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Round Table – Annuities

Can annuities cater for a changing demographic?

Owen Walker, Deputy Editor

Are pensions fit for a twenty-first century purpose?

BEN STAFFORD : The simple answer is yes. Annuities are a timeless product because they address a timeless need – secure income. Ultimately, people do want security; there's lots of uncertainties in life and there is always going to be demand for a product that delivers this. The other key factor is that, in a world where we're going from defined benefits (DB) to defined contribution (DC), the number of people buying annuities is going to increase.

BILLY BURROWS : Annuities do what they say on the tin, which is provide income for life. But I am concerned that a lot of people are making decisions about what is a long-term contract using short-term factors and influencers.

ASTON GOODEY : Annuities will always have a place in the market, but the products need to evolve. Around 20 o0r 30 years ago people didn't have the life expectancy they have now, so people need to make their retirement income work harder for them. The problem with the current market is people can only afford, in the main, to buy level, fixed, conventional annuities. Therefore they won't keep pace with inflation; if inflation turns the corner there is a huge risk that people are buying products that will actually come back and potentially cause problems further down the line, because they're not getting enough by way of real income.

For example, in 1990 a £10,000 pot would buy an income of around £1,500 a year. That same £10,000 now might give you an income of £650. So there have been massive falls in annuity rates, and they are now so low that people need to find alternative solutions out there, because people can't afford to live off the income they're getting from those conventional annuities.

ROY DURRANT **:** Because of all the uncertainty about investment market returns , we're seeing clients go for an annuity to provide them with a base income, so they've got that security for a certain proportion of their pension pot. Then they may leave the rest invested or go into a phasing programme where they're buying annuities at different times in their life.

STAFFORD : In 2008, 35% of people bought an annuity from a provider, but this figure is often misinterpreted. The headline that tends to follow is that it's a disgrace that only 35% 'used the open market option' (OMO). There's a tendency to overlook the fact that this isn't the number of people who have used the OMO, it's the number of people who have used it and have subsequently bought an annuity from another provider.

Research done by independent organisations including the Financial Services Authority (FSA) has consistently found that they likely figure for the total number who shopped around is close to 66%. There is a consistent three way split, where a third shops around and subsequently stay with their pension provider; a third shops around and subsequently move; and then a third who don't appear to be making any active purchase decision. Our efforts are concentrated on making sure the people who are within that last category are aware of the options.

There's a lot more detail in this OMO argument then commonly reflected in much of the trade press. The Association of British Insurers (ABI) has done exhaustive research into it and we feel confident the approach we've taken as an industry is actually going to have the right result.

GOODEY : Do we know why the third would have bothered to shop around and then not pursue alternatives?

STAFFORD : There's a black hole there at the moment, but we are actively looking to address that this year. The question is, how and why do people make that active decision? Trivial commutation and guaranteed annuity rates will be factors for some, but looking at the detail will help us address this issue. It should indicate why people are justified in staying put and other times why perhaps they definitely should have looked around.

BURROWS : Well said. It seems to me that one of the biggest issues is the OMO review has highlighted that it's not so much the of uptake, but the lack of access to advice, because these pots are so small. So you end up with two things – first of all, people with very small pots staying put, where it's probably to their advantage to stay put because the fees for advice would negate any increase. And second, you have people staying put with insurance companies where it may not strictly be the OMO but it's as good as. One of the problems of the OMO is that it disguises an even more important thing, which is not just about the annuity rate , it is actually about what the appropriate product is for people to buy.

RICHARD ROSS : I would love to see pension providers being required to include a whole-of-market comparison table as part of the pre-retirement pack, no hiding place then for pension providers who offer very poor annuity rates. It may seem a step too far for the industry, but the technology is available.

DURRANT : One of the other issues is the time it takes to transfer an annuity. If you miss two or three annuity payments, that could take several years – especially with the smaller funds – to get that back when you move over to a new company. And when you combine that with the cost of giving any advice, a lot of the time it's just not worth the client's time and the effort of taking that transfer, especially when you look at the average pension size, which is about £25,000.

STAFFORD : The options initiative has been aimed at driving down OMO, IVPP [immediate vesting personal pension] and pension transfer times. When we did the benchmark survey for the industry average back in 2007, it was 31 calendar days. Considering the latest Q4 breakdown shows this is down to 11 days for the OMO transfers, we have made good progress. Options was also extended in August last year to pension transfers, and that's down from a pre-Options benchmark of 36 days to 11. We've now got something like 16 providers on there that represent 94% of the annuities market. And better industry doesn't want the annoyed customers and bad press that sometimes rightly followed, because its not what we want to achieve for customers.

WALKER : Aston, you've been involved in the formation the Pensions Income Choice Association (PICA). Is transfer times one of the areas you've been looking at?

GOODEY : Yes, very much so. It is all about how we can better serve the needs of the retiring population. The key thing for PICA is about having a single voice. I've seen too often the different voices from different providers, all doing their own things. We've also seen a massive difference in transfer times since the introduction of the ABI Options campaign.

ROSS : Having spent some time over the last couple of years looking at the outline comparison sites and how they engage the consumer, one of my main gripes is how similar they are to advisor-facing comparison sites. We need to be offering consumers more tools and guidance on the impact of the particular annuity decisions. We should also remember that the consumer will already have a quote from their pensions provider that will have been done on a particular basis – normally a single life, level, five year guarantee. If the consumer chooses to do a quote on a different basis, this will have a major impact on the starting income. Will the consumer be aware of the basis on which the pension provider has quoted and the impact of certain decisions? I suspect not, so naturally, even though they've been proactive in using a comparison site they might feel they are better off sticking with their pension provider.

PADRAIG FLOYD : Comparison websites are fine, if you know what you're buying . But most people don't read the small print, they just work off headline figures.

BURROWS : Clearly these comparison sites are influencing customer behaviour. I have a good sense of the process and the steps that the average person should go through to buy an annuity, and getting the best rate is the easiest part of the equation. Actually it's the tip of the iceberg and one of the problems with comparison sites is they only look at the rate and ignore the many other important factors. Somebody can buy the bets annuity in the country, but its little help to them if their pension pot has fallen 20% in the last couple of years, because no one has said to them that it is important to think about investment strategy, pre-retirement. So if you have in mind the various steps that somebody would go through, then getting the best rate fits into that process. It's not the process itself.

WALKER : Is there anything that can accommodate for somebody coming into retirement and buying an annuity, without being able to afford the advice? Somebody who has got £20,000 pot?

STAFFORD : There have been efforts in this area. The obvious example is the Pensions Advisory Service (TPAS), which created an annuity planner. It's free to use, it's impartial and its had very good user feedback, and happily we know there's greater traffic of people going from their provider wake-up pack. So that indicates for us green shoots there in terms of people using it. But it can't ever be substitute for advice. The ABI has done a lot of work on the retail distribution review (RDR) with our members, and it was disappointing that we didn't have any green lights on ideas that would have allowed a simplified advice process. There's a desperate need among a large group of people out there for some kind of advice.

DURRANT : One of the things I got involved in a number of years ago was running courses and training for members of the Citizens Advice Bureau. They were starting to take the Financial Planning Certificate, and I think that's perhaps a way that people can get some advice. It needs to be government funded at a certain level, and the Citizens Advice Bureau is there. If they can give them guidance on some of the more straight forward areas, even if the advice is: you should shop around and this is how you should do it.

BURROWS : A problem with a lot of this online stuff is that in most internet shopping , you can get to the right answer if you follow your own intuition. And people are used to shopping online. They're price savvy. But with annuities, if you follow your own intuition , you could end up in the wrong place, and that's quite serious. And Roy, you've hit the nail on the head. The future is not stand alone decision trees, but more of an interactive website, where people will be able to either talk to somebody or hear somebody actually explain the options so they can take the information more easily.

DURRANT **:** The information's out there, but it's having the ability to make a decision from all that information. I could get all the information I need to service my car, but I still wouldn't know how to do it, wouldn't have the proper tools to be able to do the job properly, and wouldn't feel confident in doing that job.

GOODEY : The good news is there are more advisers looking to play in the small end of the market. The domain of the adviser has always been high net worth, and while I'm sure there are models that still want to remain that way, there are advisers that are focusing on different markets. The Annuity Clearing House still operates here to give advice to customers with small fund sizes. The world has moved on in terms of commission. With RDR, you'll get these models where you can take the commission that compensates you for the effort that you've put in with your clients. The models are becoming more flexible. It allows advisers to be remunerated for the works they do, which then allows the consumer to get the advice they weren't able to access before because they couldn't afford to pay it. So I don't think its all doom and gloom.

DURRANT : Yes, but the more choice you get at the lower end, the more advice is required, and you've got the same duty of care for somebody who's got £20,000 pension fund as someone who's got a £2m fund. The cost of the advice process is higher the more options you have. It's difficult, and I don't see there's an easy solution. We've got legal aid for people who need legal advice. Maybe there should be some financial aid, where people who have got limited means can get some form of advice. It's not because we're all wanting to concentrate on high net worth individuals. We want to be able to help everyone that comes through our doors, but we have got such high overheads and such high liabilities when we give advice.

BURROWS : The industry does tend to think of small beer and fat cat clients, but truth is most clients are actually in this so-called Middle Britain cohort. If you asked what's the advice model for Middle Britain, you end up with some quite interesting answers. To me, people are Middle Britain until they want discretionary fund management. So if you have a cohort of Middle Britain clients, what are the issues for them? They're losing value on annuities, because annuities are now being priced on post codes, and post codes are proxy for wealth and life expectancy.

If you then have Middle Britain, where they're obviously living longer, they've got higher income requirements than the past generations, they're more concerned about investment risk, and clearly inflation is a problem – so we're back to a port folio of products. But then if you look at it from the advisers point of view, they probably actually quite good and savvy at dealing with smaller pensions. They're also quite comfortable dealing with the fat cat discretionary management. But how do independent financial advisers deal with this Middle Britain cohort, who actually need the advice on the full range of annuities, including with-profits, flexible and third-way options? That's a changing dynamic that I'm sure the industry, or necessarily even the individuals themselves, have caught up with.

WALKER : So with things like post coding, lifestyling and more specialisation in annuity pricing, are we seeing the end of the bog standard annuity? And if so, does it matter?

GOODEY : It's just becoming more sophisticated. The days have gone where we would all be in the same pool, but actually I might expected to die 10 years sooner than you. And all we're saying now is by, by declaring health, postcode and other things, its just becoming more scientific. The more enhanced annuities gain a foot hold, the more it will move that way. The figures typically quoted show about 40% of the market should be enhanced, and I know for a fact that for Nick Flynn at Retirement Adviser, 62.5% of his business is going enhanced. He genuinely believes, and I've got no reason to doubt him, that it's the way he asks the questions, to elicit the right information from the end customer.

STAFFORD : The key issue to recognise here is that, for some people with DC pensions, the retirement income decision can seem abstract and unfamiliar. Also, the market isn't static – there are new products being released to cater for everything from impaired life expectancy to people's desire for varying degrees of investment growth. There is all this activity going on – lots of innovation and new products – but much of this is only visible from the industry side of the fence. It is difficult to grasp all these changes from the consumer's perspective, which is why getting advice and clear information is so critical.

ROSS : And why do you think that is?

STAFFORD : Because for some people in the population there's still a failure to understand some basic concepts around what a money purchase pension is. And we're not even talking annuities: it's sometimes a failure to understand what type of pension a person has.

BURROWS : A lot of activity and interest goes into setting up a pension, and most customers are then completely on their own until they retire, when there's more activity. But what about the activity in the middle? If you can get some activity in the middle, it will mean the end will be better.

DURRANT : One of the big issues is that the general public haven't got the general knowledge to really deal with their income over time, and when I start dealing with a client it takes about two years, and probably about four or five meetings, before they start to get financially educated about what they're doing and what that means for their own situation. I don't know how you can take that education and give it to people who need it.

BURROWS : It's true. And one of the things I'm quite clear about is even people with small pots, it's wrong to think if they get a letter from the insurance company they'll go and shop around and buy annuity. What these people are doing is saying "we haven't really taken much interest, actually we'll start taking a bit of interest – we want someones who's going to hold our hand and educate us". That doesn't happen overnight. It may not be two or three face-to-face meetings, but it may well be two to three visits to a website or other engagement. It's how you get people involved, because if they get involved, the chances are they'll understand it.

ROSS : There doesn't seem to be any discussion about the role of the employer. I don't know if things have changed with money purchase schemes. If you think about all the tools you're given as an employee, they're all focused on the accumulation phase. But is there any help that converts this into an income? Rather than targeting a funded retirement, you should be targeting some form of income, because that's what you can relate to.

STAFFORD : Consumer research suggests the workplace can be a more effective place for conveying detailed information. The research we did last year showed that in the absence of a financial adviser, many people speak to colleagues, or former colleagues who recently retired. It does seem that when you're in the work place, people are slightly more receptive to reading things they might not otherwise want to read. There has to be opportunities here, in terms of engaging employees in their pension arrangements, especially with the introduction of auto-enrolment in 2012.

FLOYD : And you're also in a financial relationship with your employer anyway, because they pay you. You trust them to do that, so you then think 'they must know something that I can take home'.

STAFFORD : There's a degree of trust there, and there's a real opportunity here. In 2012, we'll have the ability to auto-enrol, not just into the Nest (National Employee Savings Trust), but also qualifying schemes, and there is a big opportunity to make sure we get the positive inertia so that people who are spending more in the first place, have actually got better funds. But Billy's point here is you've got a fund there that is actually going to give you options at retirement. Just hoping for the best isn't obviously the best strategy.

WALKER : What do you think the future holds for variable annuities, considering The Hartfords exit from the market?

DURRANT : There is a strong argument for offering third-way as part of your armoury when your giving advice. Its not going to be right for everyone; there is a cost involved for having that type of structure and guarantees. But for certain clients it has benefits. It's certainly something that we're constantly reviewing.

GOODEY : It's a shame because the Hartford were leading that market at the time they left. Actually speaking to an adviser, they seemed to be the ones that probably got it more right than anyone else. Some of the reputational thing is still there and like with profits, it's very difficult once you've got a badge to actually shake it off. That's unfair, because there are some companies that have got it right and some that didn't get it so right. But everyone gets tarred with the same brush.

One of the problems we saw with variable space was that providers came up with something that was very different, and actually from an advisers perspective I think a lot of them found it hard to compare or contrast. In face, we've seen it recently with Living Time and LV. From what I'm hearing they're almost identical products. So actually it's very easy to compare or contrast and that is quite helpful from an advisers perspective.

DURRANT : You can strip out the cost of some variable annuities. But they got very expensive last year when the markets were volatile, hence the reason why some of the companies withdrew. Some of their products are also opaque. So if we can get to the point where we know exactly how they're investing, we know exactly what they're charging and that charge isn't going to increase dramatically in the future, then the clients can make a decision; we can give proper advice on it.

ROSS : The vast majority of customers take level annuities, but I'm interested to know how customers plan to deal with inflation in these cases and how many would take an index-linked annuity if you have a conversation with them about inflation.

DURRANT : If you look at the difference in the starting income between a level annuity and an indexed annuity, it's 50% less than standard quotes. We don't know what inflation's going to be in the future, but it can be up to 20 years before you break even. And your lifestyle from age 60 – 70 is probably going to be a lot more active and you need higher levels of income during this period. So clients are often looking at it and thinking 'I'd rather have more now; I don't know if I'm going to live another 20 or 30 years'. We all want an indexed income, but very few are prepared to pay he cost to take it.

WALKER : Where do you see the next innovation coming from in the at-retirement market?

GOODEY : There will be more focus on the area that sits between the conventional and drawdown, particularly at the low end. Everyone's concentrating very much on £100,000-plus pots, but actually everyone knows the majority of customers in the UK are at a lower level than that. The whole retirement market sector is just a fantastic place to be in at the moment, whether you're an advisor or a customer. The simple reason being that it is changing very rapidly and all for the benefit of the consumer.

BURROWS : The innovations in two areas. First of all, it'll be around suitable investments to back up annuities. The second innovation will be around advice models, because there's clearly a whole cohort of people who need advice that is more sophisticated than just buying a fixed annuity, but not as sophisticated as discretionary fund management and Sipps (Self Invested Personal Pensions). If you get the advice model right and get some more suitable products, the future looks encouraging.

ROSS : I feel like the next innovation will be around the process and the consumer journey. There needs to be more integration in the industry, which would allow providers and advisers to take a lot of costs out of their processes and making advice on the small pots more viable. At the moment, there are too many disparate systems and manual processes involved in the annuity process.

STAFFORD : There is plenty of innovation in the annuity market at the moment. The issue is really around making sure that levels of awareness and engagement are high enough, both during the accumulation phase and at retirement. Advice is a key issue, and there is demand across the spectrum, whether it's a simple form of advice on annuities or whether you want to go through the more complex options. At the moment, there's a gap in the market for a simplified advice process, and that's where the greatest value can be added.

DURRANT : I don't think it'll happen, but where I' d really like to see innovation is intergenerational planning. I want to see the government change its stance around the inheritability of pension funds. We've got a massive savings short fall and the younger generation have got pitifully low pension funds. The baby boomers have got a large proportion of wealth tied up in property and pension schemes, and I'd like to see a more sensible approach to passing down that wealth within pension schemes to the next generation.

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