Association of British Insurers

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# PENSION ANNUITIES

## Pension annuities and the Open Market Option


**Report from ABI Research Department**

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# EXECUTIVE SUMMARY

## Key findings

- The UK pension annuities market has tripled in size in the last 15 years. In 2007, premiums in the pension annuities market were over £11 billion and over 400,000 contracts were sold. Demand for pension annuities is set to rise further in the coming years, due to a rise in the number of maturing defined contribution pensions.
- Almost two-thirds of annuitants arranged their annuity 'internally' (through the provider of their private pension). The average premium for an annuity purchased internally was £13,000. The average premium for an annuity purchased 'externally' (from a provider other than the provider of their private pension) was £24,000.
- The majority of providers (17 out of 23) offer 'internal' annuity rates on the most popular product (a single-life level annuity) that are at least 95% of the highest rate available externally.
- Eighty-five percent of customers purchase a single-life level annuity at a rate of at least 95% of the highest external rate.
- The lifetime gain from buying the highest paying annuity available externally compared to the average internal annuity rate is £530 for a pension fund of £10,000. Our survey finds that almost half of internal annuity purchases are for £10,000 or below.

## Background

The aim of this research is to establish how well the pension annuities market is working. The research, based on a survey of ABI member companies who provide annuities, has been prompted by three main factors:

- Concerns that not enough people are shopping around for annuities by using the Open Market Option (OMO).
- The combined effect of low gilt yields and increases in longevity on annuity rates.
- Anticipated growth in demand for annuities as defined-contribution pensions take a larger share of the total private pensions market.

The aim of the survey was to gain a better understanding of the structure of the annuities market, the extent to which consumers were exercising the OMO and the gains that consumers could make from shopping around for an annuity provider.

Of the 36 ABI member companies providing annuities, 26 responded to the survey representing 92% of pension annuity premiums and 89% of contracts. To supplement this, we also conducted research using existing data from the ABI, the FSA comparative tables and the magazine 'Moneyfacts Investment Life & Pensions'.

## The pension annuities market

Under the Open Market Option, consumers can compare annuity rates offered by other annuity providers and arrange an 'external' annuity (with a company other than that used to build up the consumer's pension fund). Alternately, they can arrange an annuity with the provider they have built up their pension fund with – referred to in this report as an 'internal' annuity. We estimate that one-third of annuitants shop around then buy externally, one-third shop around then buy internally and one-third do not shop around (and buy internally).

Almost two-thirds of personal pension annuity contracts are sold internally. In value terms, over 50% of annuity-purchase premiums came from internal purchases. Our survey finds that those individuals who purchased an annuity internally had a smaller average pension fund (£13,000) than those who purchased externally (£24,000).

Our survey finds that 23% of all annuities bought in 2006 had a fund value of less than £5,000, and 41% had a value of less than £10,000. As annuity providers commonly set minimum purchase prices on external sales, consumers with smaller pensions funds are likely to be limited in their choice of providers. However, we also find that in practice firms do at times provide external annuities to customers who do not meet their minimum purchase price criteria.

Our survey shows that almost half of those who purchase their annuity internally have pension funds of under £10,000. In contrast, just over a quarter of those who purchase their annuity externally have funds of under £10,000. This indicates that a large proportion of those who currently do not buy externally may have good reasons for not doing so. Apart from the possibility that the internal rate may be a good deal (and this is particularly likely where they are entitled to a Guaranteed Annuity Rate), many of those who do not buy externally have relatively small pension funds and consequently have limited opportunities, and limited potential gains, from buying externally.

## Annuity prices

To look at the scope for consumers to get a higher income by buying their annuity externally, we looked at the dispersion of annuity rates as a percentage of the highest available OMO rate. This is similar to the methodology used by the FSA in its 2002 study.

For the most popular annuity product (a single-life level annuity) the majority of providers (17 out of 23) offer internal rates that are above 95% of the highest OMO rate. One firm offers an internal annuity rate that is less than 90% of the highest OMO rate, and one provider has an internal rate that is above the highest OMO rate. Four providers have internal rates that are equal to the highest OMO rate. Consumers with pensions at these firms would see no financial gain from exercising their OMO.

We cross-checked these results using data from the FSA comparative tables and Moneyfacts Investment Life & Pensions. While this cross-check is not perfect – most notably the Moneyfacts and FSA data is only for *external* annuity rates – the findings are consistent with the results of our survey. For example, the Moneyfacts data shows the lowest external rate is 89% of the highest OMO rate, while seven out of nine firms have an external rate that is at least 97% of the highest OMO rate. This compares with a lowest internal rate of 89% and a lowest external rate of 93% in our survey.

## Annuity prices by number of customers

To see how many consumers could benefit financially from exercising their OMO we weighted our results for each firm by the number of annuities sold. This allows us to get a good approximation of how many consumers stand to benefit and by how much from using the OMO.

We find that 85% of customers we have information for receive an annuity rate that is at least 95% of the highest OMO rate. We also find:

- 35% receive a rate that is either above the highest OMO rate or equal to it.
- 26% of customers receive a rate that is 99% of the highest OMO rate.
- 15% of customers receive a rate that is less than 95% of the highest OMO rate (1% of these had bought externally).
- 81% of customers buying *internally* got an annuity rate at least 95% of the highest OMO rate
- 91% customers buying *externally* got an annuity rate of 99% of the highest OMO rate or higher.

We have also compared our results with those obtained by the FSA in 2002. The FSA use a joint-life level annuity and found that 78% of annuities were bought at a rate between 85% and 95% of the highest OMO rate. Our results for a joint-life level annuity show that 78% of these annuities are bought at a rate which is between 95% and 100% of the highest OMO rate.

The FSA had a larger number of firms in its sample and included more smaller firms. There were also other differences in approach. However, as our survey covers 87% of the conventional annuities sold by volume and 91% of the conventional annuities sold by value, the differences in the samples do not account for all the differences between the two surveys.

## Lifetime gains

Another way to analyse the difference between internal annuity rates and the highest OMO annuity rate is to compare the potential lifetime gains that can be made by consumers.

To do this we use the annuity rates that we obtained from our survey and an estimate of the annuitant's life expectancy based on the Government Actuary's Department data. We then use these figures to calculate the lifetime difference between the average internal annuity rate and the highest OMO annuity rate.

For a 65-year-old male buying a conventional single-life level £10,000 annuity with a five-year guarantee, the lifetime gain from buying the highest OMO rate annuity compared to the average internal annuity rate annuity would be £530 or £26 a year. Table 1 shows the lifetime gains for funds of different sizes.

**Table 1 Lifetime gain from getting the highest OMO rate compared to the average internal annuity rate for a male aged 65 buying a conventional single-life level annuity with a 5-year guarantee**

| | Pension fund size | | | |
|---|---|---|---|---|
| | £10,000 | £20,000 | £25,000 | £35,000 |
| OMO High | 14,090 | £28,915 | £36,306 | £51,094 |
| Internal Average | 13,560 | £27,515 | £34,521 | £48,447 |
| Life Time Gain | £530 | £1,400 | £1,785 | £2,647 |
| Yearly Gain | £26 | £68 | £87 | £128 |
| % Gain | 3.91% | 5.09% | 5.17% | 5.46% |

**Note:** Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts. Our survey found that 15% of contracts sold in 2006 were over £35,000.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and GAD data.

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# 1.0 INTRODUCTION

The aim of this research is to establish how well the pension annuities market is working. The research has been prompted by three main factors:

- Concerns that not enough people are shopping around for annuities by using the Open Market Option (OMO).
- The combined effect of low gilt yields and increases in longevity on annuity rates.
- Anticipated growth in demand for annuities as defined-contribution pensions take a larger share of the total private pensions market.

## 1.1 Approach

In order to gain a better understanding of how well the UK pension annuities market is functioning we conducted research using:

- ABI New Business statistics.
- An Autumn 2007 survey of member companies who provide annuities. We use this new data to estimate: the size of the annuities market; the availability of annuities to customers shopping around; the dispersion of annuity prices under a number of different scenarios; and to identify the potential gains from buying externally.
- The monthly magazine 'Moneyfacts Investment Life & Pensions' and the FSA comparative tables to estimate the dispersion of pension annuity prices as a cross-check on our results.
- Government Actuary Department (GAD) and our Autumn 2007 survey data to estimate the lifetime gains from buying externally.

## 1.2 Structure of the report

The report is structured as follows:

- Section 2 provides background on the UK pension annuities market.
- Section 3 looks at the pension annuities market, in particular, the size and type of annuities sold and how this varies by whether the annuity is sold 'internally' or 'externally'.
- Section 4 looks at price dispersion and the potential lifetime gains from buying externally.

# 2.0 BACKGROUND

## 2.1 Overview of annuities

A pension annuity is used to convert the money an individual has built up in their pension fund over their working life into a regular stream of income during retirement. Since this income is guaranteed until death, it effectively insures the individual against outliving their pension fund. The overall annuities market is split into two categories:

- **Purchased life annuities.** These allow a fund to be converted into an income stream. The purchase of these annuities is voluntary.
- **Pension annuities.** Individuals that contribute to defined contribution pension schemes are required to purchase an annuity as part of the terms of their pension contract. The compulsory age limit for annuitisation is currently set at 75.[1]

The pension annuities market is much larger than the purchased life annuities market: in 2007 premiums in the two markets were £11,028 million and £47 million respectively.[2] The UK pension annuities market has tripled in size in the last 15 years. The demand for pension annuities is set to rise further in the coming years, due to a rise in the number of maturing defined contribution pensions.[3]

There are several types of annuity products available on the market. The most popular is a single-life level annuity. This pays the same amount of income (usually monthly) for the rest of the individual's life, therefore declining in real value due to inflation. Joint-life annuities continue to pay an income to the spouse or partner should the annuitant die. A guarantee can be added to an annuity, usually for a five or ten-year term, so that if the individual dies within this period the beneficiaries will receive the income that would have been paid to the annuitant until the end of the term. Other common types of annuity products include:

- Escalating annuities. Escalating annuities increase either by a constant proportion each year, for example 3% per annum, or by the rate of increase in the Retail Prices Index (RPI).
- Investment-linked annuities. Investment-linked annuities can be with-profits or unit-linked. In both cases the income paid by the annuity will vary with the performance of the underlying investments.
- Enhanced or impaired life annuities. Impaired life annuities pay a higher amount than normal annuities if you have a health problem (such as cancer or chronic asthma) that could reduce your lifespan. Enhanced annuities pay a higher amount than normal annuities if you are a smoker or overweight.

[1] Stark (2002) shows the majority of individuals (81%) purchase their annuity between the ages 60-69, with 14% annuitising before 60 and 5% annuitising at 70 or above.

[2] ABI New Business statistics, February 2008.

[3] ABI (2005), '‘The pension annuity market – developing a middle market'.

Individuals are allowed to take up to 25% of their pension fund as a tax-free cash lump sum. The rest of the fund must be used to purchase an annuity by the age of 75. In addition, there are 'trivial commutation' rules in place which allow individuals with a modest pension fund to take the whole amount as a lump sum. The trivial commutation limit is set a 1% of the lifetime allowance (£16,500 in 2008/09).

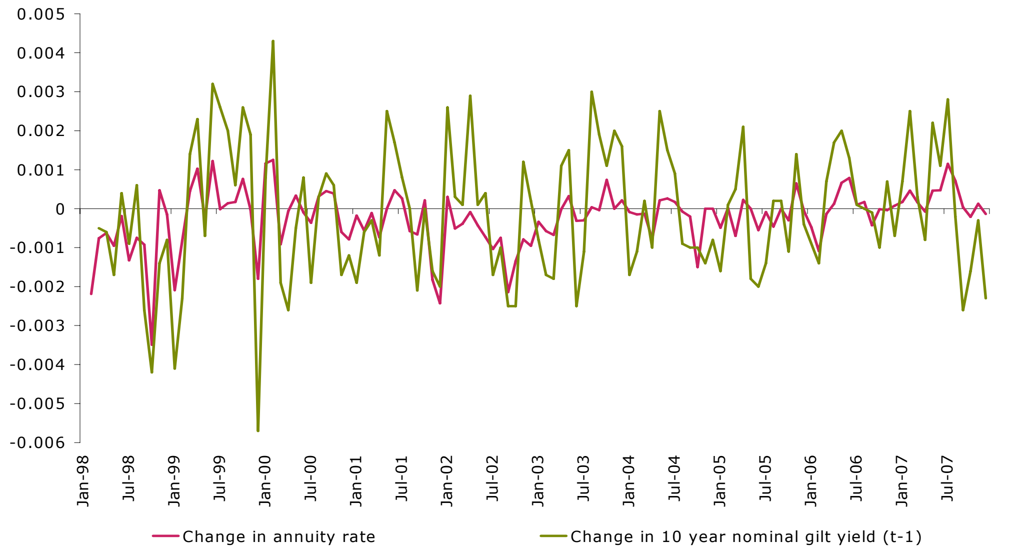
## 2.2 The Open Market Option

The government introduced the Open Market Option (OMO) in 1978. This gives policyholders the right to shop around for annuities from other ('external') providers and compare this to what is on offer from the ('internal') provider of their pension. To improve the effectiveness of the OMO, in September 2002, the FSA introduced new rules requiring pension providers to inform customers of their right to shop around before purchasing an annuity (the 'wake up' letter). In 2003 annuities were added to the FSA's Comparative Tables.

## 2.3 Pricing annuities

Annuity rates depend on life expectancy, the premium paid and the type of annuity. An individual's life expectancy takes into account factors such as age, gender and health. Individuals with below average life expectancy are more likely to receive higher annuity rates. Insurers also use long dated government securities (gilts) in order to help manage these long-term liabilities. Therefore the return on annuities is also closely linked to gilt yields. In Figure 1 we plot the change in the annuity rate (the average annuity rate from eight firms for which we have data throughout the period) and the change in the 10-year gilt yield. To take account of the speed with which firms react to changes in gilt yields, we lag the change in gilt yields by one month.

## Figure 1    Changes in the annuity rate and gilt yields




**Note:** See Appendix 1 for individual annuity rates and the gilt yield.

**Source:** Bank of England and ABI Research Department. Annuity rates calculated using Moneyfacts Investment Life & Pensions.

Figure 1 shows that changes in the gilt yield are followed by similar though smaller changes in annuity rates. The correlation coefficient between the two variables is 0.7. We have also modelled the relationship between the annuity rate and the gilt yield. Our results show that there is a valid long run relationship between these two variables. For further details please see Appendix 1.

Gilt yields are low by historical standards. For example, the yield on a 10-year gilt was 4.5% in January 2008 compared to 8.8% in January 1995 and 11.4% in January 1985. In light of the relationship between gilt yields and annuity rates, the decline in gilt yields partly explains falling annuity rates. (Increasing longevity is another important factor in declines in annuity rates.)

# 3.0 THE PENSION ANNUITIES MARKET

## 3.1 Background

In Autumn 2007 the ABI conducted a survey of members who provide annuities. The aim of the survey was to gain a better understanding of the structure of the annuities market, the extent to which consumers were exercising the OMO, and the potential gains that consumers could make from shopping around.

## 3.2 The data survey

Companies were asked to provide information on the volume and value of annuity business sold in 2006. We also requested that companies quote their annuity rates as of 1st June 2006 in order to capture a period when gilt yields were relatively stable.[4]

The first half of the questionnaire asked companies whether they sell annuities externally (under the OMO) and, if so, whether there are any restrictions in place (for example, a minimum purchase price). We also asked firms to give details of any Guaranteed Annuity Rate (GAR) annuities and annuities sold with a guarantee period. Firms were then asked to provide information about the volume and value of their annuity business, including internal and external annuity rates across a number of products, and the distribution of internal and external annuities sold by value and sales channel.[5]

Of the 36 ABI member companies providing annuities in 2006, 26 responded to the data survey representing approximately 92% of pension annuity premiums and 89% of contracts.[6] Of these, 15 companies reported having internal annuity business only, and one company offered annuities to external customers only. Ten offered annuities both internally and externally.

## 3.3 Restrictions on external sales

All annuity providers place some form of restriction on external annuity sales. Most of these relate to a minimum purchase price. One provider maintains discretion over the minimum purchase price. Three providers have a minimum purchase price of £5,000 (for two providers this applies to combined pension funds), a further two have a minimum

[4] We chose a period where gilt yields were relatively stable to minimise any distortions that arise when providers respond at different times to changes in gilt yields.

[5] Internal and external annuity rates for pension fund sizes of £10,000, £20,000, £25,000 and £35,000 were requested for the following products: single life level male (no guarantee), single life level female (no guarantee), single life level male (guaranteed for 5 years), RPI-linked male (no guarantee), joint-life level reducing by 50% on death of male (no guarantee for males aged 65 and females aged 62 at point of purchase).

[6] Pensions annuities are also sold by firms that are not ABI members. From FSA returns we estimate that ABI members accounted for well over 95% of pension annuities sold (by volume and value) in 2006. We estimate that our survey covers 89% of the ABI members in terms of contracts and 92% in terms of premiums. We have cross-checked this with FSA Form 47 returns and found similar results.

purchase price of £10,000 and one provider has a minimum purchase price of £60,000 (on combined pension funds). One provider has a minimum purchase price that varies according to product. They have a minimum purchase price of £10,000 for standard annuities and £30,000 for enhanced and impaired life annuities. Three companies have further restrictions – one has a minimum purchase price of £10,000 and does not accept safeguarded rights or attaching earmarking options, one only sells enhanced and impaired life annuities and the other restricts the sale of annuities to specific occupations. We found that, in practice, firms do at times provide annuities to customers who do not meet their minimum purchase price criteria.

Our survey shows that 23% of annuities sold in 2006 were for less than £5,000. In effect this means 23% of people had little choice of provider if they were to exercise their OMO. Forty-one percent of annuities sold in 2006 were for less than £10,000. These annuitants were able to choose from four of the nine annuity providers that sell externally. Table 2 summarises the number of firms selling external annuities for different pension fund sizes.

**Table 2 Firms providing external annuities for different pension fund sizes (2006)**

| | % of pension annuities contracts sold in 2006 | Number of firms providing externally in 2006 |
|---|---|---|
| Funds less than £5,000 | 23% | 1 |
| Funds less than £10,000 | 41% | 4 |
| Funds less than £60,000 | 93% | 8 |
| All funds | 100% | 9 |

**Note:** Firms with occupation restrictions and only selling enhanced and impaired life annuities are excluded. Note that in practice, firms do at times provide annuities to customers that do not meet their minimum purchase price. Since June 2006, another provider has started making annuities available externally for sums less that £5,000.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and ABI statistics.

## 3.4 Internal and external sales

The survey data allows us to calculate the proportion of pension annuity contracts sold internally and externally in 2006. This is shown in Table 3.

**Table 3 Proportion of internal and external pension annuities sold in 2006**

| | Internal purchase | External purchase |
|---|---|---|
| Proportion by no. of contracts | 67% | 33% |
| Proportion by value | 56% | 44% |

**Note:** Total market covers level, escalating, investment-linked, enhanced and impaired life annuities.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007.

Two-thirds of personal pension annuity contracts were sold internally (by the provider of the annuitant's pension). In value terms, over 50% of premiums came from internal purchases. Thirty-three percent of contracts were purchased externally. This is in-line with other estimates (ABI New Business statistics for 2006 also show 33% of contracts were purchased externally).

The figures for those buying internally should not be interpreted as those who could have obtained a better rate using the OMO. They also include those with funds which are too small to exercise the OMO, and those who obtained a rate internally that is either the same as or above the highest OMO rate. For example, IFF (2003 and 2005) found that 37% and 31% of annuitants respectively use the OMO to shop around but choose to stay with their existing provider. Similarly, FSA (2007) find that 34% of consumers bought externally in 2006, while 66% claimed to have shopped around before purchasing their annuity.

Drawing this evidence together indicates that around one-third of annuitants shop around then buy externally, one-third shop around then buy internally and one-third do not shop around (and buy internally).

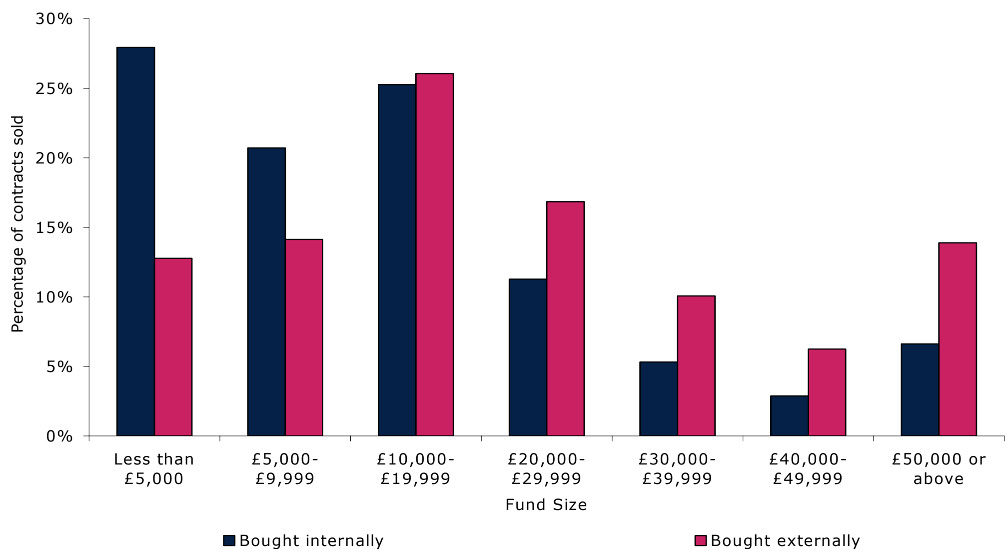
The IFF (2003) research also found that of those that shop around for an annuity and stay with their pension provider, 47% said they did so because the deal they got from their pension provider was as high or higher than the deal they could get elsewhere. A further 12% said an IFA had advised them to stay with their pension provider. Sixteen percent (and 28% of those with pension funds under £10,000) said that the sums involved did not justify buying externally. The IFF (2005) research found that amongst those *not* shopping around, 12% said the small amounts involved meant shopping around was not worthwhile.

## 3.5 Size of annuities sold

The distribution of pension annuities is summarised in Figure 2. Our survey shows that those individuals who purchased an annuity externally had a larger average pension fund (£24,000) than those who purchased internally (£13,000). The average value of an annuity sold in 2006 was £16,000.[7] The median annuity lies within the group £10,000-£19,000.

[7] In all cases we have excluded the top and bottom deciles when calculating our averages to remove the impact of outliers. The unadjusted averages are £30,000 (external), £19,000 (internal) and £23,000 (total).

**Figure 2 Size of pension annuities sold in 2006**




**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007.

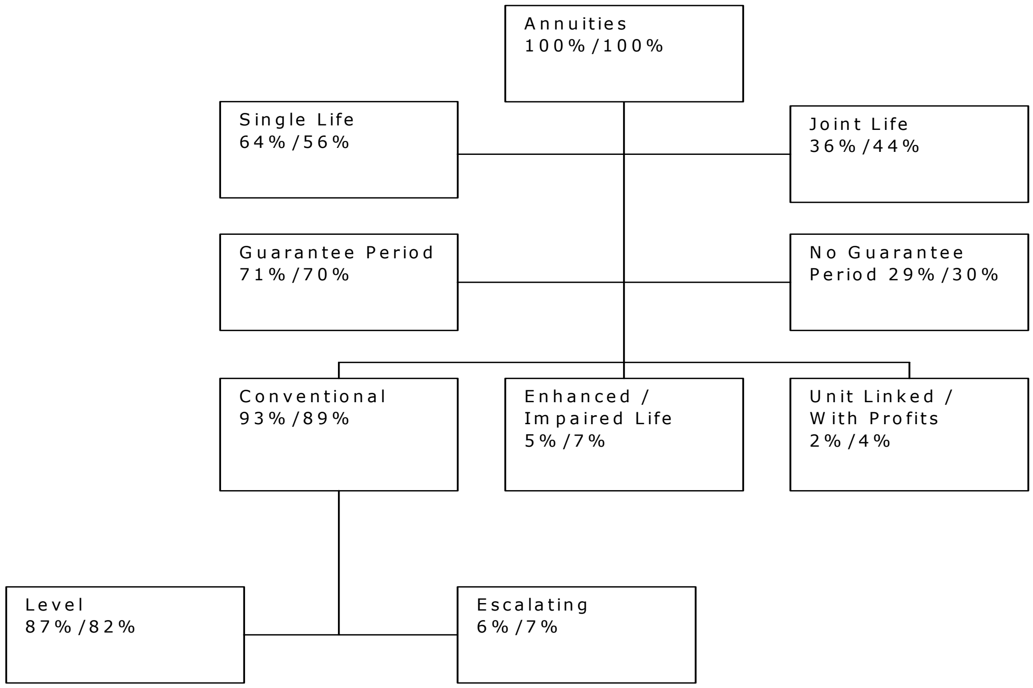
Our survey shows that almost half (49%) of those who purchase their annuity internally have pension funds of under £10,000. In contrast, just over a quarter of those who purchase their annuity externally have funds of under £10,000. This indicates that a large proportion of those who currently do not shop around may have good reasons for not doing so. Apart from the possibility that the internal rate may be a good deal (and this is particularly likely where they are entitled to a Guaranteed Annuity Rate), many of those who do not buy externally have relatively small pension funds so have limited opportunities, and limited potential gains, from shopping around (the gains from shopping around are discussed in Section 4). In addition, research by Harrison *et al* (March 2006) finds that IFAs do not usually deal with annuities under £50,000.

At the other end of the scale we find that 30% of those buying externally and 15% of those buying internally have pension funds above £30,000.

## 3.6 Type of annuities sold

We have also estimated the size of the pension annuities market and the breakdown of contracts sold from our data survey. Overall, around 350,000 pension annuities were sold in 2006. Figure 3 breaks down annuity sales into type of annuity.

**Figure 3 Breakdown of pension annuities sold in 2006 by type of product (% volumes / % values)**




**Note:** These percentages are based on the 24 firms who were able to split their business. We have cross-checked these estimates where possible with ABI Statistics and FSA Form 47 returns. The figures shown above are broadly consistent with both of these. We may understate the proportion of products sold that were investment-linked and enhanced / impaired life (in both cases by around two percent).

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007.

Our survey found that the most popular annuity product was a conventional (excluding impaired life / enhanced) level annuity, accounting for 87% of all new contracts in 2006. Conventional escalating annuities made up 6% of the market, investment-linked 2%, and enhanced / impaired life annuities 5% of the market. The general low take-up of non-conventional products may in part be due to the restrictions placed on them.[8]

Section 4 of this report looks at the gains that can be made from shopping around in terms of annuity rates. It does not look at the gains that could be made from shopping around between annuity *types*. Commentators have, for example, suggested that the take-up of enhanced and impaired life annuities could be higher than the take-up we observe at present. Other things equal, this would tend to provide higher annuity incomes for those taking enhanced or impaired annuities instead of standard annuities. Hargreaves Lansdown (2008) refer to an estimate that 40% of consumers could qualify for an enhanced / impaired life annuity. IFF (2003) find one-third of annuitants consider another type of annuity from the one that they buy and 17% had considered an impaired life annuity.

[8] For example, we noted earlier how one firm had a minimum purchase price of £30,000 on with-profit and enhanced annuities compared to £10,000 for level annuities.

Almost two-thirds of annuities sold were single-life annuities. Seventy one percent of pension annuities were sold with a guarantee period. Seventeen percent of annuities sold were Guaranteed Annuity Rate (GAR) annuities (this is not shown in Figure 3).[9] The availability of GAR annuities is an important factor in determining whether customers choose to shop around. GARs that were bought in 2006 were usually written during periods when gilt yields were high and offer high annuity rates compared to those that were available through the OMO in 2006.

In terms of annuity size, those who purchased GAR or level annuities had the lowest pension funds on average (£20,700 and £21,700 respectively). The less common products, investment-linked and enhanced or impaired life annuities had larger fund sizes, on average (£45,000 for investment-linked and £31,400 for enhanced and impaired life).[10]

## 3.7 Distribution of annuities

According to ABI statistics, 83% of external contracts (by value) were arranged through an Independent Financial Advisor (IFA).[11] Thirteen percent of external contracts were arranged by an adviser tied to a single provider. By contrast, 48% of internal contracts were arranged via an IFA and 8% as single tie, while 44% were classed as non-intermediated sales (annuities purchased directly from the provider, with no intermediary involvement). In this instance, it is important to recognise that the customer might have reached the provider in the following ways: entirely on his/her own initiative; through an advertisement mailed to a list bought from a third party; through the provider's authorised introducer; or at an earlier date through an intermediary who was no longer involved in (or remunerated for) the current sale.

[9] Nine firms provided GAR annuities.

[10] These averages are for the whole sample and include outliers.

[11] ABI statistics, February 2008.

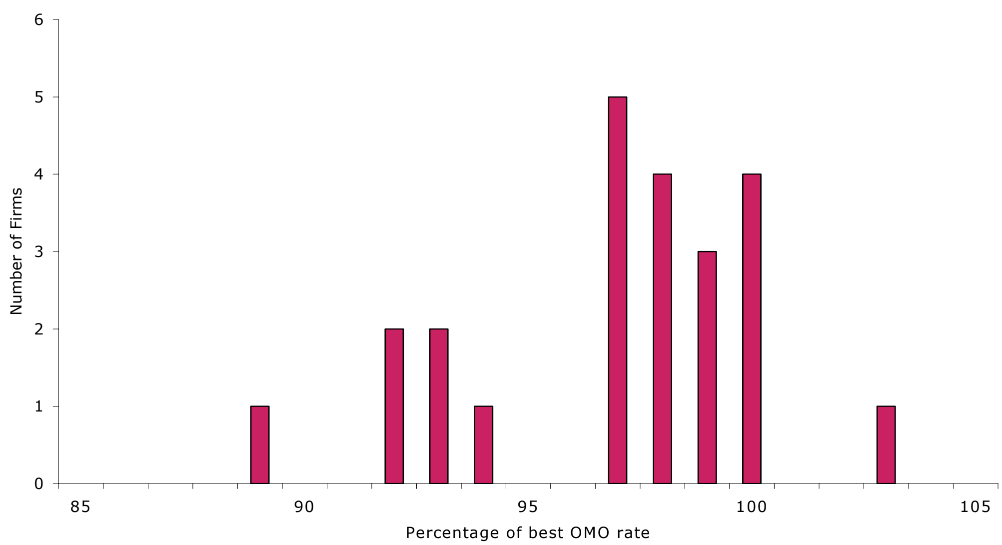
# 4.0 THE GAINS FROM SHOPPING AROUND

In this section we look at the gains that can be made from shopping around. We have collected annuity rate data for six different annuity products.[12] These can be used to show the dispersion of annuity rates as a percentage of the highest available OMO rate. This is similar to the methodology used by the FSA (see Cook *et al* 2002 for further details).

## 4.1 Annuity prices by firm

For level and escalating annuities we find that the majority of firms offering an annuity rate at least 85% of the highest OMO rate regardless of joint-life or single-life, gender and guarantee period. With this in mind we have chosen to present a 65-year-old male buying a £10,000 conventional single-life level annuity with no guarantee. We have used this case for simplicity and because single-life level annuities accounted for 60% of all annuities sold in 2006. We have also looked at joint-life level annuities and found very similar results to those presented here. Single and joint-life level annuities account for 87% of all annuity sales.

**Figure 4 Internal annuity rates as a % of the highest OMO rate for a male aged 65 buying a conventional single-life level annuity for £10,000**




**Note:** Annuity rates as at June 1st 2006. Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts.

**Source**: ABI Research Department. Calculated using ABI Annuity Survey 2007.

Figure 4 presents the number of annuity providers and their internal rates as a percentage of the highest OMO rate (which is set at 100%). The majority of providers (17

[12] For one firm we only had annuity rates for products based on a purchase price of £10,000. Rates for £20,000, £25,000 and £35,000 were approximated using scaling factors based on the FSA comparative tables.

out of 23) offer internal rates that are above 95% of the highest OMO rate. One firm offers an internal annuity rate that is less than 90% of the highest OMO rate. One annuity provider has an internal rate that is above the highest OMO rate. Four providers have internal rates that are equal to the highest OMO rate. Consumers with pensions at these firms would see no financial gain from exercising their OMO.

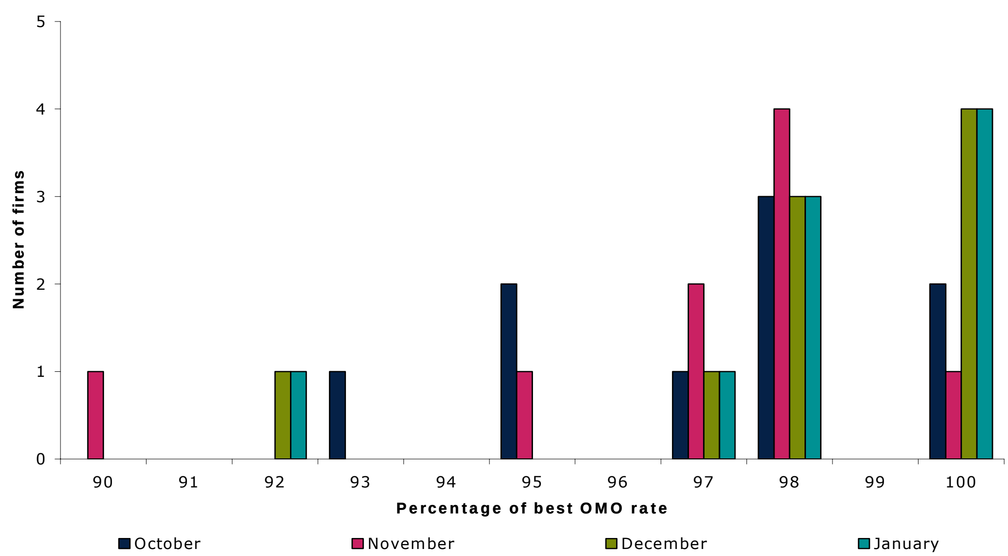
Looking at the less commonly sold products (single and joint-life level annuities account for 87% of the market) we find that the dispersion of prices is wider. For example if we take a £20,000 RPI linked annuity, the lowest internal rate was 77% of the highest OMO rate, while the highest internal rate was 112% of the highest OMO rate (both these rates were outliers offered by firms with market shares under 1%).

### 4.1.1 Other data sources

As a cross-check on our results we have performed the same exercise using data from the FSA comparative tables and Moneyfacts Investment Life & Pensions.

We have used the FSA comparative tables for the first working day of October, November, and December 2007, and January 2008. Comparing our survey results with the FSA comparative tables is not perfect – the FSA only provide external annuity rates and these apply to a different time period than the one covered in our survey. Nevertheless, the comparison does allow us to perform a cross-check on the distribution of annuity rates and the results are set out in Figure 5.

**Figure 5 FSA comparative tables: external annuity rates as a % of the highest OMO rate for a male aged 65 buying a conventional single-life level annuity for £10,000**




**Note:** Annuity rates as at the first working day of October 2007, November 2007, December 2007 and January 2008. Includes 9 firms. (We exclude firms that restrict sales to those in specific occupations.)

**Source**: ABI Research Department. Calculated using FSA comparative tables.

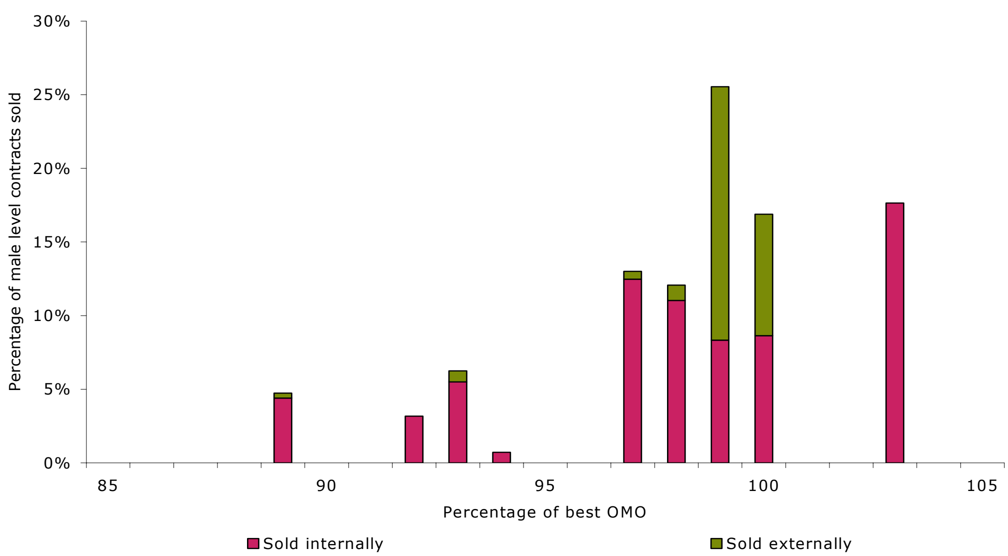
The dispersion of annuity rates from the FSA comparative tables are similar to those calculated using our survey. The lowest external rate is 90% of the highest OMO rate and the majority of firms offer rates above 97% of the highest OMO rate in all four periods. This compares with a lowest internal rate of 89% and a lowest external rate of 93% in our survey.

The annuity rates from Moneyfacts Investment Life & Pensions refer to the same point in time as our survey (June 2006). Like the FSA comparative tables they cover external annuity rates whereas our survey looked at external and internal rates. The results from Moneyfacts are again similar to ours. The lowest external rate is 89% of the highest OMO rate, while seven out of nine firms have an external rate that is 97% of the highest OMO rate or higher.

## 4.2 Annuity prices by number of customers

While Figure 4 is useful in terms of analysing how firms compare to one another, it does not tell us how many consumers could benefit financially from exercising their OMO. We do this by weighting the bars by the number of male level annuities sold in 2006 for each firm. This allows us to get a good approximation of how many annuity buyers stand to benefit and by how much from buying externally.[13]

**Figure 6 Volume weighted annuity rates as a % of the highest OMO rate: male aged 65 buying a conventional single-life level annuity for £10,000**




**Note:** Annuity rates at June 1st 2006. Twenty-two firms representing 91% of conventional (excluding enhanced / impaired life) pension annuity premiums and 87% of contracts. We have estimated the volume of contracts sold by one firm using ABI New Business statistics.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007.

[13] Here we take annuity rates from a single day and compare them to sales for the year. When looking at volume of sales we also include guarantee period annuities and annuities sold to those who had ages other than 65.

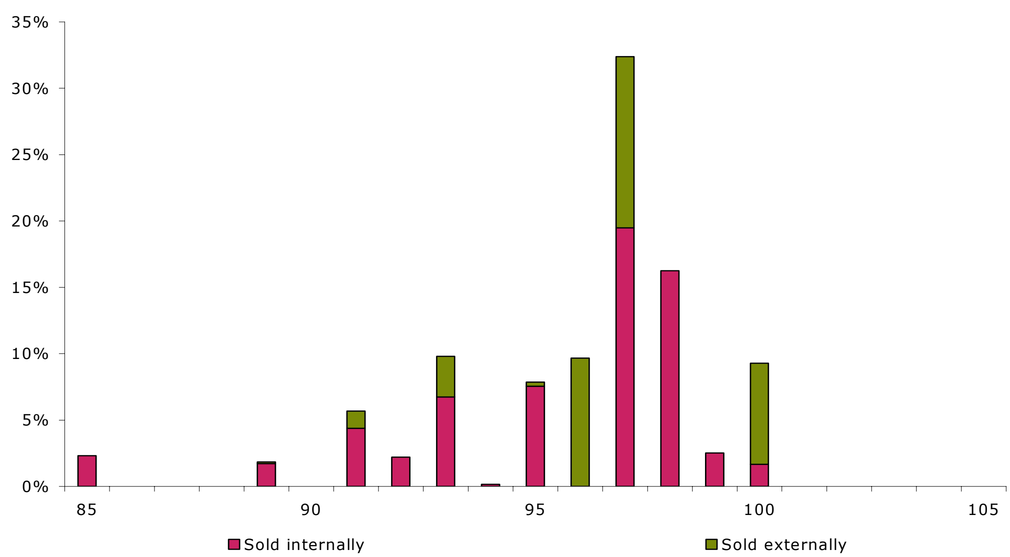
Figure 6 also makes the distinction between annuities sold externally and annuities sold internally. It shows that 35% of consumers receive a rate that is either above the highest OMO rate or equal to it. A further 26% of consumers receive a rate 99% of the highest OMO rate.

Overall, 85% of the customers we have information for receive a rate of at least 95% of the highest OMO rate. Fifteen percent of customers receive a rate that is less than 95% of the highest OMO rate (1% of these had bought externally). The majority of customers buying externally got an annuity rate of 97% of the highest OMO rate or higher. Of those consumers who buy internally 81% got an annuity rate at least 95% of the highest OMO rate.

### 4.2.1 Comparison with FSA (2002) results

We have also estimated price dispersion for joint-life level annuities so we can compare our results to those obtained by the FSA in 2002.

**Figure 7 Volume weighted annuity rates as a % of the highest OMO rate for a male aged 65 and a female aged 62 buying a conventional joint-life level annuity reducing by 50% on the death of the male for £10,000**




**Note:** Annuity rates at June 1st 2006. Twenty-Two firms representing 91% of conventional (excluding enhanced / impaired life) pension annuity premiums and 87% of contracts. We have estimated the volume of contracts sold by one firm using ABI New Business statistics.

**Source**: ABI Research Department. Calculated using ABI Annuity Survey 2007.

There are some differences between our work and the FSA's. The FSA had a larger number of firms in its sample. Our smaller sample may in part be a reflection of market consolidation and firm exit between 2001 and 2006. It is also possible that the FSA has included smaller firms in its sample who are not ABI members. While the FSA weights its results by all maturing pension policies, we weight our figures by the volume of joint-life level annuity contracts sold. The FSA also divide their sample between firms actively marketing and not actively marketing annuities, whereas we look at the number of contracts sold internally and externally. Nevertheless, we can still make useful comparisons between the two sets of results.

The FSA's findings show that the annuity rates offered by companies actively marketing annuities are clustered closer to the highest OMO rate (generally, between 92% and 100% of the highest OMO rate) than those who do not actively market annuities.[14] Similarly, we find that most companies who sell externally offer rates that are within 93% of the highest OMO rate.

FSA (2002) find that 78% of maturing policies receive an annuity rate between 85% and 95% of the highest OMO rate. Our results show that 78% of contracts sold are between 95% and 100% of the highest OMO rate. Overall, these figures suggest that the market is working better in 2006 than it was in 2001 (the date to which the FSA work relates). Any improvement in the working of the market may in part be explained by the introduction of the 'wake up' letter in 2002 and the inclusion of annuities in the Comparative Tables in 2003 (the annuities section of the Comparative Tables receives the most visitors (FSA 2007)).

Ten ABI member firms did not take part in our survey, and it may be that some of these firms offer lower rates than the firms that did take part in the survey. This might explain why our results are different from the FSA results. However, as our survey covers 87% of the conventional (excluding enhanced / impaired life) annuities sold by volume and 91% by value, the differences in the samples do not account for all the differences between the two surveys. In order to check this we have assumed that the 13% of contracts which we have not captured lie below 90% of the highest OMO rate. Under this assumption we find that 69% of contracts sold are between 95% and 100% of the highest OMO rate and 77% are between 93% and 100% of the highest OMO rate.

## 4.3 Lifetime gains

To establish how much consumers could be better off by we look at the lifetime gains from buying externally.[15] To do this we use the annuity rates that we obtained from our survey and an estimate of the annuitant's life expectancy, which is available from the Government Actuary's Department (GAD).[16] We then use these figures to calculate the lifetime difference between the average internal annuity rate and the highest OMO annuity rate.[17] This represents a conservative scenario, as our data show that the majority

[14] The FSA define 'actively marketing' as a firm that sells pension annuities externally and actively markets its products to consumers.

[15] We have excluded two firms from our analysis - one who only sells enhanced and impaired life annuities and one who sells to those in specific occupations.

[16] Government Actuary's Department Cohort Life Tables, November 2006. Life expectancy for Males at 65 = 20.6 years, Males at 60 = 24.9 years, Females at 65 = 23.1 years, Females at 60 = 27.8 years.

[17] We have decided against using a present value approach because we feel that the gains can be more easily understood in nominal terms.

of consumers are likely to buy annuities from providers offering better rates.[18] In the following two sub-sections we estimate lifetime gains by pension fund size and by product.

### 4.3.1 Lifetime gains by pension fund size

When analysing the lifetime gains by fund size we have chosen the case of a 65-year-old male buying a conventional single-life level annuity with a 5-year guarantee, and calculated the returns from buying externally for a range of purchase prices.

**Table 4 Lifetime gain from getting the highest OMO rate compared to the average internal annuity rate for a male aged 65 buying a conventional single-life level annuity with a 5-year guarantee**

| | Pension fund size | | | |
|---|---|---|---|---|
| | £10,000 | £20,000 | £25,000 | £35,000 |
| OMO High | £14,090 | £28,915 | £36,306 | £51,094 |
| Internal Average | £13,560 | £27,515 | £34,521 | £48,447 |
| Life Time Gain | £530 | £1,400 | £1,785 | £2,647 |
| Yearly Gain | £26 | £68 | £87 | £128 |
| % Gain | 3.91% | 5.09% | 5.17% | 5.46% |

**Note:** Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts. Our survey found that 15% of contracts sold in 2006 were over £35,000.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and GAD data.

Table 4 shows the lifetime return for the highest OMO annuity rate and the average internal annuity rate (excluding firms who had internal rates equal to or above the highest OMO rate). In the case of a male aged 65 purchasing a £10,000 annuity, the lifetime gain from getting the highest OMO rate compared to the average internal annuity rate would be £530 or £26 a year.

We also looked at the lifetime gains from getting the highest OMO rate compared to the lowest internal annuity rate. For a male aged 65 buying a single-life level annuity with a 5-year guarantee, we find that the yearly gains range from £77 to £310 and the percentage lifetime gains range from 12% for a £10,000 annuity to 14% for a £35,000 annuity respectively. However, our results in Figure 7 indicate that this is not a useful comparison for the majority of annuitants as relatively few (4.6%) take the lowest rate.

### 4.3.2 Lifetime gains by product

To analyse the lifetime gains by product we have chosen a purchase price of £10,000 and calculated the difference between the internal average annuity rate and the highest OMO annuity rate.

[18] In addition, the actual gain to the annuitant may be lower due to the interaction between income (from the annuity and other sources, such as the Basic State Pension), taxes, and means-tested benefits.

Table 5 shows the lifetime gains for a range of different pension annuity products. For example, in the case of a male purchasing a single-life level annuity, the lifetime gain from getting the highest OMO rate compared to the average internal annuity rate would be £446 or £22 a year.

**Table 5 Lifetime gain from getting the highest OMO rate compared to the average internal annuity rate. £10,000 purchase price**

| | Level | Level - female | Level 5 year guarantee | Escalating 3% | RPI linked |
|---|---|---|---|---|---|
| OMO High | £14,152 | £14,850 | £14,090 | £15,069 | £13,109 |
| Internal Average | £13,706 | £14,030 | £13,560 | £14,141 | £12,722 |
| Life Time Gain | £446 | £820 | £530 | £928 | £387 |
| Yearly Gain | £22 | £35 | £26 | £45 | £19 |
| % Gain | 3.25% | 5.84% | 3.91% | 6.56% | 3.04% |

**Note:** All annuities are for a 65-year-old male except where indicated. RPI estimated at 2.5% per annum. Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts. All annuities are conventional. See Appendix 2 for lifetime gains for other fund sizes.

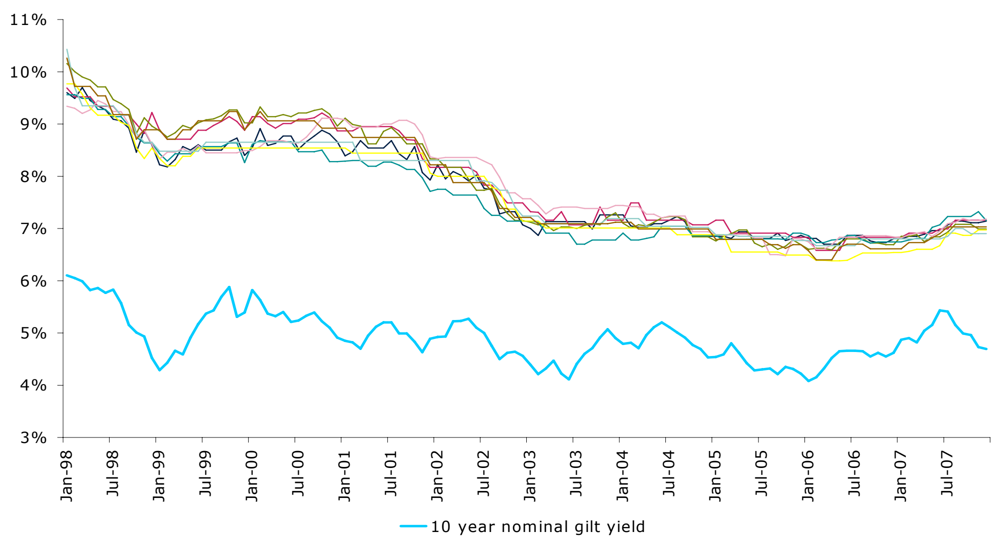
**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and GAD data.

# A1 ANNUITY RATES AND GILT YIELDS

In Section 2 we discussed the relationship between the gilt yield and annuity rates. This Appendix looks at the relationship between the two variables in more detail. The results suggest that there is a valid long run relationship between annuity rates and gilt yields.

Figure 8 plots the monthly annuity rate for eight companies (who collectively accounted for 82% of annuity premiums in 2006) from Moneyfacts Investment Life & Pensions and nominal 10-year government gilt yields from the Bank of England for the period 1998 - 2007.

**Figure 8 Annuity rates and nominal 10 year gilt yields**




**Note:** Annuity rate is for a male-aged 65 purchasing a single-life non-guaranteed annuity for £10,000.

**Source**: ABI Research Department calculated using data from Moneyfacts Investment Life & Pensions and the Bank of England.

From Figure 8 it appears that both the annuity rate and the gilt yield are non-stationary – in other words their mean varies over time. This is important because (if true) it implies the need to establish that they are cointegrated for there to be a valid long-run relationship between the two variables. We test for stationarity using an Augmented Dickey Fuller test and this confirms that both variables are non-stationary.

We test for cointegration using the Johansen methodology and apply the Pantula principle to choose the most appropriate Vector Error Correction Model (VECM).[19] We begin with a more restrictive model, including an intercept but no time trend or linear trend in the

[19] The Pantula principle chooses both the correct specification of the deterministic components and also the order of cointegration rank (r), by starting with the most restrictive model and continuing until the null hypothesis cannot be rejected.

data.[20] We also identify that six lags are sufficient to estimate the number of cointegrating relationships between the annuity rate and the gilt yield.[21] The Johansen procedure provides two tests (the trace statistic and the maximal eigenvalue statistic) to help establish the number of cointegrating vectors. We find that one cointegrating relationship exists at the 5% significance level.[22]

Establishing that the annuity rate and the gilt yield are cointegrated is important, because it shows that there is a valid, long run relationship between the two. The form of that relationship goes the right way. In the normalised unrestricted VECM, where the annuity rate is set equal to 1, it is useful to note that the coefficient on the gilt yield has the sign that we would except with a negative coefficient of –3.51.

One interesting question is therefore whether there is a one-for-one relationship between the two variables, so we impose a restriction of 1 on the annuity rate and –1 on the gilt yield. Once the number of cointegrating relationships has been established, likelihood-ratio (LR) tests can be performed to test different hypotheses about the cointegrating vector. The results suggest there is no evidence of a one-for-one relationship between the annuity rate and the gilt yield in the long run.[23] One reason for this may be that additional factors, such as changing longevity, may be playing a role.

[20] We decide against choosing the most restrictive model with no intercept or trend as it does not make sense on inspecting Figure 8 (if this model were valid it would suggest that the trend in the annuity rate and the gilt yield is identical).

[21] We start with 12 lags and test down for significance, given that the model is more robust to over specification of lags than under specification.

[22] First we test the null hypothesis of no cointegration: $\lambda$-trace statistic of 27.36 > critical value of 20.26 ($\lambda$-max statistic of 24.55 > critical value of 15.89) so under both tests we reject the null. We then test the null hypothesis of at most 1 cointegrating relationship: $\lambda$-trace statistic of 2.81 < critical value of 9.16 ($\lambda$-max statistic of 2.81 < critical value of 9.16) so under both tests we do *not* reject the null and conclude there is only one cointegrating relationship.

[23] An LR test is performed to identify whether the restriction of 1 on the annuity rate and –1 on the gilt yield is valid. We get a chi-squared test statistic of 20.62 > critical value of 3.84 so we reject the null hypothesis that the restriction is valid, which leads us to conclude there is not a one-for-one relationship between the two variables.

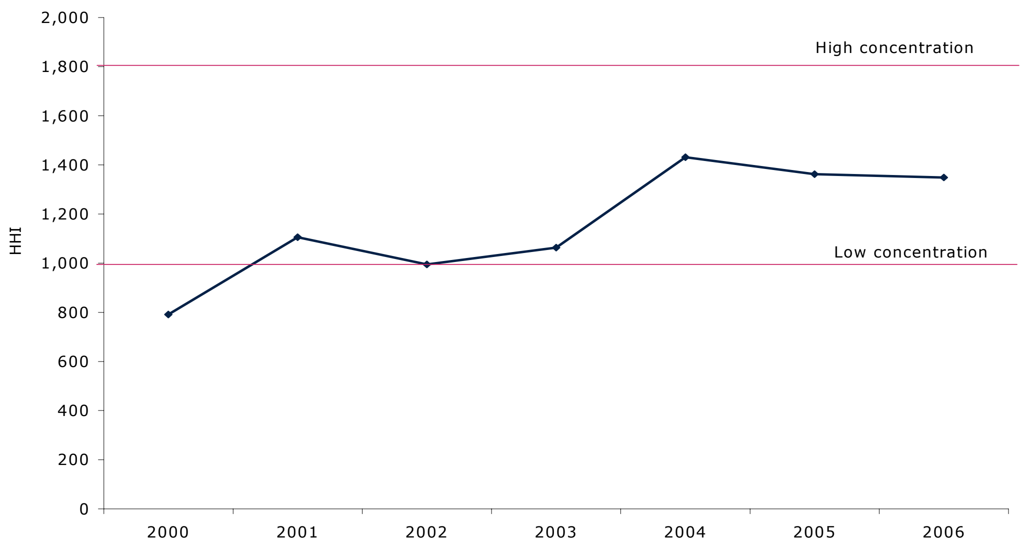
# A2 ANNUITIES: CONCENTRATION RATIOS AND MARKET SHARES

This section uses published data to analyse concentration ratios and market shares.

## A2.1 Concentration ratios in the UK pension annuities market

The standard measure of concentration is the Herfindahl-Hirschman Index (HHI). This measure is often used by competition policy analysts to assess the impact of mergers and acquisitions. The HHI is calculated by taking the sum of the squares of the market shares of the firms competing in the market. By taking the sum of squares the HHI takes account of both the relative size of firms as well as their distribution. The index can take any value between 0 (perfect competition) and 10,000 (a total monopoly). The US Department of Justice Merger Guidelines defines HHI of below 1,000 as low concentration, between 1,000 and 1,800 as moderate concentration and above 1,800 as heavy concentration. Using market shares based on the company data from 2000-2006 we have plotted the HHI in Figure 9.

**Figure 9 Concentration in the UK pension annuities market, 2000-2006 (HHI)**




**Note:** Based on 42 companies supplying data on the number of annuities sold in 2000 and 2001; 38 companies in 2002, 2003 and 2005; 33 companies in 2004 and 36 companies in 2006.

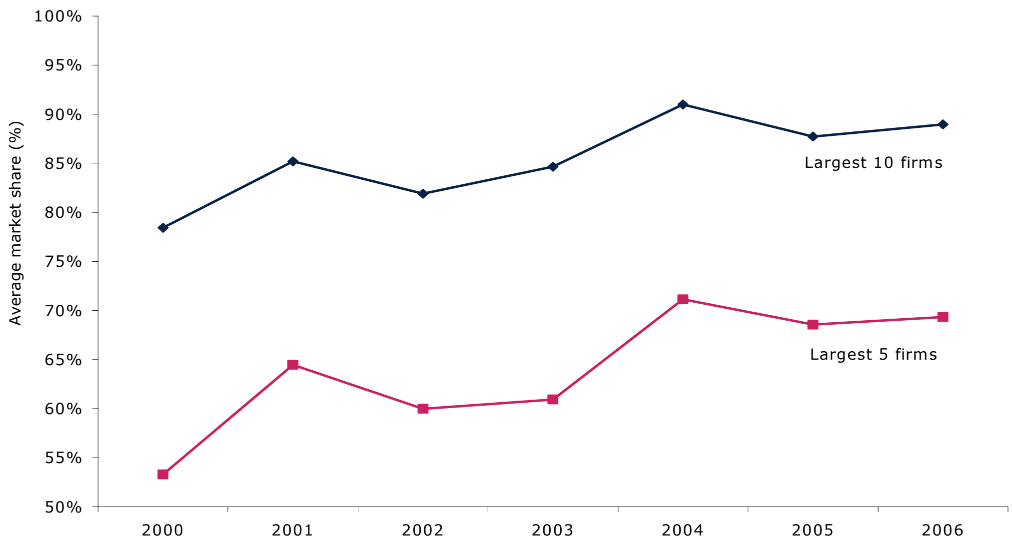
**Source**: ABI Research Department. Calculated using ABI statistics.

The HHI averaged 1,157 over the period 2000-2006, indicating moderate concentration in the UK pension annuities market. The increase in the HHI between 2003 and 2004 is in part due to a reduction in the number of providers competing in the market (from 38 in 2003 to 33 in 2004). Moderate concentration in the market is true across four of the six years, with the exception of 2000 and 2002 when the market had a low concentration.

## A2.2 Market share in the UK pension annuities market

In 2006 there were 36 ABI member companies selling annuities, down from 42 in 2000. Of these 36, 14 firms had market shares of over 1%, while the market share of the top 10 firms accounted for 89% of the market. Sixteen providers each had market shares below 0.5%.

**Figure 10 UK pension annuities market shares, 2000-2006**




**Note:** Based on 42 companies supplying data on the number of annuities sold in 2000 and 2001; 38 companies in 2002, 2003 and 2005; 33 companies in 2004 and 36 companies in 2006.

**Source:** ABI Research Department. Calculated using ABI statistics.

The average combined market share for the largest 10 companies was 85% between 2000 and 2006, ranging from a low of 78% in 2000 to a high of 91% in 2004. The increase in market share of the largest providers between 2003 and 2004 was due in part to consolidation, with the number of providers falling from 38 in 2003 to 33 in 2004. Over the six-year period as a whole (2000-2006), the average market share for the largest five firms was 64%, ranging from a low of 53% in 2000 to a high of 71% in 2004.

## A3 LIFETIME GAINS FOR DIFFERENT PENSION FUND SIZES

**Table 6 Lifetime gain from getting the highest OMO rate compared to the average internal annuity rate. £20,000 purchase price.**

| | Level | Level - female | Level 5 year guarantee | Escalating 3% | RPI linked |
|---|---|---|---|---|---|
| OMO High | £28,974 | £30,261 | £28,915 | £30,686 | £26,753 |
| Internal Average | £27,686 | £28,491 | £27,515 | £28,754 | £26,520 |
| Life Time Gain | £1,288 | £1,770 | £1,400 | £1,932 | £233 |
| Yearly Gain | £63 | £77 | £68 | £94 | £11 |
| % Gain | 4.65% | 6.21% | 5.09% | 6.72% | 0.88% |

**Note:** All annuities are for a 65-year-old male except where indicated. RPI estimated at 2.5% per annum. Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts. All annuities are conventional.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and GAD data.

**Table 7 Lifetime gain from getting the highest OMO rate compared to the average internal annuity rate. £25,000 purchase price.**

| | Level | Level - female | Level 5 year guarantee | Escalating 3% | RPI linked |
|---|---|---|---|---|---|
| OMO High | £36,383 | £38,162 | £36,306 | £38,492 | £33,576 |
| Internal Average | £34,727 | £35,757 | £34,521 | £36,092 | £32,556 |
| Life Time Gain | £1,656 | £2,405 | £1,785 | £2,400 | £1,019 |
| Yearly Gain | £80 | £104 | £87 | £117 | £49 |
| % Gain | 4.77% | 6.73% | 5.17% | 6.65% | 3.13% |

**Note:** All annuities are for a 65-year-old male except where indicated. RPI estimated at 2.5% per annum. Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts. All annuities are conventional.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and GAD data.

**Table 8 Lifetime gain from getting the highest OMO rate compared to the average internal annuity rate. £35,000 purchase price.**

| | Level | Level - female | Level 5 year guarantee | Escalating 3% | RPI linked |
|---|---|---|---|---|---|
| OMO High | £51,203 | £53,430 | £51,094 | £54,133 | £47,552 |
| Internal Average | £48,731 | £50,300 | £48,447 | £50,705 | £45,745 |
| Life Time Gain | £2,471 | £3,131 | £2,647 | £3,429 | £1,807 |
| Yearly Gain | £120 | £136 | £128 | £166 | £88 |
| % Gain | 5.07% | 6.22% | 5.46% | 6.76% | 3.95% |

**Note:** All annuities are for a 65-year-old male except where indicated. RPI estimated at 2.5% per annum. Twenty-three firms representing 92% of conventional (excluding enhanced / impaired life) pension annuity premiums and 88% of contracts. All annuities are conventional.

**Source:** ABI Research Department. Calculated using ABI Annuity Survey 2007 and GAD data.

# A4 REVIEW OF LITERATURE

This section reviews five consumer surveys that focus on the characteristics and preferences of individuals who purchase annuities and whether they exercised the OMO or not. We also review two studies which look at the 'money's worth' of annuities – the first by Cannon and Tonks and the second by Finkelstein and Poterba. A further paper by Harrison, Byrne and Blake, which assesses barriers to using the OMO and makes a number of recommendations aimed at guiding consumers through the OMO process is also reviewed.

## A4.1 Annuities, the consumer experience, an ABI Research Report by Julie Stark (October 2002)

The ABI commissioned IFF Research Ltd to carry out consumer research into pension annuities in May 2002.[24] Five hundred interviews were conducted with people who had bought pension annuities within the last three years. One hundred and one interviews were conducted with people who had retired within that time frame but had yet to purchase an annuity. Of the main findings relating to the OMO, the survey found that:

- Two-thirds of those who purchased an annuity took some form of advice before doing so. Of those taking advice, 40% took advice from a financial advisor, 20% spoke to a provider and less than 10% sought informal advice (for example, through family and friends).
- Around a half of respondents used the OMO. This breaks down into 33% who purchased from another annuity provider and 15% who considered this option but chose to stay with their existing pension provider.
- Almost two-thirds of customers purchase one annuity. Sixteen percent purchase two annuities and 13% purchase three annuities. This finding indicates that while the majority of annuities are purchased with small pension funds, this is not compensated for by the annuitant purchasing several annuities, which in total provide a large income.
- Where advice was taken, just under half of annuitants decided to purchase from another provider, compared with a little over 10% where advice was not taken.
- Around two-thirds of respondents who bought the most common type of 'basic' annuity (single-life, level, with no guarantee) took some form of advice.
- The wealth of individuals played an important role in whether advice was taken or not. Those with greater household and personal wealth were more likely to take advice than respondents at the lower end of the income scale.

The survey also assessed individuals' appetite for reform, in terms of how interested annuitants would be in various options at the time of purchase. The survey found that:

[24] Note that this ABI research was undertaken before the introduction of the FSA disclosure in September 2002 that required firms to notify policyholders of their annuity options before purchasing a product.

- Almost half of annuitants would be interested in being given the option to purchase a money-back guarantee with their annuity.
- About a third of annuitants would like to receive more information and advice before purchasing their annuity but are not willing to pay very much for this.

## A4.2 Consumers' understanding of annuities, research for the ABI by ORC International (February 2005)

In October 2004 the ABI commissioned ORC International to undertake a research study into consumers' retirement needs and their understanding of the UK annuities market. With reference to consumers' understanding of annuities, the survey found that:

- The majority of respondents had little or no understanding of annuities.
- Those that had some awareness of annuities and how they worked understood they would receive some kind of monthly or annual income, but not a clear idea of their expected level of income on retirement.
- There was a very low awareness that the purchase of an annuity is compulsory, that it provides a guaranteed income for life and that it is non-transferable.

Consumers were also asked to outline their 'ideal features' of annuities. While it was accepted that there was no 'one size fits all' solution or product, the key needs and desires of respondents were broadly summarised as follows:

- Security – the guarantee of receiving a minimum amount for life.
- Index-linked to account for inflation.
- Simple products, but with options for choice for the more financially sophisticated.
- Simplicity or transparency where complexity was unavoidable.
- Benefits for dependents on death, particularly for those with little other provision for this.
- Options or 'bonuses', which would provide additional cover for annual or one-off expenses.

The need to further educate individuals about retirement planning and annuity products was also highlighted, including the reasons for compulsory annuity purchase.

## A4.3 Purchasing annuities and an examination of the Open Market Option, prepared for the FSA by IFF Research Ltd (November 2003)

In September 2002 the FSA introduced new rules and guidelines requiring pension providers to inform customers of their right to shop around before purchasing an annuity. In 2003 the FSA contracted IFF to research customer use of the OMO after these changes had been implemented. IFF found:

- 72% of annuitants spoke to someone before purchasing an annuity. Of these, most took advice from a professional (87%).

- Overall, 33% of annuitants had considered another type of annuity.
- 88% of policyholders were aware they had the opportunity to buy their annuity from a company other than their pension provider.
- 85% of respondents recognised that annuity rates vary according to type of annuity product and provider.
- 72% of respondents recognised that the statement ‘when buying an annuity my best option is to stay with the same company as my pension provider’ was not necessarily true.

The survey found that 59% of annuitants exercised the OMO (i.e. they bought an annuity from a pension provider other than the one they had a pension with or considered doing so but decided to stay with their current provider). Of these 37% shopped around but in the end chose to stay with their existing pension provider, and 22% chose to buy from another provider.

Those that exercised the OMO were;

- more likely to be men (64%) than women (50%).
- more financially sophisticated (high sophistication 77%, medium 72%, low 38%).
- have some prior knowledge of annuities (either self-defined 82% or through IFF’s own assessment 70%).
- more likely to have sought advice in general (64%) and sought advice from an IFA (73%).
- more likely to have a pension fund value of £20,000 or more (63%) compared with 47% of those with a fund value of under £10,000.

Of those that did purchase their annuity from a different provider, 37% did so because of a better annuity deal or rate; and 22% had followed the advice of an IFA.

Of those that shopped around but in the end chose to stay with their existing pension provider, 35% did so because of a better annuity deal or rate; and a further 12% said the deal or rate offered by their original provider was as good as they could get elsewhere. Other reasons for staying with the existing pension provider when purchasing the annuity were: the small amounts involved did not justify a switch (16% of respondents overall and 28% of those with funds of under £10,000), easier/less hassle (13%), the decision was made on the advice of an IFA (12%).

## A4.4 Retirement: Aspirations and reality, an Egg study for Just Retirement (August 2004)

This survey was conducted by Egg Design and Marketing Research on behalf of Just Retirement in order to identify individuals’ retirement aspirations. Two hundred and ten face-to-face interviews were carried out among a representative cross-section of British adults aged 50 and over between July and August 2004. The sample was split into two groups. One hundred and five interviews were carried out among those approaching retirement and 105 interviews among those who had already retired. The survey found that:

- 46% of respondents retiring within the next five years were aware of the OMO and 31% were either very likely or fairly likely to take up the OMO.
- 40% were either not very likely or not at all likely to use the OMO. The most popular reasons given for not shopping around were: happy with current provider (25%), too much hassle to shop around (21%), too complicated (21%), believe my pension company is one of the best (17%), don't believe I'd be likely to get a much better rate (17%).

## A4.5 Serious about saving – annuities: bonus or burden? Research for the ABI by IFF Research Ltd (December 2005)

This report presents the findings of research carried out by IFF in March 2005. Telephone interviews were conducted with 500 people who had bought an annuity during the previous three years. The survey found that:

- 52% of people shopped around for an annuity (i.e. exercised the OMO). This breaks down into 31% who decided to purchase their annuity with the same company, and 21% who decided to buy from a different company.
- 48% of people did not shop around for an annuity. This breaks down into 42% who did not consider shopping around for an annuity, and 6% who did consider shopping around.
- Of those exercising the OMO, 81% had received advice.
- 72% of respondents said that advice helped them to shop around and 55% said it helped them to decide whether or not to switch.

The survey identified reasons why consumers considered buying an annuity from a different provider to their pension company. The need to get the best deal was the most popular reason (43%), followed by an IFA advising the annuitant to shop around (36%). Taking informal advice from family and friends had little impact on whether consumers considered shopping around or not (3%).

In terms of those consumers who did *not* shop around, the most popular reasons given were:

- 17% said their pension saving provider had a good reputation.
- 17% had pension savings with their provider so stayed with them.
- 14% said their pension saving provider offered a good deal.
- 12% could not see the point of shopping around (given the small amounts involved).

The reasons for not shopping around also varied depending on the likely size of the annuitant's retirement income. For example, only 3% of those with a monthly income of less than £250 did not shop around because they did not know where to go. This is contrary to the view that annuitants on lower incomes and/or with smaller pension funds have difficulty in shopping around and are therefore reluctant to do so.

The survey goes on to identify factors that might encourage people to shop around and/or make the whole process easier for them:

- 59% were more likely to shop around based on advice from an IFA on a fixed fee basis (as opposed to paying commission).
- 47% were more likely to shop around based on advice through an employer.
- 37% were more likely to shop around through a telephone based information service (the most popular source being the FSA).
- 31% were more likely to shop around through an internet based interactive programme.

## A4.6 Cannon and Tonks, DWP Research Report No. 318, Survey of annuity pricing (March 2006)

The authors assess whether or not the UK annuities market is competitive in its current state and conclude that, broadly speaking, it is performing well. They argue that while the number of annuity providers has declined significantly in recent years, evidence suggests that monopoly power is not in operation. They base this conclusion on their analysis of the ratio of the expected present value of the annuity payment to the premium paid, known as the ‘money’s worth’. ’Money’s worth’ is usually between zero and one. Values in excess of one imply that life insurers are making losses; whereas values below one imply that life insurers’ costs are covered and profits are being made.[25]

A variety of studies conducted on different countries and for different time periods suggest that the money’s worth is usually in the range 0.85-1.05. These results suggest that consumers are getting a fair return, with life companies taking less than 10% in costs and profits.

## A4.7 Finkelstein and Poterba, Selection effects in the United Kingdom annuities market (January 2002)

Finkelstein and Poterba (2002) explore the existence of adverse selection in both the compulsory and voluntary purchase UK annuities market. The idea is that longer-lived individuals have greater incentives to purchase annuities (at a given price) than shorter-lived individuals, since the return on the annuity increases with the length of time the individual expects to be alive to receive the annuity payment. The authors assess whether or not individuals get value for money (the ‘money’s worth’ concept) from annuities once adverse selection is taken into account.

[25] Cannon & Tonks (2006) also suggest that money’s worth ratios in excess of unity may be due to life insurers using different actuarial projections or better interest rates in their calculations.

They compare the money's worth for a typical annuitant to that of an individual in the general population (if such an individual were to purchase an annuity). They find that in the compulsory annuities market (referred to in our paper as the pension annuities market), the money's worth ratio of a level annuity for a 65-year old man facing the population average mortality rate is 0.9. This means that for every £1 paid out in premiums, the annuitant receives a discounted present value of 90 pence.

### A4.8 Harrison, Byrne and Blake, Annuities and accessibility – how the industry can empower consumers to make rational choices, Pensions Institute (March 2006)

The authors focus on the 'middle market' for annuities (individuals who can afford to save for retirement but where income drawdown is unsuitable) and assess the main barriers to exercising the OMO. A summary of the authors' recommendations is outlined below:

- 'Details about the OMO are buried away in pre-retirement literature sent out to consumers'. They recommend that a short, standardised wake-up letter be sent out separately from the main annuities information pack, outlining the benefits of the OMO in monetary terms.
- 'Consumers do not know where to look for specialist annuity advice'. The authors note that only IFAs (or whole of market advisers) can offer a full annuity service. They find that fewer than a dozen firms specialise in annuities, with no official mechanism for consumers to identify these. The authors recommend the formation of a trade body set up by specialist annuity providers, which would apply strict entry criteria and a code of conduct for firms.
- 'Comparative tables do not list all annuity rates'. FSA comparative tables are voluntary and only provide annuity rates for 13 or so providers. Within this group there is a differential of around 15% between the top and bottom rates, with advisers suggesting that the differential across the whole market is up to 30%. The authors recommend that all annuity providers should supply their rates regularly to the FSA, irrespective of whether they operate in the open market or provide solely to their own customers.
- 'Trustees of occupational DC schemes do not have to provide the OMO'. The authors recommend that trustees with occupational DC schemes and employers with contract DC schemes refer the annuity purchase to specialist providers.
- 'The majority of annuities purchased are level rather than indexed'. The default annuity quote issued to consumers is for a single-life, non-escalating annuity with a five-year guarantee. The authors recommend that a more direct discussion of the choice between level and indexed annuities is provided, taking into account individuals' spending patterns through retirement and the potential for increased care and medical costs in later life.

The paper then goes on to discuss the barriers which stop people exercising the OMO. They find that the majority of IFAs (the main distributors of annuities through the OMO) do not offer a service if funds are worth less than £50,000, due to low rates of commission.[26] Also, unlike many other purchases, the annuity purchase is a one-off transaction that leaves no opportunity to learn through experience.

[26] IFA remuneration is based on the type of annuity (typical commission rates are higher for index linked and enhanced annuities compared with conventional annuities) and fund size (after the 25% tax-free lump sum is taken).

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