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Electronic trading platforms and the cost-effective distribution of open market option (OMO) pension annuities

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Abstract

Over the next years, the ageing profile of the UK population will lead to a sharp increase in the volumes of pension annuity sales. Every individual that participates in a defined contribution occupational or a personal pension scheme is obliged to convert the capital accumulated into a regular post-retirement income by purchasing an annuity before the age of 75. To ensure a more competitive market the UK Financial Services Authority has ruled that from 1 September 2002 pensioners must be informed that they have the right to purchase their annuities from suppliers other than their current pension provider—this is termed exercising an open market option (OMO).

However, the complicated nature of pensions and annuities means the purchase of an annuity is highly dependent upon the information provided by the sellers of these products and the advice received. Given that OMO's are supposed to encourage purchasers to be able to access information on a whole range of annuities from the various suppliers in the market, a single web-based hub that linked manufacturers, distributors and existing industry portals seemed the obvious solution to the challenges facing the industry following the government legislation. However, while the industry recognised that a single product purchasing and servicing system would meet the data management needs of all its stakeholders and carry enormous potential to realise cost and business process efficiencies, the competitive nature of the industry and the slow decision making processes within the individual companies has meant that the project to build 'The Annuity Exchange' has suffered a number of setbacks and delays.

This article describes the business case for 'The Annuity Exchange', its objectives and design, and the technical/industry engagement issues it has faced.

Keywords: E-commerce; Financial services; Pension annuities

1. Introduction

An annuity is an insurance contract that allows a lump sum to be exchanged for an income payable for the rest of the life of an individual. In broad terms its purpose is to ensure that an individual cannot outlive the funds they have accumulated for their retirement. Under UK legislation individuals that participate in defined contribution occupational pension schemes or in personal pension schemes are obligated to purchase an annuity on retirement with the proceeds of their pension schemes. The annuity purchase is normally

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undertaken at retirement but must take place by the age of 75 at the latest. The ageing profile of UK society means that the demand for annuities is expected to grow substantially for the foreseeable future.

The UK Government has recognised the problems posed by an ageing society and in response to concerns about the adequacy of private pensions savings, the Financial Services Authority ruled that pension providers were obliged to inform retirees about their right to shop around for the highest annuity rate when their fund matures; this right is known as exercising an open market option (OMO). However, the fact that a majority of policyholders do not exercise the OMO and, instead, continue to take their annuity from the company with which they built up their pension fund means that thousands of future pensioners forsake part of their post-retirement income each year.

The nature of pension annuities makes their manufacture and distribution highly dependent upon the information flows that underlie them and this, at least, partly explains why most people have not exercised the right to an OMO. Essentially, customers needed easier access to the full range of annuity products on offer and explanations of the various aspects of the various products on offer. The Annuity Exchange was established to meet the needs of consumers and suppliers following the change in legislation, which led to consumers being offered the opportunity (OMO) to purchase their annuities from the whole range of suppliers in the industry. This article describes the business case for 'The Annuity Exchange', its objectives and design, and the technical/industry engagement issues it has faced.

By replacing the current patchwork of industry portals and supply by individual providers, The Annuity Exchange (a single product purchasing and servicing platform that supports every stage of the annuity purchasing process) has the potential to realise substantial cost and process efficiencies for manufacturers, distributors and consumers. Most importantly, it can provide the quality financial advice that is required for consumers to make well-informed judgements about their post-retirement income needs. While the increased availability and quality of financial advice and the pervasive process efficiencies for those involved in the manufacture and distribution of retirement products of The Annuity Exchange have been recognised by all the industry players, competition within the industry and slow decision making within the individual companies has hampered The Annuity Exchange and the benefits it can bring UK society as a whole.

2. Background: the UK pensions system and the regulatory structure of advice

2.1. Recent trends in the UK pensions system

Increasing longevity and low birth rates will result in a substantial increase in the number of people aged 65 and above and the proportion they form of the population. In a report initiated by the Government, the Pensions Commission (2004) forecasts a doubling in the percentage of the population aged 65 and over in the next 50 years and calls for substantial adjustments in public policy as well as in private retirement and savings behaviour. In the UK, a low level of state pensions is combined with an extensive system of private funded pensions; the latter being responsible for the bulk of income replacement after retirement. Participation in employer-sponsored pension schemes varies greatly by sector—from about 30% in the private sector to an average of 90% of all public sector employees. Alternatively, employees who are not members of employer-sponsored schemes and self-employed individuals may subscribe to personal pension arrangements.

Within the employer-sponsored sector, there has been a major shift from 'defined benefit' (i.e. final salary) to 'defined contribution' (DC) pension provision after years of low equity returns. Under the terms of a DC scheme, employees accumulate capital with a pension fund throughout their working life, which they eventually turn into a regular post-retirement income by purchasing an annuity. Individuals with personal pension arrangements are also obliged to use the capital they have accumulated to purchase an annuity.

The most common types of pension annuities include standard level (i.e. the annuity rate is fixed over time), fixed rate increasing (increases by the same amount year), and inflation-linked (e.g. RPI-linked). The income from annuities is paid for life (single annuity) or, alternatively, is passed on to the spouse upon the death of the annuity holder (joint life annuity). Finally, impaired life annuities take into account the shorter life expectancy of their holder by paying a higher rate than conventional annuities.

It is a crucial aspect of the UK pensions system that consumers, once their pension fund matures, are given a choice of whether to buy an annuity from their pension provider or, alternatively, to use the capital