Shopping around for annuities: the changing market

PENSIONS POLICY INSTITUTE

PPI Briefing Note Number 127

Introduction

The introduction of the pension flexibilities under the banner 'Freedom and Choice' in 2015 brought about a huge change for UK pensions. Prior to this, people generally had to use their Defined Contribution (DC) savings to purchase an annuity to provide them with a regular retirement income. The Government lifted some of the restrictions on accessing retirement savings, creating a more flexible market with greater choice of products, in response to studies showing that the annuities market was not providing people with the most competitive outcomes. This decision was supported by a 2014 report from the Financial Conduct Authority (FCA) which concluded that people were missing out on better outcomes by an average of 6.8% of potential annuity income by not shopping around between providers.[1]

Not achieving the highest possible rate from an annuity could have a negative effect on standards of living in retirement, particularly for those people depending on their annuity as their only source of income other than their State Pension. PPI research in 2017 showed that the difference between annuity quotes (quotes of the amount received monthly or annually from the annuity provider) could be up to 40%.[2]

This Briefing Note looks at:

- how the annuities market has changed since the introduction of the pension flexibilities in 2015 and the previous PPI research in 2017;
- how shopping around (comparing the rates from different annuity providers in order to identify the best available retirement income) can benefit people in retirement;
- the reasons why people may not be choosing to purchase annuities or why they don't shop around.

Summary

- The potential market for annuities increased with the rise of workplace DC pensions.
- Fewer people are purchasing annuities than before the introduction of the pension flexibilities.
- The average pot size used for purchasing an annuity has almost doubled since 2015, rising from £37,000 to £71,000.
- Shopping around can increase a person's income and financial security throughout their retirement. In 2019, somewhere up to £130m could have been 'lost' in the first year by people not doing so.
- An individual could gain an extra £7,000 per £100,000 in their pension pot over the course of their retirement by shopping around.
- A small majority of people do appear to shop around to some degree, but many do not. Of those who do shop around, many do not seek financial advice or guidance when making the decision.
- There are behavioural factors associated with annuity purchases; they include:
  - A general lack of trust in financial services
  - A lack of engagement with DC pensions
  - An underestimation of longevity
- Current industry prompts do not appear to have encouraged more people to shop around.
- Behavioural prompts may encourage people to be more active in choosing which annuity to purchase, but must be well-targeted to succeed.

PPI Briefing Notes clarify topical issues in pensions policy.

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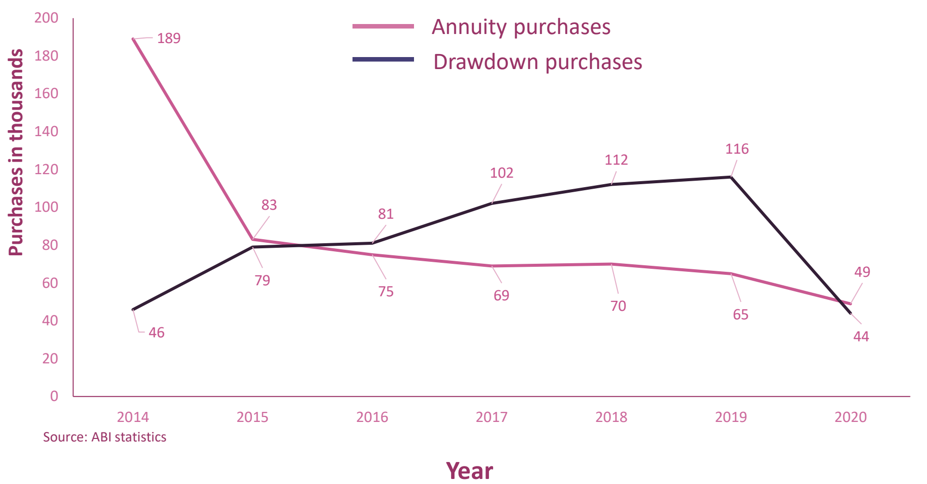
Fewer people are purchasing annuities, although the size of the market has not reduced significantly

The introduction of the pension flexibilities led to a drop in the numbers of annuities purchased falling from 189,000 in 2014 to 49,000 in 2019. At the same time, drawdown has generally increased from 46,000 transactions in 2014 to a peak of 116,000 in 2019 (Figure 1). It is worth noting that the drawdown market was severely affected by the COVID-19 pandemic in 2020 as people became more cautious about withdrawing their savings, while the annuities market was affected to a smaller degree. In addition, since 2015 there has been an increase in the numbers of people withdrawing their entire pension pot with over 250,000 full withdrawals made in 2019-20, most commonly from small pot sizes.[3]

Figure 1: Annuity purchases have declined dramatically in recent years

Annual UK annuity and drawdown purchases from ABI members (in thousands) 2013-2020



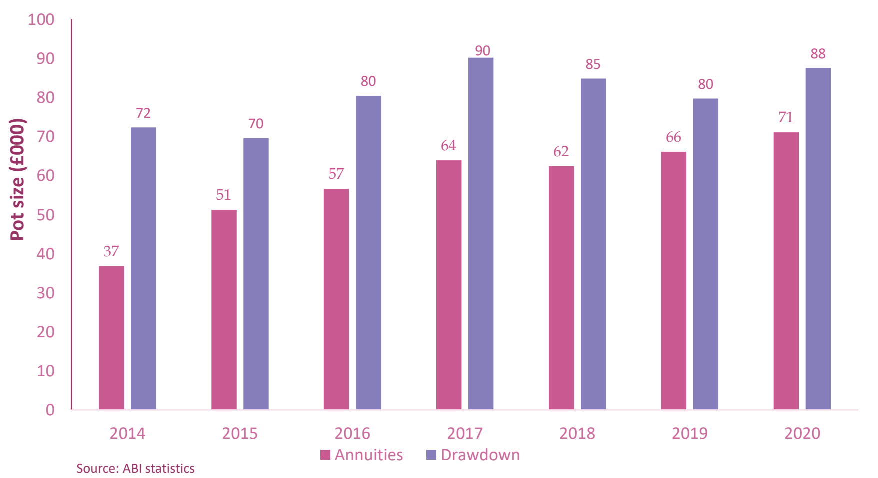
Source: ABI statistics

The average pot size associated with annuity purchases is rising

2014, a year before Freedom and Choice was introduced, saw an average pot size of just under £37,000 being used to purchase an annuity. Since then, the size of pots used to purchase annuities has risen steadily to an average of over £71,000. There are several reasons for this, not least the end of compulsory annuity purchases in 2015, which meant that people with smaller pots that would be unlikely to provide significant retirement income from an annuity purchase could now choose to access their money in other ways, driving the average premium up. The proliferation of savers with multiple smaller pots brought about by automatic enrolment has seen a decrease in average pot size and an increase in the number of deferred pots. There are currently around 8 million deferred pension pots in UK master trust DC schemes, a figure that could rise to around 27 million by 2035 if left unaddressed.[4]

Figure 2: The average pot size for purchasing an annuity has risen since the introduction of the pensions flexibilities

Average pot size of UK annuity purchases from ABI members (in £ thousands) 2013-2020



Source: ABI statistics

In comparison the average pot size used to purchase a drawdown contract has fluctuated slightly over recent years (Figure 2).

The average pot size associated with full withdrawal is considerably smaller, as would be expected. In the financial year 2019-20, it was £14,600, a drop from a peak of £16,300 in 2017-18. As people may find themselves with multiple small pension pots over their working lives as a result of automatic enrolment, the number of full withdrawals may continue to rise, though the Government is currently working on ways of ensuring multiple small pots are consolidated in future.

The size of the annuities market has remained stable since the introduction of the pension flexibilities

Since 2015, although there have been two reductions in the amount of money used to purchase annuities in the UK, the market has remained steady in monetary terms (Figure 3). The first came about as a result of people choosing different means of accessing their pension pots, and the second a temporary fall as a result of COVID-19, though annuity purchases were not as significantly affected by COVID-19 as Drawdown contract purchases.

The potential market for annuities has risen sharply in recent years as the proportion of people saving in DC workplace schemes increases

The UK annuity market began in 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, therefore increasing the number of people who were required to purchase an annuity. The introduction of automatic enrolment into workplace pension schemes has seen 10.2 million new DC savers, meaning that the number of pension pots held by DC schemes in the UK has increased to 22 million by the end of 2020. However, this does not equate to active savers, as a feature of automatic enrolment is that people can accrue savings in multiple pots. The actual number of active DC pots was around 14.6 million in 2020.[5]

People are not required to choose between an annuity and drawdown, and do not have to buy an annuity at the time they retire, nor do they have to use all their pension pot to do so. People can use drawdown products while having an annuity income, and some current drawdown holders may choose to purchase an annuity in later life, when the income is likely to be higher.

Figure 3: The annuities market has remained relatively stable since the introduction of the pension flexibilities

Value of annuity purchases per year from ABI members 2015-2020 (£millions)

Source: ABI statistics

There are a range of annuity products available (Box 1).

Box 1. Annuity products and options

Standard/Conventional lifetime annuities; annuities which pay a set rate to an annuitant until death, with no modifications to the rate.

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

Fixed-term annuities: pay out for a specific period of time with the remaining balance paid to the annuitant at the end of that time. Prior to the pension flexibilities, fixed-term annuities were limited to ten years, but now they are available for periods of up to 30 years. The market for fixed-term annuities is developing, with few providers currently offering them.

Deferred annuities: can be deferred for a specific period of time. As with fixed-term annuities, deferred annuities were available before the pension flexibilities, but they have not proved popular and are currently not being offered by any UK provider.

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

In addition, annuity rates will change depending upon where an annuitant lives, given that there are significant geographical differences in life expectancy across the UK.

When purchasing an annuity, an individual can opt for different ways of accessing their income:

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

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

Guaranteed period option: pay out for an agreed term for up to 30 years after the death of the annuitant. The guaranteed period annuity market has declined by a third since 2016, with around 30,000 purchased in 2019.[6]

Capital or Value Protection option: allow for the protection of a proportion of up to 100% of the initial capital paid to purchase the annuity, which can be paid out to family members upon the annuitant's death. These have not proved popular, with few purchases made per year.

Level payment option: pays the same nominal rate in perpetuity, with no increase for inflation.

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

Annuity payment frequency: monthly, quarterly, half-yearly and yearly payments can be made in arrears or in advance.[7]

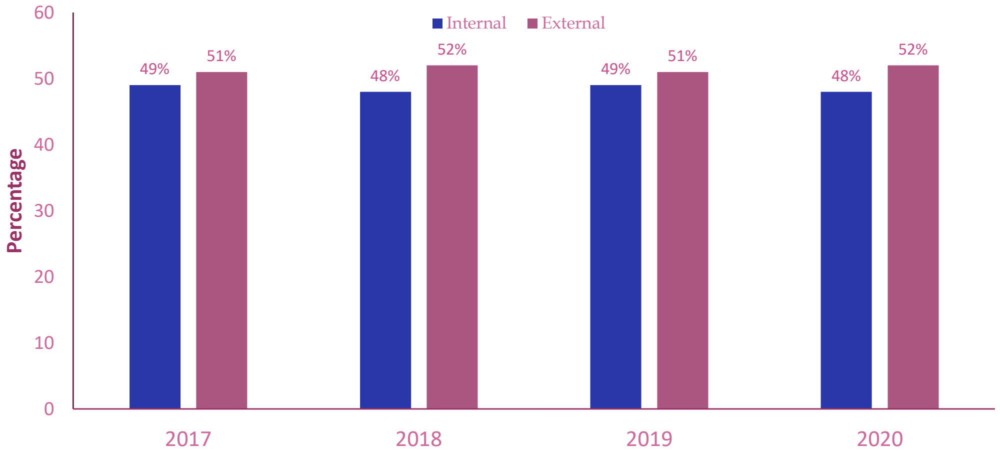
Part of the Government's rationale for introducing the pension flexibilities was that the annuities market was not "working in the best interests of all consumers. It is neither competitive nor innovative and some consumers are getting a poor deal"[8]. This conclusion was reached following the publication of a Financial Conduct Authority review of the retirement income market which concluded that people were not getting good deals on annuities because of not shopping around for the best price, 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. The pension flexibilities allowed providers to promote different products that do not provide an income for life: fixed- term and deferred annuities. While the market for fixed-term annuities is expanding and more providers are developing them, deferred annuities have proved less popular.

Most annuity providers also offer drawdown and other policies. The development of annuities is largely driven by legislation and regulation and when the pension flexibilities were announced, the rules were broadened to allow providers to offer longer term payment guarantees, increasing from a maximum of 10 years to 30 years. Also, the taxation of death benefits changed to bring annuities in line with drawdown so now if an annuitant dies before their 75th birthday, any benefits payable to their spouse or other beneficiaries is tax free.

More people buy annuities from someone other than their pension savings provider

Figure 4: The percentage of external annuity purchases has remained slightly higher than the number of internal purchases over recent years

Percentages of annual internal and external annuity purchases from ABI members 2017-2020



Source: ABI statistics

A small majority of people do appear to undertake some shopping around, evidenced by the fact that they purchase annuities from a different provider than the one they saved with (Figure 4).

However, this does not indicate how engaged with the open market these people have been, or how many providers they looked at. The numbers will also reflect that not all pension providers offer annuity products and some will refer people to an external default provider.

People could increase their retirement income by shopping around

Depending on various factors, such as age, geographical location and the type of annuity sought, people, especially those with health problems who could qualify for an enhanced annuity, could gain up to an extra 15%, £800 per year (per £100,000 of purchase price) of retirement income if they shopped around (Figure 5). At the basic level, for a lifetime annuity for a single person with a pot size of £100,000, gains of between 6% and 8% could be made. There are also significant variations in escalating annuities, where income rises with inflation.

People could also be missing out by not realising that they could be eligible for an enhanced annuity; between 39% and 48% of people who bought a standard annuity from their current pension provider in 2016 may have had qualifying health or lifestyle conditions which would have made them eligible for an enhanced annuity.[9]

Figure 5: Differences in quotes by age, location and type of annuity[10]

	Harrogate Age 66	Glasgow Age 66	Harrogate Age 76	Glasgow Age 76
Level annuity with no health problems	High £419 Low £388 Difference 8%	High £407 Low £384 Difference 6%	High £556 Low £525 Difference 6%	High £577 Low £537 Difference 7.4%
Enhanced annuity	High £449 Low £413 Difference 8.7%	High £485 Low £419 Difference 15.8%	High £675 Low £594 Difference 13.3%	High £678 Low £619 Difference 9.5%
Joint annuity	High £371 Low £355 Difference 4.5%	High £372 Low £354 Difference 5.1%	High £494 Low £482 Difference 2.5%	High £514 Low £472 Difference 8.9%
Escalating annuity	High £232 Low £199 Difference 16.6%	High £236 Low £205 Difference 15.1%	High £384 Low £337 Difference 14%	High £402 Low £349 Difference 15.2%

In monetary terms, someone purchasing an annuity upon retirement at age 66 in Harrogate (a town with a high life expectancy) could receive an additional £372 per year, while a similar person from Glasgow (a city with a lower life expectancy) could gain up to £276 per £100,000 of initial purchase price. In terms of UK average life expectancy from age 65, a woman on a single level income annuity (by far the most popular type purchased) could gain up to £7,800 and a man £7,000 over the course of their retirement.

The gap between the highest and lowest quotes has narrowed over recent years

PPI research conducted in 2017[11] made a similar comparison, and found the variations on offer were much broader, with differences of more than 20% being the norm, rising to over 40% when potentials for enhanced annuity rates were taken into account. The reduction in variation can be in part explained by a contraction in the market in terms of providers. In 2016 there were around 25 open market providers,[12] whereas in 2021 only five open market providers remain, and only four of these offer annuities to people over age 75. However, gains can still be made and the fact that there are relatively few providers should make shopping around and comparison easier. Annuity rates have also fallen, with the average rate for a level income annuity for a healthy 65-year-old falling from around 5% in 2017 to 4.5% in 2021.[13]

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There could be up to £130 million in potential extra income for annuity holders

At the base, there could be up to £130 million in the first year lost to annuitants as a result of their not shopping around in 2019 alone.[14] In the previous 2017 PPI Briefing Note, the figure calculated as being lost from not shopping around was around £130 million in the first year.[15] This figure is not directly comparable to that for 2019 as it was calculated on a different basis. The 2019 figure represents the maximum potential total annual loss, assuming everyone who purchases an annuity internally receives the lowest possible rate. The actual amount lost is likely to be lower than £130m, which implies that the yearly aggregate loss from not shopping around has reduced since 2017.

These potential loss figures do not account for people who shopped around yet stayed with their original provider, nor those who did not shop around but bought an annuity from a different provider because their pension provider did not offer annuities or a referral to a default external provider.

Levels of shopping around are lower for pension products than other financial services

The advantages of shopping around for an annuity are clear, yet only around half of people do so.[16] This figure is lower than for almost any other financial product with car and home insurance being the most common purchase that people shop around for. While these are products that are usually purchased on an annual basis, the fact that 71% of people with cash ISAs consider changing their provider over a three-year period suggests that shopping around is considered to be a more natural step in other types of personal finance transactions. It is also the case that people on lower incomes are less likely to shop around in any financial market,[17] when they might be able to benefit most as small gains are likely to have a greater impact on their financial well-being. It may also be the case that annuities are seen as more complex, which may undermine people's confidence in making comparisons between different products.

There are low levels of trust in financial services in general

The UK public does not have a great deal of trust in the financial service industry, with only 42% expressing confidence. However, confidence does increase with age, so people nearing or at retirement age have more confidence on average than younger people.[18] When different financial services were graded, pensions companies averaged a mean score of 5.4 out of 10 on levels of trust. While this is indicative of low levels of trust, it still ranks third highest among financial institutions generically.

Trust in a person's existing provider remains considerably higher than ambient trust (trust that is based on general knowledge or opinion rather than experience or evidence). For example, the Financial Conduct Authority Financial Lives Survey ranked trust in an income drawdown or withdrawal provider at a mean of 8.2 out of 10, annuity providers at 7.9, and DC pensions providers score lower at 6.9 (the lowest of all 25 provider groups measured).

Some of the reasons for this lack of trust stem from negative stories about pension scams and the collapse of large schemes and a feeling that people have little or no control over their money in an annuity.[19]

Engagement with DC pensions is low and may continue after retirement

Low levels of engagement with DC pensions during the accumulation stage may also affect how people engage when their pension matures.[20] Engagement with DC pensions is low, with 55% of people being assessed as having low or very low engagement. Again, engagement increases as people near retirement, but it remains that 41% of people aged between 55 and 65 still have low or very low engagement.[21] This lack of engagement can continue after retirement, with people continuing to stay with the same or default provider rather than shop around.

People could miss out on retirement income because they underestimate how long they might live

There is a tendency for people reaching retirement to underestimate their longevity. This is often because people think in terms of their parents' or grandparents' lives rather than their peers. This 'survival pessimism' could see people making decisions that mean they lose out on the benefits of an income for life. When people are given an objective prediction of their life expectancy, rather than relying on their own subjective assessment, they are more likely to want to purchase an annuity.[22] Survival pessimism could also explain why some people are less likely to shop around, as they may not think that they would accrue any significant benefit from doing so.

Over the last 40 years, life expectancy at age 65 has increased by almost six years for men and five years for women,[23] and while actuarial valuations will take account of this, it not only means that people could benefit for longer from a reliable income, but also that those who withdraw large sums at retirement will have to make their remaining pension pot last longer. It may be that the use of more objective assessments of longevity could encourage people to shop around more. This may overcome the idea that annuities offer poor value for money or would not make a significant difference to retirement income.[24]

Large numbers of people purchase annuities without taking financial advice or seeking guidance

Taking financial advice is likely to assist people to make more informed choices when considering which retirement products to buy and would certainly help more people to make comparisons between different providers. For example, Pension Wise reported that 23% of people who attended an appointment with them purchased an annuity in 2019-20,[25] compared to 10% of all DC savers.[26] Over the past two years, the majority (56%) of people purchasing annuities have taken either advice from a regulated provider or guidance from Pension Wise, with 44% having taken no professional advice or guidance at all (Figure 6).[27]

Figure 6: The majority of people (56%) take advice or guidance before buying an annuity, but a sizeable minority (44%) take no advice at all

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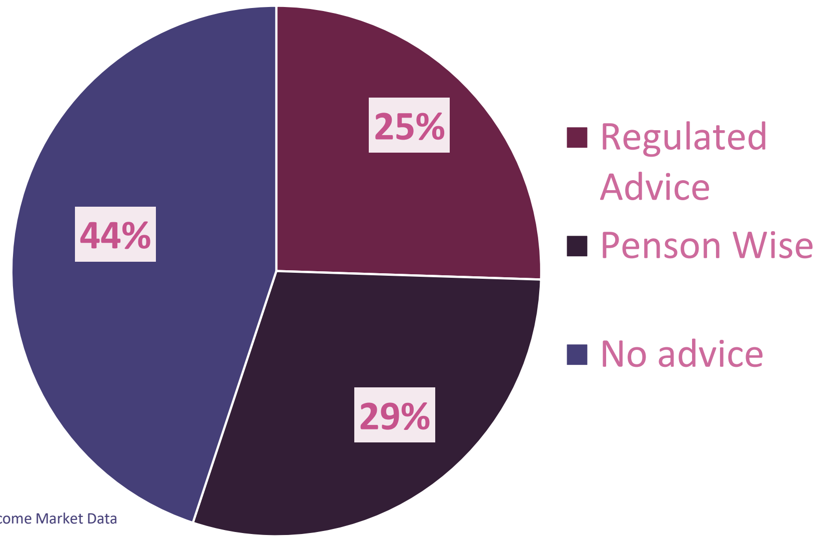
Percentage of people taking advice or guidance when purchasing annuities 2017-2019



Source: FCA Retirement Income Market Data Series 29.09.2020

People prioritise the present over the future and rely on established patterns of behaviour

People tend to employ heuristics when making decisions, basing their actions on previous experience and opinion (both their own and others'). This means that repeated patterns of behaviour develop which may lead to lower outcomes, including ignoring or delaying making difficult decisions. People need to understand that their financial decisions are a priority at the appropriate time and be allowed access to the tools necessary to make informed decisions. This can mean a combination of using 'teachable moments', where individuals are most receptive to specific messages and 'learned experience' whereby they have the opportunity to put what they have learned into effect.

Industry prompts about annuities appear to have had little effect on people's behaviour

The Financial Conduct Authority's annuity prompt requirements came into force in March 2018. The rules require firms to give a range of pension annuity quotes whenever a provider is asked to provide an annuity quote on one of their own products. If the highest quote is the market leading quote, rather than the firm's own quote, then a visual comparison of the difference in the annuity income between the two quotes should be given. Providers are also required to set out additional information about enhanced annuities, and whether the consumer may be eligible to buy one.[28] However, these prompts are only provided once an individual has decided to consider buying an annuity and do not appear to have made an impact on the numbers of people purchasing from external providers.

Behavioural prompts may encourage people to be more active in choosing which annuity to purchase, but must be well-targeted

Prompts and nudges have some capacity for encouraging people to shop around for the best deal for them. However, prompts should be timely and straightforward if they are to be understood. More interactive behavioural interventions may prompt people into buying annuities and shopping around for the most suitable deal at or just before retirement when they are most likely to be engaged with their pension.[29] To be effective, behavioural interventions should take account of the demographics of the audience, such as its level of knowledge, any relevant cultural attitudes, income, gender and age. This will require a more holistic and flexible approach to ensure the most appropriate level of intervention and support for people. It may also be the case that increased engagement in the accumulation phase of DC pensions will have a positive effect when savers come to make decisions about their retirement income.

Conclusion

Shopping around in the annuities market can give people an increased retirement income and greater peace of mind in knowing that they will have a regular income for life. However, around half of people appear not to do so. There are behavioural factors associated with not shopping around, particularly to do with a lack of trust in the financial sector, a lack of engagement with workplace DC pensions during accumulation and an underestimate of longevity. The current industry prompts do not appear to have affected the market, with no increase in the numbers of people shopping around for annuities since 2015, so it may be that more interactive means of encouraging people to make active and informed decisions should be employed throughout their pension journey.

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[3] FCA Financial Lives Survey, 2020

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[5] TPR (2021), DC Trust Scheme Return Data 2020-2021 www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2020-2021#56a3fa2c08c44eaab6b7367f5f49b39e. Accessed 22.07.2021

[6] ABI (2021) Quarterly Pension Annuities by Age and Size of Fund

[7] Yearly in arrears will pay the highest annual income available whilst yearly in advance will pay the least

[8] HM Treasury (2014), Freedom and Choice in pensions, Cm 8835

[9] FCA (2017), Review of annuity sales practices, Thematic Review TR 16/7

[10] Percentages are rounded to the nearest whole number

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[14] 2019 figures were used because of the atypical contraction of the market due to COVID-19 in 2020.

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[24] IFF Research (2017) Retirement Outcomes Review Interim Report: Annex 4

[25] Pension Wise service evaluation. Experiences and outcomes of customers using Pension Wise in 2019/20

[26] FCA Retirement income market data 2019/20

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