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BRIEFING NOTE

A market-orientated solution to the problem with annuities

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David Mowat, MP for Warrington South, recently suggested in a House of Commons debate that the Coalition should create a nationalised, low-cost, annuity provider to protect pensioners from poor retirement products. This is an excellent suggestion. But there is a more market-oriented way of achieving the same end.

The problem: the Open Market Option does not work

The current Open Market Option (OMO) allows retirees to shop around for the best annuity rate, and the most appropriate product. But the evidence is that it is ineffective. One third of over-55s have "never heard" of the OMO, a problem compounded by 70% not fully understanding what an annuity is.[1] The consequence is that many (most?) retirees end up with annuities significantly smaller than they would have had, had they shopped around.

The public's disillusionment with annuities has been fuelled by:

- low annuity rates, due to low interest rates, poor investment returns (over the last decade) and increasing longevity; and,
- the lack of annuity contract standardisation (which renders price comparison websites useless).

But, perhaps more seriously, there is a growing awareness that the annuity market is "opaque and unfair" and "toxic", depriving retirees of up to £1 billion of income each year.[2]

An efficient annuity clearing house is required

The most simple solution would be to make the exercise of the OMO mandatory (i.e. no longer an option). This could be achieved via a new annuities clearing house; essentially, a marketplace in which all annuity providers participate (perhaps through the purchase of a tradable licence).

Shortly before retirement (three months, say?), a standard form could be submitted to the clearing house, via the savings pot administrator, detailing:

- any ill-health issues (confirming eligibility for an enhanced annuity); and,
- the type of annuity required (guaranteed, index-linked, joint life, etc).

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1 Based on research conducted by MGM Advantage.

2 A joint report by the NAPF and the Pensions Institute, *Treating DC scheme members fairly in retirement?,* February 2012.

As many people will not know which type of annuity is appropriate for them, an information pack should include details of how to obtain independent advice.

Providers could then bid, daily, for the annuity business, with unsold annuities being retendered the following day (and an end-of-week "sweep" may be required). This process should introduce pricing tension and, with all transaction prices being published at the end of the day, the transparency that is currently lacking. Individuals would then have the information they require to choose the particular annuity which best suits their needs.

Additional features of the clearing house would help overcome other problems facing today's aspiring annuitants, including:

- the packaging together of small pension pots, ahead of bidding, to encourage stronger bids; and,
- a tailored market, specifically for enhanced annuities, with public guidelines as to how different enhanced annuities are priced.

Safeguards would be required to ensure that successful bidders are credit-worthy institutions. Annuitants should also be permitted to specify any preferred annuity providers. In such cases, they should receive the details of the winning bid as well as those of their preferred providers' bid, if different.

A pre-requisite: contract standardisation

As a pre-condition to participating in the clearing house, annuity providers should adhere to a limited set of simple, standardised annuity contracts; templates created by the industry to improve transparency. The industry's usual clamour of complaint, concerning the inequity of limiting choice, should be given short shrift.

A role for the state?

If the financial services industry fails to establish an operative annuities clearing house within two years, the Coalition should itself facilitate a national annuity support and brokerage service, as suggested by David Mowat MP. Indeed, the Treasury itself would probably be keen to participate, as this would provide an alternative source of funds to the Gilts markets (with longevity risk being laid off through the reinsurance market).

This note is based on a section from Michael Johnson's forthcoming report on how to put the saver at the heart of the financial services industry.