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FSA urged to name and shame poor value annuity companies

Today researchers at the Pensions Institute, Cass Business School, will recommend that the Financial Services Authority (FSA) should require all 100+ insurance companies and friendly societies that sell annuities, whether in the open market or to their pension customers, to list their rates in the FSA website comparative tables. At present only 13 companies provide rates on a voluntary basis. The full list of rates would enable consumers to compare directly the quotes they receive from their pension provider with those of top providers, which may offer an income 20-30% higher.

The Pension Institute's third report on the UK pensions market, *Accessible Annuities: How the industry can empower consumers to make rational choices*, will also urge specialist financial advisers, which can provide low-cost open market option (OMO) quotations for all fund sizes, to form a new trade organisation. The FSA and the Department for Work and Pensions (DWP) should provide a link to this organisation on their pensions website pages and in consumer literature, alongside the existing links for generalist adviser trade bodies, the report states.

Speaking at the National Association of Pension Funds (NAPF) investment conference in Edinburgh, Debbie Harrison, an author of the report and Senior Visiting Fellow of the Pensions Institute, Cass Business School, says, "These two simple steps alone could transform the way consumers buy their retirement incomes. At present, while all companies must send details of the OMO to customers, the information is buried in long and complex documents, which suggest implicitly that the consumer will buy direct from their current provider. Telling people to seek independent advice is not effective because only a minority of the 5000 regulated firms that offer pensions and investment advice provide a low-cost full market search. The chance of finding a specialist through an adviser trade body that uses a postcode search engine is slim."

The open market option was introduced by the Income & Corporation Taxes Act 1988 and allows individuals with defined contribution (DC) pension arrangements, such as personal pensions, to take their fund away from their existing provider to seek a better annuity rate elsewhere. At present two in three consumers do not use this option.

"Intuitively most consumers understand the importance of shopping around and they apply this commonsense approach to most of their purchases", Harrison says. "Consumers build up a learning curve with property purchase, as they do with cars, holidays, and other 'big ticket' items. The annuity purchase is a one-off transaction, so there is no opportunity to learn through experience."

Alistair Byrne, a Fellow of the Pensions Institute, Cass Business School, and co-author of the report, says, "The lack of a learning curve adds significantly to the fear factor and the behavioural barriers that prevent people from exploring the annuity market and buying with confidence. The fact that two-thirds of investors do not use the OMO is a result of something more than inertia. Rather it is a paralysis that is triggered when consumers are faced with a range of complex decisions and are afraid of making a single irrevocable choice that is wrong."

The report recommends that the ‘wake up’ information on the OMO, which providers must send to customers pre-retirement, should be clear and direct, explaining the benefits of the open market option in monetary terms. A short, standardised letter on the OMO should be sent separately from the main information pack. This is more likely to provoke an active response, the authors argue.

Importantly, the report stresses 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). This suggests that a focus on rate alone is misleading and that the efficient use of the OMO requires a mechanism that unites consumers with specialist, low-cost, advisers.

Byrne says, “To make a rational choice consumers must understand the nature of their DC pension arrangements and any reasons why making use of the OMO is not beneficial, including features such as a loyalty bonus, an exit penalty, and the availability of a guaranteed annuity rate (GAR). For the average consumer this information may not be obvious from the pension documentation. “

The report also recommends that the government should encourage employers to provide generic seminars and referrals to specialist advisers in the workplace, making use of the tax-deductible £150 per annum per employee that became available for pensions advice in November 2004. Trustees of occupational DC schemes and employers with contract DC schemes should also refer the annuity purchase to specialist advisers. Some trustees and employers already do this on a voluntary basis.

The report was sponsored by the National Association of Pension Funds (NAPF), AEGON UK, Just Retirement, Legal & General, and Prudential. Its primary focus is 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 convert the DC pension fund to an annuity as soon as earned income stops.

David Blake, Director of the Pensions Institute, Cass Business School, says, “The purpose of *Annuities and Accessibility* 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. Our objective was to identify mechanisms for distributing the OMO to consumers and which ensure rational choices are made.”

For more information or to obtain a pre-publication copy of the report contact:

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The report will be available on the Pensions Institute website on Thursday 16 March: www.pensions-institute.org.

Notes to editors

The annuities market is already large and is growing rapidly, which indicates that the impact on consumer welfare of any distortions in the market will be increasingly significant. We know, based on 2004 figures provided by the Association of British Insurers (ABI), that about 350,000 people each year are joining the ranks of the many millions of people who rely in retirement on pension annuities either to provide their main private income or to supplement income from other sources, such as occupational pension schemes. Annuity payments – that is the amount insurance companies pay out to annuitants – totalled £7.7bn in 2004.

Since 1994, sales of annuities have almost trebled and the ABI expects the annuity market to double over the next six years. This would raise the value of sales – that is the total amount consumers invest in annuities – from about £7.5bn per annum in 2004 to over £18bn in 2012. These figures include all annuities whether they are purchased directly by individuals (including those purchases made using the OMO) or by a third party on their behalf, such as the trustees of an occupational scheme.

There is ample evidence from the NAPF and the Pensions Commission, among others, that private sector employers are moving to DC arrangements. During the next decade, the trend from DB to DC in the private sector will accelerate. As the Pensions Institute 2005 report *Pyrrhic Victory?* observed, within five years the vast majority of private sector defined benefit (DB) schemes, which link pensions to salary and service, will close to future accrual, forcing employees to depend on replacement DC schemes. In this situation members retain their rights to DB benefits built up to date but rely on DC for future service.

The Institute's October 2004 report, *Delivering DC*, noted 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 complex decisions about their annuity purchase.

About the Pensions Institute

The Pensions Institute at Cass Business School was founded by Professor David Blake in 1996. As the first and only UK academic research centre focused entirely on pensions, the Institute brings together a broad range of disciplines from economics, finance, insurance, and actuarial science through to accounting, corporate governance, law, and regulation.

The objectives of the Pensions Institute are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, and to employers and trustees.

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The school undertakes research of national and international significance and supports almost 100 PhD students. Cass has the largest Finance Faculty and the largest Actuarial Science & Statistics Faculty in Europe. Our finance research is ranked 2nd in Europe and 4th in the World outside the US by *Financial Management Magazine* and our insurance and risk research is ranked 2nd in the world by the *Journal of Risk and Insurance*.

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