Financial Conduct Authority

Thematic Review TR14/2

Thematic Review of Annuities

February 2014

Contents

Abbreviations used in this paper

ABI	Association of British Insurers
DB	Defined benefits
DC	Defined contributions
DWP	Department of Work and Pensions
TPR	The Pensions Regulator

Foreword by Nick Poyntz-Wright, Director of Long-Term Savings and Pensions, Supervision Division

We estimate that around 10.5 million consumers have defined contribution (DC) pension savings[1] that will need to be converted into an income at some point. There are two ways to do this: buying an annuity or using income drawdown.[2] Although income drawdown is increasing in popularity, annuities are still the most common product in this market. In 2012 420,000 annuities were sold, 16 times more than income drawdown products, with a premium value of £14bn compared to £1.2bn for income drawdown.[3]

The decline of defined benefit (DB) pensions and the introduction of auto-enrolment will see more people reaching retirement with DC pension savings. The Department for Work and Pensions (DWP) estimate that automatic enrolment will see up to 11 million extra people enrolled into workplace pensions, the majority of these are expected to be into DC schemes.[4]

The Treasury and DWP helped focus the industry on improving shopping around and access to the open market through their Open Market Option Review Group, which we participate in. There are also a wide range of other organisations with an interest in annuities who we continue to work with. Most recently the Financial Services Consumer Panel published a report and consumer research in December 2013.

Our role and findings

As the conduct regulator for financial services, we aim to ensure that consumers get a fair deal from the financial services products they purchase. Where we see consumers suffering poor outcomes we seek to understand and address the causes. Making the right decision when purchasing an annuity is particularly important, as it is usually irreversible and can affect a consumer's income for the rest of their lives.

As part of our thematic work into the annuities market we estimated the extent to which consumers would be better off purchasing their annuity on the open market. We found that most consumers could get a better deal on the open market. We have also considered some potential drivers of provider and consumer behaviours including a high-level assessment of the expected profitability of annuity business.

1 Estimated in Wells J (2014), Pension Annuities: A review of consumer behaviour using information from Cox P (2013), Private pension wealth among 55-64 year olds in the UK (paper published by NEST as part of its 2013 forum) http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-research-into-retirement-decisions,PDF.pdf

2 For an occupational trust based scheme there may also be a scheme pension available.

3 ABI data for new business premiums Annual pension annuity by type 2012.

4 Automatic enrolment into a workplace pension – Key facts March 2013 https://www.gov.uk/government/publications/automatic-enrolment-key-facts-booklet

Consumer inertia plays a significant role and some providers may be benefitting from this through the expected profitability of the annuities they sell to their existing customers.

Given the findings of our review, and the importance of the decisions consumers make in accessing their pension savings, we believe we need to carry out further work to assess how well the market is working for consumers.

In light of the recent amendment to the Financial Services and Markets Act 2000, the FCA has a new competition objective and duty. This new competition remit gives us a strong mandate to promote competition in the interests of consumers. Market studies are our new main tool for examining competition issues in the markets, enabling us to understand why a particular market may not be working well for consumers, leading to proposals as to how they might work better.

We are therefore launching a market study that will examine retirement income as a whole, analysing how well the market works for consumers today and how it might develop going forward. The market study will also look at firms' current sales practices and strategies when selling annuities to their existing pension customers.

If we find that competition is not working well or that potential market developments pose risks for consumers, we will find solutions, and if we see firms treating their customers unfairly we will act to address this through our supervisory powers.

1. Executive Summary

Why have we reviewed annuities?

Our vision is to make financial markets work well so consumers get a fair deal. We want consumers to be able to make well-informed decisions about products that meet their needs, provided by firms who have their customers' interests at the heart of their business.

We are concerned that too many consumers purchase an annuity from their existing pension provider without considering what would be available to them on the open market. In 2012 around 60% of annuities were purchased from customers' existing pension providers or through a third-party arrangement (see Chapter 2).

Increasing awareness of the open market, improving disclosure and facilitating shopping around have been the focus of a number of industry, Government and regulatory initiatives:

- In 2002, the Financial Services Authority introduced rules requiring insurers to inform their existing pension customers that they could purchase an annuity on the open market and to improve consistency between firms in the way this was done.[5]
- Following discussions with the Government led Open Market Option Review Group, the Association of British Insurers (ABI) introduced its Code of Conduct on Retirement Choices[6] (ABI Code) in March 2013 and began the publication of annuity rates[7] in August 2013.
- The Pensions Regulator (TPR) also published guidance for trustees of occupational schemes on the retirement process in November 2013.[8]

It is too early to assess the impact of the latest initiatives by the ABI, but previous initiatives focusing on disclosure have increased consumer awareness of the right to shop around, with nine out of ten individuals now being aware of this.[9]

5 FSA Policy Statement 106 – Disclosure: Trading an endowment policy and buying a pension annuity April 2002 http://www.fsa.gov.uk/pubs/policy/ps106.pdf

6 Consumers in the Retirement Income Market : Code of Conduct on Retirement Choices was published in March 2012 with implementation from 1 March 2013 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/The%20ABI%20Code%20of%20Conduct%20on%20Retirement%20Choices.ashx

7 ABI Annuity Window first rate publication was 21 August 2013 https://www.abi.org.uk/Insurance-and-savings/Products/Pensions/Annuity-rates

8 Regulatory guidance for Defined contribution schemes November 2013 http://www.thepensionsregulator.gov.uk/docs/guidance-dc-schemes.pdf

9 Retirement choices: baseline to measure effectiveness of the code of conduct – results of customer research ABI May 2013 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/Retirement%20Choices%20research%20May%202013.ashx

However, the number of consumers who say they shop around has remained at around two-thirds for the last ten years, with initiatives to improve this resulting in incremental increases.[10]

Others have tried to assess how much better off consumers would be buying an annuity on the open market, but they have been limited by the lack of available information about the annuity rates that insurers offer to their existing pension customers (the ABI publication of annuity quotes means that some limited information of this type is now available). As we regulate pension and annuity providers, we can gather detailed information from firms and look at this issue in greater depth.

While it is important for consumers to optimise their income in retirement, it is also important that they:

- convert their pension to an annuity at the right time for them (e.g. it may be more appropriate for them to use drawdown initially or to defer taking an income)
- buy the right 'shape' of annuity for them (e.g. single life or joint life, level or escalating, enhanced or standard, and with or without guarantee)

The right time to annuitise and the right 'shape' annuity is very much based on individual consumer circumstances, so we do not consider this in our modelling of consumer outcomes in Chapter 2, but we do consider it in our review of consumer research in Chapter 4.

Shopping around vs switching

There is an important difference between shopping around and switching, and shopping around does not necessarily lead to switching.

Shopping around is usually measured through consumer research and it can mean different things to different people, e.g. how many quotes do you need to have got to have shopped around?

Switching is a quantitative measure based on actual purchases. An individual may have switched without shopping around (for example, looking at one other provider, perhaps as a response to a direct offer financial promotion, is not, in our view, shopping around).

Neither measure considers the outcomes experienced by consumers in this market. We looked at one aspect of the outcome for consumers buying annuities from their existing pension providers - whether they would be financially better off buying on the open market.

10 FSA Consumer Research Paper 22 Purchasing annuities and an examination of the open market option November 2003 found 59% of annuitants shopped around. http://www.fsa.gov.uk/static/pubs/consumer-research/crpr22.pdf ABI research Retirement choices: baseline to measure effectiveness of the code of conduct – results of customer research May 2013 found 63% of annuitants shopped around (link in footnote 7).

What were our objectives?

We started our thematic review in January 2013 and we:

- assessed whether and by how much consumers would be better off buying an annuity from the open market rather than their existing pension provider (see Chapter 2)
- considered the drivers of provider behaviour, including assessing, at a high level, the profitability expected from their annuity business (Chapter 3)
- reviewed existing research about consumer behaviour and engagement to better understand how this affects shopping around and the choice of annuity (see Chapter 4)

We undertook this work to determine whether further work was required and what focus further work might have.

Scope of our review

Our review was focused on consumers with contract-based pensions who purchase an annuity from their existing pension provider or through a third-party arrangement.

We have not looked at members of trust-based occupational pension schemes and the similar decisions they make when buying annuities (although they are included in the consumer research in Chapter 4). The pension provision element of this is outside our regulatory remit. We have liaised with TPR throughout our review and will continue to do so.

The data we have analysed covered approximately 330,000 annuity sales in 2012. This represents around 78% of all annuity sales. This is due to the following:

- We excluded investment-linked annuities from our review on the basis that these make up a very small proportion of the market (less than 5% of annuity sales).
- We also excluded escalating annuities as relatively few are sold (around 5% of all annuity sales in 2012).
- We excluded customers that obtained a guaranteed rate from their existing provider, as we assumed that they are getting the best rate available to them. There may be exceptions to this, such as where someone has serious health problems, but we believe these cases would be quite rare. Data provided by firms indicates that around 50,000 annuities sold in 2012 obtained a guaranteed rate (12% of all annuity sales in 2012).

Where we set out the results of our analysis in Chapter 2 and present data in Chapter 3 all of the above annuities are excluded.

How does this thematic review relate to changes in the annuities market?

Our review took place at a time of significant change and uncertainty in the annuities market. The implementation of the EU Gender Directive, the Retail Distribution Review (RDR) and the development of Solvency II requirements[11] have contributed to a period of significant uncertainty for annuity providers. This is coupled with historically low annuity rates, driven in part by historically low interest rates as well as other factors such as improving life expectancy.

There has also been an acceleration in the last five years of the use of individual underwriting and the growth of enhanced annuities. This has had most impact on the open market, with fewer providers now actively competing for standard annuity business.

In our view it is unlikely that the market will become more stable in the medium term and the reactions of firms to the current operating environment could exacerbate the conduct issues in this market. Therefore we believed it would be better to undertake this work now.

The results represent the position for consumers at a particular point in time. We carried out our review after the ABI Code of Conduct on Retirement Choices was introduced. However, our work also drew on data from before the introduction of the code. Any impacts of the ABI Code and the ABI annuity rate publication are therefore not fully represented in our work. It is our understanding that ABI data is not yet showing any significant change in consumer purchasing patterns. We will continue to follow the trends in this market and the results from the ABI's own evaluation of its code's effectiveness.

The Treasury and DWP continue to take an active interest in annuities through their Open Market Option Review Group. The industry participates in this group and the ABI has recently launched a review of retirement options.[12] We continue to work closely with the Government and other parties in this area.

What did we find?

Overall our results indicate that some parts of the annuities market are not working well for some consumers.

We found that 80% of consumers who purchase their annuity from their existing provider could get a better deal on the open market.

We have identified two groups of consumers who are particularly at risk of not getting a good deal:

- Those with small pension funds[13] are generally offered lower annuity rates than those with larger funds and have less choice of providers on the open market. More of these customers will get the best deal available to them from their existing pension provider, so our concerns here are with how the market serves these customers rather than with shopping around and switching.

11 An agreement in principle on the way long-term products will be valued under Solvency II was reached by the European Parliament, Commission and Council on 13 November 2013 after our assessment took place.

12 A new retirement – insurance industry review of retirement options https://www.abi.org.uk/Insurance-and-savings/Topics-and-issues/A-new-retirement

13 primarily those with less than £5,000 and to a lesser extent those with between £5,000 and £10,000.

- Those who would be eligible for an enhanced annuity but do not explore this option stand to gain the most from shopping around, but they also need to be aware of and understand their potential eligibility for an enhanced annuity.

Overall, firms expect the annuities they sell to their existing pension customers to be more profitable than business conducted on the open market. Several insurers have retention of annuity business as part of their business strategy and one of the drivers of this may be the expected profitability of this business.

Without doubt, encouraging consumers to shop around is a good thing, and the work by the ABI and others in this area should continue. However, consumer research, in particular behavioural economics research, tells us that there are significant barriers to consumers shopping around in this market and that the traditional method of disclosure may not be enough to change consumer behaviour.

Next steps

Based on the findings from this review, we believe that it is appropriate for us to undertake a competition market study on products for retirement income. Market studies are our new main tool for examining competition issues in the markets we regulate, and allow us to look more broadly at a market as a whole with a view to analysing how competition works today, and how it might develop going forward. The results of the thematic review have been used in developing the scope of the market study, and will inform that ongoing work.

The market study will seek to identify ways of improving consumer engagement to prompt shopping around, it will look at market dynamics (for example, patterns of market entry and exit) to understand what drives the high levels of concentration observed in parts of these markets, and it will look at how these markets are likely to develop in future in response to changing retirement patterns and needs. The market study will include a supervisory element reviewing how pension providers sell annuities to their existing customers. If we find poor sales practices we will ask firms to make changes immediately, and may require further action following the final report on the market study.

Who should read this paper?

This paper is directed at firms selling annuities and those who have existing DC pension customers, their representatives and consumer representative groups. Individual consumers may also find the results of interest.

2. The benefits of shopping around and switching provider

This chapter sets out our key findings from the analysis of the data provided by firms. Detail on our methodology can be found in Annex A. We used a simplified model and therefore the findings are indicative estimates. Some of the key aspects of our approach are set out below.

- **We compared annuity rates offered to existing pension customers to the average of the top three rates available on the open market.** We chose to use this as a benchmark rather than the best open market rate as we believe it is more realistic than expecting everyone to be able to obtain the best rate.

- **We used a single 'health' factor – smoking – to represent eligibility for enhanced annuities.** This means that the range of outcomes for those eligible to enhanced annuities is likely to be wider than in our estimates. However, we chose smoking as the average increase in income for a smoker was assessed to be close to the average increase in income across all enhanced annuities compared to standard annuities.

- **Our results look at the average position over a number of scenarios based on age, pension fund size (after any tax-free cash has been taken) and health.** The variation in outcome for some consumers may therefore be greater than estimated in our review.

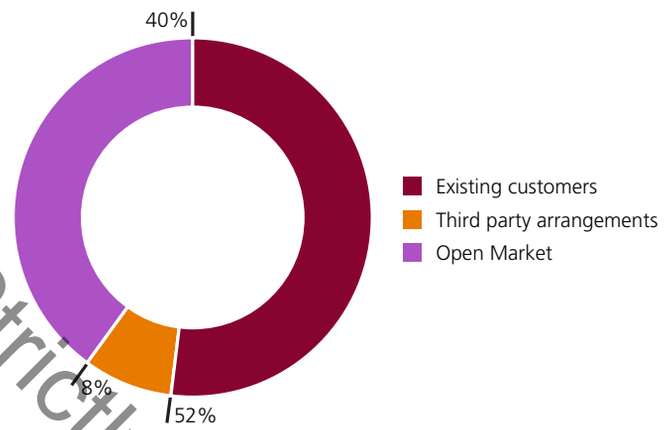
- **We have focused on those consumers who could get a better deal on the open market. We have not included those whose existing pension provider offers as 'good' or 'better' an annuity rate as the benchmark.** That means that the estimates we have made relate only to the consumers who would benefit from shopping around and switching.

In addition we recognise that a significant increase in switching in this market would be likely to result in changes both in annuity rates and potentially in the firms offering annuities on the open market. It should also be noted that our analysis represents a particular point in time and cannot necessarily be extrapolated into the future if there are changes in this market that have an impact on annuity rates and consumer switching behaviour.

What proportion of annuities was sold to existing pension customers?

In 2012, 60% of annuities were purchased through the customer's existing pension provider or a third party with which their provider has an arrangement. Where a pensions provider has an arrangement with a third party to offer annuities to its existing pension customers, we do not consider purchases from this third party to be an open market purchase.

Chart 1: Annuity sales by volume 2012



Do providers offer different rates to existing pension customers and open market customers?

Based on the rates quoted for two dates in 2013, we found that providers operating on the open market offer the same annuity rates to their existing pension and open market customers.[14] There were two firms that were exceptions to this where the rate offered to existing pension customers was better than for those purchasing on the open market. There were some instances of providers having different product offerings for existing customers and open market customers. In particular, there were three providers who offered enhanced annuities on the open market, but not directly to their existing pension customers (at the time of the review).

Some providers use a third party to provide annuities to their existing pension customers, either for all annuities or for enhanced annuities only. In general these arrangements result in a better deal for the existing pension customers than the existing provider's offering, but were often still below what could be achieved on the open market. **In some cases the annuity rate these third-party annuity providers offer through these deals may be worse than the rate consumers could obtain from that same provider on the open market.** Our data is limited in this area as individual deals between providers are set up on different terms and we collected information on the rates most commonly offered.

There are a number of reasons why the annuity rate offered by a firm as a third-party provider may differ from the rate they offer on the open market. For example, the provider might have additional knowledge about the customers that alters their estimation of life expectancy. We are also aware that in some cases the third-party provider will pay a commission to the pension provider for the introduction of the customer.

We are concerned about arrangements that may not be set up in the best interests of customers, particularly where this results in a better rate being available from the same provider on the open market. We will be looking at the associated sales practices in the supervisory element of the market study.

14 This is based on the quotes we requested so we cannot be fully conclusive that there were no cases where open market rates given were better than those given to existing customers.

Do open market customers get offered different rates by providers through different open market distribution channels?

We asked firms to provide open market quotes for customers purchasing directly from the firm, through a non-advised intermediary and through an advised distribution channel. As rates could vary within these channels, due to different levels of commission being taken by different non-advised intermediaries, we asked for the most common quote for each channel.

To ensure a fair comparison we specified an adviser charge to be applied to the advised channel (assumed to be facilitated through the product). Although the data we collected was therefore limited, it indicated that **in general, for customers with pension funds over £10,000, the annuity rate outcome (after commission or an adviser charge is paid) for an open market customer is the same regardless of whether they purchase directly from the firm, via a non-advised intermediary or with advice.**[15]

How much better off would consumers be purchasing an annuity on the open market?

We estimate that overall 80% of those purchasing an annuity from their existing pension provider would benefit from shopping around and switching. For standard annuities we estimate 79% could get a better deal on the open market, and for enhanced annuities the proportion is 91%.

We looked separately at how much better off consumers buying standard and enhanced annuities from their existing pension provider would be if they had purchased an annuity on the open market as well as looking across all annuitants (table 1).

Table 1: Estimated annual income gains by consumers from purchasing an annuity on the open market

	Standard	Enhanced	All annuitants
Average fund size used for annuity purchase	£17,000	£26,800	£17,700
Average annual income achieved from existing pension provider	£1,000	£1,630	£1,030
Average amount of annual increase in income	£67	£135	£71
Average proportion annual income could be increased by	6.7%	8.3%	6.8%

15 This is based on an assumed adviser charge. Where a customer is able to negotiate a more favourable adviser charge they are likely to get a better outcome from taking advice. However, the adviser charge we asked firms to use is in line with the average adviser charge firms told us they are facilitating.

How much could those buying standard annuities increase their income by?

On average we estimate that those who purchase a standard annuity from their existing pension provider could increase their income[16] by £67 per year by purchasing an annuity on the open market.

There is wide variation in the gains consumers could make depending on the annuity rate offered by their existing pension provider. Chart 2 illustrates the amount by which the average customer of each firm in our survey could improve their income through shopping around and switching (this includes two firms who are acting as a third party but have no internal pension customers of their own).

Customers of some firms will get the best rate from their existing pension provider, while others could increase their annual income by as much as £171 on the open market. The existing pension customers of one firm on average got an annuity rate as good as or better than our benchmark. This firm is not included in Chart 2.

In general our modelling indicates that consumers whose pension provider does not operate on the open market get a lower annuity rate if they purchase a standard annuity from their pension provider than if their provider also sells annuities on the open market.

Chart 2: Average estimated amount by which consumers purchasing standard annuities could increase their annual income

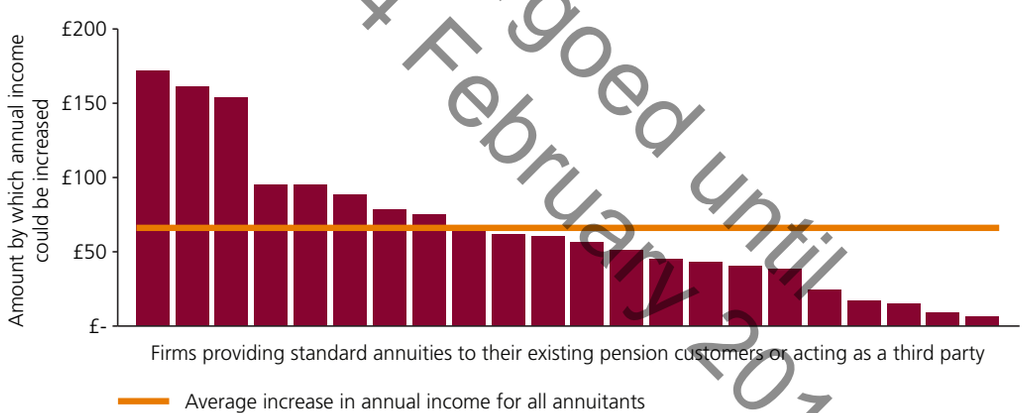


Chart 2 does not take account of the volume of customers who purchase their annuity from their pension provider in each firm.

How much could those buying enhanced annuities increase their income by?

On average we estimate that consumers purchasing enhanced annuities from their existing pension provider could increase their annual income by £135 by purchasing an annuity on the open market.

This is more than twice as much as for those purchasing standard annuities, but proportionately it is not double the benefit, as in general enhanced annuities are purchased by those with larger pension funds and also enhanced annuity rates are generally higher (see Table 1). Again there is wide variation in the gains consumers could make depending on their pension provider.

16 When we refer to income throughout this paper we mean gross income.

Chart 3 shows the nine providers who either offer enhanced annuities to their own existing pension customers or act as a third party to a provider who does not offer its own enhanced annuity (there is one more firm but their existing pension customers on average get a good deal from their existing provider). There are also fewer pension providers offering enhanced annuities to their existing customers, which we discuss further in Chapter 3.

Based on our analysis we estimate that consumers of some firms could increase their annual income by as much as £278 by purchasing their annuity on the open market. However, we have used one lifestyle factor in our analysis, and the variation may be different for other lifestyle or health factors (depending on the impact that factor has on life expectancy).

Chart 3: Average estimated amount by which consumers purchasing enhanced annuities could increase their annual income

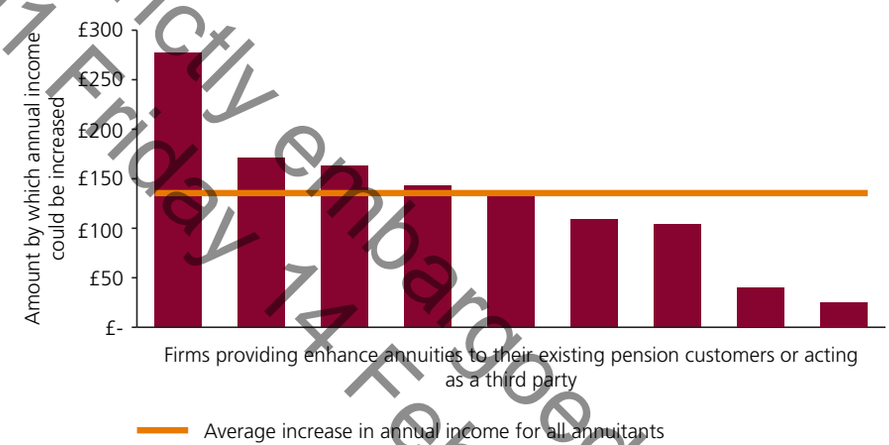
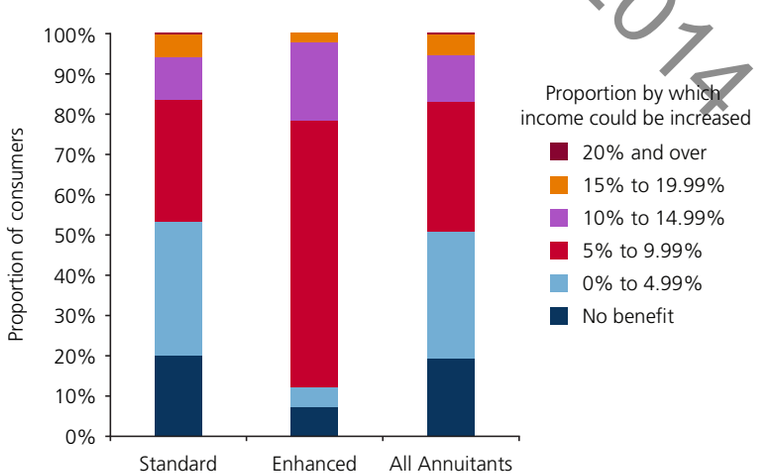


Chart 4 shows a breakdown of how much those purchasing an annuity from their existing provider could increase their annual income. This shows that more of those purchasing enhanced annuities could get a significant increase in income from shopping around and switching than those purchasing standard annuities.

Chart 4: Proportion by which consumers could increase their annual income by shopping around and switching



Although the average increase in annual income is £67 or £135 a year, there will be many who could benefit more, and **we estimate half of those customers purchasing an annuity from their existing pension provider could increase their annual income by more than 5% on the open market.**

How much could those buying a standard annuity who would have been eligible for an enhanced annuity increase their income by?

It is likely that some of the consumers purchasing standard annuities from their existing pension provider would be eligible for an enhanced annuity (either from their provider or using the open market). For these consumers the potential benefit is likely to be far greater than shown above. **We estimate that on average these consumers could benefit by £110 to £175 per year.**[17] However, the true range of benefits will depend on the nature of an individual's health conditions.

What is the impact over an individual's lifetime?

An annuity pays an income to the customer until they die (and possibly then to their dependant if joint life or within a guaranteed period). To assess the impact of switching over the lifetime of each annuitant, we estimated how much they would have needed to increase their pension savings to achieve the equivalent annual income available on the open market from their existing pension provider (Table 2).[18]

Table 2: Additional amount in pension savings that would be needed to purchase the income available on the open market from the existing pension provider

Standard	Enhanced	All annuitants
£1429	£2428	£1497

What does this mean for each annual cohort of annuitants?

In our analysis we identified approximately 150,000 consumers each year who stand to benefit from shopping around and switching based on 2012 sales data. Table 3 shows the annual increase in gross income that these consumers could achieve and the total increase in pension savings that would be needed for these consumers to get that income from their existing pension providers.

17 Based on the average fund size of £17,000 and annual income from a standard pension of £1000 set out on page 14.

18 For example, if a consumer is offered a 5% annuity rate from their existing provider for a fund size of £10,000 and a rate of 5.5% on the open market they would need an extra £1000 in their pension fund to get the same income they could have got with £10,000 on the open market.

Table 3: Annual income increase available and increase in savings needed for the group of consumers buying an annuity each year.

	Standard	Enhanced	All annuitants
Annual increase in income	£9.5m	£1.4m	£11m
Additional pensions savings needed	£204.3m	£25m	£230m

While these benefits are theoretically available in the current market, we believe there are a number of reasons why it may not be possible for these benefits to be fully realised:

- The capacity of the firms with the best rates will be limited.
- Significant increases in shopping around are likely to have an impact on the rates available on the open market and the firms offering annuities on the open market.
- There are significant behavioural barriers in getting consumers to shop around and switch provider and consumers also make decisions on other factors than price.

Some of this is reflected in our use of the average of the top three open market rates for comparison rather than the best rate. We consider it more appropriate to look at a range of potential benefits for consumers from shopping around and switching. **If between half and all of those who could benefit from shopping around and switching did so, we estimate that the improvement in annual income would be between £6m and £11m, and the lifetime benefit potentially available would be between £115m and £230m for the group of consumers buying annuities from their existing pension providers each year.**

This is a significant amount of value that consumers could benefit from by switching. This does not necessarily mean that insurance companies are 'keeping' all of this money from consumers. There are some consumers who are not taking advantage of providers who are able and willing to offer annuities at more competitive rates. The consumer behaviour contributing to this is explored in Chapter 4. We present the findings from our exploration of the profitability of annuities in Chapter 3, along with other considerations of provider behaviour.

Are there additional concerns for those with small pension funds?

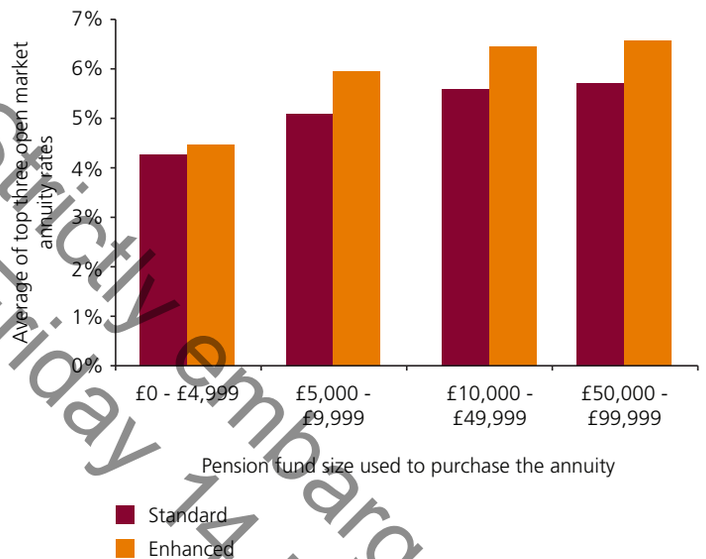
Our data shows that in 2012 27% of annuities sold to existing pension customers were for fund sizes of less than £5,000. These customers are less likely to be able to gain from shopping around as they have no real choice on the open market.

Although at the time of our survey three firms theoretically offered standard annuities and two firms offered enhanced annuities for this size of fund, our understanding is that these are not actively promoted. Around half of these consumers are getting the best rate from their existing pension provider, the remainder could theoretically benefit from shopping around, but by less than 5% on average.

Our data is limited in this area. For example, we are not able to identify where an individual may have annuitised more than one pension fund and obtained a rate based on the combined value, but where these have been set up as separate annuities due to the way the annuity providers systems operate.

The annuity rates offered to these consumers are lower than for those with larger pension funds. Chart 5 shows the average of the top three open market rates provided by firms for a 65 year old with different fund sizes.

Chart 5: Average of the top three open market annuity rates based on quotes provided for a 65 year old



While it is likely that this is in some part due to the fixed costs of providing an annuity representing a larger proportion of the pension fund, it is clear that those with small pension funds are not well served in this market.

3.
Products and providers in the annuity market

Whether or not consumers shop around and purchase an annuity on the open market depends on a number of factors, including the activity of providers, as well as consumer attitudes and behaviour. In this chapter we look at the activity of providers in the following areas:

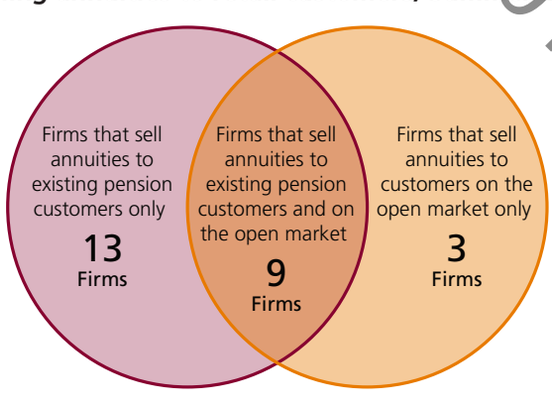
- The number of providers active in the annuities market and their market share in 2012.
- The access that consumers have to enhanced annuities from their pension provider.
- The results from our assessment of profitability that providers expect from annuity business.
- Retention rates of pension providers.

We will build on our understanding of provider behaviour in our market study. We will also look at how pension providers sell annuities to their existing customers in the supervisory element of the market study.

Providers in the market

We gathered information from 25 firms, which represent 98% of the pension annuity market by volume of sales in 2012. As Diagram 1 shows, 13 firms sold annuities to their existing pension customers only and the remainder operated in the open market.

Diagram 1: Firms selling annuities to retail customers, Summer 2013



The open market for standard annuities is very concentrated. Charts 6 and 7 show the share of the open market firms have by estimated premium for standard and enhanced annuities in 2012 (based on the data provided for our review). There were only six firms offering standard annuities on the open market in 2012 and three of these accounted for 97% market share by

estimated premium. This concentration has increased over time. In contrast, more providers are entering the open market to sell enhanced annuities. At the time of this report there are 10 providers with the expectation that two more will be entering the market soon.

Chart 6: Open market share by est. premium 2012 - standard annuities (6 firms)

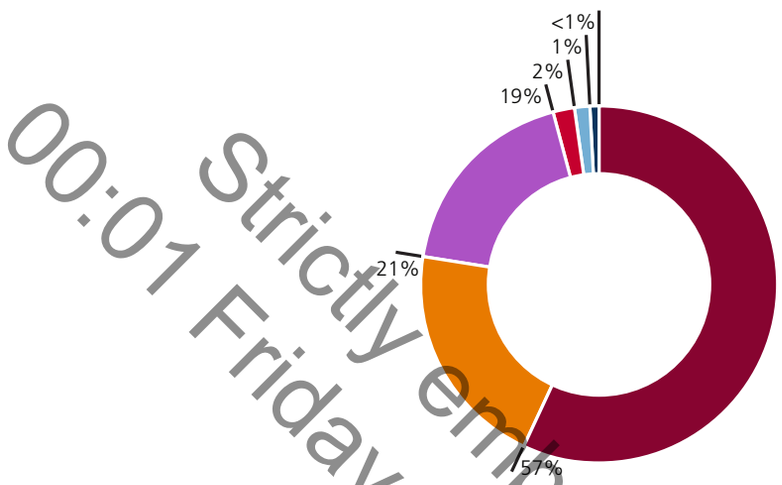
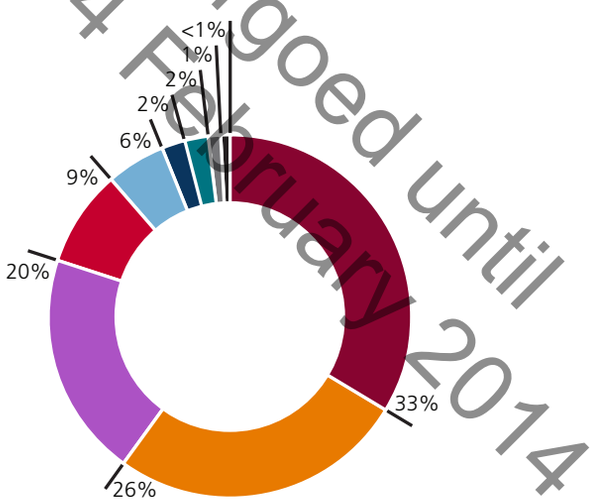


Chart 7: Open market share by est.premium 2012 - enhanced annuities (9 firms)



Access to enhanced annuities for customers annuitising with their pension provider

While all 22 providers that offered annuities to their existing pension customers provided standard annuities, only ten of these offered enhanced annuities to their existing pension customers (either themselves or using a third party) at the time of our survey in Summer 2013. For the customers of the remaining firms, it is very important that the availability of enhanced annuities is communicated clearly. The ABI code requires pension providers to tell their customers about enhanced annuities, and those that do not offer enhanced rates are expected to inform customers that they do not offer these and their customers may be able to get a higher rate elsewhere.[19]

19 The ABI Code of Conduct on Retirement Choices.

Chart 8: Estimated take-up of enhanced annuities 2012

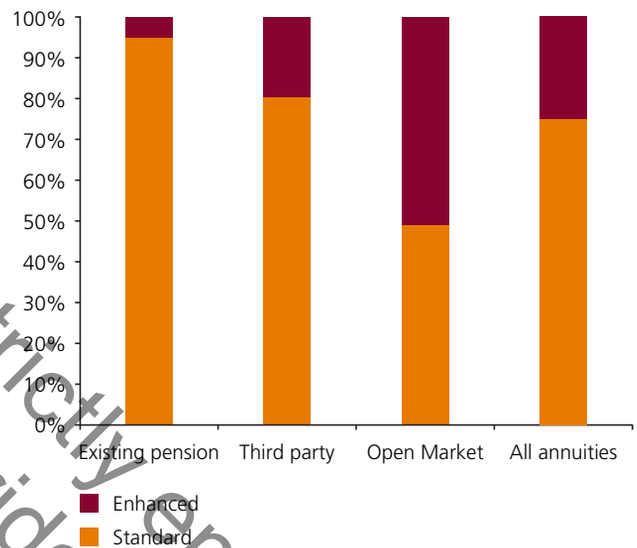


Chart 8 shows the proportion of customers who purchased an enhanced annuity in 2012. Only 5% of annuities sold by providers to their existing pension customers were enhanced compared to 50% of annuities sold on the open market. This may be because consumers who are obtaining an enhancement are the ones who have identified this and are using the open market. However, it is also possible that a significant number of consumers purchasing standard annuities from their existing provider may be eligible for an enhanced annuity.

We do not yet know the impact that the disclosure of information about enhanced rates under the ABI Code will have and whether it will mitigate this risk. We will look closely at what pension providers tell their customers about enhanced annuities in the supervisory element of the market study.

Expected profitability of annuity business

We assessed profitability in the annuity market to understand to what extent pension providers benefit from customers who do not shop around for an annuity. We worked closely with Towers Watson to develop the approach used to measure annuity profitability.

As the 'actual' profitability of annuity business will not be known for many years in the future, we had to consider 'expected' profitability, that is the value of profits that providers expect to make in the future from the annuity business written in a particular period.

Measuring the expected profitability of annuities is complex and requires assumptions about the future, such as the life expectancy of customers, the amount of assets firms need to hold to meet future annuity payments to customers, the investment returns the firms expect to make on those assets and the administration expenses. At the time of our review there were further complications because of the recent introduction of the Retail Distribution Review and the Gender Directive. Although there is now general agreement in principle on certain relevant aspects of Solvency II, this was not in place at the time of the analysis. Firms therefore had to make assumptions about the timing and potential impact of Solvency II within their pricing.

All of these factors mean that the profit firms actually make in the future might be quite different from the profit they expect to make when an annuity is written.

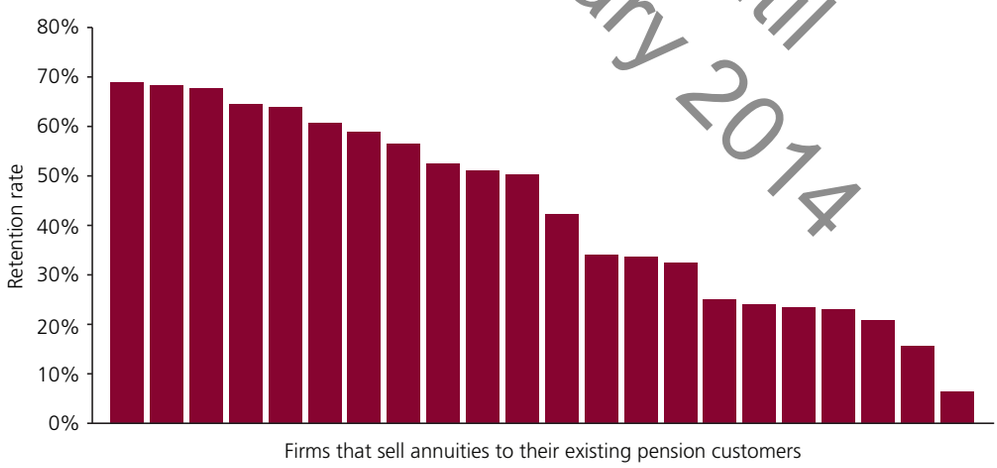
Given these points, the purpose of our initial assessment was to determine whether there were concerns about expected profitability that would merit further investigation, rather than to provide an in-depth profitability analysis or reach a definitive conclusion. The results of this indicative assessment are that there are different average levels of profitability between different segments of the market. **Overall standard annuities offered to existing pension customers were expected to be more profitable than annuities written in the open market.** In addition, preliminary analysis of the data suggests that profitability may be higher for standard annuities when compared to enhanced annuities, but further work is needed to check this.[20] We have concluded from this work that further investigation is required and we will take this forward as part of the market study.

Retention rates

We know from our wider work assessing providers' business models that some have active contact plans in place to engage with customers in the lead up to retirement. In some cases these contact plans may influence customer retention and loyalty and reduce levels of shopping around.

We measured pension providers' retention rates in 2012 – that is, the proportion of customers who annuitised with their pension provider – and found these varied widely between firms (Chart 9).[21] It should be noted that in these retention rates, where a firm has an agreement with a third-party provider, the sales under this arrangement are not included in the proportion of customers the firm retained. Where a firm has such an arrangement their retention rate may be artificially reduced in Chart 9.

Chart 9: Retention rates in 2012



20 It should be noted that the profitability analysis supporting our results is commercially sensitive at both a market and firm level and will not be made public.

21 Retention has been calculated by collecting base data from firms and using this to make our own estimate of retention for each firm, rather than asking firms for their own measure of retention.

In general firms offering poorer annuity rates retained fewer customers. However, there were some exceptions and retention rates overall remained high.

There are many reasons why firms may have different retention rates, including:

- whether the annuity rate they offer is a good deal
- their customer base (e.g. firms with customers with small pension funds may have higher retention rates given their customers have less choice on the open market)
- their sales practices

We would be concerned if insurers used sales techniques that were designed to retain customers by putting them off shopping around. The supervisory element of the market study will look in detail at a sample of pension providers' selling practices, including any retention strategies they may have, which will consider whether the best interests of customers are appropriately prioritised within these strategies.

4.
Consumers in the annuity market

We commissioned a review of the existing consumer research on annuities, which we have published alongside this report. This has helped us to consider our findings within the context of the consumer issues identified. It has also enabled us to consider how successful previous regulation by the FSA and action by the industry has been in addressing some of the behavioural barriers.

We recognise that the majority of the existing consumer research was undertaken before the ABI Code was implemented and therefore does not take into account any changes in attitudes and behaviours as a result.

We summarise below the key consumer issues that have informed our conclusions and next steps.

Awareness

Awareness of the open market option among consumers is high. Nine out of ten consumers[22] are aware that they can purchase their annuity from a different provider than their pension provider. This awareness has improved over time as regulatory and industry standards have increased the level and quality of disclosure required.

However, awareness of the open market option does not always result in consumers shopping around, and shopping around does not always result in switching. The research suggests that 63%[23] of consumers shop around for an annuity. Shopping around is a subjective concept, so it means different things to different consumers and is measured inconsistently. Our understanding of shopping around behaviour is derived from consumer research, reliant on potentially inaccurate self-reported behaviour. However, the research provides useful insight despite its limitations.

The research highlights that self-reported shopping around activities range from seeking help from a financial adviser, to researching the options available in the press or through websites to obtain multiple quotes, to simply speaking to friends and family before making a decision. Some consumers claim to have shopped around and made a decision without comparing quotes (25% of those consumers claiming to have shopped around). Also, 37% of consumers buying an annuity do not shop around. This suggests that almost half of all consumers that buy an annuity are not making an informed decision based on 'real' shopping around that involves comparing quotes.

22 Retirement Choices: baseline to measure the effectiveness of the code of conduct (ABI 2013).

23 ABI 2013, as above.

Engagement

We recognise that most consumers find it difficult to assess risk and uncertainty in financial products.[24] This results in a general lack of engagement in the annuity purchase, with many consumers struggling to evaluate the options to find the best deal at retirement.

Auto-enrolment potentially reduces consumer engagement, as they no longer need to engage with or actively participate in pension-saving activities. Therefore, these consumers will be faced with choices at retirement with relatively little knowledge of the value of their pension savings.

When consumers eventually engage with their pension savings, this can often result in disappointment with the amount of pension savings they have, and disillusionment about the level of income they can obtain.

Other factors add further complexity to consumer decisions. For example, the impact of interest rates on annuity rates or increasing life expectancy, both of which have resulted in historically low annuity rates and mean that there are difficult decisions to make about when to annuitise. These factors make the decision more complicated and contribute to the sense of disappointment.

Deciding what shape of annuity to buy

Our review of consumer research suggests that consumers are not prepared for the range and complexity of the decisions they need to make at retirement. There are a number of decisions that consumers must engage with to make a well-informed decision about buying an annuity. Alongside the timing of their retirement, they must also consider whether or not to take benefits through income drawdown, and if they choose an annuity, the 'shape' of annuity to purchase. Consumers often have not engaged in building up their pension savings and this affects how they engage with their retirement income choices.

Once consumers are confronted with annuity choices they are faced with decisions that require them to consider their future circumstances, and attribute a future value to options such as joint versus single life, guaranteed periods, inflation protection and death benefits. These decisions all require making judgements about what will happen in the future and the relative values placed on protecting their income against uncertain events. This is something that is very challenging, even for consumers with high levels of financial capability.

These options all reduce the amount of initial income paid out by the annuity. A quote has traditionally been provided by 'default', and this quote was usually for a level, single life. This is now likely to be provided alongside other quotes available on joint lives, or with inflation protection (as required by the ABI Code[25]). However, this 'default' quote will still be included in the wake-up packs issued, and it generally illustrates the most income available at the outset.

Although a level, single life annuity may not provide the most appropriate cover to the individual annuitant, behavioural biases and the complexity of the decision are likely to prevent some

24 FCA (2013) Applying behavioural economics at the FCA: http://www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-1

25 ABI Code of Conduct on Retirement Choices (2013) on unrequested illustrations.

consumers from making the necessary trade-offs to calculate that they or their spouse may be better off in the long-term choosing other options. The complexity of the decision involved, combined with the inability to make trade-offs about future needs, reinforces present bias, a preference towards taking benefits today, over saving or waiting to take benefits tomorrow.

Research shows that consumers also have a poor understanding of the risks associated with not exercising the various options available to them. For example, many consumers are complacent about the effects of inflation over time and its ability to erode the value of their income in the future.

Two-thirds of consumers were aware that they were potentially entitled to an enhanced or impaired life annuity.[26] However, our data suggests that overall only 25% of annuities purchased in 2012 were enhanced, suggesting that again awareness may not result in engagement in the process, or change the decision made. A further area of confusion highlighted in other research is that customers may not be aware of different levels of underwriting for enhanced annuities that result in different outcomes.

Inertia

Consumers' behavioural biases can inhibit shopping around. It is well documented that inertia acts as a barrier to shopping around and leads consumers to the easiest and most straightforward choice available to them, which in the current cases involves accepting their existing pension provider's annuity as presented to them during the 'wake up' process.

The lack of clarity in the gains available from shopping around does very little to counteract the inertia, or encourage consumers to expend the time and effort involved in shopping around and then completing the application process with an alternate provider.

Much of the burden is removed when the consumer purchases an annuity from their existing pension provider that has their personal details and preferred retirement date, contacts them at this time, and has direct access to their funds. This could be a reasonable response if consumers do not trust themselves to make better choices on the open market.

Consumer decisions are not based on rates alone. Even though a better annuity rate may be available, some consumers choose to stay based on the trust and confidence in their existing provider.

Sources of information and advice

As discussed, consumers seek help from a range of sources of information or advice (annuity providers, financial advisers, non-advised intermediaries, and friends and family). The easiest and often most timely source will be their pension provider.

There has been a trend away from providing mass market advice across a range of products, including annuities. A number of annuity brokers and specialists have adjusted their services to develop non-advised propositions for consumers.

26 Retirement Choices: baseline to measure the effectiveness of the code of conduct (ABI 2013).

Recent research[27] highlights that there are some high-quality services available but there is also some scope for poor practice.

We recently completed a review of annuity comparison websites that indicated some scope for improvement in these services. We have published a guidance consultation that details our findings and sets out proposed guidance to improve the websites for consumers.[28] We also provided feedback to firms involved in the review setting out the areas for improvement and expect firms to act on this.

27 Consumer Panel 2013.

28 Add footnote reference when ready.

5.
Conclusions and next steps

Conclusions

Our work suggests that some parts of the market are not working well for consumers. More specifically we have identified the following concerns:

- The majority of consumers (60%) do not switch providers when they buy an annuity, despite the fact that we estimate 80% of these consumers could get a better deal on the open market, many significantly so.

- We estimate that the aggregate benefits that consumers miss out on by not shopping around and switching is the equivalent of between £115m and £230m of additional pension savings. We recognise that this may not be realisable, as changes in switching behaviour would be likely to result in changes within the market.

- In part consumers miss out on the benefits available from shopping around and switching due to their lack of engagement in pensions and annuities, the confusing trade-offs they face and the impact of behavioural biases that makes it difficult for consumers to make the right choices and may result in many of them not shopping around effectively.

- There is also an incentive on providers to retain their existing pension customers, as overall the estimated levels of expected profitability of standard annuity business sold to existing pension customers is more than the expected profitability of annuity business sold on the open market.

- The differences in retention rates (i.e. proportion of pensions annuitising with their pension provider rather than switching) between firms varies widely and some firms have relatively high retention rates and have active retention strategies that may increase customer loyalty and reduce the propensity to shop around.

- There are particular groups of consumers where it appears that the market is not working well. There is an apparent lack of choice and ability to switch for those with small pension funds and lower annuity rates available to these consumers generally, which is likely in part to be due to the fixed costs of providing an annuity representing a larger proportion of the customer's funds.

- There is also a lack of access to enhanced annuity rates for some consumers annuitising with their existing pension provider and not shopping around.

Next steps

Identifying the root causes of these issues and determining what changes are needed requires further work. So we are continuing our programme of work on annuities by launching a competition market study into retirement income (annuities and income drawdown). The market study will allow us to assess how well competition works for consumers in these markets with a view to exploring whether any remedies are required to drive competition and improve consumer outcomes in this area.

In particular, the study will:

- seek to identify ways of improving consumer engagement to prompt shopping around
- look at market dynamics (for example, patterns of market entry and exit) to understand what drives the high levels of concentration observed in parts of these markets
- look at how these markets are likely to develop in the future in response to changing retirement patterns and needs.

The market study will include a supervisory element looking at pension providers' sales of annuities to their existing customers. If we find poor sales practices we will ask firms to make changes immediately, and may require further action following the final report on the market study.

As some of our findings raise wider issues for Government policy, such as the choice available to customers with small pension funds, we have shared our findings with the Treasury and DWP to feed into the wider work they are doing in this area.

Annex A
Methodology

To estimate how much better off consumers could be from buying an annuity on the open market rather than their existing pension provider we carried out a survey of 25 firms (representing 98% of annuity sales by volume within the scope of our review).

This included asking firms to provide quotes based on hypothetical customer profiles as if they were their existing pension customers and open market customers. We then compared the rates offered to existing customers with the rates available on the open market. The key elements of our methodology are set out below.

- We divided consumers who purchase annuities into 16 segments and designed a hypothetical customer for each segment.
- These segments were based on age, fund size used to purchase the annuity and health.
- We set a specified postcode that we believed to be relatively neutral.
- We specified a single life annuity for our analysis, but used one additional consumer profile with a joint life annuity to see how results compared with single life annuities. We found that the analysis using a joint life profile gave broadly similar results as for the corresponding single life profile.
- We asked firms to provide quotes for these customer profiles for two dates in 2013 both after the implementation of the ABI code.
- We gathered information on the number of annuity sales made within each consumer segment in 2012 to weight the quotes in our model.
- We also collected data for the first half of 2013 to see if the volumes had changed significantly from 2012.
- We compared annuity rates offered to existing pension customers to the average of the top three rates available on the open market.
- We did not net off profiles that got a better deal than the average of the top three open market rates against those who got a worse deal. Our analysis and results only covers those who got a worse deal.

Exclusions and limitations

- We excluded from our weighting data sales of annuities for more than £100,000 (as they only accounted for 6% of all annuity sales by volume in 2012[29]).

- We also excluded from our weighting data annuities where the rate was based on a guaranteed rate making the broad assumption that these guaranteed rates represent the best deal available.

- We used two quote dates to make some allowance for the fact that annuity rates change over time and that there will be differences between firms in the timing of updating of annuity rates. We recognise that this is limited and understand that our results represent the picture at a particular point in time.

- Both dates on which quotes were requested were after the implementation of the ABI code.

- We asked firms to provide their open market rates based on the most commonly quoted rates offered across the three open market distribution channels: direct, non-advised and advised.

- We used one health profile – a smoker – to represent customers eligible for an enhancement. This is a significant simplification. Smoking was chosen as it is widely used as an underwriting factor and our discussions with providers of enhanced annuities indicated that the uplift given to those who smoke is close to the average uplift given for enhanced annuities overall. Where there were firms who did not provide smoker annuities but provided other enhanced annuities we have made adjustments to compensate for this. So we are confident that our overall estimate for those purchasing enhanced annuities is reasonable. The range of outcomes at a consumer level is likely to be much wider than we have shown.

29 ABI data 2012.

Glossary

This glossary sets out the key terms we use and how we have defined them for this report.

Annuitant – a customer who has purchased an annuity.

Annuity – an insurance contract that provides a customer with a guaranteed income for life in return for a lump sum premium paid from a pension policy.

Annuity rate – the first year's annual payment received by a customer expressed as a percentage of the premium paid for the annuity.

Defined benefit pension – an occupational pension where the income at retirement is based on the number of years in the scheme and the individual's earnings.

Defined contribution pension – a pension scheme where a fund is built up through contributions and investments which results in a pot of money to be converted into an income at retirement.

Enhanced annuity – an annuity where the rate is increased due to the customer's health or lifestyle factors that the insurer has knowledge of. This includes the whole spectrum of enhancements from smoking to fully medically underwritten annuities (often called 'impaired life' annuities) on the basis of specific health conditions. The customer will have to disclose their state of health to the provider on their application form, and may have to be medically examined for impaired life annuities.

Escalating annuity – an annuity where the annual payment rises over time. The most common escalation is for the annuity payment to rise by a fixed percentage such as three or five percent per year, however it may also be linked to the Retail Price Index (e.g. RPI-linked or indexed annuity).

Guaranteed annuity rate (GAR) – GARs are included in some existing pension contracts, allowing the customer to convert their pension fund to an annuity at a rate defined within the pension contract (in some cases only available on a specified retirement date).

Income drawdown – income drawdown allows the customer to take an income from their pension fund, while the remainder of the fund remains invested. Unlike an annuity the customer continues to bear investment risk and longevity risk (the risk that they outlive their money). There are also different tax rules for annuities and income drawdown arrangements and differences in what happens when the customer dies.

Investment-linked annuity – an annuity where the income paid to the customer is linked to the performance of an underlying investment. This includes with-profits and unit-linked annuities.

Level annuity – an annuity whose payments remain the same, in monetary terms, for the duration of the contract. This can be contrasted with an escalating annuity.

Standard annuity – an annuity where the rate is not underwritten on the basis of the health or lifestyle factors of the customer (other than their age or fund size). Where only a postcode is used in setting the rate we consider this to be a standard annuity.

Third-party arrangement – an arrangement between pension and annuity providers where one provider has an agreement to provide annuities for all or a subset of the other's existing pension customers. This includes where the annuity provider is part of a panel of providers, but not where there is an intermediary referral process in place (through an independent financial adviser or broker).

Financial Conduct Authority

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