What is the impact of not shopping around for annuities?

Introduction

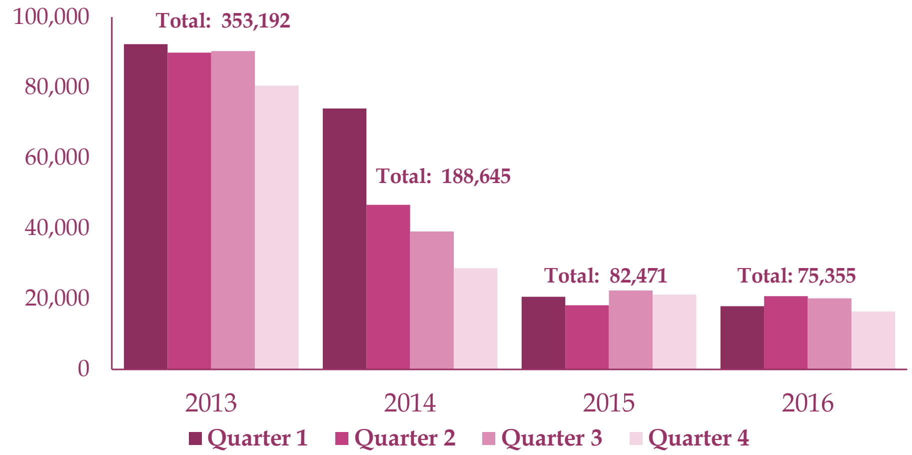
The UK annuity market is undergoing a transition as a result of the removal in 2015 of the effective requirement for those with Defined Contribution (DC) savings to purchase an annuity, "Freedom and Choice".

Prior to the 2015 policy change, those who wished to access their DC savings generally had to purchase an annuity (though there were exceptions for those with very small pension pots and those who could prove that they had an alternative, secure source of retirement income).

Part of the Government's rationale for the change was that the annuities market was not "working in the best interests of all consumers. It is neither competitive nor innovative and some consumers are getting a poor deal".[1] This conclusion was reached following the publication of a Financial Conduct Authority review of the retirement income market which concluded that people were not getting good deals on annuities as a result of not shopping around for the best price. The report concluded that annuitants who did not shop around were forgoing an average 6.8% of annuity income in retirement as a result,[2] which could negatively affect standards of living, particularly for those dependent on their annuity as their only source of retirement income beside their State Pension.

Chart 1: Yearly annuity sales have dropped by 79%

Quarterly annuity sales by ABI members, 2013 to 2016



Source: ABI stats

This Briefing Note explores how the use of annuities has changed since Freedom and Choice and calculates to what extent annuitants are currently forgoing income in retirement by not getting the best deal.

There are several annuity types available

The UK annuity market has existed in its current form since 1956, when the Finance Act introduced DC pensions which required members to annuitise their pots at retirement. Since that time, the proportion of people with DC savings has grown, as has the market for annuities. In 2016, there were 12.3 million active members of DC schemes[3] and there were around six million annuities in payment.[4]

Prior to Freedom and Choice, 90% of DC assets were used to purchase annuities, and sales of annuities peaked in 2009 at 466,000.[5]

Prior to Freedom and Choice, the majority of annuities were "lifetime annuities" which pay an income to an annuitant until their death instead of ceasing to pay out at a particular age (Box 1).

Box 1: Types of lifetime annuities

Single-life annuity – pays out only to the annuitant, without a subsequent income to a spouse or dependent on the annuitant's death.

Level annuity – pays the same nominal rate in perpetuity, with no increase for inflation.

Joint life annuity - for an initial reduction in the annuity rate (the amount of money paid to the annuitant monthly or yearly), joint-life annuities pay out to a spouse or dependent on the annuitant's death.

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Index-linked and escalating annuities – for an initial reduction in annuity rate, these annuities increase in line with some measure of inflation or a pre-set amount (e.g., 2%, 2.5%).

Enhanced or impaired-life annuities – higher rate annuities available to those with life-limiting health conditions (e.g. diabetes) or lifestyle factors (e.g., smoking).

Postcode annuity - those living in postcodes associated with low life expectancy are eligible for higher annuity rates.

With-profits or investment-linked annuities - annuities which provide opportunities for investment returns.

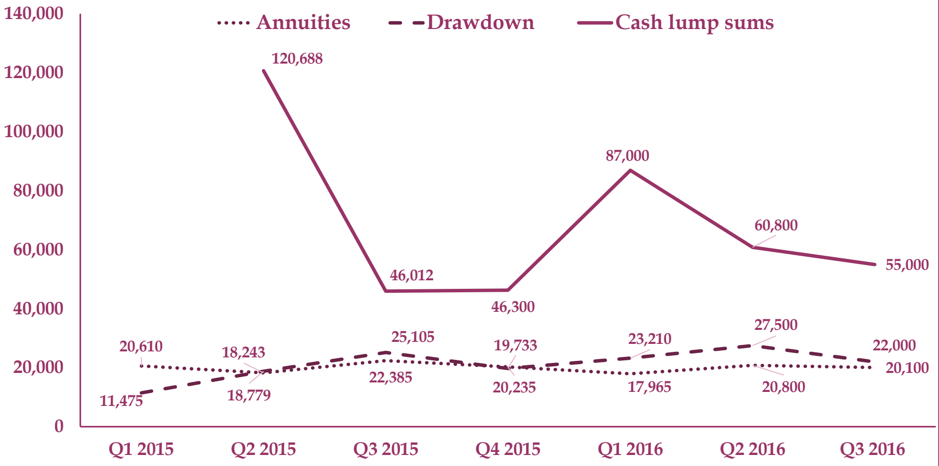
Freedom and Choice has paved the way for new annuity types

The annuities described above continue to be available post Freedom and Choice, but the removal of the requirement for a secure lifetime income has paved the way for other types of annuities, in particular: "fixed-term" annuities (which pay out for a fixed period of time with or without a lump sum balance returned to the annuitant at the end) and "deferred" annuities (which can be bought many years prior to the time they commence paying out).

Deferred annuities are a form of longevity insurance; if people live for longer than expected they will have a secure form of retirement income in these later years.

Chart 2: More people are withdrawing money through cash lump sums than through drawdown or annuity products

Numbers of drawdown and annuity purchases and cash lump sum withdrawals by quarter, ABI members



Source: ABI stats

Fewer people are purchasing annuities

The greatest effect that Freedom and Choice has had on the annuity market is that annuity purchases have decreased significantly. In 2013, prior to the announcement of Freedom and Choice, 353,192 annuities were purchased (from ABI members). By 2016, this had dropped by 79% to 75,355 annuity sales (Chart 1).

Those not purchasing annuities are still accessing their DC savings. Currently the most popular way of accessing DC savings is through cash lump sums.

In Q3, 2016:

- 55,000 people fully withdrew their DC pension savings via lump sums,
- 22,000 invested in drawdown, and
- 20,100 purchased an annuity (Chart 2).[6]

However, those accessing lump sums generally have smaller pot sizes than those using annuities or drawdown. In Q3, 2016:

- The average full lump sum withdrawal was just over £13,900,
- The average drawdown contract was for a fund of just over £76,000, and
- The average fund size for an annuity purchase was just over £58,100.[7]

These patterns are consistent with those seen during the whole of 2015 and 2016, with the largest funds being used for drawdown, on average, the second largest being used to purchase annuities, and smaller funds being withdrawn through cash lump sums (Chart 3).

DC access decisions are complex

In order to make informed DC access decisions, people need to understand how longevity, inflation, market performance and the potential need for health or social care, could affect needs and sources of retirement income.

The risks attached to accessing DC savings have increased since the introduction of Freedom and Choice, because annuities protect against some of these risks. However, while lifetime annuities can provide security against living for longer than expected (longevity risk) and most market-based risks, they do not always protect against inflation risk or allow people to leave an inheritance (though there are annuities which rise with inflation or allow for a lump sum if the annuitant dies before a certain age).

For some people, a cash lump sum withdrawal or using drawdown will be the most appropriate way of accessing DC savings and for others a combination of two or three of these methods will be most advisable.

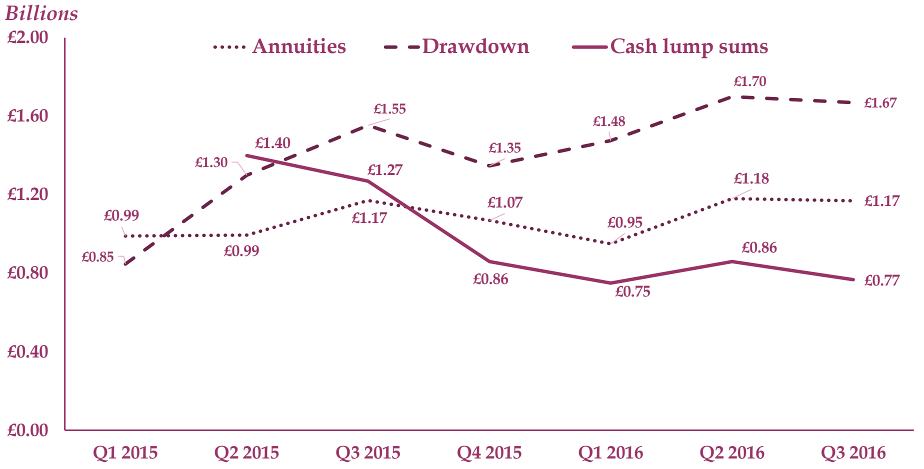
The decisions that people make about accessing DC savings, and their outcomes, will be affected by other sources of savings and assets (such as earnings, savings, housing, and investments).

Fewer people are using advice to purchase annuities

Deciding how to access DC savings is difficult for the majority of people due to generally low levels of financial capability and numeracy in the UK.[8] Therefore, some source of advice, guidance or information may be required to assist DC savers to make informed decisions about access.

Chart 3: People are spending more money on drawdown products than on annuities or through lump sum withdrawals

Value of retirement income products and cash lump sum withdrawals by quarter (billions), ABI members



Source: ABI stats

The proportion of people using either independent advice or restricted advice to purchase an annuity has dropped by 9% since 2013. In 2013, 65% of people purchasing an annuity did so without independent or restricted advice, compared to 75% in 2016 (Chart 4).

However, those who did not use independent or restricted advice may have used other forms of advice or guidance. There are many voluntary organisations providing guidance and information on pensions including: The Pensions Advisory Service, the Citizens Advice Service and the Money Advice Service. There is also the Government's offer of a free, independent guidance session for 45 minutes, available to those over age 55 with DC savings; Pension Wise. Since its launch in April 2015, Pension Wise has delivered 134,000 guidance sessions (face to face or over the telephone).[9]

There are fewer annuity providers than before Freedom and Choice

As a result of the reduction in annuity sales, there have been some shifts within the annuity market. Some annuity providers have introduced new products, such as deferred or fixed-term annuities, and/or started providing drawdown. Some annuity providers have merged,[10] others are withdrawing from the annuity market in favour of other forms of insurance products.[11] In 2016, there were around 25 annuity providers in the UK.[12]

Around 80,000 people are still buying annuities a year

While fewer people are buying annuities than before, around 20,000 are purchased each financial quarter. It is not known what proportion of these people are shopping around for their annuities. However, prior to Freedom and Choice, around 80% of those who bought an annuity internally (from their original pension fund provider) did not shop around, though 20% did shop around and decided to remain with their original provider (either because they felt they had the best deal with their provider or for other reasons, such as guaranteed annuity rates).[13]

It is relatively safe to assume that a proportion of people who purchase their annuities from an internal provider do not shop around for the best deal or understand all of the options available to them, because the majority of annuities are purchased unadvised, and a large proportion of internal purchases were unadvised previously.

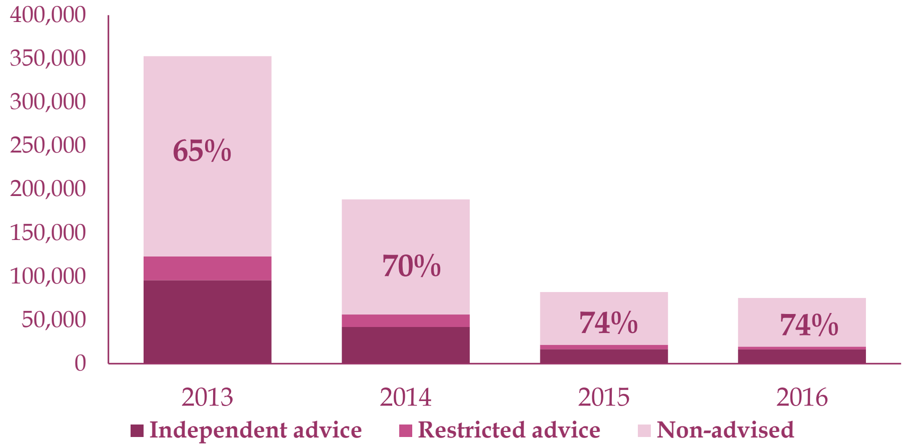
Annuity quotes can vary by up to 40%

Those who do not shop around for an annuity may not be getting the best deal, though some who do not shop around may still get the best annuity from their provider. This is particularly the case when people are entitled to a guaranteed annuity with rates which the provider committed to when the annuitant began saving into their pension.

Shopping around for the best deal is not limited to looking around for the best rate for a single-life, level annuity. It also includes determining what the most appropriate type of annuity for an individual's needs might be and at what age is best to make the purchase.

Chart 4: Fewer people are using advice to purchase annuities

Annuities purchased with advice, restricted advice and no advice, 2013 – 2016 (ABI members)



Source: ABI stats

Those with health problems, who live in particular post codes or who wait until older ages can receive a significant uplift in their annuity rate (Chart 5).

In order to illustrate the potential range between annuity rates, Chart 5 shows a snapshot of the lowest and highest annuity rates quoted on an annuity comparison site.[14]

The quotes are gender neutral and are for a person:

- Aged 65 or 75,
- With or without life-limiting lifestyle factors (smoking and obesity),
- With or without a joint annuity (which pays out 50% of the annuity rate for life to a dependent on the death of the annuitant), and
- With or without inflation linking.

Quotes, unless otherwise specified, are for someone living in Harrogate (where life expectancy is relatively high). The low life expectancy postcode is for an area of Glasgow in which life expectancy is relatively low.[15]

Annuity quotes from different providers varied in this example by up to 41%. However, this comparison tool does not cover the entire market and some providers may offer higher or lower rates.

- The most significant variations were for quotes for escalating (inflation-linked) annuities, with the highest quote being 41% higher than the lowest for the person living in Glasgow (age 65, single-life annuity).
- There was also a significant uplift between quotes for enhanced annuities (for those with poor health) and standard lifetime annuities, of up to 19% (age 75, single-life).

Those who wait an extra ten years to purchase an annuity (age 65 vs. age 75) could also see an uplift of around 40%.

It should not be assumed that those who do not shop around always receive the worst deal and those who do shop around always get the best deal. However, those who shop around will have a higher chance of understanding what deals are available and securing a more appropriate annuity for their needs.

Chart 5: Low and high annuity quotes can vary by up to 40%

Monthly annuity quotes based on different criteria using a comparison site (06.06.17)

	Level Single life		Escalating (single-life)		Joint life (level)		Enhanced (level, single-life)	
	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest
65	£364	£448 (23% higher)	£205	£277 (35% higher)	£325	£391 (20% higher)	£407	£498 (22% higher)
75	£499	£583 (17% higher)	£304	£411 (35% higher)	£396	£443 (12% higher)	£535	£679 (27% higher)
Low life expectancy post code age 65	£392	£446 (14% higher)	£207	£292 (41% higher)	£356	£407 (14% higher)	£410	£534 (30% higher)

Around £130 million could be forgone by people purchasing an annuity in 2016

The proportion of people purchasing annuities internally was around 60% in 2013, 2014 and 2015. The amount spent on internal annuities was:

- £4.9 billion in 2013
- £3.4 billion in 2014
- £2.5 billion in 2015, and
- £2.3 billion in 2016

In 2016, 52% of annuities were purchased internally. If it is assumed that (as found in the FCA thematic review of annuities mentioned above) that 80% of these people could have found a better deal of around 6.8% by shopping around, then the potential amount forgone during the lifetime of people who purchased annuities in 2016 could be around £130 million (Chart 6).

There are moves among providers to encourage more shopping around

When providers communicate with DC scheme members about retirement options they are required to notify them of their right to shop around for the best annuity rate.[16]

Prior to Freedom and Choice there were also industry-based initiatives designed to educate people about their options and encourage them to shop around.[17]

There are still industry-based efforts to ensure shopping around, though these now apply to a wider variety of retirement-income products than just annuities.[18] There is little data on the extent to which people are currently shopping around, but the increased focus on DC savers at-retirement decisions in the wake of Freedom and Choice has expanded the availability of advice, guidance and information which might help more people purchasing an annuity to shop around for the best deal.

Conclusions

Prior to the introduction of Freedom and Choice in 2015, around 90% of DC assets were used to purchase annuities and around 60% of annuities were purchased internally from the existing pension provider.

The FCA estimated that around 80% of those purchasing annuities could have increased their retirement income through shopping around, by an average of 6.8%. Annuity quotes sourced today show that the difference between the highest and lowest quote for an individual could vary by up to 40%.

Those who do not shop around for a good annuity rate may, therefore see their retirement income significantly decreased as a result, reducing standards of living in retirement. With the advent of Freedom and Choice, fewer people are purchasing annuities, but there are still around 80,000 annuities being purchased a year, and around 52% of these are purchased internally.

Prior to and post Freedom and Choice there have been industry moves to encourage more shopping around and there is also free, impartial guidance on offer to those approaching retirement with DC savings (Pension Wise). It is unknown to what extend the levels of shopping among those annuitising have changed. If it is assumed that 80% of those purchasing internally continue to lose, on average, around 6.8% of retirement income, then this could represent a loss of around £130 million over the lifetimes of those purchasing annuities in 2016. It is important that industry and those providing guidance and support continue to work on helping people to understand the benefits of shopping around for the best annuity rate. Though fewer people are purchasing annuities than before, they still form a significant element of many peoples' retirement income.

Chart 6: Around £130 million was forgone in 2016 by not shopping around

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Lifetime retirement income forgone from annuities purchased in 2016 as a result of not shopping around

Year	2013	2014	2015	2016
Proportion of annuity contracts purchased internally	57%	58%	60%	52%
Proportion of annuity contracts purchased externally	43%	42%	40%	48%
Aggregate value of annuities purchased internally	£4.9bn	£3.4bn	£2.5bn	£2.3bn
Potential aggregate lost value from not shopping around in one year	£260m	£190m	£140m	£130m

[1] HM Treasury (2014) *Freedom and Choice in pensions* Cm 8835
[2] Financial Conduct Authority (FCA) (2014) *Thematic Review of Annuities* TR14/2
[3] PPI (2016) *The future book: unravelling workplace pensions 2016 edition*
[4] ABI stats
[5] Association of British Insurers (2015), Press release, 03.11.15 *"£4.7 billion paid out in first six months of pension freedoms"*
[6] Association of British Insurers (2017), Press release, 11.04.27 *"The new retirement market: the evolution continues"*
[7] Association of British Insurers (2017), Press release, 11.04.27 *"The new retirement market: the evolution continues"*
[8] PPI (2014) *Transitions to retirement: how complex are the decisions that pension savers need to make at retirement?*
[9] www.gov.uk/performance/pension-wise (sourced 06.06.2017
[10] Just Retirement and Partnership have merged to become "Just".
[11] February 10, 2017, Financial Times *"Prudential to withdraw from UK annuity market"*
[12]ABI members participating in quarterly ABI surveys
[13] Financial Conduct Authority (2014) *Thematic Review of Annuities* TR14/2
[14]Money Advice Service annuity comparison tool
[15] Calton, Glasgow, G31
[16]Financial Conduct Authority, Conduct of Business 19.4
[17] Association of British Insurers (2013) *The ABI Code Of Conduct On Retirement Choices*; Association Of British Insurers (2014) *Retirement Choices: Measuring The Effectiveness Of The Code Of Conduct Following Its Implementation*
[18] Association Of British Insurers (2014) *Making Retirement Choices Clear: A Guide To Simplifying Language On Retirement Options*

For more information on this topic, please contact
Daniela Silcock Head of Policy Research
020 7848 4404 Daniela@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk