB schemes for these bonds. However, in the short to medium term, demand from DB schemes may rise as their membership matures and asset/liability matching strategies demand lower risk investments.

A second issue is the capacity of insurers to hold population longevity risk. While insurers can diversify away the risk of any one annuitant living for an unusually long time by having a large pool of annuitants, there is a residual risk that the pool will live longer than expected. This risk cannot be diversified away. At present, options for hedging this risk in capital markets are limited. Reinsurance is the longest established route but because reinsurers are faced with the same problems with hedging the risk, they tend to charge a lot. There is also a small but developing market in longevity swaps (a contract providing for the exchange of a fixed regular payment against a regular payment linked to population longevity outcomes). Given the thin state of the longevity risk market, there is an argument that the size of the annuities market will be constrained by the capacity of insurers to hold the associated longevity risk on their own balance sheets.

However, there are good reasons to believe this constraint may be a relatively flexible one. In the past two years a number of firms have entered the market as providers of bulk annuities which are used by DB schemes to buy-out their liabilities to pay future pensions. This innovation was driven by a previous lack of competition in that market (two firms controlled the whole market) and a belief that it was possible to offer bulk annuities more cheaply and still make money. In other words, when the price of longevity risk became high enough, new entrants were encouraged. If a similar phenomenon occurred for individual annuities, it seems reasonable to expect a similar market response whether that be through the development of capital market instruments to allow the trading of longevity risk or through new entrants.

In all, while there are clearly challenges which the annuities market will have to meet to keep pace with demand, there are good reasons to have faith in market solutions to these challenges. A fuller discussion of the emergence of capital market solutions can be found in, for example, Blake, Cairns and Dowd.[7]

Annuities Market: Innovation and Development

As the pension annuity market in the UK continues to grow and mature developments and innovations continue to occur. Some of these developments are "market-led" created by the annuity providers, primarily due to the level of competition in the sector. Other developments are "government-led", designed to ensure that consumers are getting a fair deal and that the market can continue to meet the demands of its customers and operate efficiently, or respond to events, notably the introduction of autoenrolment.

Market Innovation

Developing Mortality Pooling (Specialised Annuities): One main development in annuities relates to annuity pricing and specifically to longevity assumptions. As annuity providers get more longevity data they are able to improve their mortality assumptions. This has led to the introduction of more sophisticated enhanced (or impaired life) annuities. These products pay out an increased annual income due to the decreased life expectancy of an individual. The decrease in life expectancy may be based on an existing condition or on a "lifestyle choice" (such as smoking or obesity). Along similar lines, but a more recent development, are postcode annuities. Annuity providers now have enough data to be able to estimate life expectancy based on an individual's postcode.

These improvements in estimating life expectancy have resulted in higher annuity rates being available to some people. However, these would traditionally be the people who did not live as long once the annuity commenced and therefore one potential side-effect of these developments is the "concentration of the mortality pool". As mortality pooling relies on a cross subsidy between those who live shorter than average and those who live longer there is a danger, as yet unrealised, that more accurate annuity pricing for those with a lower life expectation, for whatever reason, will reduce the annuity rates (and therefore incomes) available for those with longer life expectancy. It remains to be seen exactly what impact these developments will have on the annuities market in the UK.

Shared Risk Products: As a result of reduced legislative prescription as to the nature of pension annuity products the pensions and annuities providers are currently looking into developing so called "shared risk" products. Although primarily conceptual at this time these products would combine some elements of annuities with some of the guaranteed elements of defined benefit schemes. There are various forms that such products could take and a number of companies are investigating the best way to bring such a product to the market.

Mid Market Products: Another market innovation based on the reduced legislative prescription and currently in the early stages of development. These products would be designed to provide benefits with elements of both annuities and income withdrawal products. They are intended to offer elements of income withdrawal to those with more modest pension pots. Again there are various methods of replicating some of the elements of these two distinct pension income-generating products and a number of companies are looking at the options in this area. One example from a

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[7] *The Birth of the Life Market.* David Blake, Andrew Cairns and Kevin Dowd. Asia-Pacific Journal of Risk and Insurance (2008), Volume 3, Issue 1:6-36.

large UK insurer bridges the gap between annuity and drawdown by combining a guaranteed income with investment control up to the age of 75. Its features are as follows.

- From the starting age (minimum 55) up to the age of 75, income is drawn down, with a minimum income guarantee. As well as the basic guarantee, income may increase if underlying investments perform well. The increases are 'locked-in'.
- There is a choice of four passive funds, four active funds and a cash fund.
- There is an annual charge for the guarantees, with the amount depending on the underlying investment.
- The level of guaranteed income depends on whether policy is single or joint life, and the age of starting to take income.

This particular example is only available for those with pension pots of £50,000 or over. The mass-market product with elements of drawdown remains elusive.

Auto-enrolment

The advent of personal accounts and, in particular, auto-enrolment brings with it a number of challenges for annuitisation. Members will tend to be on low to median incomes, and hence accumulate relatively small pension pots. More importantly, a number will have made no active choice at all about their pension, staying in a personal account through inertia, rather than choosing to opt out, and making no active fund choices.

Despite the small scale, the sheer number of Personal Accounts members – up to 9 million – means that the Personal Accounts scheme has the potential to distort the annuities market unless significant numbers of account holders make an active choice about their annuity provider.

The Personal Accounts Delivery Authority (PADA) published a consultation paper in December 2008 [ref] which sets out the decumulation options for personal accounts. PADA proposes the following design components:

- Good quality, timely information to help members choose a retirement income product
- Information about the benefits of the *open market option* (which is discussed more generally in the following section)
- A *focused choice* option, that points members to a limited selection of annuities providers who agree to meet certain conditions set by the personal accounts scheme
- A process for dealing with members who do not make any kind of choice: a possible default annuity option

PADA also notes that a solution is needed for very small pots, and that the costs of information and advice need to be kept very low. Making pensions available to low to middle earners depends crucially on keeping management charges as low as possible.

Improving the efficiency of the market

The Open Market Option

The Open Market Option (OMO) allows those with accumulated pension savings to choose the provider from which they buy their annuity. By using the OMO and shopping around people may be able to increase the annual income they get from their pension savings by a significant amount. For example for a 60 year-old male wanting a single life, flat rate annuity the monthly income can vary from £460 to £566 per month[8]

The most recent data from the ABI suggests that only 40% of those taking an annuity from a personal pension do so on the open market. Of those who do not take the open market option, ABI research suggests that half are aware of the option but choose not to exercise their right and the other half remain unaware of its existence.

In its Pre-Budget Report in 2007 the Government published a review of the operation of the OMO[9]. The review made a number of recommendations aimed at improving the operation of the OMO. These were:

- The Pensions Advisory Service (TPAS) should look into setting up a web-based structured choice tool to guide people through their retirement income options. The web-tool should include information choosing the most appropriate annuity for them such as a single or joint life annuity and flat rate or escalating. The tool should also provide appropriate links to the Financial Services Authority (FSA) comparative tables. TPAS should ensure that relevant stakeholders are given the opportunity to be involved in developing and publicising the tool.

- The Department for Work and Pensions should lead on facilitating the development of better-focused information along the lines of a structured choice approach (where individuals are guided by providing them with enough appropriate information to make their own choices), again with the close involvement of stakeholders.

- The FSA should obtain relevant management information from the alleged worst performing annuity providers in terms of delays in transferring funds. It should assess this information against its Treating Customers Fairly principle and make any recommendations necessary. The FSA should then review firms' progress at a later date. The FSA should make it clear that all providers should collect and monitor management information on their performance in transferring funds under the OMO. This should be considered as an integral part of ensuring their compliance with Treating Customers Fairly principles.

- The FSA should review pension saving providers' maturity literature against its Treating Customers Fairly principle to see how effectively the Open Market Option is being communicated to consumers. As part of this work the FSA should also collect information on the annuity rates offered by providers.

[8] Using FSA comparative tables 20/01/09 for 60 year old male, non smoker, single life, flate rate annuity.
[9] See www.hm-treasury.gov.uk

- The Association Of British Insurers (ABI) should encourage initiatives to share OMO best practice amongst their members including a re-vamp and promotion of their Statement of Good Practice on Pension Maturities. This Statement of Good Practice should later be submitted to the FSA with a view to gaining confirmation as “Recognised Industry Guidance”. The Pensions Ombudsman should state that it will have due regard to the ABI Statement of Good Practice when deciding complaints.

- HM Revenue and Customs should clarify to the pensions industry that tax legislation allows pension schemes to offer an annuity under an open market option without having to provide a pension savings vehicle themselves and that those providing pension savings do not need to operate an annuity of their own. This will help remove any misunderstanding that might prompt some pension providers who are reluctant to accept annuity business to offer uncompetitive rates.

- HM Treasury should report annually at the UK’s Pre-Budget Report regarding how well the Open Market Option is operating and what progress has been made.

In line with the last of the recommendations above, an update on the progress of the OMO was published shortly after the Pre-Budget Report 2008. This demonstrated that significant progress had been made against these recommendations:

- The Pensions Advisory Service (TPAS) launched a structured choice web-based tool in May 2008. This can be seen at www.pensionsadvisoryservice.org.uk. The tool guides people through the choices involved in selecting an annuity and includes a link to the FSA’s annuity comparison tables, allowing people to compare annuity rates from different providers. Initial results are promising, showing that around 95% of those who have used the site, and provided feedback, found it useful and felt that it would help them to make a more informed choice about their annuity. The Association of British Insurers (ABI) will be encouraging its members to inform those nearing annuitisation about the website.

- The Department for Work and Pensions and the Treasury have formed a working group to look at the operation of the Open Market Option. The group comprises representatives from Government departments, regulatory bodies, consumer groups and the pensions industry. The group has made recommendations regarding best practice and will continue to work towards improvements in the operation of the Open Market Option

- The FSA has reviewed reported delays in companies making Open Market Option transfers against its Treating Customers Fairly principle and found that 62% of the cases fell outside of acceptable guidelines[10]

    - unacceptable delays were caused by transferring pension firms not paying the Open Market Option funds within ten business days of receipt of all documents 26% of the total cases reviewed.
    - Delays were caused by other parties in 36% of the total cases reviewed. This means that customers, their advisers or receiving

[10] See www.fsa.gov.uk

scheme operators took longer than ten business days to supply a document or other information to the transferring firm.

- As can be seen the reasons for, and sources of, these delays varied and correspondingly a number of solutions will be required. In the first instance the FSA has committed to working with the industry to reform the overall process – in particular, to achieve standardisation and rationalisation of the systems and documentation involved in fund transfer;

- The FSA has also reviewed the information that pension companies send to their customers as they approach retirement. This research has shown that the material provided by almost 40% of the firms examined did not meet the FSA's minimum requirements for Treating Customers Fairly. All of the firms involved received individual feedback from the FSA and were given until December 2008 to ensure that their documentation met the requirements;

- The ABI has produced a new Good Practice Guide: "Improving Customers' Retirement Experiences" and is working with member companies to promote best practice. The Guide includes new template content for pension companies' pre-retirement "wake-up" letters, which emphasises the potential benefit of shopping around. The guidance also requires firms to promote details of the Pensions Advisory Service online annuity choice tool;

- HM Revenue and Customs has clarified the tax position, by stating that tax legislation allows pension schemes to offer an annuity under an open market option without having to provide a pension themselves.

The Treasury will continue to monitor progress in the operation of the Open Market Option against key success criteria:

- people coming up to retirement understand the importance of choosing the right annuity and of shopping around for the best rate; and
- the process of shopping around and switching providers is as quick and simple as possible.

The Treasury will also continue monitoring the percentage of people making use of the Open Market Option.

Financial capability

The UK's overall approach in relation to financial products is to allow the market to develop freely, subject to conduct of business rules to protect consumers. Regulation can help reduce the detriment caused by significant information asymmetries between consumer and provider, but not eliminate it. The impact of information asymmetry is greater when 'repeat purchases' are infrequent or, as in the case of annuities, decisions are one-off. Increasing consumers' financial capability is seen as an important way of exerting competitive pressure on the market and avoiding the need for too much expensive consumer protection regulation.

Once purchased an annuity is payable for at least the remainder of the individual's lifetime. This could be a significant period and the annuity could represent the majority of that person's income during that period as well as any continuing income for a surviving spouse or other dependents after the member's death. Few other products can have such a profound impact on an individual's lifestyle and it is therefore highly desirable that people choose the right type of annuity for their needs as well as getting the best available rate.

The FSA's 2006 baseline survey showed poor levels of financial capability amongst UK citizens. The most significant finding for annuities is that people did not take adequate steps to choose products to meet their needs. They failed to shop around, and demonstrated a poor understanding of risk and product detail. Only 21 per cent of the sample conducted a search for a 'best buy' across all financial products. Older people performed below average on this measure of capability.

It is hence not surprising that relatively few people make an active choice of annuity and so fail to maximise their income in retirement.

There are a number of questions people in a DC pension scheme need to think about as they approach retirement age:

- Should I buy an annuity? It may not be worth doing so for small pension pots, which can be taken as cash. Or with a large pension fund, an individual may want to consider income drawdown initially.
- When should I buy an annuity? Annuity rates can fluctuate considerably over the period of a few years. For those who are not dependent on the income immediately they retire, there is a complex judgement to be made about whether waiting a few years might result in a better, or worse, annuity rate.
- How much should I take as a lump sum? A cash sum is attractive, but reduces the amount available to generate an income.
- What type of annuity should I buy?
- Should I shop around?
- Should I take independent advice? Independent Financial Advisers can help the individual find their way through the complex issues involved, but there are a number of reasons people do not use them. There is a general belief that IFAs charge high fees, or are motivated by commission rather than the interests of the customer[11] For small funds, the expense may not be worthwhile.

There is already a good deal of information provided to people approaching retirement, from the 'wake-up' packs distributed by insurers to the independent advice available through TPAS and the FSA, which produces factsheets on a number of pension issues through its *Moneymadeclear* website. In addition there are projects around the country which are aimed at helping older people to manage their finances better. One example is 'Your Money Matters', a collaboration between a major UK high street bank and a third sector organization focused on older people. This provides advice on basic money management and debt.

Money Guidance

Despite the volume of information (or more likely because of it) people often prefer to talk through their financial matters with someone who can help them reach a decision.

As part of its approach to financial capability, the UK Government identified a gap in the provision of easily accessible guidance on money, which is impartial, tailored to personal circumstances but not geared to selling products. In short, there was nothing between the IFA for the better-off and debt advice for those who found

[11] *Information Needs at Retirement: Qualitative research focusing on annuitisation decisions.* Sarah Horack, Margaret Watmough, Andrew Wood and Kate Downer. DWP Research report No. 515.

themselves in financial difficulties. To examine this ‘advice gap’, the Government commissioned Otto Thoresen, CEO of Aegon UK, to investigate the feasibility of a national approach to delivering ‘generic’ (unregulated) advice. Thoresen’s report[12] sets out a high-level blueprint for what he called Money Guidance, which would help people think through their financial issues in a straightforward way, via a website, or by telephone or face-to-face.

Money Guidance is being piloted in the North of England in the spring. The ambition is that it will help people engage with the personal finances and, among other things, help them get to grips with the volumes of information they routinely receive on financial matters.

HM Treasury
22 January 2009

[12] *Thoresen review of generic financial advice: final report.* March 2008.