International Organisation of Pension Supervisors

Transparency and competition in the choice of pension products: The Chilean and UK experience

Gonzalo Reyes, Superintendencia de Administradoras de Fondos de Pensiones, Chile
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ABSTRACT

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The growing importance of defined contribution (DC) pension plans is focusing attention on the decumulation or payout phase of pension systems. Where annuitization is encouraged or mandatory, how to ensure that individuals get the best price for annuity products is key. The complicated nature of these decisions means that purchases are highly dependent on the information and advice provided by the sellers of these products. This can be a problem where annuity providers are already involved in the pre-retirement, accumulation phase, leaving individuals open to abuse if 'locked-in' and not able to 'shop around' to find a better annuity rate from alternative providers.

This paper discusses two countries building centralized information and quotation systems for annuity products to help individuals select the right retirement product at the right price. The SCOMP system in Chile is examined and developments around the Open Market Option (OMO) in the UK are discussed, with lessons drawn for other pension supervisory authorities contemplating introducing such centralized systems.

Keywords: annuities, decumulation, pay-out phase, defined contribution pension plan, quotation systems

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I. Background

The growing importance of defined contribution (DC) pension plans has caused increased attention to be focused on the decumulation or payout phase of pension systems – in particular as the reformed systems in several countries will shortly have to start paying out pensions (for example Hungary from 2012 and in Poland from 2009).

Yet a framework for how to transition between the accumulation and decumulation phases has yet to be outlined in detail, or even put in place at all, in several countries. Nonetheless, the decumulation phase is just as important if the new systems are to achieve their goal of providing efficient and effective retirement incomes. Pension supervisors need to handle the transition to the decumulation phase carefully to avoid beneficiaries making choices which could lock them into a suboptimal pension payout for the rest of their retirement.

In systems where annuitizing the accumulated pension balance is encouraged or mandatory, an important challenge is how to ensure that individuals get the best price for annuity products where these are purchased individually. The complicated nature of pension and annuity products means that their purchase is highly dependent on the information provided by the sellers of these products and the advice received. The problem in many countries is that the annuity provider is already involved in the pre-retirement accumulation phase, which can leave individuals open to abuse if 'locked in' and not able to 'shop around' to find a better annuity rate from an alternative provider. However, making such comparisons is difficult and time consuming. The annuity purchase decision, which is the most common mechanism consumers use to convert a DC fund into an income stream in retirement, needs to be handled carefully.

Several countries are therefore looking at providing a centralized system for comparing annuity prices. Consumer understanding of annuities is very low and people do not fully comprehend the risks of the decisions they are taking. Such a centralized system can help to increase knowledge and understanding, particularly when coupled with some product explanation or advice, in addition to comparative quotations between standardized products. Furthermore, such systems may deliver cost savings and efficiencies (via potentially lower marketing and distribution costs for providers) which may be reflected in more competitive annuity pricing.

Providing competitive quotations may also assist with the timing of an annuity purchases. In addition to locking in to a suboptimal provider or product, individuals also risk locking into an annuity at a poor time, when annuity rates are low (meaning that two individuals with the same accumulation balance could potentially face the prospects of living on very different retirement incomes simply from having chosen to annuitize at slightly different times). Providing standardized, centralized quotations may help individuals assess whether it is a good time to make an annuity purchase within systems which allow flexibility in the annuity purchase date (e.g. in the UK where individuals can annuitize up to the age of 75, or in Chile where participants may opt for a programmed withdrawal and choose to annuitize at a later time).

In most countries, comparative annuity quotations can be obtained via third-party, financial advisor or brokers. Indeed, as Pugh (2008) points out, a Google search of "annuity quotations" will generate more than 500 links[1]. The services come in several forms, with various levels of responsibility being assumed by the third party, and with various remuneration structures. However such third-parties are normally paid by commissions, may be tied to one provider, and may only be licensed to provide quotations rather than advice. In

[1] In Chile, according to the registry at the Superintendence of Insurance and Securities, there exist more than 980 individual brokers and 100 institutional brokers authorized to commercialize annuities.

addition, advice may be costly - prohibitively so for individuals with small accumulated balances.

An alternative is therefore for the governments or regulatory authorities to become involved in providing or supporting centralized, comparative information on annuities, in order to provide trusted, neutral advice to the broad population and to help them to make efficient choices at the time of retirement. A survey from the UK (see ABI (2005c), revealed that individuals would be more likely to compare providers if such information were available, and that their preferred source of information was governmental agencies - in particular the Financial Regulatory Authority, the main financial regulator in the UK.

Table 1: What would make consumers more likely to shop around?

Proposal	More likely to shop around	No more likely to shop around	Don't know
Advice from IFA on a fixed fee basis	59%	36%	5%
Advice through employer	47%	43%	10%
Interactive programme available on the internet	31%	65%	4%
Telephone-based information service	37%	61%	2%

Source: ABI 2005(c)

Table 2: Possible Providers of a Telephone Information Service

Provider	More likely to use	No more likely to use	Don't know
Government's Pensions Service	64%	30%	6%
Financial Services Authority	82%	18%	1%
Insurance industry	50%	46%	4%
Independent broker	61%	34%	4%
Citizen's Advice Bureau	62%	35%	3%
Another Government agency	54%	41%	5%

Source: ABI 2005(c)

This paper discusses two countries which have or are attempting to build centralized information and quotation portals for annuity products. In **Section II,** the Chilean experience is examined. The SCOMP system was introduced in Chile in 2004, providing comparison between the programmed withdrawals and annuity products allowed under the individual account based pension system. **Section III** looks at UK developments. In the UK, where annuitization of pension balances is compulsory by the age of 75, the Open Market Option (OMO) system has since 2002 required pension providers to inform individuals of their right to purchase an annuity from a supplier other than their current pension provider. Comparative quotations are provided by the Financial Services Authority. The government is in addition working to introduce a centralized web-based tool to guide individuals through their choice of annuity product. **Section IV** suggests lessons learnt for other pension supervisory authorities contemplating introducing such centralized quotation systems.

II. The Chilean automated System of pension bids[2]

1. Introduction

Individuals who have accumulated a significant amount of savings for old age are often interested in purchasing financial products to transform their pension wealth into a stream of income for retirement, such as an annuity. This process is usually not an easy one: retirement products are often complex for the averagely educated individual and price comparison is not readily available.[3]

In the Chilean pension system, this is a particularly important issue, as most future pensioners will have to face that decision at retirement. Chile replaced in 1980 the traditional PAYG system with a unique national defined contribution scheme in which dependent workers transfer their social security contributions to private pension fund managers (the AFPs). At retirement, individuals above a minimum wealth threshold have the option of using their lifetime savings to buy an annuity-type product from a life insurance company or receive a programmed withdrawal (PW) stream from an AFP.

Originally, the retiree could freely choose where to buy an annuity and the result was the emergence of a network of life insurance salesmen. Individuals consequently ended up transferring a large fraction of their savings to intermediaries in the form of commissions. To make the process more transparent and competitive, a law was passed in 2004 that introduced an electronic system of offers by which all annuity purchases had to be processed: the pension offers and quotation system (known as SCOMP by its Spanish acronym).

This document presents a description of the system, historic statistics since its creation and some preliminary evaluations of its performance in helping individuals make informed decisions and establish an efficient competitive market. In the last section we present some of the challenges of the system and lessons learned from its implementation.

2. Description of the system

i. retirement in the Chilean system

In the Chilean system there are 3 types of pensions, old age, early retirement and disability and survivorship pensions. In order to retire, affiliates or beneficiaries must fulfill the requisites for each type of pension.

For the period December 1981-December 2007, the number of pensions paid has increased significantly, reaching 642,064 in 2007. The type of pension that has grown most rapidly is the early retirement pension, with an average annual increase of 29%; the following figure shows that evolution.

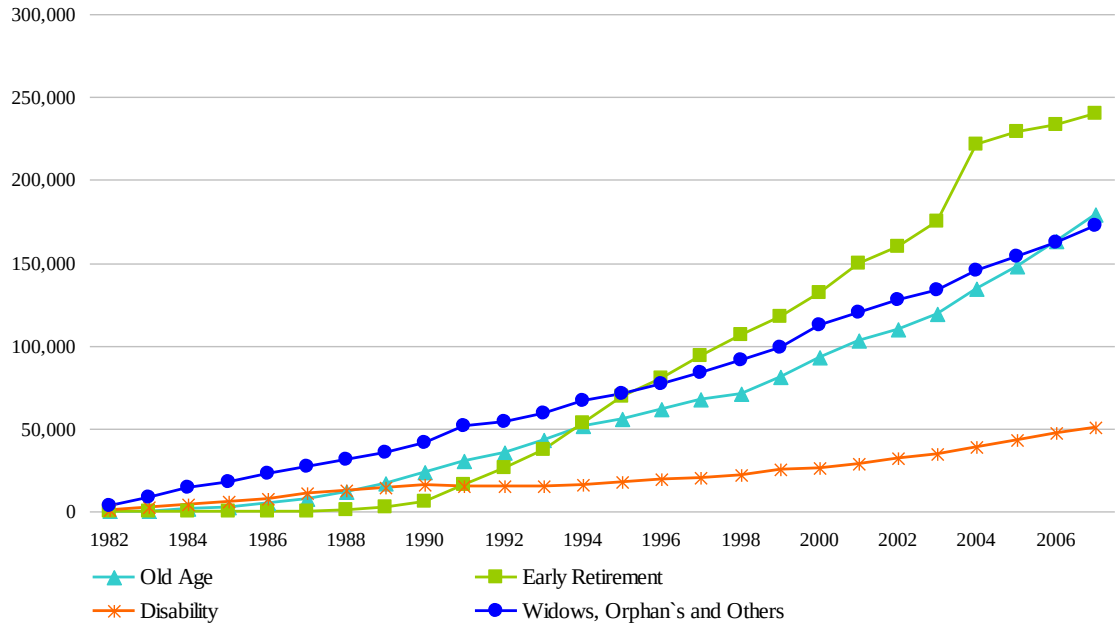
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[2] The section of the paper was drafted by the Chilean Superintendency of Pension Fund Administrators. We acknowledge the useful contributions made by Eduardo Fajnzlber and Isabel Poblete in drafting this document.

[3] Although internet price comparison sites have facilitated that process, especially for products like car or life insurance.

Figure 1: Numbers of Pensions

(In December of each year)



Source: Chilean Superintendence of Pension Fund Administrators (SAFP).

The affiliates or beneficiaries in each type of pension must select a pension mode. In Chile, members can decide between four modes of pension: Programmed Withdrawal (PW), immediate life annuity, temporary income with deferred life annuity, Programmed Withdrawal with immediate life annuity. [4] The main characteristics that differentiate each mode are which party bears the survivorship risk, the financial risk, the possibility of leaving bequests and which type of institution administers the resources. Lump-sum payments are restricted and only allowed if the remaining balance is enough to finance a pension that is at least 150% of the minimum pension and corresponds to a 70% replacement rate.

Members can freely switch from AFP, even when retired and also at the moment they choose their pension mode. AFPs pay Programmed Withdrawals and may not offer annuities. Only life insurance companies are allowed to offer annuities. Since the PW calculation is standard across AFPs, they can only differ in the commission they charge (and the expected return an affiliate may obtain in one administrator versus another)

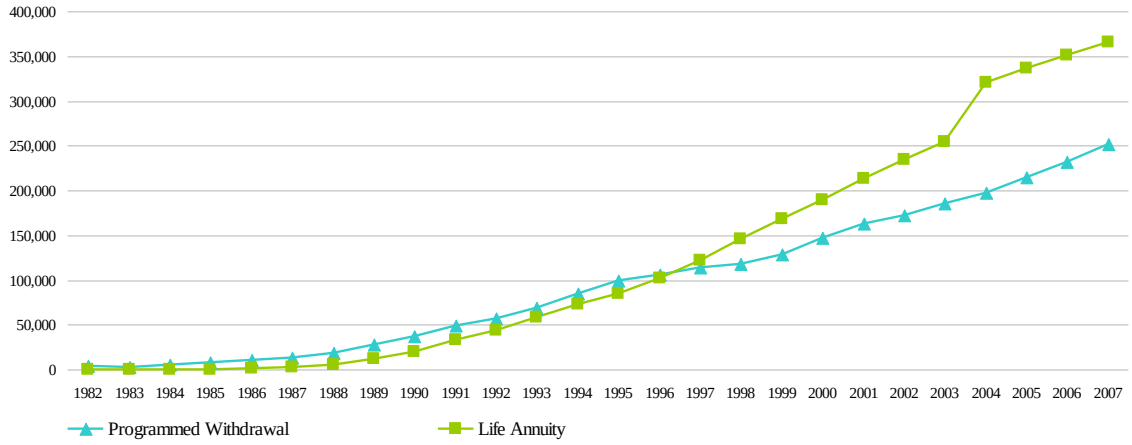
Some members are not allowed to select a life annuity. If the accumulated balance in the individual capitalization account is less than the minimum pension guaranteed by the State at the date of the pension request, the member will not have right to choose any form of life annuity. In this case, the AFP administers the pension claim and calculates the corresponding Programmed Withdrawal. In all other cases, if the member can choose a life annuity, the AFP will have to start the pension selection process by emitting a certificate of balance and entrering it to the SCOMP.

[4] Under a programmed withdrawal scheme, the AFP keeps investing the individual's savings but pays him or her a monthly pension, which is recalculated every year as a function of current balance, the structure of beneficiaries and age and gender specific life expectancy

The following graph shows the evolution of the two main pension modes, life annuity and PW. Life annuities have experienced accelerated growth since 1988, partly driven by the significant increase in the pensions due to early retirement[5].

Figure 2: Number of Pension by Mode

(In December of each year)



Source: SAFP

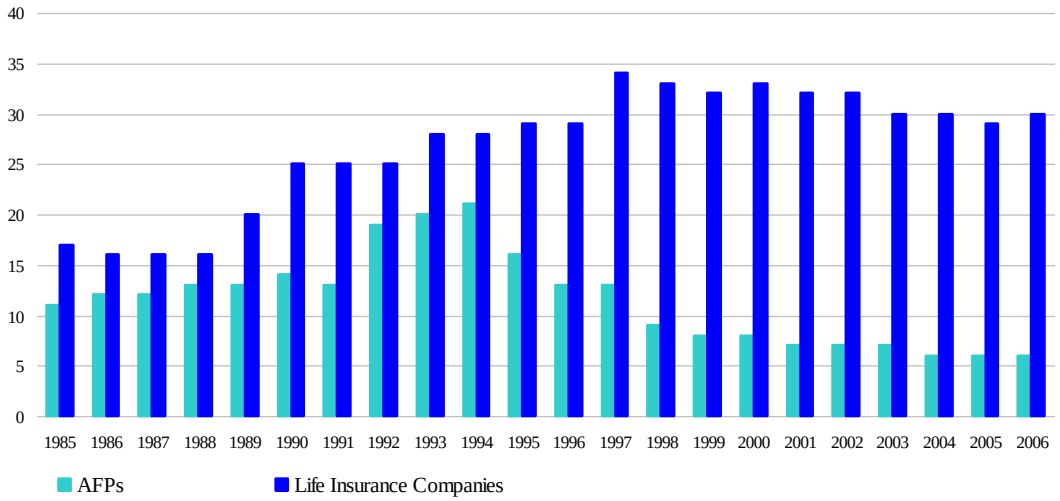
ii. Description of the industry of pensions offers

Retirement products are distributed by different organizations - PW are sold by AFPs (their sole providers) while annuities are provided by insurance companies and sold either directly by insurance companies or through brokers that act as intermediaries. The market for retirement products has evolved in different ways in the last 20 years. As shown in figure 3, the number of AFPs has declined in that period from approximately 20 to only 6 recently. By contrast, the increase in the number of annuities contracted in the 1990s coincides with an increase in the number of companies operating in the life insurances market, with a maximum of 34 companies in 1997.

[5] On the demand side, early retirees may value the longevity insurance provided by an annuity more highly than those retiring later. On the supply side, providers also have an advantage in providing annuities to early retirees and were therefore keen to sell these products to them. James et al (2005) provide an analysis of the link between early retirement and annuitization in the Chilean pension system

Figure 3: Number of Life Insurance Companies, AFPs

(1988-2006)



Source: SAFP, Chilean Superintendence of Insurance and Securities (SVS).

In practice, the AFPs do not dedicate much effort to selling PW. Instead, their focus is in the accumulation phase. The reason is that a high percentage of the population that take out PW are retirees of low income whose small accumulated balances do not make them eligible to buy annuities.

On the other hand, for life insurance agencies the sale of annuities is a big source of its business, hence they are very interested in the commercialization of this product.

iii. The SCOMP

The SCOMP is an electronic system of interconnection between AFPs and Insurance Companies that commercialize life annuities. Utilization of the system is compulsory for all affiliates to the private pension system who decided to retire, with the exception of individuals who have not accumulated enough funds in their accounts and whose only choice for retirement is a PW stream of payments from an AFP. Transmission of information about affiliates or beneficiaries to all participating organizations, as well as the resulting pension quotations, take place through this System. Only the necessary information is made available to participants, keeping the identity of the affiliate or beneficiary anonymous.

The SCOMP was designed to improve the competition and transparency in the commercialization process. The simultaneous access to the System of all the agents involved in the pension process (Insurance Companies, Brokers and AFPs), in addition to the delivery of comparable information on the different offers of life annuities and amounts of PW, increases the amount and ease of comparison of information available to consumers.

Intermediation fees are applicable depending on the channel used by the member to request a quote from the system. If the member "enters" the system through an AFP no intermediation fee is charged. If the member enters the system through an insurance company, an intermediation fee applies only in the case the member chooses an offer made by that company. If the member uses a broker to consult the system, an intermediation fee freely set by the parts apply, with a maximum level of 2.5% of the individual's balance.

Consulting this System is compulsory for any member who is in a position to choose a life annuity and wishes to retire, and also for those pensioners in PW mode who decide to change their pension mode. However, consultation is merely informative; in other words, the System provides the member with information about the offers made by the Insurance Companies and the amounts of PW to which he/she is entitled in each of the existing AFPs.

There are no restrictions in relation to the offers that the member may choose, nor the obligation to accept any of them. The System operates in the following form:

1. The member approaches the AFP or makes use of the services that the administrators offer by Internet or e-mail and initiates the procedure to retire, either by old age, early retirement or disability. The AFP sends the member's balance certificate[6] with personal data to the SCOMP system;

2. The member selects participants in SCOMP to request quotes. Participants include AFPs, brokers and Life Insurance Companies[7];

3. The member sends a request for annuity quotes, with or without the assistance of brokers or sales agents. Members can make up to three separate requests for each certificate issued by his or her AFP.[8]

4. The central information system validates the personal information of the member (e.g. age, sex, eligibility, balance), assigns a code and sends the information with the request to Life Insurance Companies;

5. The Life Insurance Companies send their annuity quotes, and AFPs send information about PW payments;

6. SCOMP sends the PW and annuity quotes to the member. The quotes are valid for 15 days;

7. The member has five alternatives: to accept one of them; consult the SCOMP again; request external offers; request the holding of an auction within the System; or give up the idea of retiring or changing pension mode.

As regards to external offers, i.e. those that the member can seek outside the Consultation System, these must fulfill the requirement of being higher than the one offered in the System by the same Insurance Company for the same type of life annuity.

In order for an auction to take place in the SCOMP, members must do the following:

- choose the type of life annuity
- indicate at least three Life Insurance Companies that may take part in it, and
- fix the minimum bid in relation to the offers received in the System.

In the auction, as long as there is more than one bid, the member is obliged to sign for a pension with the company that makes the highest bid.

The diagram below illustrates the operation of the SCOMP system established by the law[9].

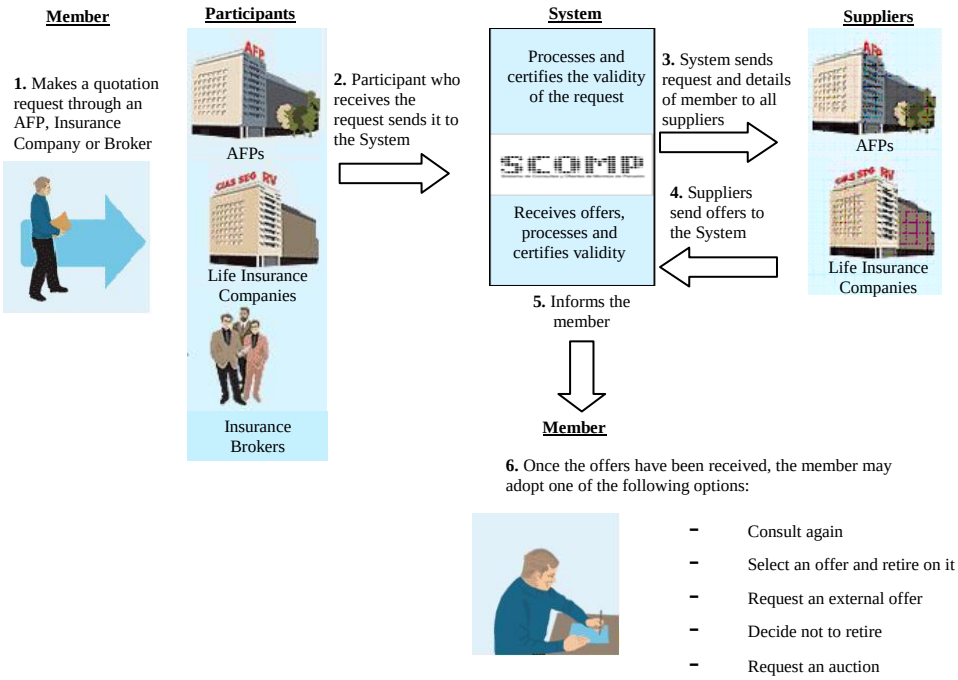
[6] This document is necessary to start any retirement process in the system.

[7] The form of entrance to the System determines the existence or not of costs of intermediation when contracting a life annuity. In particular, if the affiliate accesses the system through an AFP, no intermediation fees or charges are allowed.

[8] The individual can request quotes for a number of different products at the same time: immediate life annuity, temporary income with deferred life annuity, programmed withdrawal with immediate life annuity and programmed withdrawal.

[9] See "The Chilean Pension System".

Figure 4: How SCOMP operates.



3. *Performance of the system*

i. *Utilisation*

Since its creation, in August 2004, the SCOMP has been performing according to expectations. As Table 1 shows, 114,244 retiring members made 149,155 requests for quotes through the new System, corresponding to an average of 1.3 requests per member. Brokers participated in about 39% of these requests. Approximately 34% of the requests were done by an AFP and 27% by life insurance companies. No clear tendency can be inferred from the relative importance of each source of access over time. Of all requests made, 82% were finally accepted by the affiliate or beneficiary.

Table1: Evolution of the system

Years	Number of Requests	Number of requesting members	Average Requests	Accepted Requests	Access to the System (% of total)		
					Broker	Life Insurance Company	AFP
2004	17,275	14,426	1.20	9,849	40.75%	27.91%	31.35%
2005	43,434	33,714	1.29	28,294	36.58%	25.19%	38.23%
2006	37,309	29,154	1.28	23,146	38.95%	26.66%	34.40%
2007	51,137	37,606	1.36	32,524	40.20%	27.79%	32.01%
Total	149,155	114,900	1.30	93,813	38.90%	26.76%	34.34%

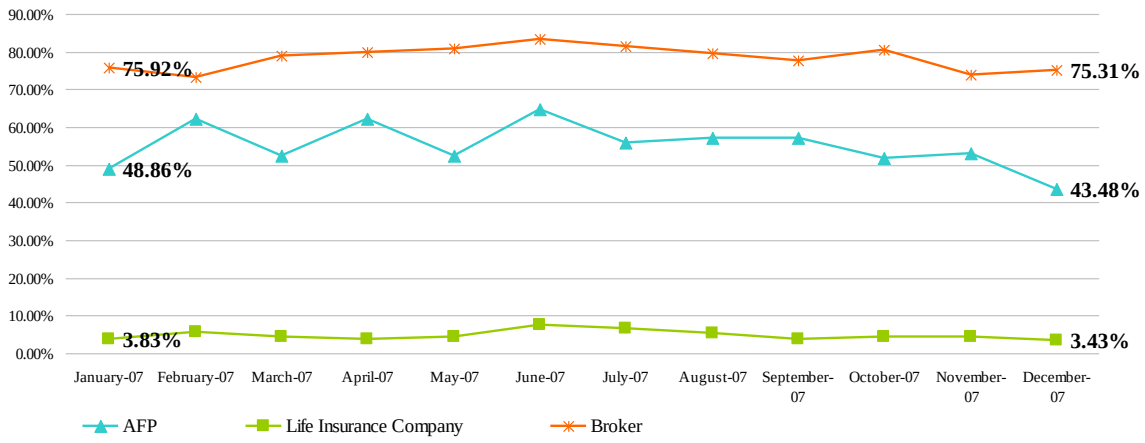
Source: SVS

Although 34.34% of the participants who enter the System do so directly, only 12% finalize the process without paying any commission. Additionally, only a small fraction of the participants has utilized the option to auction. This evidence indicates that the new System has facilitated the access to the information; nevertheless, only a small proportion of individuals get to finalize the process without the aid of an intermediary.

ii. Intermediation and choice

It is interesting to note that the participation of an intermediary also favors the pension decision making process. Figure 2 shows that the 75.31% of individuals that enter the System assisted by a broker accept the best quote, while only 44% do so if they enter via an AFP. Thus, the data suggests that the channel of access to the System influences the selection of quotes.

Figure 5: Evolution % Last Year, Members that Accept the Best Quotes, by Access to the System.



Source: SAFP

As of December 2007, among the total of people who selected the pension type through the System, 40.4% of them chose a life annuity, 38.8% a PW, 20.7% a temporary income with deferred life annuity and just the remaining 0.07% a PW with immediate life annuity. Among those who chose a life annuity, 20.71% selected the offer within the System, while the remaining 79.29% accepted an external offer.

Although an important group of individuals accepts offers outside the System, the new System allows for better conditions of selection for the members. As shown in Table 2, 63% of the contracted annuities correspond to the best quote, and 85% are within the three best ones, in terms of amount.

Table 2: Accepted of Annuity Offers by Ranking of Quotes.

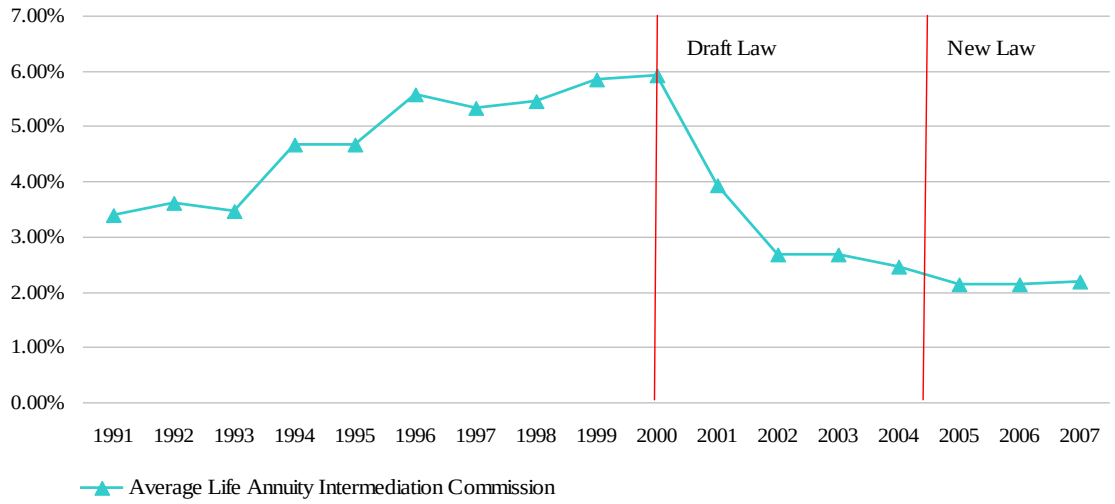
	Years					
	2004	2005	2006	2007	Total	% Accumulated
Best Quote	4,409	11,638	10,033	12,285	38,365	63.42%
Second Best Quote	1,029	2,830	2,291	2,624	8,774	77.92%
Third Best Quote	499	1,342	1,193	1,410	4,444	85.27%
Other Quotes	703	2,541	2,676	2,994	8,914	100%
Total	6,640	18,351	16,193	19,313	60,497	---

Source: SVS

iii. Commissions

The SCOMP, along with the establishment of maximum commissions that the Insurance Companies can pay their sales agents and life annuity brokers, has allowed for a significant reduction in the commercialization commission charged on the individual account balance of affiliates. The following figure shows the evolution of this commission. At the beginning of the 90s average commission reached 3%, increasing constantly to reaching 6% at the end of 1999. In 2000, the government submitted a draft of the new pensions law to Congress. Almost immediately, a strong reduction in the commission can be observed. The new law set a cap on the intermediation fee at 2.5% of the individual account balance. Therefore, after its approval, the average intermediation fee has remained below that amount.

Figure 6: Evolution of Average Intermediation Commission.



Source: SVS

iv. Money worth ratios

Additionally, Rocha et al. (2007) show that during that period there were a significant reduction in the dispersion of Money`s Worth Ratios (MWRs)[10]. Table 3 shows the declines in the coefficient of variation and the reduction in the dispersion of MWRs after 1999. While the dispersion of MWRs declines after submission of the draft pension law to congress in 2000, the effects of the actual approval and implementation of the law in 2004 are less clear. This may be due to the limited amount of information, based only on one month.

Table 3: Mean, Standard Deviation, and Coefficient of Variation of All MWRs in Different Years.

	March 1999	March 2002	March 2003	March 2004	March 2005
Mean	0.980	1.080	1.036	1.064	1.062
Std. Dev.	0.049	0.047	0.042	0.045	0.045
Coef. Var.	5.009	4.363	4.074	4.239	4.245

Source: Rocha et al.

[10] The Money`s worth ratios is an indication of the value provided to the customer in an annuity product. It is defined as the ratio of the expected value of the benefits payable under the contract to the premium paid. An efficient and transparent annuities market would produce similar MWRs.

4. Challenges

The new System has worked effectively in the 4 years since its launch. Members value the information given by the System and the possibility of accessing the market – a task that was quite troublesome when the SCOMP did not exist, especially for people from rural areas or from regions with limited access to financial institutions.

Initially, brokers and Insurance Companies were against the obligatory nature of the System and rejected the maximum cap of the commission that could be charged for the services of intermediation. Nevertheless, since the law was approved they have worked together to ensure the smooth operation of the System.

The initial challenge in the process of implementation of the SCOMP was to achieve the interconnection between all the agents related to the commercialization process (a technological challenge). A private company is in charge of giving the necessary support for the direct transmission of the information, maintaining the trustworthiness and security of the information that it handles. The System operates so that each participant receives the information that is directed to him in appropriate time and the confidentiality of the data is preserved.

Although the system allows a participant to have in a single document all the alternatives available to decide among retirement products, understanding that amount of information still proves to be difficult for the average member. Recall that the Chilean Pension System is mandatory; therefore a vast majority of members have low levels of financial education and have had little involvement with financial products, including their own pension savings, throughout their lives.

At the moment, the improvement of the documents that the System gives to members is being sought, so that they are easier to understand. A typical document may consist of up to 10 pages of information with alternative retirement products, such as different guaranteed periods for life annuities and several combinations of annuities with PW. Although the System was designed so that individuals could directly make their quotations, an important group of individuals still accepts an offer with the intermediation of an agent or broker. This suggests that members still feel that they need the aid of an intermediary to make a decision about a retirement product.

This situation could be improved if the outcome of the system is simplified, but it can also be due to the fact that the system was implemented after more than 20 years of experience with a decentralized market in which intermediaries emerged. Countries implementing a centralized quotation system from the beginning may not face this complex interaction between intermediaries and the market for retirement products.

The option of implementing such a system as a complement or as a replacement of other forms of intermediary agents may also depend on the degree of development of the system, the level of knowledge that members have about the system, the level of financial education of participants, the existence of a market for intermediaries of retirement products, the level of competition of such a market, the mandatory nature of the system and the relative importance of pensions obtained from this system in comparison to alternative sources of retirement income available to members.

III. The Open Market Option (OMO) Mechanism in the UK

1. OMO Background

Given the relatively modest amounts provided by public pension provisioning in the UK, many individuals supplement their retirement income via the voluntary private pensions sector, comprising DB or DC occupational schemes and personal pension arrangements. With DB schemes and DC schemes (also known as 'money purchase' schemes) up to 25% of accumulated pensions wealth may be taken in the form of a lump sum, with the requirement that the balance must be annuitized by the age of 75.

Although individuals have had the right to shop around for an annuity via the so-called Open Market Option (or OMO) since 1978, the majority use their pension provider to also supply their annuity, despite the fact that – as pointed out by the ABI amongst others (see ABI (2005b)) - they are not necessarily receiving the best annuity rate. To ensure a more competitive annuities market the UK, Financial Services Authority (FSA) ruled that from 2002 pensioners must be informed that they have this right to purchase their annuities from suppliers other than their current pension provider – i.e. to exercise an open market option (OMO)[11]. This is done via a 'wake up letter' which is sent to individuals 4-6 months before their retirement date, with a second letter (containing more detail and a quote on how much income would be received if an annuity were provided by the current pension provider) sent 6 weeks before retirement. The UK Pensions Regulator also encourages trustees of DC pension schemes to provide more support to members going through the retirement process and its good practice guidance gives examples of the steps trustees can take to help members with the OMO[12] Using the OMO is voluntary on the consumer's part and the provision by insurance companies of OMO rates (as opposed to their own internal pension customer base) is also voluntary.

However, a government assessment of the OMO system has reported only partial success (see FSA 2003). Knowledge and understanding of annuity issues has increased - as has the use of the OMO – but only around 1 in 3 individuals switch to a different annuity provider, despite the fact that the differential income offered by the existing pension provider and the top OMO rate can be as much as 30% (Harrison et al (2006)). Problems identified with switching include inertia, lack of awareness, complexity of forms, time delays in making transfers, lack of alternative quotes, the gain 'not looking big enough' (i.e. a lack of understanding), or (on a more positive note) wishing to stay with the company one has built a good relationship with[13]. In addition, reference to the OMO is often buried within a broader pack of pre-retirement literature and may therefore not receive the necessary attention. The

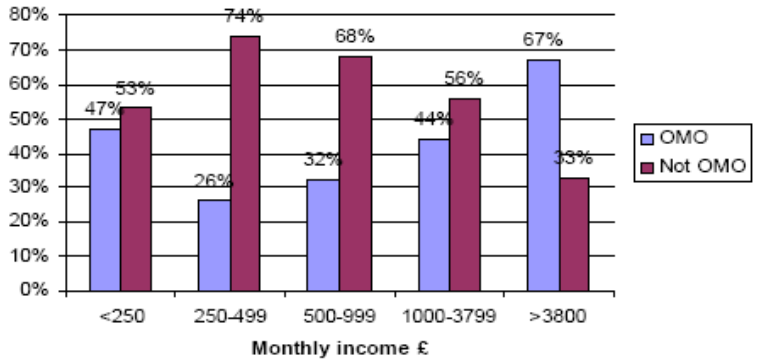
[11] The FSA's rules around the provision of information to members of personal pension schemes, including self-invested personal pension schemes, stakeholder pension schemes, and free standing additional voluntary contributions. The separate but complementary Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SII 996/1655), applies to occupational pension schemes (DB & DC) and requires scheme trustees to tell the member about the availability of the OMO at least 6 months before the member's retirement date. The regulation of workplace pensions in the UK falls to the Pensions Regulator. The Financial Services Authority provides no advice for trustees in this area. The FSA rules only provide protection to the member when advice is obtained from an authorized financial advisor. A member of a personal pension scheme will almost certainly obtain their advice from someone who is authorised and the member will then have the protection offered by the FSA rules. That protection is not available to a member of an occupational pension scheme who gets assistance from scheme trustees or HR professionals, or who chooses to use the two stage web tool instead of obtaining advice from an authorized adviser. Hence the Pension Regulator promotes, to the community it regulates, the use of financial advice from appropriately authorized advisers. The UK Pensions Regulator will shortly be issuing web based guidance focussed on occupational pension schemes, covering good practice in member retirement options and the open market option. It will include an explanation of the legal requirements, an outline of trustees' responsibilities and guidance on good practice.

[12] http://www.thepensionsregulator.gov.uk/guidance/dcScheme/retirementOptions/index.aspx

[13] Other valid reasons for not switching providers are commutation on triviality grounds or guaranteed annuity rates from the original provider (which will almost certainly be better than current OMO rates)

decision on whether to use the OMO or not also appears to be linked to levels of monthly income.

Chart 1: Percentage of People who Exercise the Open Market Option, by Monthly Income



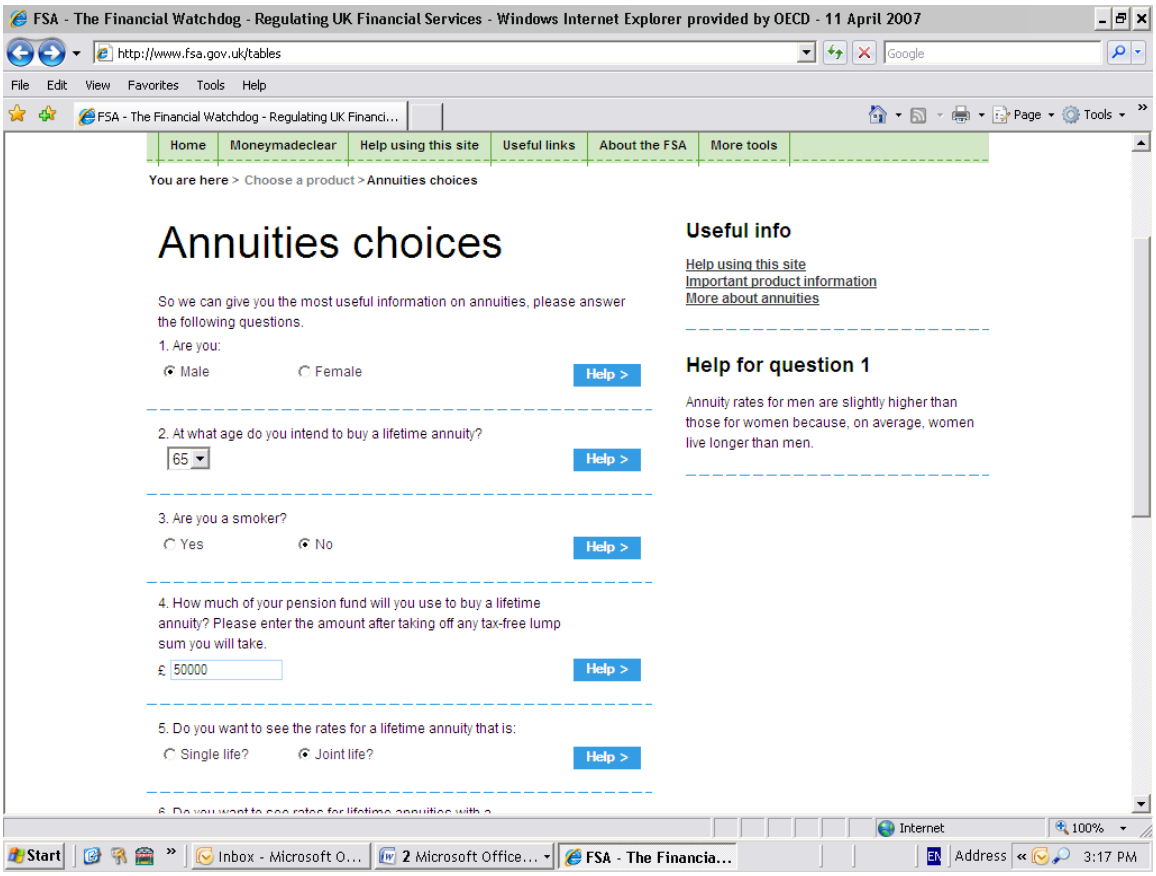
Source: ABI 2005(c)

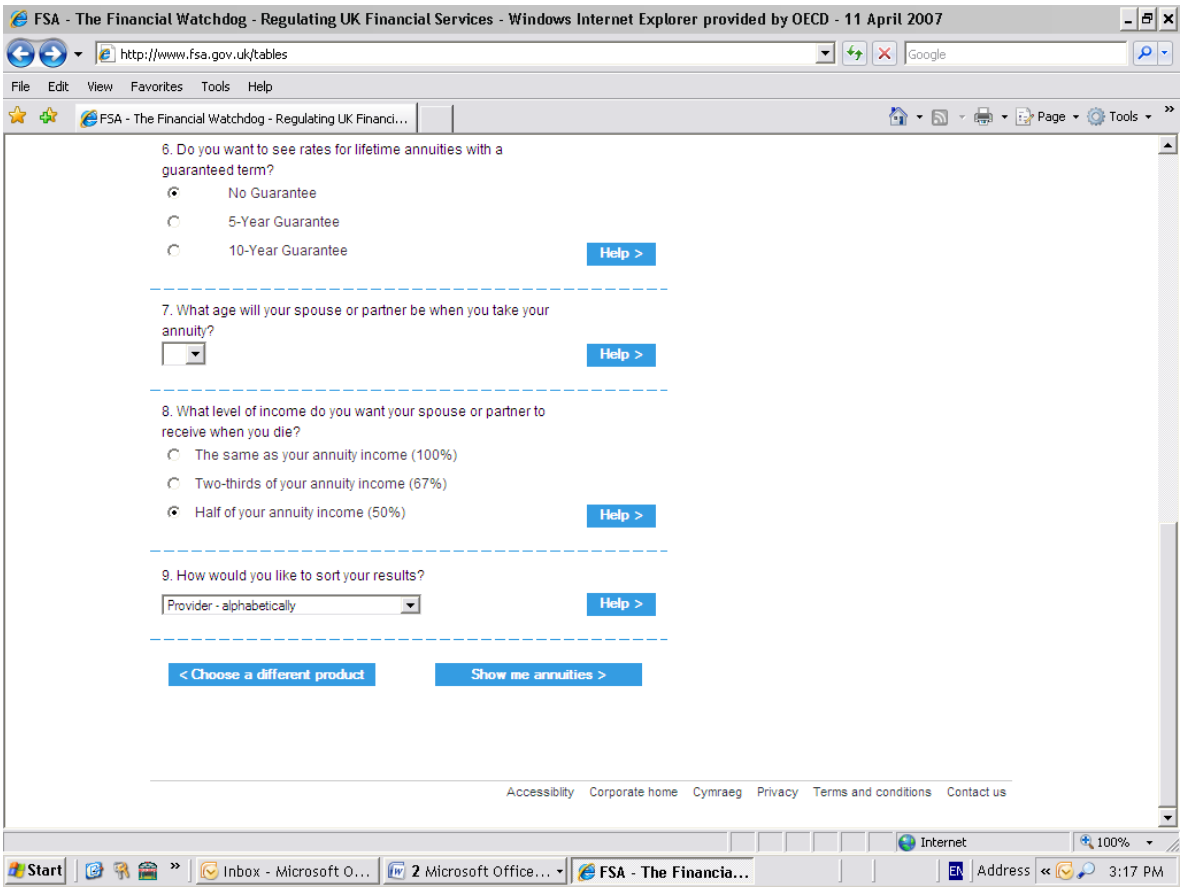
2. OMO Improvements

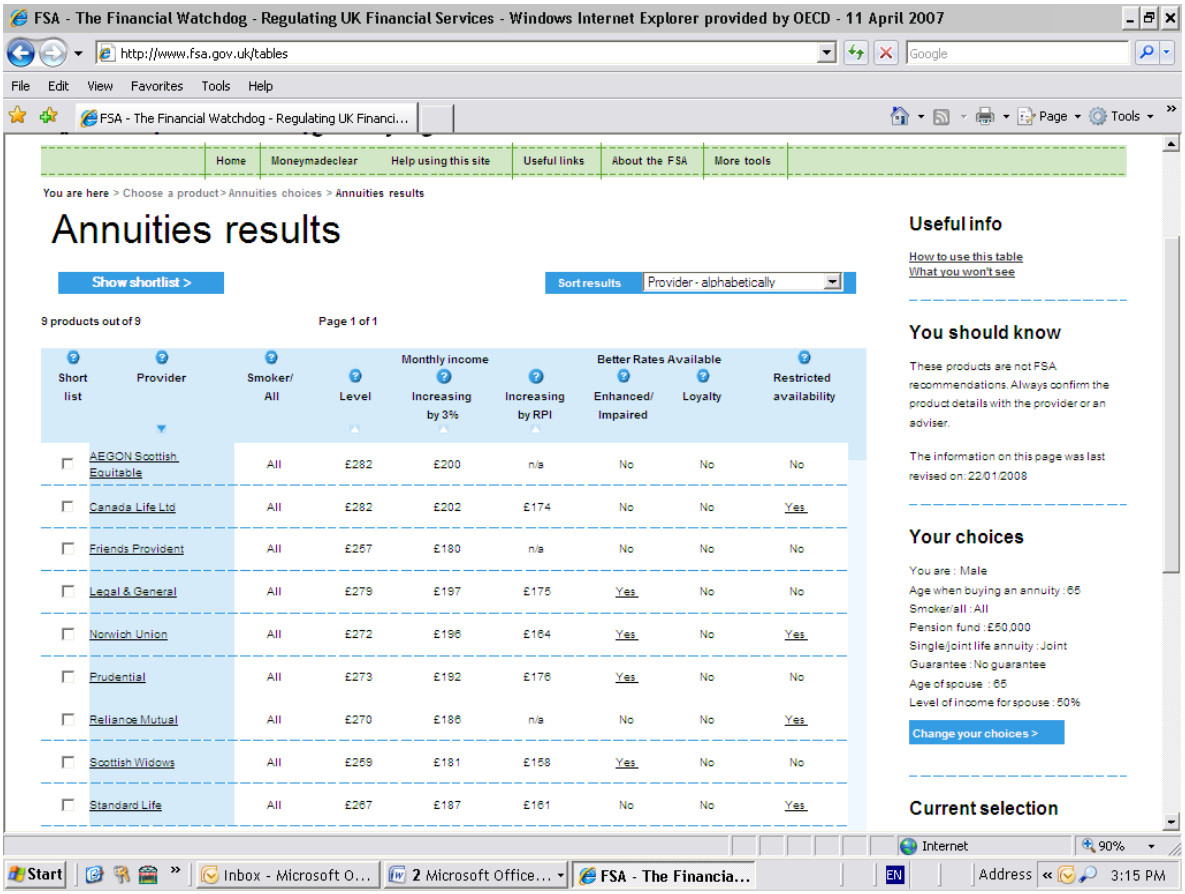
i. Comparative Quotations

The UK government is consequently working to improve the OMO system. Centralized, comparative annuity prices are provided by the FSA[14] (an example of the system follows). Individuals are asked a set of standard questions regarding the type of annuity they would like and comparative quotations from the providers are then given. Though providers take part on a voluntary basis (given that if their involvement was mandatory there would be restrictions in how the data was published), all the main insurance companies who are active in the annuities market are represented.

[14] See http://www.fsa.gov.uk/tables

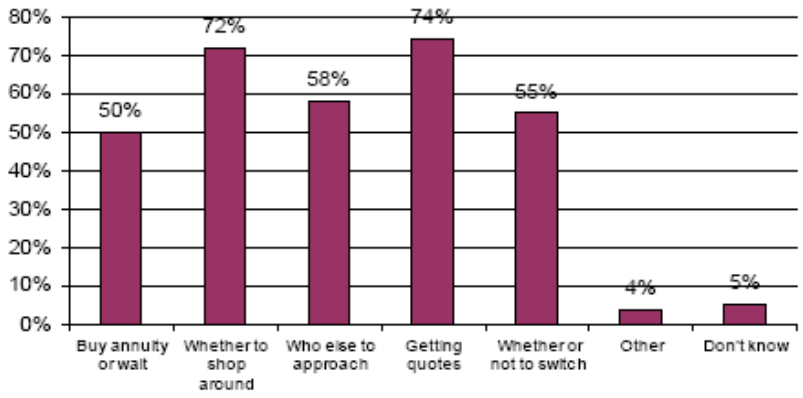

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http://www.fsa.gov.uk/tables
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Useful links
About the FSA
More tools
You are here > Choose a product > Annuities choices
Annuities choices
So we can give you the most useful information on annuities, please answer the following questions.
1. Are you:
Male
Female
Help >
2. At what age do you intend to buy a lifetime annuity?
65
Help >
3. Are you a smoker?
Yes
No
Help >
4. How much of your pension fund will you use to buy a lifetime annuity? Please enter the amount after taking off any tax-free lump sum you will take.
£ 50000
Help >
5. Do you want to see the rates for a lifetime annuity that is:
Single life?
Joint life?
Help >
Useful info
Help using this site
Important product information
More about annuities
Help for question 1
Annuity rates for men are slightly higher than those for women because, on average, women live longer than men.
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6. Do you want to see rates for lifetime annuities with a guaranteed term?
No Guarantee
5-Year Guarantee
10-Year Guarantee
Help >
7. What age will your spouse or partner be when you take your annuity?
Help >
8. What level of income do you want your spouse or partner to receive when you die?
The same as your annuity income (100%)
Two-thirds of your annuity income (67%)
Half of your annuity income (50%)
Help >
9. How would you like to sort your results?
Provider - alphabetically
Help >
< Choose a different product
Show me annuities >
Accessibility Corporate home Cymraeg Privacy Terms and conditions Contact us
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100%
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An ABI survey (see ABI (2005c)) has shown that individuals do now know that they can shop around for alternative annuity products and pricing and that they know where to go to get such information (only 7% and 3% of consumers claimed not knowing these facts as the reason why they only got a quote from their existing service provider). They also value such information and services.

Chart 2: How Advice Helped Consumers



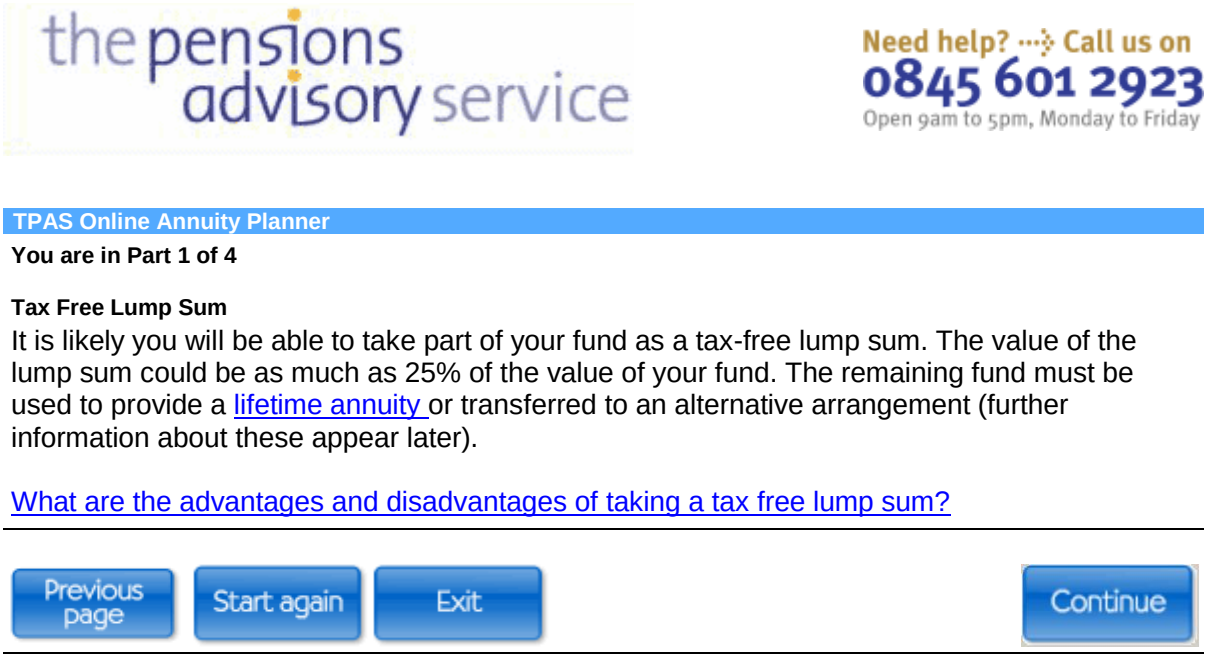
Source: ABI 2005(c)

ii. Annuities Information

However, ensuring that individuals obtain competitive prices for annuities may not be sufficient. Evidence from the UK suggests that they are not necessarily choosing the right product. For example, though insurers interviewed for the Harrison et at (2006) paper estimated that 80% of individuals with DC funds were offered a competitive annuity rate by

their pension provider, all this means is that many may be buying the incorrect product at the right price (e.g. the paper estimates that in 80% of cases, consumers may have been able to do better by purchasing an enhanced annuity from another provider). The fact that 80% of customers opt for level annuities may suggest that not all individuals are buying the products best suited to their needs, a message also supported by the ABI (ABI (2005)c))Individuals may also not be annuitizing at the right time, (two-thirds taking up an annuity as soon as they retire (ABI(2005b)).,

Experts have suggested that for the OMO process to operate efficiently the annuity selection must involve two distinct stages, of which securing a competitive rate is the second. The first is to ensure that individuals select the right type of annuity product and features (see Harrison et al (2006)). The UK government has therefore developed such as two stage system, with the involvement of the Pensions Advisory Service (TPAS) – an independent voluntary organisation providing pension advice that is funded by a UK grant. TPAS have developed an online system to help individuals choose what type of annuity is right for them[15]. Individuals are guided through a series of questions which will lead to a tailored answer as to what type of annuity would suit their circumstance. For example, when being asked to identify whether married or single, information will be provided on single vs. joint life annuities and in what circumstances the latter may be valuable. Information of alternatives to less standard products and other options (such as alternative secured pensions and the tax implication of these) is also provided. The respondent will then be guided to the FSA's comparative tables to find the best price for the product they have selected, or will be armed with a better understanding when consulting with a financial advisor[16]. An example of the sort of information provided regarding the decision whether to take part of a pension fund as a lump sum is provided below.



[15] See www.pensionsadvisoryservice.org.uk

[16] The UK Pensions Regulator also has a role to play in the process – in promoting the use of personal financial advice from appropriately authorized advisers to help members with the OMO make properly informed retirement choices. The Regulator also encourages scheme trustees to facilitate a level of support to members that enables them to make properly informed decisions on their retirement and annuity options. TPR has recently published good practice guidance on member retirement options and the Open Market Option (OMO) which sets out the trustee's responsibilities in providing retirement options

Tax Free Lump Sum

It is likely you will be able to take part of your fund as a tax-free lump sum. The value of the lump sum could be as much as 25% of the value of your fund. The remaining fund must be used to provide a Lifetime Annuity or transferred to a permitted alternative arrangement. Note that you only have one chance to take your lump sum - once you have set up an annuity, you cannot take a lump sum at a later date.
Taking a lump sum can be very attractive:

- It is paid tax-free – unlike income, which is taxable
- It is money here and now
- You can choose how to use it – you could:
    - Pay off a debt
    - Save or invest it
    - Spend it
- Any money you have left from the lump sum when you die can be passed on to your family in a straightforward way - unlike taking an income, which means you have to make specific choices to provide for someone else, otherwise the income stops when you die.

However, there could be a disadvantage to taking the lump sum:

- It comes from your pension pot, so there will be less left to provide you with an income
- If you want to provide an income for your spouse after you die, the more money there is in your pot, the higher your spouse's income could be.

Make sure you take into account your other savings and sources of income when you make this choice. If you are likely to depend on Pension Credit, be aware that both your level of income and any lump sum savings can affect whether you qualify or not.

Though the insurance industry has developed quotation systems itself[17], the UK government wished to provide a central quotation system to cover those who do not know how to or cannot afford to get advice from other sources (particularly those with small balances). The system is said to have been relatively straight forward and economical to set up given standard annuity tables are used and UK regulation (including tax rules) drives what can be offered. In terms of the advisory service, the involvement of a wide range of partners with different experience has been appreciated (e.g. in addition to government bodies TPAS has also consulted with industry via the Association of British Insurers). The main challenge has been to explain these complex products to a mass market (avoiding jargon etc.) - hence the TPAS system went through extensive testing with consumers before launch[18] (test groups with large funds, small funds, of certain ages and pension advisors being used). This user testing was felt to have greatly improved the quality of the system – though coordinating with a large number of groups proved challenging (in terms of reconciling conflicting inputs and advise), and meant the timetable for the introduction of the system was too ambitious and had to be extended.

In terms of technology, the development and launch of the system went smoothly, though TPAS note that they maybe should have started with more comprehensive and flexible software in order to allow even more functionality to have been introduced. Marketing of the

[17] For example the set up of the Annuity Exchange is discussed in Hagensorff et al (2006). Problems with using an industry-based central quotation system are said to include standardizing terminology and technology.

[18] As Harrison et al (2006) note: "Consumer testing will be important to structure the way this information is presented. Some participants in our research argued that concepts like decision trees are not a panacea, as a significant proportion of consumers do not find them helpful or easy to use in the context of a complex decision process."

service is being done by various governmental and regulatory bodies and TAPS will track users carefully over the coming months to establish how users are coming to the service and consequently develop other avenues to ensure as wide a usage as possible (e.g. coordinating with pension fund trustees and employers to promote the service).

IV. Conclusions and Lessons for Other Countries

Buying an annuity is not like purchasing other consumer (even financial) products. Individuals may have only one opportunity to do so and therefore cannot learn from experience or correct any mistakes made. Yet the decision is also one of the most important that an individual can make in their lives – determining what may be their subsistence income for many decades. Hence pension supervisory authorities are increasingly concerned that individuals are given the necessary information and assistance to make correct decisions relating to their retirement income.

The provision of independent, comparable quotations and information on annuity products may be particularly important in countries where the market for these products does not always function ideally. Examples discussed by Rusconi (2008) include the UK (where the number of providers has declined from around 100 providers in the 1970s to closer to 20 currently), Australia (where the top 3 providers have market shares respectively of 20%, 18% and 13% respectively), and in markets such as South Africa where there are only a handful of active players. Aside from the number of providers, the spreads between the best and worst contract terms offered in some countries remains high (see also Rocha & Thorburn (2006)). As Rusconi points out: "Sustained large price ranges, particularly through time and across rating factors, should give policymakers considerable cause for concern regarding the sensitivity of customers to pricing differences, for they suggest that, despite the financial significance of the annuity decision, customers are not shopping around to find the best deal" He goes on to suggest that: "Perhaps supervisors could start by gathering information regarding the price at which annuities are actually purchased, because without such information, market dynamics cannot properly be understood, and without this understanding informed regulatory intervention is difficult".

The experience of Chile and the UK shows that central quotation systems, whether organized or mandated and supervised by governmental organizations, can play a role in assisting with decisions relating to retirement income. Costs may be controlled and more informed decisions by individuals can result. Though these systems are still being developed and improved, some initial lessons can be drawn for supervisory and other government authorities in other countries contemplating introducing such systems themselves:

- simply informing individuals of their right to get a quote from an alternative annuity supplier to their pension provider may not have sufficient impact;
- individuals also need to be able to identify the right type of annuity for them, as well as just comparing quotes- therefore a two tier system offering information as well as quotations may be preferable;
- comparative quotation systems have been shown to add value to individuals and improve their annuity choices (even the possibility of making quotations centralized and easily comparable can cause commissions -i.e. costs to consumers to decline);
- making the provision of quotations compulsory may be required to ensure full involvement of all industry players and to overcome resistance;
- government organized or supervised systems may be necessary to ensure broad coverage and provide credibility / reassurance;
- the involvement of a wide range of players into the development of these systems (including industry input) can be helpful, if challenging and timely to coordinate;

- standardized system are relatively economic and not too technically challenging to set up, though ensuring interconnection between all agents can be an issue initially and attention should be paid that the software used is sufficiently flexible;

- given the complexity of products, attention needs to be given to ensuring that the information and data is understandable by a broad audience;

- given low levels of financial literacy and confidence with these products, building a role for intermediaries to provide advice and assistance may still be recommended, but free, objective provision of such information from government sources may be desirable (particularly for those with low balances who may not be able to access or afford such advice);

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