Best Practice for Annuity Distribution

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There is ample evidence from the National Association of Pension funds (NAPF) and the Pensions Commission, among others, that private sector employers are moving from Defined Benefit (DB) to Defined Contribution (DC) pension arrangements. During the next decade, the trend from DB to DC in the private sector will accelerate. Many commentators expect that within five years the vast majority of private sector DB schemes will close to future accrual, forcing employees to rely on replacement DC schemes. It is also clear that the success of DC pension arrangements relies in equal measure on an efficient accrual stage (contribution levels, asset allocation, charges) and an efficient 'decumulation' or annuity purchase system (choice of structure, features, and rate). Over the next 10-15 years the 'DC-boomers' – the first generation of employees in the private sector that will rely largely on DC – will reach retirement and face decisions about annuity purchase.

The Pensions Institute (www.pensions-institute.org) has recently published a report – 'Annuities and Accessibility' – that sets out to identify barriers to greater efficiency in the pension annuity market and to propose solutions. The purpose of the report is to stimulate the debate in the DC market with reference to the annuity purchase decision, which is and will remain the most common mechanism consumers use to convert a DC fund to an income stream in retirement. The focus of the research is mainly on mechanisms for distributing annuities to consumers and ensuring appropriate choices are made. In particular, it considers the 'middle market' for annuities – that is, individuals who can afford to save for retirement but for whom sophisticated 'drawdown' arrangements are generally unsuitable. For most people in this market it is necessary to use the DC pension fund for income purposes as soon as earned income stops.

The open market option

Members of DC pension schemes approaching the point of retirement will usually be offered by their scheme provider the opportunity to convert their fund into retirement income via the purchase of an annuity. However, the rate they are offered may or may not be competitive relative to rates available in the wider marketplace. To protect consumers from the detriment of being forced to accept an uncompetitive rate, legislation requires the pension provider to allow the consumer to purchase an annuity from another insurance company. This right is known as the 'open market option' (OMO).

Intuitively most consumers understand the importance of shopping around and they apply this commonsense approach to most of their purchases. Yet at present, two in three consumers do not use the OMO for their annuity purchase, suggesting some form of 'inertia' is at work. The differential between the income offered by the existing pension provider and the top OMO rate can be as much as 30%. Over a retirement of 20 or more years, the 'loss' to the consumer, therefore, can be very significant.

The annuities experts interviewed in the Pensions Institute research pointed out that for the OMO process to operate efficiently the annuity selection must involve two distinct stages, of which securing a competitive rate is the second. The first stage is to ensure that the individual selects the right type of annuity (conventional vs. enhanced, for example) and the most appropriate features (indexation and a partner's pension, for example). To illustrate this important point, an individual who would qualify for an 'enhanced' rate due to lifestyle factors such as smoking and obesity could lose 20% of the potential income if he or she buys a conventional annuity, even where this is a competitive rate in the open market for the individual's age and fund size.

Recommendations for change

The Pensions Institute research highlights a number of areas where improvements can be made to the mechanisms for distributing annuities. For the most part these involve improving the transparency of the market or providing consumers with easier access to specialist advice.

- More direct pre-retirement information

At present, details about the OMO are buried in pre-retirement literature sent to consumers. The combination of FSA regulatory requirements for the provision of information and the pension companies' own marketing literature results in information overload for consumers. The Pensions Institute report argues that the 'wake up' information on the OMO required to be sent by providers to all individuals pre-retirement should be clear and direct, explaining the benefits of the open market option in monetary terms. A short, standardized letter on the OMO could be sent separately from the main pack. This is more likely to provoke an active response.

- Easier access to specialist annuity advice

Only an independent financial adviser can offer a full annuity service, as the service is predicated on the ability to broke the entire market. Fewer than a dozen national firms specialise in annuities and there is no official mechanism for consumers to identify these. The FSA annuity leaflets and website currently provide links to IFA trade bodies. In turn these bodies will help an individual identify local IFA firms, in most cases using a search engine that relies on the consumer's postcode. The firms identified, therefore, may not be annuity specialists and might only sell two or three annuities a year. The Pensions Institute report suggests that specialist annuity advisers should form and promote a trade body along similar lines to the Safe Home Income Plan (SHIP) companies that operate in the equity release market. The organisation could be mentioned on the websites and in the literature of the FSA, Association of British Insurers (ABI), and Department for Work and Pensions (DWP) among others, allowing consumers to identify appropriate firms.

Trustees of occupational DC schemes could also benefit from the creation of this new trade body. Trustees must provide scheme members with information about the OMO, but they need not actually provide the member with advice or assistance in securing an appropriate annuity type and a favourable rate. The Pensions Institute report suggests trustees could refer retiring members to one of the specialist annuity advisers, who in turn would secure an annuity for the member.

- Increased transparency of annuity rates

At present the FSA comparative annuity tables show only the rates voluntarily provided by approximately 13 leading insurers. Even within this group there is a 15% differential between the top and bottom rates. Advisers suggest that across the whole market – over 100 companies – the differential is up to 30%. The lack of a single public source of annuity rates for all insurance companies hampers consumers from making comparisons between the rate that they are offered by their existing pension provider and other rates available in the OMO market. The Pensions Institute authors suggest that all insurance companies that sell annuities, whether in the open market or solely to their own customers, should be required to provide their rates regularly to the FSA, so they can be shown in monetary terms in comparative tables.

- Workplace advice

Employees tend to trust employers to provide them with retirement information. Regulations prevent employers from making specific recommendations. Nor do employers have the specialist knowledge or desire to do so. The Pensions Institute report suggests employers should be encouraged to provide generic seminars and referrals in the workplace making use of the tax-deductible £150 per annum per employee that became available for pensions advice in November 2004. Providing personal advice to all employees could be too onerous for most employers, but one-off advice at retirement should be less of a burden.

- More information on annuity indexation and inflation

At present the ABI best practice guidelines suggest that the default annuity quote issued to the pension scheme member should be that of a single life, non-escalating annuity, with a 5-year guarantee. This is consistent with actual purchasing behaviour in the annuity market, where 80% of customers opt for level annuities. Level annuities may be appropriate where spending is skewed towards the early (active) years of retirement and declines as individuals become older. However, individuals may opt for level annuities not for these rational reasons, but because they do not fully understand the issues at stake. They may be tempted to take the highest short-term income without considering the inflation risk they are taking and the impact of declining purchasing power through time. The Pensions Institute report suggests that pre-retirement literature produced by providers and regulators should include a more direct discussion of the choice between level and indexed annuities. It should discuss in frank terms how the purchasing power of a level annuity will decline through time, but invite the individual to consider their likely spending patterns in retirement, including the potential for increased care and medical costs in later life.

Conclusion

For most DC pension scheme members, annuities form a crucial part of the process of securing an adequate retirement income. There is evidence that the annuities market does not always operate effectively and that many consumers could achieve a better deal if they had improved information and advice. The Pensions Institute report provides a number of recommendations for changes that can either improve the information available to retiring pension scheme members or ease the process of accessing specialist advice. Given the growing importance of the annuity market, it is crucial for the industry to develop and take forward these ideas.

Endnote:

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