Removing the requirement to annuitise by age 75

The NAPF response to HM Treasury's consultation, September 2010

Executive Summary

- The NAPF recognises the need to find more innovative and flexible ways to encourage saving. We believe that the Government's primary concern should be on reforming the annuities market so that it can meet the needs of the majority of savers and annuitants.
- We support the retention of the 25% tax free lump sum and the EET principle of pensions taxation. These act as important incentives for individuals to save in pensions.
- The Government's proposal to introduce a blanket 55% tax recovery charge is welcome in principle. Individuals should be encouraged to use their pension income in retirement but the Government must acknowledge that the majority of people receive only basic rate tax relief on pension contributions.
- The Government should consider lowering the limit for capped drawdown to 100% of the value of an equivalent annuity, taking into account the needs of individuals with impaired life expectancies.
- The Minimum Income Requirement (MIR) should be set around £16,000, as individuals with capital above this level are usually ineligible for benefits such as Housing Benefit and Council Tax benefit.
- The Government must recognise the challenge these proposals pose for the provision of information and advice. Many people often turn to their employers for information on pensions. The Government should provide guidance for employers regarding the changes around annuitisation and give employers assurance that won't be held liable for providing information.

Introduction

1. **The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential serves to the pensions sector.**

2. The NAPF and its members recognise the changing face of pension provision in the UK and the need to find more innovative and flexible ways to encourage individuals to save for their own retirement. The debate around the need for compulsory annuitisation has spanned many years and we welcome the opportunity to respond to this consultation. However, we believe that the

Government should focus its attention on introducing more flexibility into the annuities market so that it meets the needs of savers. Retirement income products need to be able to respond to the needs of savers in light of recent trends in working longer, increasing longevity and changing work patterns, but this could be addressed through more innovative and flexible annuity products. There may also be a case for increasing the age at which an annuity must be purchased to 80, considering increases in longevity and the rising State Pension Age.

3. The need to encourage individuals to save for their own retirement stems from the fact that many people simply are not saving enough, or at all. Earlier this year, the NAPF proposed a series of reforms to the UK pension system to encourage individuals to save for their retirement in the report *Fit for the Future: NAPF's Vision for Pensions*. The introduction of a single Foundation Pension set at £8,000 a year along with innovations in workplace pensions would significantly increase the size of individuals' pension pots and would provide a powerful incentive to individuals by ensuring that it pays to save for their own retirement.

4. For the vast majority of individuals, purchasing an annuity will still be the best option. According to a 2009 DWP report, over 76% of all annuities were purchased with funds of less than £20,000 and 67% were purchased by individuals under the age of 65.[1] In contrast, the average pension fund moved into income drawdown last year was £52,000.[2] The same DWP report found that people do not have a reasonable understanding of pensions, especially when it comes to investments and decumulation. Research conducted by the NAPF suggests that individuals actually prefer regular, guaranteed income retirement. Instead of removing the requirement to annuitise at age 75, the Government should focus its attention on achieving more flexibility within the annuity market to suit the needs and spending habits of individuals. Products like stepped or variable annuities, temporary annuities and flexible lifetime annuities are already developing and should be encouraged.

5. We are pleased that the Government has committed to retaining the Exempt-Exempt-Taxed ("EET") principle for pensions taxation, as well as the Pension Commencement Lump Sum, a move the NAPF called for in *Fit for the Future: NAPF's Vision for Pensions.* A large percentage of individuals use their 25% tax free lump sums to achieve financial security in later life. According to a 2008 Scottish Widows survey, 41% of current pensioners use their lump sums to pay off mortgages or clear other debt, which acts as an important incentive to save in a pension.

6. The Government must consider carefully the impact the removal of the requirement to annuitise at age 75 will have on the provision of financial

[1] DWP, "DC Pensions", 2009
[2] According to Hargreaves Landsdown.

information and advice. Bodies such as the newly formed Consumer Finance Education Body (CFEB) have a role to play, but the Government must also recognise that people often turn to their employers and pension schemes for financial information. It is imperative that the Government publish clear and easy-to-understand guidance for employers on how to communicate with their employees following the abolition of compulsory annuitisation. The Government should also provide assurance to employers and trustees that they will not be subject to litigation if they provide this information.

Answers to specific questions

The Government has asked for views on the following topics:

<u>Developing a new tax framework for retirement</u>

1. **The level of an appropriate annual drawdown limit for capped drawdown**.

   Under the new system, individuals will have the ability to use drawdown past age 75 and will therefore be exposed to risk for a longer period of time compared to the current system. Reducing the annual capped drawdown limit (currently 120% of the value of an equivalent annuity) would have some advantages. Primarily, it would reduce the risk of individuals running out of money in the later stages of retirement and eventually falling back on means tested benefits.

   Special consideration should be given to individuals with impaired life expectancies. Individuals who would have been eligible to purchase an impaired life annuity should be able to draw 100% of the value of an equivalent impaired life annuity.

2. **Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75**.

   The UK pensions tax system has been designed to encourage individuals to lock their savings away until retirement. The principle of Exempt-Exempt-Tax ("EET") is more easily understood by savers than alternative systems and incentivises savings at the front end. The Pension Commencement Lump Sum also acts as a powerful incentive and the NAPF is pleased that that the Government has confirmed that it will continue. Many people use their Pension Commencement Lump Sum to achieve financial security in later life. According to the 2010 NAPF Workplace Pensions Survey, a third of respondents said its removal would discourage them from saving in pensions.

   The Government's proposal to simplify the tax treatment of pension benefits is also welcome. The NAPF supports the overall principle that the taxation of pension

NAPF Securing the future of pensions

benefits should be designed only to recover past tax relief on pension contributions. This includes the taxation of pension income at marginal income tax rates. The Government should not incur a positive gain from the taxation of pension benefits.

The Government has proposed that the recovery charge on all death benefits will be 55% (except for those who die before age 75 without having accessed their pension pot, which will remain tax-free). This consistency is a welcome change from the current system where different types of payments and benefits each incur different tax charges. The NAPF is of the view that the recovery charge should be used to encourage individuals to use their pension pots in retirement, but the Government must also recognise that the majority of people will receive basic rate tax relief on their pension contributions during accumulation. It should be noted that the suggested recovery charge of 55% is consistent with the current tax charge of 55% levied on unauthorised payments and therefore could be viewed as punitive in the same way that unauthorised payments are designed to be punitive.

Minimum Income Requirement

3. **What income should be considered "secure" for the purposed of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.**

According to the Office of National Statistics, pension income[3] constitutes almost 60% of total income for pensioner couples and 80% for single pensioners. Investment income comprises approximately 10% of total income. Earnings also makes up almost 25% of income for pensioner couples, while for single women pensioners it is only about 8% of income.

However, income from investments and from earnings is volatile and can fluctuate according to market pressures. The NAPF therefore agrees with the Government that only pension income, including income derived from defined contribution (DC) pensions through the purchase of an annuity, should be considered for the purposes of the MIR. It will be crucial to specify in guidance what kinds of occupational pension scheme payments meet the MIR criteria. For example, spouses' benefits should be included in the definition.

The Government has also proposed that only pension income and annuity income which is uprated by at least Limited Prices Indexation (LPI) can be considered secure for MIR purposes. This requirement will have implications for current annuity policyholders. Almost 90% of individuals purchase a conventional

[3] Pension income includes both state and private or occupational pensions.

level (non-escalating) annuity[4] so the vast majority of individuals who have already purchased an annuity will be unable to use flexible drawdown arrangements. The Government should consider allowing level annuities above a certain amount, perhaps at least 25% above the MIR to mitigate inflation risk, to qualify for the MIR.

It has also recently announced that occupational pension schemes will be able to uprate annual increases using Consumer Prices Index (CPI) instead of Retail Prices Index (RPI). It is unclear what effect this CPI/RPI shift will have on occupational scheme payments and the Government must first clarify the situation before setting this requirement in legislation.

4. **What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.**

As the Pensions Commission itself acknowledged, it is extremely difficult to define "adequacy" when it comes to individuals' income needs in retirement. Adequacy depends on a number of factors including level of income but also including the age at which income is taken. The Pensions Commission also pointed out that people often define adequacy based on their own standards of living but in many cases, even this benchmark is flawed because inflation can erode individuals' income.[5]

What this demonstrates is that there isn't a one-size-fits all approach to setting the level for the MIR. We must therefore look to the purpose of the MIR, which is to balance increase flexibility around retirement income with the reduced risk of individuals falling back on means tested benefits.

Benefit income makes up the largest source of income for the majority of pensioners in the UK. According to the ONS, a single pensioner under the age of 75 receives on average £7,332 a year in benefit income, which includes the State Pension, Pension Credit, Housing Benefit and Council Tax Benefit. Past age 75, the average amount of benefit income received by single pensioners increases to £7,852.[6]

The MIR must therefore be set well above the current Pension Credit level of £6,760 to account for the fact most pensioners receive extra income from other benefit sources. An appropriate MIR level seems to be around £16,000 as individuals with capital above this level are usually ineligible for Housing Benefit or

[4] Association of British Insurers, "Pension Annuities and the Open Market Option," 2008.
[5] Pensions Commission First Report, "Pensions: Challenges and Choices", 2004.
[6] ONS, Pensions Trends, Chapter 11.

Council Tax Benefit.[7] This level could be expressed in a variety of ways, but the MIR must be able to reflect increases in the cost of living or means tested benefits thresholds.

One way to express this level is as a percentage of average earnings. Average earnings are currently £26,000.[8] The MIR could be set at 60% of average earnings, which would equate to £15,600. As average earnings increase, the MIR would increase as well.

It is important to remember that only a small percentage of individuals would be able to qualify for an MIR of £16,000. According to the MoneyMadeClear annuity calculator, an individual would need a pot of around £225,000 in order to reach the MIR, in addition to the State Pension.[9] A 2009 DWP report states that the average pot size used to purchase an annuity in 2008 was £26,000.[10] It might be possible to reduce the MIR so that more individuals are able to qualify, but this increases the risk that individuals may fall back on means tested benefits. The NAPF believes this risk must be avoided.

Adjusting the MIR for different ages add too much complexity to the new system and as a result is unnecessary. Income needs often fluctuate throughout retirement and it is difficult to predict spending patterns as they vary between individuals and households. According to the Pensions Policy Institute, pensioners tend to spend a larger percentage of their income in the early years of retirement, spend a smaller percentage in the middle, and then increase spending once again at the end of their life to account for the costs of health care[11]. The MIR should be set at level high enough to cover any fluctuations in an individual's income needs over the course of retirement.

5. **Whether a different MIR should be set for individuals and couples.**

The MIR should be set at a single rate based on individual income. This would be consistent with the Government's commitment to ensure that everyone can build up a pension in their own right. Recent reforms to the State Pension system will make it easier for people, especially women and carers, to accrue a full Basic State Pension in their own right. The NAPF's proposal for a Foundation Pension would further alleviate the discrepancies. Additionally, the introduction of automatic enrolment and mandatory employer contributions will give every person access to a pension that comes with their job. Changes in annuity policy should reflect this welcome development.

[7] In the case of an individual who has already purchased a level annuity prior to the abolition of compulsory annuitisation, the MIR should be set at £20,000 to mitigate against inflation risk.
[8] ONS, Annual Survey of House and Earnings, 2009.
[9] A non-smoking female taking an RPI-linked annuity at age 70 would receive £10,500 a year. Calculated on 10 September 2010.
[10] DWP, "DC Pensions", 2009
[11] Pensions Policy Institute, "Retirement Income and Assets: Do pensioners have sufficient income to meet their needs?" 2009.

6. **How often the MIR level should be reviewed.**

   If the MIR were linked to a percentage of average earnings, it would increase automatically as average earnings increase. As a result, there would be no need for the MIR to be reviewed regularly. However, the MIR should be reviewed in conjunction with any fundamental changes to or review of the benefits system.

7. **How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.**

   One way to minimise the burdens on individuals and the industry would be to base the assessment process on the information already provided on income tax receipts, self-assessment forms, PAYE slips, etc. Individuals will be familiar with these mediums and will be able to find the required information quickly.

<u>The UK Annuity Market</u>

8. **Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.**

   The UK annuity market is one of the most sophisticated in the world and already a number of providers have developed innovative annuity products such as fixed-term or temporary annuities and flexible lifetime annuities. However, many people could benefit from products which combine a baseline guaranteed income with investment options or income drawdown. Such products would provide both the security of a steady, lifetime income while at the same time allowing part of the pot to remain invested. The Government should work with the industry to identify barriers to product development in this area specifically.

   To help alleviate the "small pots" issue (where individuals accumulate multiple small pension pots over their working lives), the Government could consider allowing spouses to combine their pots to purchase one joint-life annuity, as the NAPF and other organisations have proposed. Although couples should not qualify for the MIR on joint income, this development would help couples who fall well below the MIR criteria either jointly or individually to secure a better income in retirement.

9. **How the industry, Government, and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.**

A 2009 report by the DWP stated that only 10-15% of DC scheme members understand the investment risks they face.[12] A separate report by the FSA suggests that understanding of decumulation products like annuities, income drawdown and equity release remains poor. [13] Research suggests that more than 75% of individuals in the UK do not have a financial adviser.[14] For these individuals, having access to easy-to-understand advice and information will be crucial to the success of their retirement decisions in the absence of the requirement to purchase an annuity by age 75.

Research also suggests that employees trust information provided by employers (or independent third-parties through the workplace) more than information provided by the Government or the financial services industry. According to the DWP's 2007 survey "Trust and confidence in Pensions and Pensions Providers", employees trust their employers the most when it comes to pensions, followed by not-for-profit organisations.

The Government must recognise this and provide support for employers. The workplace is an efficient and effective communication channel. Information can be passed on using face-to-face seminars and group sessions and/or interactive online training and education.

The NAPF has developed considerable expertise in pension education through our PENSIONFORCE service, which is delivered through the workplace and backed by the DWP. The Government should provide further support to initiatives such as PENSIONFORCE to ensure that individuals make appropriate choices following the end of the requirement to annuitise by age 75.

10. **Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.**

The ability of the market to supply annuities at attractive rates is dependent upon a number of factors, such as interest rates, gilt yields, and solvency requirements. While the requirement to annuitise at age 75 will no longer exist, the NAPF anticipates that the large majority of individuals will continue to do so anyway and therefore the impact on the demand for annuities will be minimal.

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[12] DWP, *DC pensions,* 2009.

[13] FSA, *Finance in and at retirement – results of our review,* 2007.

[14] Sun Life Financial of Canada's Unretirement Index 2010.

September 2010

Response to HM Treasury Consultation "Removing the requirement to annuitise by age 75" by Partnership

Introduction

Partnership is delighted to have the opportunity to respond to HM Treasury's consultation. We wish to congratulate the Government on this consultation, which provides a range of retirement funding options which will meet the Government's objectives of 'making savings … more flexible and attractive in order to encourage people to take greater responsibility for their financial future'.

This response sets out what Partnership is, examines the key issues and opportunities that this consultation provides the Government and then responds to questions in the Consultation in the order in which they are made.

Partnership

Partnership is a specialist provider of financial solutions for people with health/ lifestyle conditions, as well as those suffering from a serious medical impairment. Partnership was the first company in the UK to offer higher retirement incomes by taking account of people's health and lifestyle conditions. It has been a consistent innovator developing this sector by championing the needs of those with even modestly reduced life expectancies.

Partnership has led the way in providing products designed specifically for individuals whose health and lifestyle is likely to result in a reduced life expectancy. Partnership is expert in the field of medical underwriting and has a unique in-house data set. Partnership believes that its years of accumulated data and knowledge give us a unique understanding of the impact of health and lifestyle choices on longevity. This, in turn, enables it to offer the most accurate assessment of a client's life expectancy and therefore offer the fairest price to them.

Partnership has the most comprehensive offering in the retirement sector and offers a complete range of Enhanced Annuity solutions, from clients who smoke or have minor health impairments, through to serious conditions such as cancer. Partnership is the largest provider of annuities for Long Term Care funding in the UK, with 80% of the market, and also offers specialist Protection solutions for clients who have been declined cover from standard providers. Partnership offers a firm commitment to supporting advisers in growing their business.

Key Issues

There are significant market failure issues which must be addressed by the consultation.

Not losing sight of the benefits of annuities - The continuing and enduring benefits of annuities must not be overlooked. Ideally they should be promoted. For many people in retirement, an annuity, which provides a guaranteed income for life, will be the best product.

Many important commentators, who understand that a low risk, simple and transparent product like an annuity provides peace of mind as a result of guaranteed income for life, have recognized this. The benefits of a guaranteed income from an annuity should be set against both the cautionary background of the recent catastrophic failure of equity markets and the explosion in life expectancies seen since the mid 1970's.

Seizing the opportunity to make the Pensions Annuity Market work using the Open Market Option - This consultation also provides an opportunity to ensure that the 80% of people in retirement with pension pots of under £30,000 that currently default into poor value annuities can genuinely exercise their choice to increase their income in retirement by shopping around for the best annuity rate (known as the Open Market Option or 'OMO'). It is an enduring public policy scandal that after 20 years, only one in three people shop around for the best annuity rate, with the majority defaulting into lower rates from ceding providers (Partnership's data shows that internal annuity transactions account for 62% of all annuities in 2009). This is despite the fact that many people might benefit by increased retirement incomes of up to 20% for life. This can be more, if they are among the 40% of people who are eligible for an enhancement for reasons of a medical or health condition (only 10% of whom currently do shop around).

The scale of the problem is significant and does need to be addressed urgently. Partnership's figures suggest that most average men and women retiring in the UK today can look forward to a State pension of under £6,000 per year, plus a private pension of around £2,000 a year (or in this latter case £40 per week).

Further recent analysis of the market by Partnership estimates that pensioners with funds of less than £40,000 who ignored the open market option last year, will receive £450 million less income for the rest of their lives. Last year people with health conditions missed out on 19 per cent income uplifts, equivalent to £311 million for the rest of their lives. This represents 69% of the total pension income missed by people with funds under £40,000 last year and suggests a significant inequality between the poorest and least well and wealthiest, where the majority of the latter (people with pension funds over £40,000 did shop around).

We believe that this can be supported by:

- *A True Wealth Warning and Pensions Passport for potential annuitants* - Partnership supports PICA (Pensions Income Choice Association) in its proposals to introduce a Pensions Passport. Partnership believes that a strongly worded Wealth Warning (please see response to A 2 below) and Pensions Passport if combined would play a significant role in assisting pensioners chose the best annuity for them and increase their income for life.

- *Clear information* – We believe the following information, which is a matter of public importance, should also be addressed as a result of this consultation:

Open Market Option (OMO) information split by premium amount. There is no mechanism to provide clear and transparent information about the OMO take up by fund size.

Fund information captured by person, rather than by fund size. This will enable us to get a true picture of pension provision and in particular what pension provision those individuals have who have collected a range of small personal pensions during the course of a career with multiple companies. (Again please see our response to A.2 below)

Both sets of data should be collected openly by the FSA.

Ensuring MIR is maintained at a 'healthy' level for changing retirement needs including Long Term Care - The needs of people in retirement will change significantly over the next decades, particularly among the oldest cohorts, who will require sources of funding for domiciliary care and residential care. Typical fees for many quality care homes can be up to £50,000. We have estimated that self funders (those people with over £23,250 in assets including property) who have depleted their capital prematurely and have had to fall back on the state costs local authorities in England alone nearly £1 billion a year. We have estimated that this will increase (according to prudent health inflation assumptions) to £2.75 billion in 20 years time. This must be factored into any MIR level. (Please see A.4)

Appropriately Prudent Capped Drawdown limit - Capped drawdown limits post age 75 must be monitored closely to reflect the very real risk that a person may live through several investment crises and live beyond the age of 100 years. Our stochastic models, demonstrate how cautious one needs to be in setting the limits for this capped drawdown category if the objective is to avoid people exhausting their funds. (Please see our response to A1)

Annuity innovation – through 'commutation' - This Consultation provides an important opportunity for the industry to start reflecting some of the benefits envisaged within the Consultation paper in a 'capped drawdown' scenario within annuity products themselves. By this we would welcome the opportunity for annuities, which provide a guaranteed income for life, to also provide 'commutation' options, where annuitants can defer income to a later phase of their retirement to meet their changing needs or indeed accelerate future income to today provided the MIR floor on the remaining annuity benefit is not breached.

The older a pensioner becomes the greater their needs for more income to cover, for example domiciliary care and residential care costs. This innovation will not just provide the comfort of guaranteed income but the flexibility to manage their retirement income to meet their needs. An increase in the range and type of guaranteed financial product for people in retirement will be a very welcome and possibly unforeseen benefit of this consultation. This should certainly help encourage more people to save for their retirement while providing much needed safeguards against asset volatility and ever increasing longevity.

Response to Annuity Consultation
Developing a new tax framework for retirement (Chapter 2)

A.1 The level of an appropriate annual drawdown limit for capped drawdown.

We welcome the capped and uncapped drawdown models and believe that the decision to put choice back in the hands of individuals is a very welcome step. It is important to ensure that the capped drawdown limits post age 75 reflect the very real risk that a person may live through several investment crises and live beyond the age of 100 years. Outline stochastic models demonstrate how cautious one needs to be in setting the limits for this capped drawdown category if the objective is to avoid people exhausting their funds.

For example one model we have developed for Capped Drawdown assumes the level of drawdown is fixed at outset and therefore is effectively modelling how quickly the fund is exhausted if one allows the income to remain constant. It shows that at older ages safe drawdown limits are well below annuity rates, **by age 75 It suggests anything over 50% of the age 75 annuity rate is potential unsustainable** as a proposal as funds will be exhausted too quickly.

Another model we have developed aims at identifying what the theoretically correct limits are at different ages. It allows for the drawdown process of limits that adjust over time and resets the maximum drawdown every fifth year by reference to the fund value at that point, assuming the Treasury's objective is to have a broadly level income profile, the theoretically correct drawdown limit (as % of annuity limit at outset) is the one that produces an approximately level income profile. **This suggests that at age 50 that is just below the annuity rate (not as high as current 120% limit)** but if one goes into drawdown **at age 75 the level needs to be between 33% and 50% of the annuity rate at age 75**.

We would also like to see an environment that fully harmonised the treatment (including tax treatment) of drawdown and 'unsecured pension' benefits. This would be consistent with the original intention of pension simplification e.g. one set of coherent rules for all pension products. The current situation adds to the consumer view that pensions are an overly complicated area and this can act as a deterrent to pension planning.

A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

We welcome the Government's approach and support its aims. We consider annuity purchase to be the best method of providing income from pension savings for a significant number of consumers (as more than 80% of fund values are less than £40,000) due to the certainty and guarantees that annuities provide. We expect the majority of retirees with private pension pots will continue to purchase an annuity before age 75 (due to retirement affordability) but we support the flexibility proposed. We expect the changes to apply to very few individuals.

One further area that we feel warrants serious consideration is the low take up of the Open Market Option (OMO).

True Wealth Warning and Pensions Passport - Partnership believes that a true Wealth Warning and 'Pensions Passport' (proposed by the Pension Income Choices Association (PICA)) if combined would play a significant role in assisting pensioners to shop around and get better retirement income outcomes.

A true wealth warning - We would request that ceding providers give a proper 'wealth warning' to potential annuitants highlighting not only: the annual amount they will offer the potential annuitant; but also comparison to the best 'Open Market Rate' that annuitant would be entitled to. The emphasis must be on the potential annuitant agreeing that they will accept responsibility for receiving less retirement income for life. They should also be notified that if they have a health condition they may be eligible for far more income.

Pensions Passport - Partnership supports PICA (Pensions Income Choice Association) in its proposals to introduce a Pensions Passport. PICA in its *Optimising Value in Retirement* report would improve the current process.

The three steps consist of a clear and easy to use form (a Pensions Passport) which:

- Focus on the choices and decisions people face at retirement and the action they need to take.

- Production of a personalised statement containing sufficient information for people to use to obtain quotations.

- Short communication requiring the member to inform the company/trustees how the fund should be applied.

All communications sent in this process are to be written in a clear, unbiased manner with as little jargon as possible. Those approaching and recently retired, when surveyed by PICA, agreed the three step process has raised their awareness of the open market option and how it could be used.

These actions will not only benefit these pensioners, who typically are among the poorest people in the UK, it will have a profound impact of the Government's exposure to means tested benefits.

Clear information - There are also two other areas of public importance which can be addressed as a result of this consultation.

Open Market Option (OMO) information split by premium amount. There is no mechanism to provide clear and transparent information about the OMO take up by fund size. We know that those people with the smallest funds (e.g. £10,000 and below) are among the least likely to shop around for the best annuity rate compared to those with significant funds (e.g. £100,000). We will seek to prove this by interrogating our own data compared to the market, however without clear transparent information capturing this, it will be extremely difficult to highlight the discrepancy between the two categories of potential annuitant, given that arguably, those people with smaller funds and facing far greater poverty in their retirement, will need as much income as possible. We would ask that the FSA collates and regularly publishes this information as soon as possible to ensure the consultation produces a better outcome for everyone, not just those with larger funds.

Fund information captured by person, rather than by fund size. This will enable us to get a true picture of pension provision and in particular what pension provision those individuals have who have collected a range of small personal pensions during the course of a career with multiple companies. This information again is important. Again we would suggest that this information should be collected openly by the FSA.

Minimum Income Requirement (Chapter 3)

A.3 What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

At face value compulsory escalation or indexation seems fair. However, it removes the individual choice and is particularly unfair for individuals who have lower life expectancy and would not benefit from escalation or indexation as they will not recover the lost income (if they had chosen a level non-escalating income). Furthermore, it may have the effect of reinforcing the view that insurers profit from early death. We are of the view that a level of uplift of say 20% (between level non-escalating and escalating incomes) would be an appropriate safe guard.

A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

The needs of people in retirement will change significantly over the next decades. This must be reflected in the MIR. The most significant impact will be among people aged over 85, who are now set to increase by over 60% in the next 20 years and people aged over 75 who will increase by around 70% in the same time period (Laing and Buisson 2009). In particular their requirements to find sources of funding for domiciliary care and residential care (the average age of our care policyholders who enter residential care is 87) which can be significant with typical fees for many quality care homes being £50,000. We have estimated that self funders (those people with over £23,250 in assets including property) who have depleted their capital prematurely and have had to fall back on the state costs local authorities in England alone nearly £1 bn a year. Clearly any MIR should take account of these new but no less important funding elements.

The value of an annuity purchase price as well as the annuity income should be assessed (as they are in the current system used in Ireland). A higher purchase price for younger individuals would seem logical but there should be enough flexibility to allow for individuals who have lower life expectancy to be assessed by the income measure in isolation.

A.5 Whether a different MIR should be set for individuals and couples.

This is a complex issue and individuals and couples both need to be accounted for due to, general speaking, the lower pension held by women in the UK. Therefore, there should be facility to ensure that the primary earner cannot reduce pension investments to the extent that a spouse is unable to show an appropriate level of MIR on the death of the primary earner and indeed may then fall back on means tested benefits.

A.6 How often the MIR level should be reviewed.

The MIR should be reviewed annually but linked to an established measure of 'national average earning' as the state pension will use this from April 2010 in order that individuals may plan adequate retirement funding strategies.

Additionally, we believe that making use of the same link to 'national average earnings' will ensure that pension savings and retirement incomes are on a level playing field (and prevent the type of confusion that multiple measures would generate).

A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

Use of the current self-assessment regime could be a useful way of assimilating retirement income into all individuals planning.

Additionally, as well as ensuring that the MIR is linked to 'national average earnings' only true retirement income such as State Pension and Registered Pension Scheme income should be assessed. As many other investment producing income can erode the value over time, which may lead to falling back on means tested benefits and therefore should not be considered.

The UK annuity market (Chapter 4)

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

There are two areas that warrant review due to the current unnecessary complexity that may have been unintended consequences of previous pension reform.

Firstly, we consider the second crystallisation requirement to be an unnecessary administrative burden on providers and individuals (Benefit Crystallisation Events 4 and 5A).

The second crystallisation requires assessment of the primary benefit crystallisation to the extent that any increase in the value of sums and assets in an Unsecured Pension fund is measured against the Lifetime Allowance and could occur when investment growth on an Unsecured Pension fund exceeds withdrawals.

We believe that the frequency of the second crystallisation resulting in a LTA recovery charge is very limited and does not justify the complexity, the efforts of providers and inconvenience to individuals in making the assessment. With regard to BCE 5A, we believe it is particularly unfair to involve 75 year old individuals in the complex assessment process.

We also believe that, because the sums and assets which result in a second crystallisation event arise from investment growth which is generally taxed, and not tax relieved contributions, it is in appropriate to apply a LTA recovery charge to this element.

Secondly, we believe that payments made by Lifetime Annuity providers after the purchase of annuity should no longer be the responsibility of the Registered Pension Scheme as required by Finance Act 2004, s161 (3) and (4)).

We consider it inappropriate that Registered Pension Scheme retain responsibility for unauthorised payments on behalf of a scheme member after a Lifetime Annuity has been purchased for that member and where the payment is made by the annuity provider without the knowledge or other involvement or influence of the Registered Pension Scheme.

It is our view that responsibility for an authorised payment should extend to the purchase price paid to the annuity provider. Thereafter, any payment made to the annuitant should be at the business risk of the annuity provider and considered neither authorised nor unauthorised under FA2004.

A.9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.

While we believe that the removal of compulsory annuitisation at age 75 gives a significant and welcome bolster to the concept of pension savings, it is our view that the number of individuals deferring annuity purchase beyond age 75 will continue to remain low and will be almost exclusively made up of affluent individuals with access to advice. We do not believe Government and other public bodies should focus resources on this issue and believe the resources should be directed to maximising the use of the OMO and facilitating a simpler shopping around process for consumers and especially those with small funds (who represent the significant majority of retirement transactions).

Our research and the research conducted by PICA shows that individuals using the OMO can increase their retirement income by 20% and, for individuals with health complications, by considerably more. We believe improving the income offered by annuities reduces dependency on the State and that State advertising would be offset by an increased tax take and less reliance on benefits.

Our research also shows that more than 80% of pension pots have a value of less than £40,000. The OMO generally provides individuals with increased income after remunerating financial advisers through a commission payment. However the level of commission on small pension pots makes it financially unviable for advisers to conduct the full financial review required by FSA best practice. It is generally accepted that small pension pots should be used to secure an annuity and the FSA itself states that funds of less than £100,000 should not normally be applied to unsecured pension contracts.

We propose that the Regulator introduces a simplified advice process for pension funds of less than £40,000 and remove the need to comply with the current full regulatory requirements and the administrative burden and expense that this causes.

A.10 Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

We firmly believe that the tax rate of 55% on return of funds is excessive and completely unjustified. It is a de-motivating factor and adds to the view of pension being complex. We would go further and state that this rate of tax (which is charged before any additional IHT liability) on death benefits prevents people considering 'value protection'. When 'value protection' should be viewed as a way of passing wealth between family members, which in turn would lift more people out of means tested benefits.

The consultation document acknowledges "There is widespread misconception that the balance of an individual's pension fund remaining on early death represents a profit on the part of the provider". In order to eliminate this misconception, annuities should be available without punitive taxation on a returned fund. We believe that most consumers seeking to protect their own pension fund would be higher rate tax payers and beneficiaries of the high rate tax relief. Increasing the tax charge from 35% to 40% would be acceptable and presented as a recovery of the tax relief previously granted on funds that are not ultimately used to provide retirement income.

We also propose tax free, or reduced tax, transfer of residual funds to pension policies held by other individuals who are not dependants of the principle, such as next generation family members. This allows individuals to feel assured of value for money as well as creating retirement provision for the next generation. Under the current regime a refund taxed at 35% could be bequeathed to an individual and subsequently invested in a pension with full tax relief. Our proposal has therefore limited tax implication and encourages pension investment.

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Response to HM Treasury Consultation “Removing the requirement to annuitise by age 75” by Partnership

Introduction

Partnership is delighted to have the opportunity to respond to HM Treasury’s consultation. We wish to congratulate the Government on this consultation, which provides a range of retirement funding options which will meet the Government’s objectives of ‘making savings … more flexible and attractive in order to encourage people to take greater responsibility for their financial future’.

This response sets out what Partnership is, examines the key issues and opportunities that this consultation provides the Government and then responds to questions in the Consultation in the order in which they are made.

Partnership

Partnership is a specialist provider of financial solutions for people with health/ lifestyle conditions, as well as those suffering from a serious medical impairment. Partnership was the first company in the UK to offer higher retirement incomes by taking account of people’s health and lifestyle conditions. It has been a consistent innovator developing this sector by championing the needs of those with even modestly reduced life expectancies.

Partnership has led the way in providing products designed specifically for individuals whose health and lifestyle is likely to result in a reduced life expectancy. Partnership is expert in the field of medical underwriting and has a unique in-house data set. Partnership believes that its years of accumulated data and knowledge give us a unique understanding of the impact of health and lifestyle choices on longevity. This, in turn, enables it to offer the most accurate assessment of a client’s life expectancy and therefore offer the fairest price to them.

Partnership has the most comprehensive offering in the retirement sector and offers a complete range of Enhanced Annuity solutions, from clients who smoke or have minor health impairments, through to serious conditions such as cancer. Partnership is the largest provider of annuities for Long Term Care funding in the UK, with 80% of the market, and also offers specialist Protection solutions for clients who have been declined cover from standard providers. Partnership offers a firm commitment to supporting advisers in growing their business.

Key Issues

There are significant market failure issues which must be addressed by the consultation.

Not losing sight of the benefits of annuities - The continuing and enduring benefits of annuities must not be overlooked. Ideally they should be promoted. For many people in

partnership

retirement, an annuity, which provides a guaranteed income for life, will be the best product. Many important commentators, who understand that a low risk, simple and transparent product like an annuity provides peace of mind as a result of guaranteed income for life, have recognized this. The benefits of a guaranteed income from an annuity should be set against both the cautionary background of the recent catastrophic failure of equity markets and the explosion in life expectancies seen since the mid 1970's.

Seizing the opportunity to make the Pensions Annuity Market work using the Open Market Option - This consultation also provides an opportunity to ensure that the 80% of people in retirement with pension pots of under £30,000 that currently default into poor value annuities can genuinely exercise their choice to increase their income in retirement by shopping around for the best annuity rate (known as the Open Market Option or 'OMO'). It is an enduring public policy scandal that after 20 years, only one in three people shop around for the best annuity rate, with the majority defaulting into lower rates from ceding providers (Partnership's data shows that internal annuity transactions account for 62% of all annuities in 2009). This is despite the fact that many people might benefit by increased retirement incomes of up to 20% for life. This can be more, if they are among the 40% of people who are eligible for an enhancement for reasons of a medical or health condition (only 10% of whom currently do shop around).

The scale of the problem is significant and does need to be addressed urgently. Partnership's figures suggest that most average men and women retiring in the UK today can look forward to a State pension of under £6,000 per year, plus a private pension of around £2,000 a year (or in this latter case £40 per week).

Further recent analysis of the market by Partnership estimates that pensioners with funds of less than £40,000 who ignored the open market option last year, will receive £450 million less income for the rest of their lives. Last year people with health conditions missed out on 19 per cent income uplifts, equivalent to £311 million for the rest of their lives. This represents 69% of the total pension income missed by people with funds under £40,000 last year and suggests a significant inequality between the poorest and least well and wealthiest, where the majority of the latter (people with pension funds over £40,000 did shop around).

We believe that this can be supported by:

- *A True Wealth Warning and Pensions Passport for potential annuitants* - Partnership supports PICA (Pensions Income Choice Association) in its proposals to introduce a Pensions Passport. Partnership believes that a strongly worded Wealth Warning (please see response to A 2 below) and Pensions Passport if combined would play a significant role in assisting pensioners chose the best annuity for them and increase their income for life.

- *Clear information* – We believe the following information, which is a matter of public importance, should also be addressed as a result of this consultation:

  Open Market Option (OMO) information split by premium amount. There is no mechanism to provide clear and transparent information about the OMO take up by fund size.

  Fund information captured by person, rather than by fund size. This will enable us to get a true picture of pension provision and in particular what pension provision those individuals have who have collected a range of small personal pensions during the course of a career with multiple companies. (Again please see our response to A.2 below)

  Both sets of data should be collected openly by the FSA.

Ensuring MIR is maintained at a 'healthy' level for changing retirement needs including Long Term Care - The needs of people in retirement will change significantly over the next decades, particularly among the oldest cohorts, who will require sources of funding for domiciliary care and residential care. Typical fees for many quality care homes can be up to £50,000. We have estimated that self funders (those people with over £23,250 in assets including property) who have depleted their capital prematurely and have had to fall back on the state costs local authorities in England alone nearly £1 billion a year. We have estimated that this will increase (according to prudent health inflation assumptions) to £2.75 billion in 20 years time. This must be factored into any MIR level. (Please see A.4)

Appropriately Prudent Capped Drawdown limit - Capped drawdown limits post age 75 must be monitored closely to reflect the very real risk that a person may live through several investment crises and live beyond the age of 100 years. Our stochastic models, demonstrate how cautious one needs to be in setting the limits for this capped drawdown category if the objective is to avoid people exhausting their funds. (Please see our response to A1)

Annuity innovation – through 'commutation' - This Consultation provides an important opportunity for the industry to start reflecting some of the benefits envisaged within the Consultation paper in a 'capped drawdown' scenario within annuity products themselves. By this we would welcome the opportunity for annuities, which provide a guaranteed income for life, to also provide 'commutation' options, where annuitants can defer income to a later phase of their retirement to meet their changing needs or indeed accelerate future income to today provided the MIR floor on the remaining annuity benefit is not breached.

The older a pensioner becomes the greater their needs for more income to cover, for example domiciliary care and residential care costs. This innovation will not just provide the comfort of guaranteed income but the flexibility to manage their retirement income to meet their needs. An increase in the range and type of guaranteed financial product for people in retirement will be a very welcome and possibly unforeseen benefit of this consultation. This should certainly help encourage more people to save for their retirement while providing much needed safeguards against asset volatility and ever increasing longevity.

Response to Annuity Consultation
Developing a new tax framework for retirement (Chapter 2)

A.1 The level of an appropriate annual drawdown limit for capped drawdown.

We welcome the capped and uncapped drawdown models and believe that the decision to put choice back in the hands of individuals is a very welcome step. It is important to ensure that the capped drawdown limits post age 75 reflect the very real risk that a person may live through several investment crises and live beyond the age of 100 years. Outline stochastic models demonstrate how cautious one needs to be in setting the limits for this capped drawdown category if the objective is to avoid people exhausting their funds.

For example one model we have developed for Capped Drawdown assumes the level of drawdown is fixed at outset and therefore is effectively modelling how quickly the fund is exhausted if one allows the income to remain constant. It shows that at older ages safe drawdown limits are well below annuity rates, **by age 75 It suggests anything over 50% of the age 75 annuity rate is potential unsustainable** as a proposal as funds will be exhausted too quickly.

Another model we have developed aims at identifying what the theoretically correct limits are at different ages. It allows for the drawdown process of limits that adjust over time and resets the maximum drawdown every fifth year by reference to the fund value at that point, assuming the Treasury’s objective is to have a broadly level income profile, the theoretically correct drawdown limit (as % of annuity limit at outset) is the one that produces an approximately level income profile. **This suggests that at age 50 that is just below the annuity rate (not as high as current 120% limit)** but if one goes into drawdown **at age 75 the level needs to be between 33% and 50% of the annuity rate at age 75**.

We would also like to see an environment that fully harmonised the treatment (including tax treatment) of drawdown and ‘unsecured pension’ benefits. This would be consistent with the original intention of pension simplification e.g. one set of coherent rules for all pension products. The current situation adds to the consumer view that pensions are an overly complicated area and this can act as a deterrent to pension planning.

A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

We welcome the Government's approach and support its aims. We consider annuity purchase to be the best method of providing income from pension savings for a significant number of consumers (as more than 80% of fund values are less than £40,000) due to the certainty and guarantees that annuities provide. We expect the majority of retirees with private pension pots will continue to purchase an annuity before age 75 (due to retirement affordability) but we support the flexibility proposed. We expect the changes to apply to very few individuals.
One further area that we feel warrants serious consideration is the low take up of the Open Market Option (OMO).

True Wealth Warning and Pensions Passport - Partnership believes that a true Wealth Warning and 'Pensions Passport' (proposed by the Pension Income Choices Association (PICA)) if combined would play a significant role in assisting pensioners to shop around and get better retirement income outcomes.

A true wealth warning - We would request that ceding providers give a proper 'wealth warning' to potential annuitants highlighting not only: the annual amount they will offer the potential annuitant; but also comparison to the best 'Open Market Rate' that annuitant would be entitled to. The emphasis must be on the potential annuitant agreeing that they will accept responsibility for receiving less retirement income for life. They should also be notified that if they have a health condition they may be eligible for far more income.

Pensions Passport - Partnership supports PICA (Pensions Income Choice Association) in its proposals to introduce a Pensions Passport. PICA in its *Optimising Value in Retirement* report would improve the current process.

The three steps consist of a clear and easy to use form (a Pensions Passport) which:

- Focus on the choices and decisions people face at retirement and the action they need to take.
- Production of a personalised statement containing sufficient information for people to use to obtain quotations.
- Short communication requiring the member to inform the company/trustees how the fund should be applied.

All communications sent in this process are to be written in a clear, unbiased manner with as little jargon as possible. Those approaching and recently retired, when surveyed by PICA, agreed the three step process has raised their awareness of the open market option and how it could be used.

These actions will not only benefit these pensioners, who typically are among the poorest people in the UK, it will have a profound impact of the Government's exposure to means tested benefits.

Clear information - There are also two other areas of public importance which can be addressed as a result of this consultation.

Open Market Option (OMO) information split by premium amount. There is no mechanism to provide clear and transparent information about the OMO take up by fund size. We know that those people with the smallest funds (e.g. £10,000 and below) are among the least likely to shop around for the best annuity rate compared to those with significant funds (e.g. £100,000). We will seek to prove this by interrogating our own data compared to the market, however without clear transparent information capturing this, it will be extremely difficult to highlight the discrepancy between the two categories of potential annuitant, given that arguably, those people with smaller funds and facing far greater poverty in their retirement, will need as much income as possible. We would ask that the FSA collates and regularly publishes this information as soon as possible to ensure the consultation produces a better outcome for everyone, not just those with larger funds.

Fund information captured by person, rather than by fund size. This will enable us to get a true picture of pension provision and in particular what pension provision those individuals have who have collected a range of small personal pensions during the course of a career with multiple companies. This information again is important. Again we would suggest that this information should be collected openly by the FSA.

Minimum Income Requirement (Chapter 3)

A.3 What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

At face value compulsory escalation or indexation seems fair. However, it removes the individual choice and is particularly unfair for individuals who have lower life expectancy and would not benefit from escalation or indexation as they will not recover the lost income (if they had chosen a level non-escalating income). Furthermore, it may have the effect of reinforcing the view that insurers profit from early death. We are of the view that a level of uplift of say 20% (between level non-escalating and escalating incomes) would be an appropriate safe guard.

A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

The needs of people in retirement will change significantly over the next decades. This must be reflected in the MIR. The most significant impact will be among people aged over 85, who are now set to increase by over 60% in the next 20 years and people aged over 75 who will increase by around 70% in the same time period (Laing and Buisson 2009). In particular their requirements to find sources of funding for domiciliary care and residential care (the average age of our care policyholders who enter residential care is 87) which can be significant with typical fees for many quality care homes being £50,000. We have estimated that self funders (those people with over £23,250 in assets including property) who have depleted their capital prematurely and have had to fall back on the state costs local authorities in England alone nearly £1 bn a year. Clearly any MIR should take account of these new but no less important funding elements.

The value of an annuity purchase price as well as the annuity income should be assessed (as they are in the current system used in Ireland). A higher purchase price for younger individuals would seem logical but there should be enough flexibility to allow for individuals who have lower life expectancy to be assessed by the income measure in isolation.

A.5 Whether a different MIR should be set for individuals and couples.

This is a complex issue and individuals and couples both need to be accounted for due to, general speaking, the lower pension held by women in the UK. Therefore, there should be facility to ensure that the primary earner cannot reduce pension investments to the extent that a spouse is unable to show an appropriate level of MIR on the death of the primary earner and indeed may then fall back on means tested benefits.

A.6 How often the MIR level should be reviewed.

The MIR should be reviewed annually but linked to an established measure of ‘national average earning’ as the state pension will use this from April 2010 in order that individuals may plan adequate retirement funding strategies.

Additionally, we believe that making use of the same link to ‘national average earnings’ will ensure that pension savings and retirement incomes are on a level playing field (and prevent the type of confusion that multiple measures would generate).

A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

Use of the current self-assessment regime could be a useful way of assimilating retirement income into all individuals planning.

Additionally, as well as ensuring that the MIR is linked to ‘national average earnings’ only true retirement income such as State Pension and Registered Pension Scheme income should be assessed. As many other investment producing income can erode the value over time, which may lead to falling back on means tested benefits and therefore should not be considered.

The UK annuity market (Chapter 4)

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

There are two areas that warrant review due to the current unnecessary complexity that may have been unintended consequences of previous pension reform.

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The second crystallisation requires assessment of the primary benefit crystallisation to the extent that any increase in the value of sums and assets in an Unsecured Pension fund is measured against the Lifetime Allowance and could occur when investment growth on an Unsecured Pension fund exceeds withdrawals.

We believe that the frequency of the second crystallisation resulting in a LTA recovery charge is very limited and does not justify the complexity, the efforts of providers and inconvenience to individuals in making the assessment. With regard to BCE 5A, we believe it is particularly unfair to involve 75 year old individuals in the complex assessment process. We also believe that, because the sums and assets which result in a second crystallisation event arise from investment growth which is generally taxed, and not tax relieved contributions, it is in appropriate to apply a LTA recovery charge to this element.

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While we believe that the removal of compulsory annuitisation at age 75 gives a significant and welcome bolster to the concept of pension savings, it is our view that the number of individuals deferring annuity purchase beyond age 75 will continue to remain low and will be almost exclusively made up of affluent individuals with access to advice. We do not believe Government and other public bodies should focus resources on this issue and believe the resources should be directed to maximising the use of the OMO and facilitating a simpler shopping around process for consumers and especially those with small funds (who represent the significant majority of retirement transactions).

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Covering email:

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The scale of the problem is significant and does need to be addressed urgently. Partnership's figures suggest that most average men and women retiring in the UK today can look forward to a State pension of under £6,000 per year, plus a private pension of around £2,000 a year (or in this latter case £40 per week).

Further recent analysis of the market by Partnership estimates that 70% of pensioners with pension funds under £40,000 ignored the open market option last year. This will lead to them to those people receiving £450 million less for the rest of their lives. Typically those people could look forward to 12% increase in income. However people with health conditions would gain even more, missing out on 19 per cent income for life, equivalent to £311 million for the rest of their lives or 69% of the total pension income missed by people with funds under £40,000. This suggests a significant inequality between the poorest and least well and wealthiest, where the majority of the latter (people with pension funds over £40,000 did shop around).

We believe that this can be supported by:

- A True Wealth Warning and Pensions Passport for potential annuitants - Partnership supports PICA (Pensions Income Choice Association) in its proposals to introduce a Pensions Passport. Partnership believes that a strongly worded Wealth Warning (please see response to A 2 below) and Pensions Passport if combined would play a significant role in assisting pensioners chose the best annuity for them and increase their income for life.

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Please find attached our full response. Should you wish to see our stochastic modelling used to assist with our consultation response please contact me directly.

Best regards.

Philip Brown

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BY EMAIL

Dear Sir/Madam

Removing the requirement to annuitise by age 75 - Response from The Pensions Advisory Service

Our background
The Pensions Advisory Service (TPAS) is an independent non-profit organisation, funded by grant-in-aid from the Department for Work and Pensions (DWP), which provides free information and guidance to members of the public on a wide range of pensions matters. It also provides a free dispute resolution and conciliation service for anyone who has a complaint or dispute with their pension provider. The service is sustained by a nationwide network of volunteer advisers supported and augmented by technical and administrative staff. All advisers at TPAS are pensions professionals with experience in the pensions industry and all act in accordance with the TPAS Code of Practice.

In answering the ten questions posed in the document, we have limited our response to this document to areas where we have had direct experience.

We also have some general comments to make.

A summary of the key points we have raised
- In our experience, the compulsion to purchase an annuity by age 75 is an issue that only affects a very small number of people;
- The requirement to annuitise by age 75 does cause problems for individuals who have lost contact with their pension provider;
- Consideration should be given as to whether the current five yearly review of the Unsecured Pension limits should be more frequent.
- A considerable number of people contact our service to check advice they have received elsewhere to use the Unsecured Pension rules simply to access their tax-free cash sum, taking nil income withdrawals;
- In our view, expanding the market to introduce more products is likely to make it more difficult for the vast majority of individuals to make a choice.

General comments on the topic under consultation

In our experience, the compulsion to purchase an annuity by age 75 is an issue that only affects a very small number of people. It is generally accepted by Unsecured Pension providers and advisers that individuals need a minimum ‘pot’ of retirement savings before it is sensible to draw an income instead of buying an annuity. The threshold varies among providers between £75,000 and £130,000. In addition, a relatively small proportion of people will have the confidence, financial capability and access to advice to take their income in a different way beyond age 75. However, for those who would be able to take advantage of the proposed changes, the impact on the individual is likely to be significant.

Our experience suggests that the requirement to annuitise by age 75 does cause problems for individuals who have lost contact with their pension provider. Where the provider has been unable to trace an individual at their normal retirement date, they will typically make another attempt shortly before the individual’s 75th birthday. If they are successful in tracing the individual, he or she will be at a disadvantage because they will have run out of time to secure a better deal through the ‘open market option’. If they are unsuccessful, the provider may buy an annuity on the individual’s behalf, with the individual having lost the right to a tax-free cash sum. However, we recognise that leaving funds invested or moving them into a suspense account instead also has risks and implications for untraceable individuals.

Developing a new tax framework for retirement (Chapter 2)

We generally support the five principles and the detail on them as set out in Chapter 2 of the consultation document.

A.1 The level of an appropriate annual limit for capped drawdown

Setting an appropriate annual drawdown limit for capped drawdown is largely a matter for the Government Actuary’s Department and actuarial commentators. However, we agree that it is a legitimate aim to set the rate in a way that helps to prevent capital being used up too quickly. We have recently been contacted by some individuals who have not fully appreciated the risks in taking maximum income withdrawals and who are now concerned at the very low level of their remaining Unsecured Pension fund. This suggests to us that consideration should be given as to whether the current five yearly review of the Unsecured Pension limits should be more frequent.

A considerable number of people contact our service to check advice they have received elsewhere to use the Unsecured Pension rules simply to access their tax-free cash sum, taking nil income withdrawals. This may be distorting the picture of how Unsecured Pension features in retirement planning i.e. if it were possible to take a cash sum at any time, then the Unsecured Pension facility would not be used so frequently. This may be an important consideration if government intends to introduce separate measures that allow early access to capital sums from retirement saving plans, as stated by Steven Webb, Minister of State for Pensions at the ABI Savings & Investments Conference on 13 July 2010.

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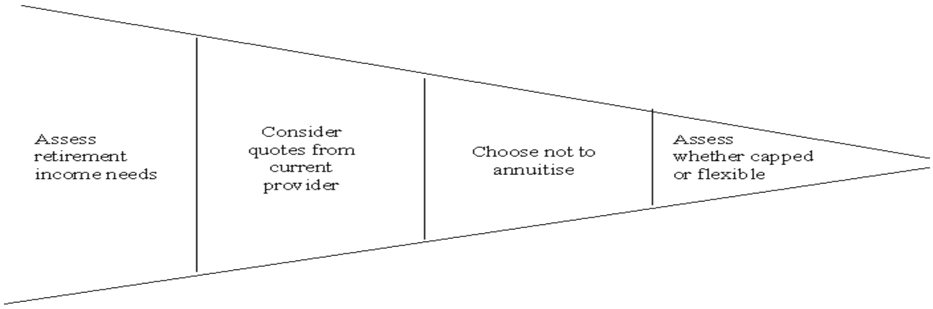
Minimum Income Requirement (Chapter 3)

A. 7 How to minimise burdens for individuals and industry in the assessment of the Minimum Income Requirement

We would expect individuals and their advisers to assess their secured income early on in the process of considering drawdown (which could be drawn as per the diagram below). This allows all parties to have a better appreciation of the significance of the information that will be needed when income is assessed against the MIR.



We would suggest that the information can be provided using pension documents that are common currency in the pensions industry at present, so that providers and plan trustees would not have to redesign processes and forms to satisfy the required test.

The UK annuity market (Chapter 4)

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

We perceive the market for compulsory purchase annuities to be limited and believe it may have limited opportunities for growth. Special annuities are expensive to cost and provide: longevity risks, the availability of matched assets and the difficulty of explaining and selling the products all have an effect on cost. Furthermore, if a provider increases its book of specialised annuities, it moves those annuitants out of the pool used to determine mainstream rates, pushing those rates down in turn. That of course makes the provider's annuity rates less competitive and less attractive to new business. The constraints of the Solvency II directive are expected to magnify these factors. Our experience is that individuals are confused by the wide choice of types of annuities available and do not understand how they are costed. In our view, expanding the market to introduce more products which are aimed at sophisticated investors is likely to make it more difficult for the vast majority of individuals to make a choice.

We believe that improving the trivial commutation rules to allow the December 2009 relaxation in the trivial commutation rules[1] to apply to **all** registered pension schemes up to a new limit of £5,000 (to be reviewed from time to time against the market) would help in this area too, by reducing costs for providers.

[1] Regulation 11, Registered Pension Schemes (Authorised Payments) Regulations 2009

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A. 9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.
The two main queries about annuities we receive from the public relate to:

- converting small, ‘uneconomic’ pots into useful income, and
- accessing the open market option to get the best annuity rate available.

The consultation document mentions at Section 1.4 that CFEB has been asked to help people make active choices about their pension saving and to choose appropriate products. We think that extending the availability and quality of advice to the majority of pension savers, who will be choosing to take an annuity, would have a greater impact on driving the culture of saving hoped for in this paper than the proposals set out in it. Given our specialisation in this complex area, we believe that we are well placed to assist people in gathering the information they need to make these choices.

Our on-line annuity planner was accessed by 29,000 people last year. Of those individuals who responded to our request for feedback, 96% found the planner useful and 93% used the information to make an informed decision about their annuity purchase. Our on-line annuity planner can be found at

http://www.pensionsadvisoryservice.org.uk/online-planners

We provide free impartial and independent information and guidance via our national telephone helpline, written enquiries and workplace seminars. Further details of our work can be found in our 2009/2010 Annual Review:

http://www.pensionsadvisoryservice.org.uk/publications/company-documents--reports

Yours faithfully

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Pensions Institute

ENDING COMPULSORY ANNUITISATION

Quantifying the consequences

A Pensions Institute report for policymakers, financial advisers, and pension scheme members

David Blake
Edmund Cannon
Ian Tonks

September 2010

Ending compulsory annuitisation: Quantifying the consequences

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List of abbreviations

ASP	Alternatively Secured Pension
BSP	Basic State Pension
CETV	Cash Equivalent Transfer Value
CFEB	Consumer Financial Education Body
CPI	Consumer Price Index
DB	Defined Benefit
DC	Defined Contribution
DMO	Debt Management Office
DWP	Department for Work and Pensions
EET	Exempt-Exempt-Taxed
FSA	Financial Services Authority
HMRC	Her Majesty's Revenue & Customs
ISA	Individual Savings Account
LPI	Limited Price Indexation
LGPS	Local Government Pension Scheme
MIR	Minimum Income Requirement
NEST	National Employment Savings Trust
NI	National Insurance
NRA	Normal Retirement Age
ONS	Office for National Statistics
RPI	Retail Price Index
SERPS	State Earnings Related Pension Scheme
S2P	State Second Pension
SIPP	Self-invested Personal Pension
USP	Unsecured Pension
VAR	Vector autoregression

Foreword

This is the eighth[1] of our series of reports that focus on pensions issues of direct relevance to policymakers, financial advisers, and pension scheme members.

The Conservative–Liberal-Democrat Coalition Government that came to power on 11 May 2010 announced that it was going to end the requirement for pension scheme members to purchase annuities by the age of 75.

We felt that this proposal would have some serious unintended consequences and wrote to The Times on 27 May 2010:

> *Sir, The new Government has confirmed manifesto promises to remove the requirement that individuals use their pension fund to buy an annuity at retirement. Such a policy would be popular, easy to implement and generate much needed tax revenues. However, we have grave concerns that this will have serious consequences for the security of pensioners' retirement incomes and the public finances.*
>
> *Without an annuity, retired people risk outliving their resources and also bear the responsibility of managing their financial assets. If things go wrong, they will surely turn to the taxpayer for help. The Conservatives propose a minimum annuity purchase, so pensioners never become eligible for means-tested benefits. We suspect that estimating such a minimum will be difficult, since benefits are calculated according to individual circumstances and these circumstances, together with the level of state support, are likely to change considerably over the next 30 years.*
>
> *The proposal could lead to significant changes in the nation's savings decisions and tax payments. It could also encourage members of occupational pension plans - including those in the public sector - to access their entire fund as a lump sum rather than receive it as income. This would turn the current steady decline in defined benefit pension plans into a rout, as pension fund sponsors - and that would include the Government - had to find cash immediately, instead of gradually over a long period into the future.*
>
> *We suggest that the seriousness of the unintended consequences of their pension policy is fully recognised and that the policy proposal is re-examined.*
>
> Professor David Blake, Director, Pensions Institute, Cass Business School
> Dr Edmund Cannon, University of Bristol
> Professor Ian Tonks, University of Exeter

http://www.timesonline.co.uk/tol/comment/letters/article7137165.ece

Following publication of the letter, we were approached by the Prudential and invited to prepare two reports that expanded on the ideas that were contained in the letter.

1. Previous reports are listed at the end of this document.

The first of these reports 'Ending compulsory annuitisation: What are the consequences?' published in July 2010 was designed to stimulate the debate about the proposal to end the mandatory requirement to purchase annuities in pension schemes as formally announced in the Budget Statement on 22 June 2010 and subsequently expanded upon in the HM Treasury consultation document 'Removing the requirement to annuitise by age 75' released on 15 July 2010.

This second report 'Ending compulsory annuitisation: Quantifying the consequences' is intended to provide a quantitative assessment of the issues raised in the first report. We also provide policy recommendations in relation to this proposal.

This research was sponsored by the Prudential and we are extremely grateful for their support. The Prudential has not sought to influence the conclusions of the report and they may not share or endorse the views expressed here. Furthermore, the Prudential have not imposed any conditions or requirements on the contents of the report.

We should also stress that the views in the report are those of the authors and not necessarily those of the Pensions Institute, which itself takes no policy position.

David Blake, Edmund Cannon and Ian Tonks
September 2010

Executive summary

1. The Government intends to end the requirement for defined contribution pension scheme members to annuitise their pension fund by the age of 75. This report provides a quantitative analysis of some of the key consequences of this policy.

2. We have calculated the level at which the Minimum Income Requirement would need to be set to have a minimal effect on demand for Pension Credit. We suggest that the total pension would need to be initially around £14,100 for an individual (including the BSP) and around £20,000 for a couple (including the BSP), rising in line with inflation. Further calculations which take account of uncertainty about wages and prices suggest that these levels are conservative and that there is a high probability that pensioners who annuitise to these levels will still receive significant amounts of benefits. We have not attempted to evaluate whether the total pension figures shown would meet people's actual expenditure needs throughout retirement. Given the complexity of the state benefit system and the variability in people's personal circumstances, we are unable to quantify the impact on demand for other means-tested benefits.

3. We estimate that 28 per cent of retiring pensioners with private pension savings would have sufficient pension wealth to secure a MIR at the levels outlined above. We also estimate that the minimum cost of the Pension Credit alone that these pensioners might eventually be able to claim is £83 million per annum (a total of £1.7 billion in present value terms when we add up across all future years). This figure does not include the cost arising from other means-tested benefits that we have been unable to quantify. It is crucially important for policymakers to recognise that these cost estimates are highly sensitive to the assumptions chosen, and that there is therefore a considerable risk to the public finances in setting the MIR too low. Using different but still plausible actuarial assumptions, for example, would double the cost of Pension Credit estimated above. So although this figure is uncertain, it is likely to be an under-estimate.

4. If the requirement to annuitise at age 75 above the MIR is abolished, and if instead individuals access flexible drawdown, we estimate that the compulsory purchase annuities market will shrink from its current value of £11 billion per annum to around £9 billion per annum. Further, the value of DC pension funds that could be accessed as a lump sum or drawdown product would be between £1 billion and £2 billion per annum.

5. We suggest that the proposal to abolish the annuitisation requirement for DC pension schemes will have an effect on the DB pensions market, either through DB members demanding similar rights under their scheme or through pension transfers. We suggest that if the same rules on annuitisation above a Minimum Income Requirement in the DC market are applied to the DB market, between £10.2 billion and £16.7 billion of DB pension fund assets may be accessed each year by the retiring cohort. We suggest that if the Government does not intend its proposals on the relaxation of annuity rules for DC pensions to apply to DB pensions, it will need to legislate to prevent this.

6. We argue that the proposal to abolish the annuitisation requirement will have an effect on the government bond market. If the retiring cohort of pensioners access their DC lump sums, we predict insurance companies will no longer need to hold government bonds in the same quantity to back their annuity products and would become net sellers of between £0.5 billion and £1.2 billion of gilts annually. Similarly if DB pensioners also access the lump sum equivalent of their pensions at retirement, DB pension funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. This liquidation of government debt will occur at a time when the Government is attempting to fund a huge budget deficit by issuing bonds.

7. Allowing pensioners to avoid annuitisation will make it possible for pension fund wealth to be used to escape inheritance tax. The consultation proposes a 55 per cent recovery charge. Since this merely cancels the tax relief on pension contributions of a higher rate taxpayer, such a charge may be insufficient to prevent higher-rate tax payers using pension wealth for inheritance tax planning which may result in a loss of tax revenues. However, the 55 per cent recovery charge would be penal for basic rate taxpayers. Differential treatment in this way may be perceived as unfair and result in political pressure for further changes.

8. Optimal decumulation investment strategies can be highly complex and need to take into account anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. Further, the optimal strategies are not static and involve complex choices about, say, the optimal timing of annuity purchases. However, these strategies typically fail to take into account the cognitive problems that elderly people can face when dealing with investments. The proposed change to the pensions annuity market represents a shift from a "consumption frame" to an "investment frame". We also report that, whether as a result of cognitive impairment or an inappropriate framing of choices, many older adults will find it difficult to make sensible decisions about how to invest and spend their retirement savings. The Government could find itself embroiled in another mis-selling scandal and this time involving vulnerable elderly people.

9. The Government's proposals are likely to lead to an increase in the variability of outcomes for pensioners. As a consequence of this: (i) there is the risk of increasing long-term political pressure from the retired population for a larger share of the national cake and (ii) there is the risk of increased poverty among pensioners who make poor decisions with their wealth.

1. Introduction

The Conservative–Liberal-Democrat Coalition Government that came to power on 11 May 2010 announced that it intended to end the requirement for defined contribution pension scheme members to purchase annuities by the age of 75. This was formally confirmed in the Budget Statement of 22 June 2010. The Finance Bill 2010 of 1 July announced that the minimum age for annuitisation would be raised to 77 years as a transitional measure to defer compulsory annuitisation while further consultation on rule changes takes place. On 15 July 2010, HM Treasury published a consultation document, 'Removing the requirement to annuitise by age 75', which outlined the Government's proposals. The consultation paper emphasises that the tax treatment of pension savings should continue to follow the "exempt-exempt-taxed" (EET) model, but suggests three important changes: (i) there will be no requirement to annuitise DC pension funds at age 75, and instead individuals can either choose to access their pension funds through capped drawdown (similar to the current unsecured pension or USP) or access their funds as a lump sum through flexible drawdown; (ii) in the case of flexible drawdown, the intention is to establish a minimum required annuitisation level, based on a Minimum Income Requirement (MIR); and (iii) the introduction of a tax relief recovery charge on capital withdrawals at death to recover the value of the tax relief made available during the accumulation phase of the pension scheme.

In an earlier report 'Ending compulsory annuitisation: What are the consequences?' published in July 2010, we attempted to identify some of the issues and consequences of the Government's decision to end compulsory annuitisation. We argued that these consequences fell into two categories, those that affect individuals and those that affect the wider society in terms of claims on the public purse.

It is difficult for rational, well-informed individuals to run down retirement assets at the appropriate rate: spending too quickly results in exhausting assets and lower welfare in later retirement, while spending too slowly results in under-consumption and leaving unintended bequests. The advantage of an annuity is that it overcomes both of these problems. The advantages are even larger for individuals who have low levels of financial literacy, poor understanding of longevity risk or are less than completely rational, since an annuity protects them from making serious mistakes. It also prevents them from gaming the system to increase entitlement to means-tested benefits.

The consequences of the policy change for taxpayers could be equally devastating. Not only could there be a huge increase in claims for means-tested benefits, there could also be demand from defined benefit scheme members, including public sector workers in unfunded schemes, to have their pension as a lump sum rather than as an income. There will also be new opportunities to use the pension system to create tax loopholes and there is likely to be a fall in the demand for long-term government bonds which will occur at precisely the time the Government is issuing debt to plug the hole in the Government finances. To mitigate these problems, the Government is proposing a minimum level of annuitisation in order to satisfy a MIR, with the minimum set at a sufficiently high level that pensioners could never fall back upon means-tested benefits. While this goes some way to dealing with the consequences listed above, we highlight a number of problems with determining what the minimum level should be, chief among these being the wide differences in individual circumstances.

Existing pensions policy is premised on tax exemptions being given to pension funds in exchange for those funds being used to generate a life-long pension income: compulsory annuitisation was the quid pro quo for tax relief. It is worth asking why the policy should be changed now. Willetts (2010) has observed that the baby boomer generation seems to have benefited at the expense of both previous and younger generations. We know that previous generations accepted compulsory annuitisation. The pension prospects of future generations look increasingly bleak: younger generations tend to have very little pension savings and many are likely to have to annuitise all of their pension funds under the MIR. This might result in a curious outcome, namely that the relaxation of the compulsory annuitisation requirement will only really benefit the current generation coming up to retirement (and then only a small subset of that generation). This might be perceived as generationally unfair. Further, there is a risk that many people will substitute income for capital and will be less likely to spend that capital to meet day-to-day expenses. This will lead to further demands for state support in areas such as health care, long-term care and winter fuel payments. The reforms may also result in a greater disparity of outcomes as a result of poor investment choices or excessive expenditure. This would lead to further demands for state support in addition to any demand for support from existing means-tested benefits.

One possible answer to the issue of intergenerational fairness is that by allowing individuals to avoid annuitisation they are able to pass on more wealth to their heirs. In fact, the consultation document makes it clear that "the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance" (¶2.2). But even if the policy did allow more wealth to be passed to the future generation by inheritance, only the relatively rich would benefit and this would contribute to the UK's twin problems of increasing inequality and falling social mobility, precisely one of the points that Willetts sees as an intergenerational problem.

The importance of this point is difficult to quantify and for the rest of this follow-up report, we concentrate on quantifying the more strictly economic effects of the policy of removing the annuitisation requirement. In particular, we will address the following issues, providing quantitative assessments where possible:

(i) determining the likely size of the Minimum Income Requirement (Section 2);
(ii) estimating the numbers of pensioners expected to satisfy the MIR and the value of the
means-tested benefits they might eventually claim (Section 3);
(iii) quantifying the impact on annuity markets (Section 4);
(iv) quantifying the impact of the proposal on DB schemes (Section 5);
(v) quantifying the impact of the proposal on the long-term government bond markets (Section 6);
(vi) examining the cognitive problems that elderly people can face when dealing with investments (Section 7);
(vii) considering the effect of the 55 per cent recovery charge on future savings decisions and inheritance (Section 8);

Based on our analysis in the previous sections, Section 9 provides our responses to the questions raised in the consultation document

2. Calculating the Minimum Income Requirement

Chapter 3 of the HM Treasury consultation document considers the Minimum Income Requirement (MIR). The primary purpose of the MIR is to ensure that a pensioner does not "exhaust their pension savings prematurely and subsequently fall back on the state" (¶ 3.2). Given the complexity of the state benefit system, it is impossible to devise a MIR which completely precludes pensioners receiving means-tested benefits and the consultation document recognises this by stating that the MIR must be a "reasonable proxy" which ensures that the "probability of falling back on the state is minimal" (¶ 3.12).

A further complication is that calculation of the MIR is dependent upon the future path of inflation and earnings. Based on projections of these variables over the next 35 years, we first calculate the MIR that ensures a pensioner would receive no Pension Credit or Guarantee Credit before the age of 100. We then consider a more sophisticated approach which quantifies the uncertainty surrounding projections so far into the future and use this to calculate an alternative MIR.

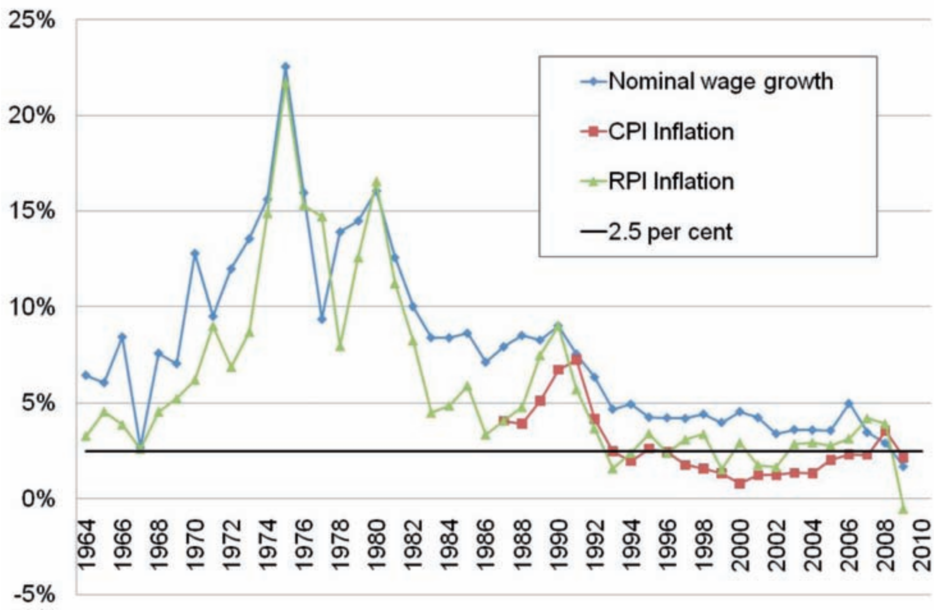
Benefits such as Housing Benefit and Attendance Allowance are dependent on tenancy and health status, respectively. The interaction of these benefits with other benefits, pension income and wealth is complicated and we ignore them in this analysis. However, the impact of these benefits along with Council Tax Benefit and long-term care support are potentially significant.

2.1 The MIR based on fixed projections of future inflation and earnings

Pensioners who have made a full set of National Insurance contributions throughout their working life will receive the full Basic State Pension (BSP), which is currently £97.65 per week for individuals and £156.15 per week for couples (respectively, £5,077.80 and £8,119.80 per year). However, Guarantee Credit ensures that the minimum income actually received is £132.60 for individuals and £202.40 for couples (£6,895.20 and £10,524.80 annually) and Pension Credit ensures that they receive benefits if their pension income is less than £9,620 and £14,130, respectively.

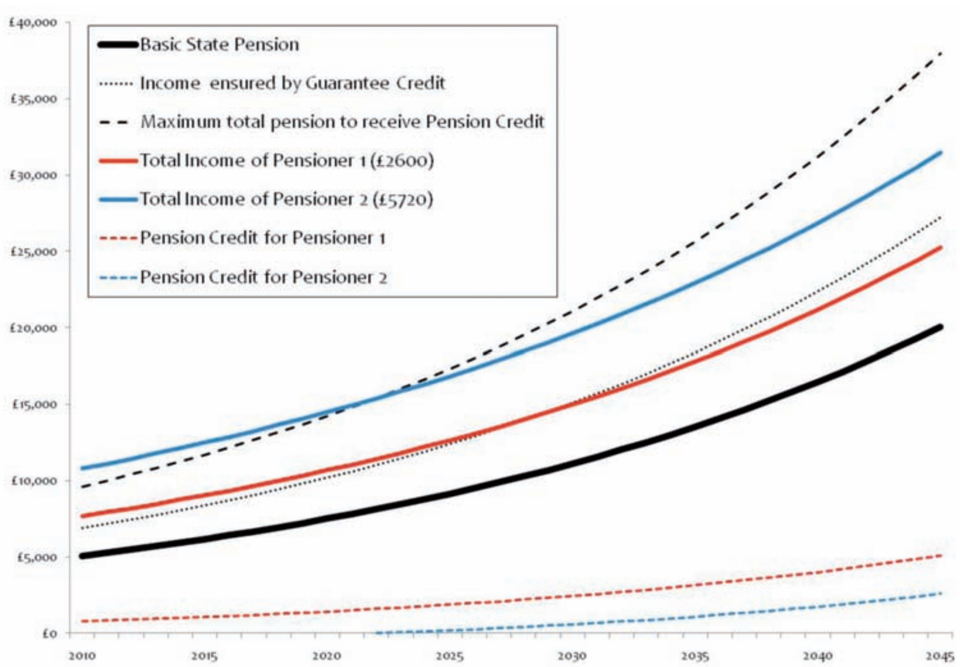
The June 2010 Budget announced a "triple guarantee" that BSP and entitlement levels would rise at the minimum of average earnings, 2.5 per cent or inflation (measured using the CPI). We show the history of these variables since 1964 in Figure 2.1, together with the RPI measure of inflation as the CPI is not available before 1988. Nominal wages have grown faster than prices in every year of the period 1993-2009 except 2009, when both wage growth and inflation were less than 2.5 per cent and 2007-8 when RPI was above wage growth. The average rate at which pensions would have grown over this period were the new policy to have been in place since 1964 is almost exactly 4 per cent per year.

Figure 2.1: Wage growth and price inflation



Assuming this 4 per cent growth in pensions continues into the future, we illustrate what might happen to the BSP and the entitlement limits in Figure 2.2 for the next 35 years (i.e., for the case of a pensioner currently aged 65 until they are 100). The solid black line shows what might happen to the BSP over the period; the dotted line shows the minimum income assured by Guarantee Credit; and the dashed line shows the maximum level of total pension income that a pensioner can have without receiving any Pension Credit.

Figure 2.2 Evolution of pension benefits



We now consider what would happen to a pensioner's private pension. For the purposes of this analysis, we mean this to include the sum of any occupational or personal pensions that an individual has and, in addition, include any SERPS or S2P.[2] The consultation document suggests (¶ 3.8, ¶ 3.9) that the MIR would include the caveat that the income would grow in line with Limited Price Indexation (LPI). LPI is defined as the lower of 2.5 percent and CPI-based inflation. From the data in Figure 2.1, the CPI-based measure of inflation has averaged 2 per cent over the period 1993-2009 and we assume that the pension grows at the same rate going forward.

Because the triple guarantee means that state pension entitlements can never grow by less than 2.5 per cent and since LPI means that private pensions need not grow by more than 2.5 per cent, it is inevitable that state pension entitlements will grow faster than any LPI-linked secured income source used to meet the MIR. Figure 2.2 illustrates this for two hypothetical pensioners. In both cases, we assume that they have no income other than their pension (i.e., they have no earnings and their total non-pension savings are less than £10,000).

Pensioner 1 has a relatively small pension fund and purchases an LPI-linked annuity starting at £2,600 per year (£50 per week). Together with the BSP, this means that his total pension income is £7,678: the growth of total BSP and private pension income is illustrated by the red line. Given his low pension income, he receives both Guarantee Credit and Pension Credit. Over time, his income rises less rapidly that the growth rate in these two means-tested benefits and, by about 2029, it is less than the minimum guaranteed. His means-tested benefits become gradually more generous over time (growing at an average of 5.5 per cent per year).

Pensioner 2 has a larger pension fund and is able to purchase an LPI-linked annuity starting at £5,720 per year (£110 per week); combined with the BSP, this makes a total of £10,798 per year (illustrated by the blue line). This means that his pension income is sufficiently high that he is not initially eligible for means-tested benefits. Because Pensioner 2's pension grows more slowly than the state entitlement cut-offs, he will become eligible for Pension Credit by 2022.

The key issue here is that the cut-offs for means-tested benefits will typically grow at the rate of (nominal) earnings and this will nearly always be higher than the rate of growth for a pension indexed by LPI.[3] We may establish the MIR with reference to the pension income streams in Figure 2.2. We need to identify a total pension income stream that intersects the maximum total income that just receives Pension Credit (the dashed line in Figure 2.2), for a pensioner aged 100 in 2045. This intersection establishes that such a pensioner would just fall into the entitlement to Pension Credit. We then track this level of pension income back to 2010.

2 The State Second Pension is based on two factors: (i) the number of years that an individual has paid NI contributions while not contracted out into an occupational pension (i.e., they are alternatives not complements); (ii) a measure of career average income (where salaries earned in earlier years are adjusted for inflation to make them comparable in real terms). Such pensions have only been in existence since 1978 when the policy was introduced as the State Earnings Related Pension Scheme (SERPS): significant changes were made in 2002 when the scheme was renamed the State Second Pension Scheme. This means that the maximum number of qualifying years earned so far is 32. Since the pension is 20 per cent of the career average income (which is itself limited by a cap) the maximum S2P is only about £3000. In the data sources we use below it is difficult to separate the S2P from the BSP. Any SERPS or S2P will contribute to the MIR automatically, since it rises in line with inflation.

3 One solution to this problem would be that pensions had to grow in line with wages to meet the MIR. Such annuity products are currently unavailable and it is difficult to see how life insurers could provide them in the absence of earnings-linked bonds (currently only RPI-linked bonds are available). We do not consider this possibility further.

Under the assumptions we have made so far about earnings and the LPI, we estimate

- the MIR for a 65-year old individual in 2010 would be £14,100.

This figure is inclusive of the BSP and so requires a minimum annuitisation of £9,000 per year (£173 per week) on top of the BSP. The MIR will ensure that he is ineligible for Pension Credit before the age of 100. The probability of a 65-year old man living to be more than 100 is currently projected to be 8 per cent.

It might be argued that to pay means-tested benefits to 8 per cent of the population is a sufficiently small cost that it would satisfy the condition in the consultation document that the costs be minimal. However, the probability of a 65-year old woman living to 100 is currently projected to be 26 per cent: there is an 8 per cent probability that the woman could live to 107. To ensure that only 8 per cent of women received means-tested benefits, it would be necessary to have an annuity whose initial payment was £10,300, 14 per cent higher than for a man.

So far we have been talking in terms of individual pensioners. But most pensioners at retirement, are in couples and for them the BSP and the entitlement cut-offs are different. Using similar analysis to the above, we estimate that

- the MIR for a couple should be £20,000 including the married couple's state pension.

We suggest that a couple would have to buy a joint annuity initially paying £11,900, but which would revert to £9,000 (the same as for an individual) upon the death of the first partner.

2.2 The MIR based on stochastic projections of future inflation and earnings

All of our analysis so far ignores the random nature of earnings and prices and the resulting uncertainty in predicting the future paths of pensions. As Figure 2.1 makes clear, wage and price inflation has in certain years been both considerably higher and considerably lower than the 4 per cent average we have used for the fixed projections.

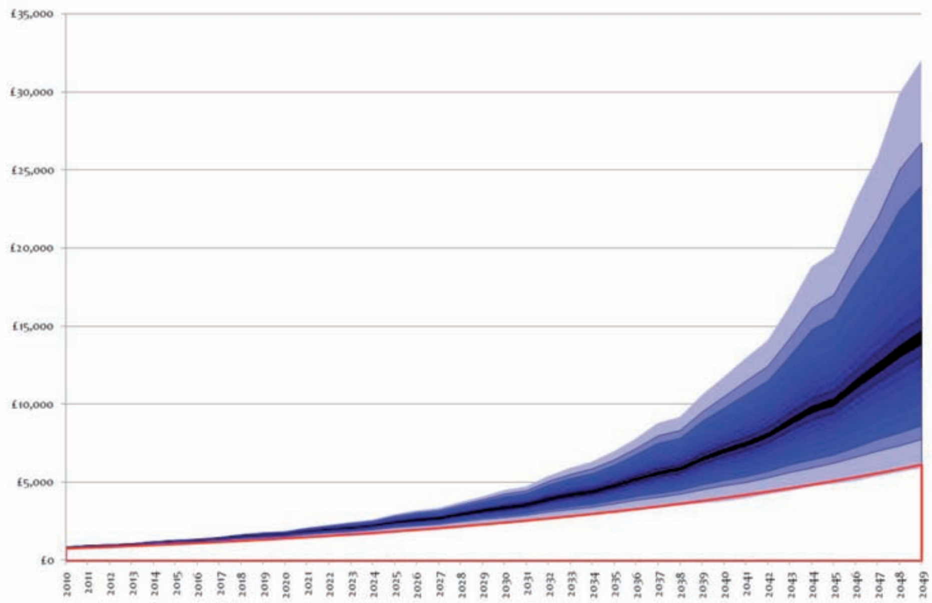
We now extend our analysis by projecting the future paths of inflation, earnings and pensions assuming the same level of variability in inflation and earnings that was observed in the period 1993-2009: this period can be considered to be one of reasonable price stability.

Based on these data, we estimated a simple econometric model of real wages and the CPI and use it to simulate possible growth paths for nominal wages and inflation. This allows us to calculate the pension payments that would be made for each growth path.[4]

4 The technical details are as follows: we modelled real wages rather than nominal wages since nominal wages are so highly correlated with inflation. The model was a two-lag vector autoregression (VAR) model which included real wage growth, CPI inflation and RPI inflation (for comparison purposes of RPI-linked pensions). The use of two lags was based upon the finding that the second lag was significant in all regressions. The model implicitly makes identifying assumptions that real wages and prices are I(1) but are not cointegrated. Projections were based on the parameter estimates from the VAR (treated as certain) with Monte Carlo disturbances drawn from a multivariate Normal distribution whose covariance matrix was taken directly from the VAR estimation. All the programming was done in OX.

Our results are illustrated in the form of a blue fanchart in Figure 2.3 for Pensioner 1 from the example above. Recall that Pensioner 1's initial private pension income is £2,600 and grows by LPI. The black line in the middle is the central estimate (i.e., the median) and successively lighter shades of blue reflect lower probabilities.[5]

Fig 2.3: Simulations of the distribution of means-tested benefits for Pensioner 1



The bright red line at the lower end of the fan chart is the line taken from Figure 2.2 which assumed complete certainty. Note that almost the entire fan chart lies above this line. The reason for this is that the effect of uncertainty is a one-way bet: LPI means that the private pension nearly always increases by less than 2.5 per cent (bounded below by zero), whereas the state benefit cut-offs nearly always increases by more than 2.5 per cent and can increase by quite a lot more.

Given the upsided nature of the risk to means-tested benefit levels when inflation uncertainty is taken into account, this suggests that the MIR should be set at a considerably higher level than that indicated in the model above assuming fixed future inflation. Our criterion then was to set the MIR to ensure that no benefits would be received before age 100. When we account for risk, we need a different criterion, so instead we look at the expected present value of means-tested benefits that an individual pensioner will receive if they buy an LPI-indexed annuity. Our results are shown in the second column of Table 2.1.

5 Each successive change in colour is the boundary of a 5-percentile range (on some computers it may be difficult to distinguish all of the colours)

Table 2.1: Means-tested benefits payable to 65-year-old pensioners with different starting pensions

Starting LPI-linked pension payment (£ per year)	Expected present value of Pension Credit		
	Male using "Lives" (PML92, sc)	Males using "Amounts" (PMA92, sc)	Females using "Amounts" (PFA92, sc)
520	39,146	48,129	61,398
1,560	32,684	40,783	52,937
2,600	26,222	33,437	44,475
3,640	19,760	26,092	36,013
4,680	13,298	18,746	27,552
5,720	8,240	12,819	20,520
6,760	5,184	8,955	15,606
7,800	3,335	6,389	12,077
8,840	2,201	4,648	9,479
9,880	1,501	3,455	7,543
10,920	1,054	2,618	6,074
11,960	761	2,019	4,945
13,000	562	1,581	4,065
14,040	425	1,257	3,371
15,080	327	1,010	2,816

The figures in the first column arise from putting weekly amounts on to an annual basis (i.e. they are multiples of 52).

Table 2.1 shows that the expected present value of all means-tested benefits to Pensioner 1 is £26,222, given his initial pension of £2,600. This might seem a relatively small sum compared with the potentially large sums that could be paid out in future years as shown in Figure 2.3. But Figure 2.3 takes no account of the fact that payments made a long way in the future need to be discounted heavily and that the probability of making those payments is also small because the further ahead these payments are due, the less likely the pensioner is to be alive to receive them. So although Figure 2.3 shows the median means-tested benefit payable to Pensioner 1 in 2045 (when he will be 100) to be over £10,000, the probability of Pensioner 1 being alive then is about 8 per cent and the effect of discounting £1 paid in 2045 to today's values reduces it to about 24 pence. So the expected present value of the possible £10,000 payment in 2045 is about £192.

Given this, Table 2.1 provides a method for setting the MIR, once the maximum acceptable level of means-tested benefits has been decided. Suppose £1,000 per year would be acceptable for example: then the MIR for a single male should be set at about £16,000 per year, including BSP.

This is a relatively high level of pension and anyone receiving such a high pension is likely to have a much higher life expectancy than a typical pensioner. We therefore re-calculated the net present value of Pension Credit using "Amounts" rather than "Lives" tables and report our results in column 3 of Table 2.1. We calculate the corresponding figures for women and these are in column 4.[6] This results in much higher figures. Although we do not use these in our analysis below, their intention is to show that our estimates are likely to be conservative and the costs to the tax payer may eventually be much higher.

2.3 The MIR and employment income

The consultation document makes it clear that the MIR must be in payment if the pensioner is to be allowed to access the rest of their pension fund and is confined to pension income (¶3.6 and ¶3.7): earnings and non-pension investment income are excluded. This is clearly correct since a pensioner will eventually choose or be forced to stop work and there is therefore no guarantee that they will continue to meet the MIR once employment ceases.

Many pensioners receive income from employment and this number is likely to increase with the removal of the default retirement age, the raising of the state pension age and the need for people with insufficient pension savings to continue to work.

It is difficult to see how a simple policy could be framed that allowed a pensioner to use earned income to meet the MIR in the short run without then creating a significant risk that they will fall back on means-tested benefits when employment ceased. For this reason, we support the proposal that the full MIR should be secured upon accessing the pension fund, regardless of employment income.

2.4 Means-tested benefits in the short run

Current pension policy allows pensioners to purchase a level annuity (i.e., one that is not indexed to any measure of inflation). For a given purchase price, these provide a much higher level of starting income. Were policy to make it compulsory to purchase a LPI-indexed annuity, it would result in many personal pensioners having a lower retirement income initially, although since it will be growing they will have a higher income in the future than if they had bought a level annuity.

A consequence of this would be that relatively poor pensioners are likely to receive more means-tested benefits upon annuitising, because they will have a

6. The "Lives" tables calculate the simple average mortality across all private pensioners. The "Amounts" tables weight by size of pension, so that richer (and therefore more longer-lived) pensioners have a disproportionate effect on life expectancy. Details can be found in Cannon and Tonks (2008).

lower income than they would have had if they had purchased a level annuity. This may be compensated for by them having lower means-tested benefits in the future. This effect will be amplified over time with the shift towards DC pensions meaning that the long-term impact on demand for means-tested benefits (and therefore the potential interaction with the MIR) will be greater.

The total effect on means-tested benefits, measured by the expected net present value, is likely to be roughly neutral, but means-tested benefits will certainly rise in the short run. We have not attempted to quantify this because of the difficulty in finding information on proportions of pensioners with different types of indexing arrangements.

Summary

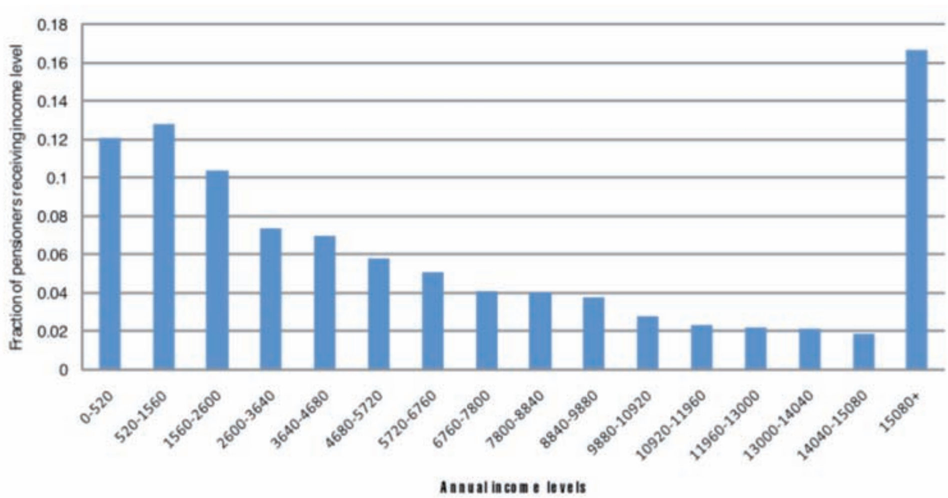
We have calculated the level at which the Minimum Income Requirement would need to be set to have a minimal effect on demand for Pension Credit. We suggest that the total pension would need to be initially around £14,100 for an individual (including the BSP) and around £20,000 for a couple (including the BSP), rising in line with inflation. Further calculations which take account of uncertainty about wages and prices suggest that these levels are conservative and that there is a high probability that pensioners who annuitise to these levels will still receive significant amounts of benefits. We have not attempted to evaluate whether the total pension figures shown would meet people's actual expenditure needs throughout retirement. Given the complexity of the state benefit system and the variability in people's personal circumstances we are unable to quantify the impact on demand for other means-tested benefits.

3. Numbers of pensioners expected to satisfy the MIR and the value of the means-tested benefits they might eventually claim

In this section, we estimate the number of pensioners likely to satisfy the MIR and the likely cost of means-tested benefits that will be payable if the MIR is set at the levels suggested in Section 2.

The mean average annual private pension income for recently retired pensioners who have a private pension is £3,536 for individuals and £9,568 for couples. From the data sources available, we are unable to separate the distribution of the recently retired from all pensioners or to separate couples from individuals. Nevertheless, it is clear from Figure 3.1 that the distribution of private pension income is very highly skewed to the right. In numerical terms, the median pension is only 61 per cent of the mean.

Figure 3.1: Distribution of total private pension income (weekly income)



Source: DWP(2010) Pensioners' Income Series

It is also clear from this figure that most pensioners have less than our estimates of the annual MIRs of £14,100 and £20,000, for individuals and couples, respectively.[7]

Because of the deficiencies of Figure 3.1, we combine the information in this figure with that in DWP (2010, Tables 2.3, 2.4 and 3.9). This suggests that the mean of the distribution of pensioner income is £168 per week and that the means of recently retired pensioner couples and individuals are £184 and £68, respectively. We use these figures to make simple mean shifts to the distribution in Figure 3.1 and then calculate the resulting proportions of these distributions.

7 These figures are calculated from the weekly averages for occupational and personal pension income in Table 2.3 of DWP (2010). These figures under-estimate the total pension figure that we need since they do not include pension income from SERPS/S2P which is aggregated with the BSP in the Table.

There are likely to be compositional effects in the distribution, which this assumption ignores, and this should be borne in mind when interpreting the subsequent calculations. A summary of our results is shown in Table 3.1.

Table 3.1: Estimates of the number of pensioners affected and the cost of means-tested benefits

	Number of Pensioners (000)	Proportion with private pension (%)	Proportion with income in excess of MIR (%)	Total expected NPV of means-tested benefits (£million)
Male individual	120	54	17	£10.8m
Female individual	68	54	5	£2.8m
Couples	248	75	32	£3.6m
Survivors*				£66.2m
Total			**28**	**£83.4m**

Note: * derived from an actuarial model and the initial number of couples

To illustrate, there are approximately 120,000 single male pensioners, of whom 54 per cent have a private pension. From our estimate of the distribution of pensions for single males, we estimate that 17 per cent of those with a pension would not receive Pension Credit if they annuitised all of their pension wealth, but by annuitising less (just sufficient to meet the MIR) they will receive some Pension Credit. We perform the same calculations for female individuals and also for couples. The total proportion of all retiring individuals who have pension savings (so a couple counts twice) affected is 28 per cent.

We now do a further calculation to estimate the costs. We assume that individuals remain as individuals, but recognise that couples are likely to become individuals as one partner dies (we ignore family creation and divorce, etc). We construct a simple actuarial model to work out the time path of the number of survivors from couples where one member dies.[8]

From actuarial tables, we can forecast the expected number of individuals, couples or survivors still alive at any point in the future. Using the model of inflation and earnings described in Section 2.2, we generate a series of tables analogous to Table 2.1 for males, females, couples and survivors using the appropriate amounts from the distribution as starting values and sum across the distribution. So, for example, the increase in the expected present value of Pension Credit to male individuals is £10.8 million per annual cohort that retires. This sum may sound rather small, but consider the following: many male individuals would have received means-tested benefits anyway; some individuals die before receiving any means-tested benefits; those who do receive means-tested benefits tend to receive them a long way into the future and so the present value is small.

8. This is based on actuarial tables PM/FL92 short cohort and assumes independence of deaths. All of the calculations in this section are based on "Lives" mortality.

The figure is even smaller for female individuals, mainly because female individuals have such small pensions to start with that they are likely to receive means-tested benefits regardless of the new policy. The group which is most likely to receive Pension Credit despite having the MIR is couples, although by the time that they receive the money one of the members of the couple is likely to have died and so only the survivor will benefit.

Summing across the different groups we see that the total cost for a single year's retirees is about £83 million. The total cost of the policy is the cost of all future years' retirees summed together (and appropriately discounted). However, the distribution and level of private pensions is likely to vary considerably between cohorts. Given data limitations, we have not attempted to calculate this directly, but instead use an annuity factor of twenty to obtain a total cost in the region of £1.7 billion.[9]

However, we believe this figure to be an under-estimate for two reasons. First, we have omitted some of the means-tested benefits that pensioners would receive (Attendance Allowance, etc). This is necessary due to limitations on data that are too restrictive for us to perform reliable calculations: as detailed in our first report, the rules for receiving such benefits are complicated and depend upon both income and wealth. Furthermore, historical data would only be of limited help, since some of the benefit rules changed in the June 2010 Budget.

Secondly, we have calculated the expected present value of benefits based on mortality which is appropriate for the whole population, but those who escape the annuitisation requirement are likely to be longer lived than normal. Comparison of the Lives and Amounts calculations in Table 2.1 suggests that using Amounts data would lead to twice as large an increase in cost as suggested.

Summary

We estimate that 28 per cent of retiring pensioners with private pension savings would have sufficient pension wealth to secure a MIR at the levels described above. We also estimate that the minimum cost of the Pension Credit alone that these pensioners might eventually be able to claim is £83 million per annum (a total of £1.7 billion in present value terms when we add up across all future years). This figure does not include the cost arising from other means-tested benefits that we have been unable to quantify. It is crucially important for policymakers to recognise that these cost estimates are highly sensitive to the assumptions chosen, and that there is therefore a considerable risk to the public finances in setting the MIR too low. Using different but still plausible actuarial assumptions, for example, would double the cost of Pension Credit estimated above. So although this figure is uncertain, it is likely to be an under-estimate.

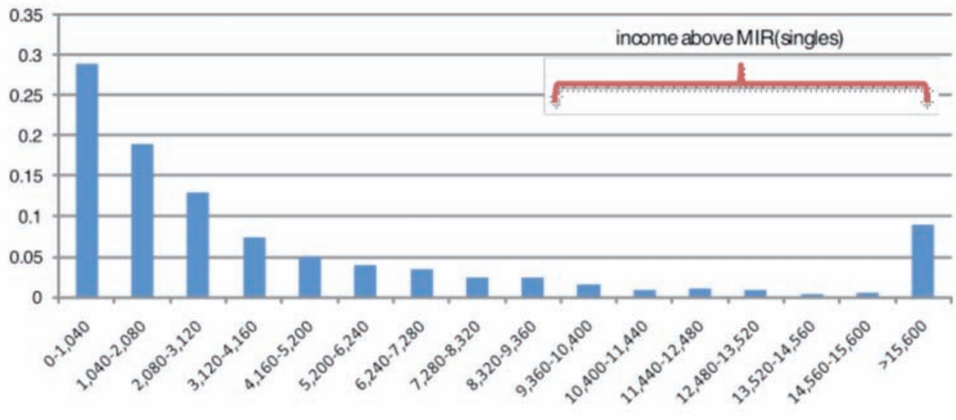
9. This is the same annuity factor as the Government uses to convert DB pension amounts into present value terms to check that the Lifetime Allowance is not violated.

4. The impact of the proposal on the UK annuity market

In 2009, according to figures from the ABI, the UK's new pension annuity market (i.e., sales of new policies) consisted of 465,000 policies with a value of £11 billion, so that the average policy value is around £23,655. We will examine the effect of the proposal to remove compulsory annuitisation of DC schemes on this market, taking into account that those individuals below the MIR will still be required to purchase an annuity.

The DWP's Pensioners' Income Series gives details of pensioners' incomes based on information collected in the Family Resources Survey (FRS). This survey provides a breakdown of pensioner income from the state pension, other benefits, investment income, earnings occupational and personal pensions. Figure 4.1 shows the distribution of pensioners' incomes from personal pensions for those in receipt of it. In 2008-09, the mean personal pension income for the recently retired was £97 per week (£5,044 p.a.).

Figure 4.1: Distribution of annual income (£p.a.) from personal pensions in 2008-09 of "recently retired"



Source: DWP (2010) Pensioners' Income Series

Relaxing the requirement to annuitise affects those individuals above the MIR and to examine the effect of the proposal on the UK annuity market we take the pensioners' incomes from personal pensions above the MIR, for those pensioners who are retiring each year, and convert into an annuity value using the following formula:

Annuity value = No. pensioners x Annuity income x Capitalisation factor

To estimate this annuity value, we need to know the number of persons retiring each year, along with their ages and gender; the personal pension income received by these groups; and a capitalisation factor that converts pension payments into a lump sum equivalent value. We discuss each component of this calculation in turn.

Number of pensioners

The DWP (2010) Pensioners' Income Series gives details of the number of "recently retired pensioner units" (about 2,000,000 units with 1,100,00 couples and 900,000 singles) in 2008-09, where "recently retired" is defined as pensioner units where the head is less than 5 years over state pension age, namely, single women between 60 and 64, single men between 65 and 69, and pensioner couples where the head is between 65 and 69 if male, or between 60 and 64 if female. Therefore, to obtain an estimate of the number retiring each year, we need to take a proportion of these figures, allowing for the fact that these five-year aggregates will include a disproportionate number of those pensioner units who have retired in the first year, and a disproportionate number of single females. We allow for these effects in Table 4.1.

Table 4.1: Numbers of retiring persons per year

	Numbers	Numbers receiving personal pension
Married couples	248,534	62,134
Single males	67,503	8,775
Single females	119,856	15,581
Total number of retiring units in 2010	435,892	86,490

Sources: DWP (2010) Pensioners' Income Series, and own calculations

The last column is obtained from the proportion of recently retired pensioner couples and single units receiving a personal pension given in the Pensioners' Income Series as 25 percent and 13 percent respectively.

Pensioners' incomes

The Pensioners' Income Series breaks down the income received from personal pension schemes, by recent retirees, and into couples and singles, and by gender. In Table 4.2, we report the mean and median amounts of personal pensions received by type of pensioner household.

Table 4.2: Average amount of personal pension income of recently retired for those in receipt of personal pensions in 2008-09

	Mean personal pension (£)		Median personal pension (£)	
	Per week	Per year	Per week	Per year
Married couples	109	5,668	48	2,496
Single males	145	7,549	69	3,605
Single females	45	2,323	21	1,109

Source: DWP (2010) Pensioners' Income Series, Table 3.7, and gender split from Table 2.6

We can combine the distribution of personal pension income from Figure 4.1 with the average amounts received by each household type to obtain a distribution of personal pensions by household type, under the assumption that the entire distribution is shifted up or down to match the average pension for that type. There are likely to be compositional effects in the distribution, which this assumption ignores, and this should be borne in mind when interpreting the subsequent calculations.

Capitalisation factor

All that remains is to apply a capitalisation factor to obtain the value of these personal pensions. We use standard actuarial methods to compute the present value of a £1 annual annuity income, by age and gender, assuming survival probabilities of each group taken from the Continuous Mortality Investigation (2002) life office pensioner tables PMA92 and PFA92 with the short and long cohort corrections.[10]

Table 4.3: Capitalisation factors for a pension of £1 per annum payable for life

	Survival probabilities	
	Short cohort	Long cohort
Panel A: Single annuity for 65-year-old male		
Level	13.6	14.4
Escalating at 2.5%	17.6	19.1
Real	19.2	21.1
Panel B: Single annuity for 60-year-old female		
Level	16.3	16.9
Escalating at 2.5%	22.6	24
Real	25.3	27.1
Panel C: Joint annuity for 65-year old male, reverting to 60% for 63-year old female on death of male		
Level	15.4	16.2
Escalating at 2.5%	20.7	22.5
Real	23	25.1

Source: CMI (2002) life office pensioner tables PMA92 and PFA92

The retiring cohort of pensioner units is made up of couples and singles, and we assume that couples purchase a joint life annuity, with the annuity payment reduced to 60 per cent on the death of the male. We assume couples consist of a 65-year old male married to a 63-year old female (based on an assumption of a 2.4 year difference in the ages of the couple[11]). Single women pensioners are assumed to be aged 60, and singles male pensioners are assumed to be aged 65.

10 Further details of such calculations can be found in Cannon and Tonks (2008)

11. Social Trends (2010), pp 19-20

Annuity values for the retiring cohort

We now combine the information in Tables 4.1, 4.2 and 4.3 to produce estimates of the annuity values implied by the personal pension incomes that are accessed by the retiring cohort. We first estimate the implied annuity values without making allowance for the MIR, i.e., by assuming that the present value of all personal pension income could be accessed at retirement.

This would be the situation if all of the retiring cohort with DC pensions accessed the capped drawdown option as explained in the consultation paper (¶ 2.14).

Table 4.4: Estimated present values of personal pensions for annual retiring cohort before applying the MIR

	Numbers receiving personal pensions	Mean pension (£ per annum)	Total present value of personal pensions (£ million)	
Capitalisation factor assumption			Level/Short	Real/Long
Married couples	62,134	5,668	5,423	5,705
Single males	8,775	7,549	901	954
Single females	15,581	2,323	590	612
Total value			6,914	7,271

Source: Own calculations based on Pensioners' Income Series

According to Gunawardena et al (2008), 87 per cent of annuity products sold, are level annuities, and for this reason we use the capitalisation factor in Table 4.3 for level annuities. The final two columns of Tables 4.4 provide estimates of the value of annuities on the basis that the products sold are level annuities. These estimates suggests that depending on the assumptions made about survival probabilities (short and long cohort projections), the total present value of personal pension income is between £6.9 billion and £7.3 billion.

However, as previously mentioned, the ABI estimate of the size of the pensions annuity market in 2009 is £11 billion, so, using our approach, we appear to have under estimated the size of this market. This under-estimation may be due to a number of factors: (i) although the modal age for annuity purchase is age 65, many people access their personal pension income before this date, which would increase the value of their annuities; (ii) some of the pension annuity market will represent annuitisation of occupational DC pensions, which are not included in the Pensioners' Income Series personal pension income figures; (iii) some of the annuities purchased are escalating or real annuities, and as Table 4.3 shows, this would involve a higher capitalisation factor; (iv) we have already mentioned that there will be compositional effects in the distribution of the data on personal pensions, in particular single females are likely to form a greater percentage of the lower incomes; and (v) there may be errors in the reporting of pension incomes.

The consultation paper suggests that only funds above those necessary to sustain a MIR may be accessed under flexible drawdown, and provided that the recipient has annuitized up to the MIR in an escalating annuity (¶ 2.15, ¶ 3.3, ¶ 3.9). Our earlier calculations have suggested that the MIR for a single person might be £14,100 (including the BSP of £5,077.80), meaning that only individuals receiving above approximately £9,000 per annum from a DC pension may access flexible drawdown, and then only having first annuitised their funds to receive an inflation-protected pension of £9,000 per annum. Similarly, for a couple, the MIR will be at least £20,000 per annum (again including the married couples' BSP of £8,119.80), meaning that only couples receiving above £11,900 from a DC pension and having annuitised to receive this pension may access flexible drawdown. We may apply a cut-off at the MIR to the distribution of personal pension income, as illustrated in Figure 4.1, to estimate the annuity value of personal pension income above the MIR, under the assumption that these individuals are only in receipt of personal pension income in addition to the BSP In other words, they are not receiving any other additional pension income (either occupational or SERPS/S2P). To the extent that individuals are receiving other secure sources of life-long pension income, this would enable greater amounts of personal pension income to be accessed under flexible drawdown. Table 4.5 shows the size of the annuity market that could be accessed at retirement above the MIR.

Table 4.5: Estimated annuity values of personal pensions for annual retiring cohort above the MIR

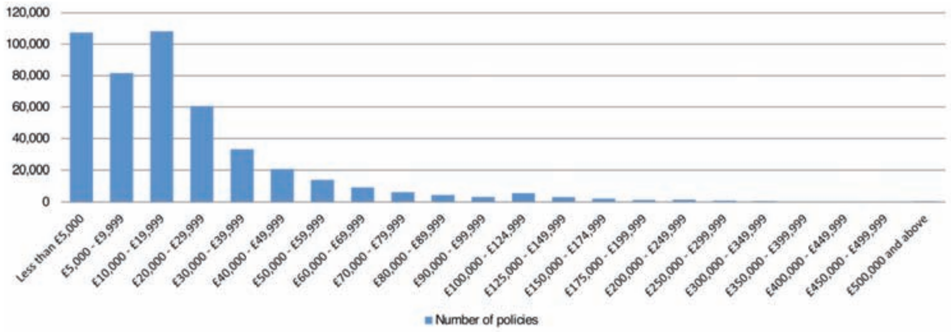
	Numbers receiving personal pensions above MIR	Mean pension above MIR (£ per annum)	Total present value for personal pensions above MIR (£ million)	
Capitalisation factor assumption			Level/Short	Level/Long
Married couples	7,767	13,200	1,078	1,067
Single males	2,325	14,711	266	271
Single females	1,402	2,909	11	0
Total value			1,354	1,339
Total value after scaling adjustment			2,155	2,025

Own calculations based on Pensioners' Income Series

The numbers in Table 4.5 are calculated on the basis that individuals whose personal pension income is above the MIR are required to purchase an escalating annuity (using the relevant capitalisation factors from Table 4.3) up to the MIR. The estimates in Table 4.5 indicate that the total value of personal pension income above the MIR is between £1.3 billion and £1.35 billion. This is around 19 per cent of the total annuity market that was estimated in Table 4.4. We believe that our estimates in Table 4.4 under-estimate the size of the annuity market as reported by the ABI. Applying a scaling adjustment to our estimates, we predict that abolishing the requirement to annuitise DC pension funds above the MIR, will cause the remaining compulsory purchase pensions annuity market to shrink from its current size of £11 billion to around £9 billion, and that the value of DC pension funds that could be accessed as a flexible drawdown product would be between £1 and £2 billion per annum.

As an additional check on these calculations, we can also use the ABI figures on the distribution of pension annuities sold by fund size as illustrated in Figure 4.2. We will assume that individuals have no more than one policy, although in practice, it is possible for individuals to have more than one policy. The Figure then shows the number of individuals buying annuities for various fund sizes.

Figure 4.2: Distribution of pension annuities sold in 2009 by size of fund



Source: ABI Annuity Sales Data

We may calculate the implied fund size necessary to satisfy the MIR, under alternative assumptions about the capitalisation factor, and, in particular, whether the annuity providers are using the long or short cohort corrections in Table 4.3.

Table 4.6: Additional estimated values of personal pension funds of annual retiring cohort

Panel A	MIR (above BSP)	Fund size necessary to satisfy MIR (£ million)	
Capitalisation factor		Level/Short	Level/Long
Married couple	£11,800	181,720	191,160
Single male	£9,000	122,400	129,600
Single females	£9,000	146,700	152,100
Panel B	**Numbers receiving personal pension above MIR**	**Total present value for personal pensions above MIR (£ million)**	
Capitalisation factor		Level/Short	Level/Long
Married couples	3,242	493	465
Single males	1,707	207	195
Single females	2,152	302	290
Total value		1,001	949

Own calculations based on ABI Annuity Sales Data

In Panel A of Table 4.6, we compute the minimum fund size necessary to satisfy the MIR for couples and single males and females, where we make the previous assumptions on the ages of the retiring cohort. We can see that the implied fund size varies depending on the relevant group from £122,400 for single 65-year-old males using the short-cohort correction to a fund size of £191,160 for a married couple. In panel B, we apply these minimum fund sizes to the distribution of funds in Figure 4.2, to obtain the potential fund sizes that could be released if these individuals accessed flexible drawdown. We assume that the distribution of these fund sizes across the type of pensioner unit is given by the ratios in Table 4.1 which again may lead to compositional errors in our calculations. The estimates in Table 4.6 suggest that the pension annuity market will shrink by between £949 million and £1 billion.

These estimates are smaller than our estimates in Tables 4.5. The two sets of estimates have been computed under different approaches: the first takes data on the distribution of pensioner incomes and imputes fund values (Table 4.5); the second takes the existing fund values of annuity policies and makes assumptions about the distribution of pensioner types. We suggest that using both approaches provides an upper and lower bound on the likely effect of the flexible drawdown option on the existing pensions annuity market.

Finally, we note some caveats on the effects of the policy change on the annuity market. Our estimates have assumed that individuals who are able to access the flexible drawdown market will do so. This is an extreme assumption to illustrate the magnitude of the potential effects. In fact, many individuals with large pension funds who could choose an unsecured pension, actually choose to annuitise and they do so between the ages of 60-65. Such individuals clearly have a demand for the hedging properties of annuities, and it is possible that even if they were able to access flexible drawdown, they would still choose to annuitise. In addition, some individuals are currently accessing USP, and it is possible that if these individuals were able to access flexible drawdown, they would be willing to annuitise up to the MIR in order to access their funds above the MIR. This would actually represent a boost to the current annuity market.

Summary

If the requirement to annuitise at age 75 above the MIR is abolished, and, if instead, individuals access flexible drawdown, we estimate that the compulsory purchase annuities market will shrink from its current value of £11 billion per annum to around £9 billion per annum. Further, the value of DC pension funds that could be accessed as a lump sum or drawdown product would be between £1 billion and £2 billion per annum.

5. The impact of the proposal on defined benefit schemes

Abolishing the compulsory annuitisation requirement for DC schemes is likely to have implications for both occupational DB and DC schemes. The Impact Assessment in the consultation document mentions the impact of the proposed change on occupational DB and DC pension schemes and ¶ 20 suggests that relatively few occupational schemes will make the required rule change in the short term. We question this view.

The Government Green Paper (DWP, 2002) carried the message that the complexity of the previous pensions regime hindered an individual's ability to make sensible savings decisions. A key proposal (subsequently enacted on A-day in April 2006) was to simplify the pensions taxation system with a move to a new system based on a Lifetime Allowance. According to HM Treasury/Inland Revenue (2002), a guiding principle in simplifying the tax rules for pensions included "consistency: to give people confidence that everyone has equivalent rights and opportunities" (¶ 3.5) and "By eliminating the complexity of multiple sets of overlapping rules, people will be freed to make clear and confident decisions about savings for retirement without the need for expensive advice. In the new single, unified regime there will be no need to distinguish between defined benefit and defined contribution schemes, allowing savers and employers sponsoring schemes to make arrangements for pensions to suit their career patterns and the needs of the labour market." (¶ 3.6)

The implementation of the Lifetime Allowance by HMRC has meant that both DB and DC pensions are deemed to have an underlying fund value. In the case of a DC scheme, this is explicit; for DB schemes, it is implicit. For tax purposes, the two types of occupational pensions are treated the same. Assuming that the desire for equality of treatment between DB and DC schemes continues, then abolishing the compulsory annuitisation requirement for DC schemes should also apply to DB schemes. In fact, the transfer rights of members of DB schemes would also imply that an individual member of a DB scheme has the right to transfer into a DC scheme.[12] FSA (2010) provides advice on the risks associated with pension transfers. Under current rules, there has been little point in DB scheme members switching to a DC scheme, since it would still be compulsory to annuitise 75 per cent of the pension fund by age 75. Given transactions costs and the fact that the pension wealth transferred may be calculated at unfavourable actuarial rates for all except those with health problems, the benefit to following this strategy has only been used by a small minority of people in particular circumstances.

Removing the annuitisation requirement could change the situation dramatically. Currently, there is a puzzle as to why individuals in a DB scheme seem content to convert their implicit pension fund into a regular pension income, whereas many individuals whose savings are in a DC scheme are reluctant to annuitise.[13]

12 Pension transfers are seen as necessary for ensuring an efficient labour market (Becker, 1964) although the Government is currently consulting on proposals that would abolish transfers between contracted-out DB and DC schemes and is seeking an amendment to the Occupational Pension Schemes (Contracting-out) Regulations 1996 and The Contracting-Out (Transfer and Transfer Payments) Regulations 1996.

13 Selection effects might explain these preferences, since individuals who choose to join a DC scheme may have different characteristics from individuals who opt for a DB scheme.

One reason relates to behavioural psychology and suggests that the annual reporting of the size of the DC pension fund, rather than the amount of pension that the fund will generate, plays a role in this puzzle. With annual pension statements in DB schemes now showing the cash value of DB pensions (in order for individuals to be informed that they are within their Lifetime Allowance), the removal of the need to annuitise, when combined with the presentation of a cash value for accrued benefits, may have significant behavioural consequences. In simple terms, it may lead DB members to prefer taking the fund rather than the pension. Further, financial advisors may have an incentive to contact retiring members of DB schemes, pointing out that they are now able to access their pension fund values. We will now provide estimates of the potential quantum here. We wish to emphasise that this is a potential unintended consequence of the proposal to relax the annuitisation requirement, but the Government may need to legislate to prevent DB scheme members also accessing flexible drawdown.

Table 5.1 shows the numbers of active, deferred and pensioner members of occupational pension schemes. There are a total of 27 million members of occupational pension schemes, split roughly equally between active members, deferred members and pensioners. Of the 9 million active members, 5.4 million are in the public sector and 3.6 million in the private sector.

Table 5.1: Number of members of occupational pension schemes in 2008

Type of member		Numbers (millions)
Active members		9.0
	Private sector	3.6
	Public sector	5.4
Pensions in payment		8.8
	Private sector	5.0
	Public sector	3.9
Deferred pension entitlements		9.9
	Private sector	6.7
	Public sector	3.2
Total		27.7

Source: Occupational Pension Schemes Survey (2009, Table 2.1)

Table 5.2 shows the 9 million active members divided across DC and DB schemes, and by size of the firm sponsoring the scheme, in terms of number of employees: 7.2 million active members are in occupational schemes in which the sponsoring firm employs more than 10,000 employees, illustrating that occupational pension schemes are typically arranged by large employers.

Table 5.2: Number of active members of occupational pension schemes in 2008, by size, sector and benefit structure (millions)

Size of unit	Private sector			Public DB	Total DB	Total
	DB	DC	Total			
10,000+	1.6	0.4	2.0	5.2	6.8	7.2
1,000-9,999	0.7	0.4	2.4	5.3	7.1	7.7
100-999	0.2	0.1	0.4	0.0	0.2	0.4
<100	0.0	0.1	0.1	0.0	0.0	0.1
Total	2.6	1.0	3.6	5.4	8.0	9.0

Source: OPSS (2009, Table 2.6)

Public sector workers are covered by a variety of occupational pension schemes which are implicitly or explicitly underwritten by the Government. Table 5.3 shows the number of active members in the major public sector pension schemes

Table 5.3: Major public sector pension schemes

Funding status	Sectors	Numbers of active members (millions). Source: Pensions Commission (2004)	Numbers of active members (millions). Source: Audit Commission (2010)
Unfunded	Civil Service, armed forces, police, fire	1.04	0.98
Notionally funded	NHS, teachers	2.02	2
Funded	Local government	1.5	1.65
Funded quasi-public sector	Universities	0.1	0.1
Total		4.66	4.73

Source: Pensions Commission (2004) Table 3.2; and Audit Commission (2010) Figure 1

All of the private sector schemes in Tables 5.1 and 5.2 are funded, although it is only the Local Government Pension Scheme in the public sector that is funded. If compulsory annuitisation of DC pension schemes is abolished, there is a real possibility that a large number of public service workers from both funded and unfunded schemes would also demand their pension as a lump sum and thereby dramatically bring forward payments from the Government. In the case of unfunded public sector schemes, effectively off-balance sheet public pension liabilities would be brought onto the balance sheet immediately, since the Government would have to issue additional bonds to make these pension payments.

A similar problem would also be felt by private sector pension funds which would be faced with raising additional funds to finance pension lump sums or would have to sell financial assets to make the cash payments.

Combining Tables 5.3 and 5.1 suggests that around 6.65 million employees are members of a funded pension scheme. Table 5.4, taken from UBS (2010), shows the estimated value of pension fund assets in self-administered DB and DC schemes, insurance company administered pension schemes, and also personal pension schemes for comparison at the end of 2009.[14] The reported values are market values and hence will fluctuate as the value of equity and bond markets fluctuate.

Table 5.4: Market value of total assets in UK pension funds at end 2009

Type of pension scheme	£ billions
Occupational self-administered DB	805
Occupational self-administered DC	270
Insurance company administered	245
Total occupational schemes	1,320
Personal pension schemes	305
Total all pension assets	1,625

Source: UBS Pension Fund Indicators (2010)

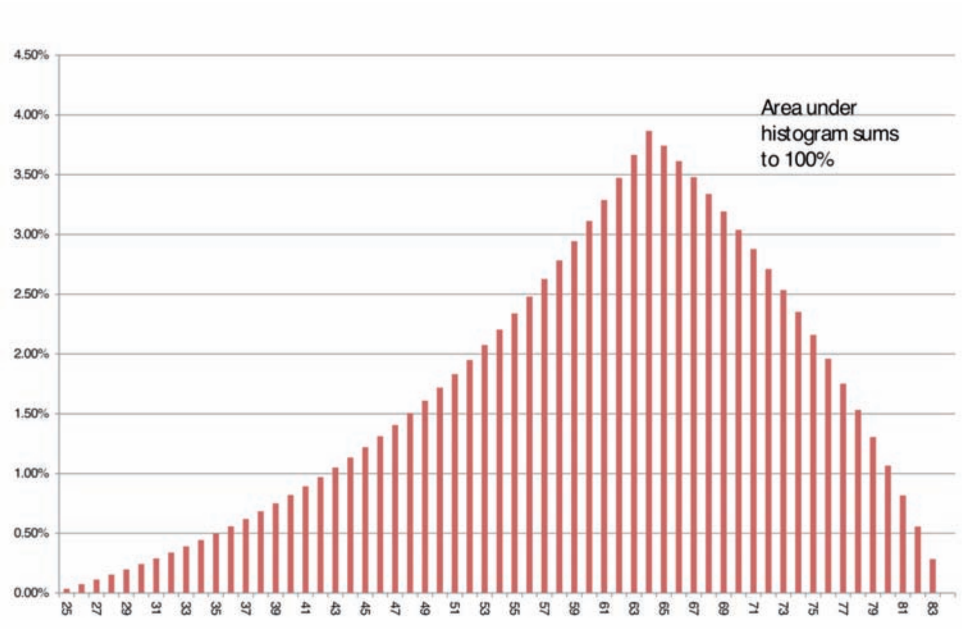
The Table shows that the total value of assets held by UK occupational pension schemes at the end of 2009 was £1,320 billion. If compulsory annuitisation is abolished, the 6.65 million active members of pension schemes would be able to access their share of these funds at retirement.

In a funded pension scheme, an individual and their employer make regular contributions and these compound at the fund's rate of return. At retirement, the accumulated funds are used to pay the pension of the members. Assume that annual contributions are £1, starting when the member is age 25 and continue for 40 years. The member retires at 65, is expected to live until age 85, and draws down the fund to zero by this age. We suppose that the annual return on pension fund assets is equal to the long-term government bond rate of 4.2 per cent.[15] Figure 5.1 shows the percentage of the total fund value that has accrued by each age between 25 and 85.

14 More detailed information on these fund values can be obtained from the ONS publication MQ5 (2010) on investments by pension funds, insurance companies and trusts.

15 Bank of England yield curves, available at http://www.bankofengland.co.uk/Statistics/yieldcurve/index.htm

Figure 5.1: Percent of pension fund total value credited to each annual cohort



Source: Own calculations

Unsurprisingly, this percentage is maximised at age 65, which means that the cohort that is retiring can access 3.87 per cent of the total fund value. Applying these calculations to the self-administered pension funds in Table 5.3 suggests that the retiring cohort will be able to access £31 billion of DB and £10 billion of occupational DC accumulated pension funds each year. This provides our initial estimates of the amount of money that can be accessed under flexible drawdown (before taking into account the MIR) and if flexible drawdown is applied to occupational pensions. We should note that some of these DC pension assets are annuitised in the pension annuity market and have already been accounted for in Section 4.

In order to provide a more sophisticated computation of the impact of DB pensioners accessing flexible drawdown, while still allowing for a threshold above the MIR, we will follow the same approach taken in Section 3 and estimate implicit pension fund values based on current occupational pension income data. To obtain an estimate of the value of DB pension funds for the annual cohort of retiring pensioners, we again use the formula:

Value of fund = No. pensioners x DB pension income x Capitalisation factor

As in Section 4, to estimate this value, we need to know the number of persons retiring each year, their occupational pension income and an appropriate capitalisation factor. We discuss each component of this calculation in turn.

Number of pensioners

As a robustness check on our previous estimates, in addition to the Pensioners' Income Series, we will also use ONS population estimates, so that we have two sets of estimates for the number of new pensioners each year.

The population estimates give the numbers of males and females for each age cohort for the entire UK population. We take the number of males retiring from the number of male 65-year-olds and split this group into couples and singles, based on the population estimates by marital status. Again, we assume that 65-year-old males are married to 63-year-old females, and the percentage of single women retiring (at an assumed age of 60) is then computed from the data in the Pensioners' Income Series as 27.5 per cent of retiring units.

Table 5.5: Numbers of retiring persons per year: Two sets of estimates

Panel A: From ONS population estimates	Numbers	Numbers receiving occupational pension
In 2010, number of males aged 65 retiring	312,720	
Of which: Married couples (aged 65/63)	245,926	152,474
Single males (aged 65)	66,794	31,393
Single females (aged 60) (27.5% of total)	118,598	55,741
Total number of retiring units in 2010	431,318	

Panel B: From Pensioners' Income Series	Numbers	Numbers receiving occupational pension
Married couples	248,534	154,091
Single males	67,503	31,726
Single females	119,856	56,332
Total number of retiring units in 2010	435,892	

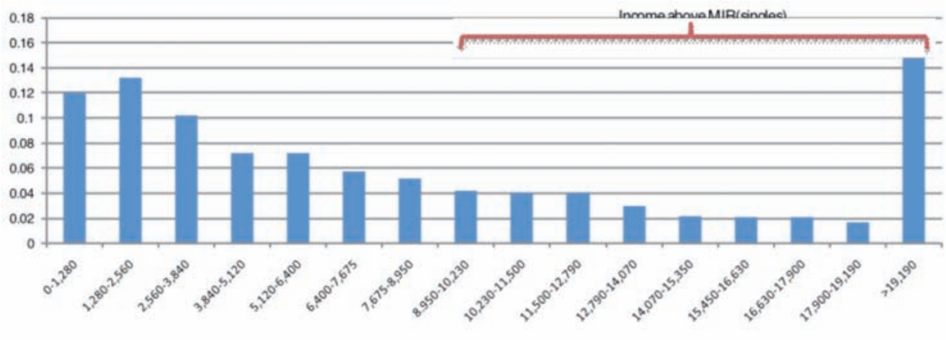
Sources: ONS Population Estimates (2009); ONS Mid-2008 Marital Status Estimates; DWP (2010) Pensioners' Income Series, and own calculations

The proportion of recently retired pensioner couples and individuals receiving an occupational pension are given in the Pensioners' Income Series as 62 percent and 47 percent, respectively, and these definitions of occupational pension income includes both DB and DC pension income.

Pensioners' incomes

The Pensioners' Income Series gives estimates of the distribution of DB and occupational DC pension income. The mean for all pensioner units is £168 per week (£8,736 p.a.), while, for the recently retired, it is £206 per week (£10,715 p.a.). The distribution of occupational pension income, for those pensioners in receipt of it, is given in Figure 5.2.

Figure 5.2 Distribution of annual income (£p.a.) from occupational pensions in 2008-09 of "recently retired"



Source: DWP (2010) Pensioners' Income Series

The Pensioners' Income Series further breaks down the income received from occupational pension schemes, by recent retirees, by couples and singles, and by gender. In Table 5.6, we report the mean and median amounts of occupational pensions received by type of pensioner household.

Table 5.6: Average amount of occupational pension income of recently retired for those in receipt in 2008-09

	Mean occupational pension (£)		Median occupational pension (£)	
	Per week	Per year	Per week	Per year
Married couples	255	13,260	158	8,216
Single males	171	8,907	93	4,833
Single females	114	5,938	62	3,222

Source: Pensioners' Income Series, Table 3.7, and gender split from Table 2.6

We combine the distribution of occupational pension income from Figure 5.2 with the average amounts received by each household type to obtain a distribution of each occupational pension by household type, under the assumption that the entire distribution is shifted up or down to match the average pension for that type.

Capitalisation factor

We use the capitalisation factors in Table 4.3 to obtain the value of DB pensions.

Pension fund values for retiring cohort

We combine the information in Tables 5.5, 5.6 and 4.3 to produce estimates of the value of the occupational pension fund that could be accessed by the retiring cohort. Table 5.7 suggests that depending on the assumptions made about survival probabilities and the type of pension received, the estimated total value of pension funds imputed to the retiring cohort varies between £40.3 billion and £66.1 billion.

Table 5.7: Estimated values of occupational pension funds of annual retiring cohorts before applying the MIR

	Numbers receiving occupational pension	Mean pension (£ per annum)	Total present value of pension funds (£ million)	
Panel A: From ONS population estimates				
Capitalisation factor assumption			Level/Short	Real/Long
Married couples	152,474	13,260	31,136	50,747
Single males	31,393	8,907	3,803	5,900
Single females	55,741	5,938	5,395	8,970
Total value			40,334	65,618
Value of occupational DB			24,604	40,027
Panel B: From Pensioners' Income series				
Married couples	154,091	13,260	31,466	51,286
Single males	31,726	8,907	3,843	5,963
Single females	56,332	5,938	5,453	9,065
Total value			40,762	66,314
Value of occupational DB			24,865	40,451

Source: Own calculations

These estimates in the row labelled "Total value" represent the value of funds attributable to the annual retiring cohort across all occupational pension assets, estimated as £1,320 billion in Table 5.4. As we have already mentioned, some of these DC pension funds are annuitised in the pension annuity market, and we need to be careful of double counting these estimates. The numbers in Table 5.4 suggest DB schemes represents 61% of all occupational pension fund assets, and so in Table 5.7, we estimate the value of occupational DB pension funds attributable to the retiring cohort as between £24.6 billion and £40.4 billion.

We now repeat these calculations to estimate the value of pension funds above that necessary to sustain an MIR, which we estimate at £14,100 pa for a single person, and £20,000 pa for a couple. Table 5.8 shows the estimated value of occupational DB pension funds that could potentially be accessed at retirement above the MIR.

Table 5.8: Estimated values of occupational DB pension funds of annual retiring cohorts with pensions above the MIR

	Numbers receiving occupational pension above MIR	Mean pension above MIR (£ per annum)	Total present value of pension funds (£ million)	
Panel A: From ONS population estimates				
Capitalisation factor assumption			Level/Short	Real/Long
Married couples	59,922	14,892	13,742	22,398
Single males	11,019	10,212	1,530	2,374
Single females	12,207	7,344	1,461	2,429
Total value			16,734	27,202
Value of occupational DB			10,208	16,593
Panel B: From Pensioners' Income Series				
Married couples	60,558	14,892	13,888	22,636
Single males	11,136	10,212	1,547	2,400
Single females	12,337	7,344	1,477	2,455
Total value			16,911	27,490
Value of occupational DB			10,316	16,769

Source: Own calculations

These calculations assume that those individuals above the MIR still take an occupational DB pension up to the MIR. In the subsequent calculations, we will use two sets of figures from Table 5.8 to assess the impact of retiring pensioners accessing the values of their pension funds above the MIR. At the lower end, under the assumption of level future pensions and with life expectancy given by the short cohort projections, we estimate the value DB pension funds that can be accessed at £10.2 billion. At the upper end, under the assumption of real index-linked pensions and assuming the long cohort projections for life expectancy, the value of DB pension funds that can be accessed is estimated at £16.8 billion.

Using the numbers of active members in different types of pension schemes from Tables 5.1, 5.2 and 5.3, we can allocate the estimated values in Table 5.8 across these schemes.

Table 5.9: Estimated size of DB occupational pension fund liabilities of the retiring cohort with pensions above the MIR, across types of scheme

Type of Scheme	No. active members (millions)	Percentage of Total	Value of pension liabilities (level/short: £ million)	Value of pension liabilities (real/long: £ million)
Private funded DB	2.6	33%	3,317	5,450
Public funded (LGPS)	1.65	21%	2,105	3,459
Public unfunded	3.8	47%	4,785	7,861
Total	8	100%	10,208	16,769

Source: Own calculations.
Note we do not include private sector occupational DC schemes in this table.

The figures in the final two columns of Table 5.9 show how the pension liabilities estimated in Table 5.8 are divided across the different types of DB pension scheme: private sector DB, public sector funded and public sector unfunded. We will now consider the impact of these fund value calculations on: private sector funded schemes, public sector funded schemes, and public sector unfunded schemes.

Impact of change in compulsory annuitisation on private sector funded schemes

We estimate that between £3.3 billion and £5.5 billion of pension liabilities in private sector DB schemes could be accessed by the annual retiring cohort. Since October 2008, the value of transfers from defined benefit schemes have to be calculated in accordance with the Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008. The cash equivalent transfer value (CETV) should broadly equal what it would cost a scheme to provide a leaving member's benefits (both accrued and discretionary) plus the value of any options the member has. The trustees can choose whether or not to include discretionary benefits. Options might include the right to commute part of the pension for a cash lump sum, the right to a higher spouse's benefit in exchange for a lower member's benefit, and the right to draw the pension before the scheme's normal retirement age (NRA). The scheme actuary, who will calculate the CETV, is entitled to take into account the likelihood of these options being exercised.

The Regulations require certain economic, financial and demographic assumptions to be made in order to calculate the CETV. These will be based on the actual scheme membership, but can be adjusted in the light of external information. The scheme's investment strategy will also influence the size of the CETV. Other things equal, a higher equity weighting in the scheme will lower the CETV, since a smaller initial investment is needed to achieve a target fund size when investment returns are assumed to be higher (as they are with equities in comparison with bonds, for example). Finally, the trustees can reduce the CETV in proportion to the size of any scheme deficit. However, they must do this on the basis of an Insufficiency Report prepared by the scheme actuary.

In order to assess the impact of allowing members of private DB schemes to access the value of their pension fund at retirement, we will use information on funding from the Purple Book, published jointly by the Pension Protection Fund and The Pensions Regulator. It is estimated that there is a universe of 7,400 PPF-eligible DB funded schemes in the private sector. Table 5.10 provides estimates of the membership of these schemes, and these membership numbers are comparable with the private sector numbers in Tables 5.1 and 5.2. The figure of 2.6 million active members in private sector occupational DB schemes in Table 5.2 is consistent with the 2.57 million in Table 5.11. The figure in Table 5.1 showing occupational pensions membership in all schemes is slightly higher than the figure in Table 5.11 and this is presumably due to members who are in occupational DC schemes and smaller DB schemes outside of the PPF-eligible universe.

Table 5.10: Membership of PPF-eligible DB universe (7,400 private sector schemes at 31 March 2009)

Type of member	Number of members
Active members	2.57
Pensioners	5.33
Deferred members	4.47
Total	12.37

Source: PPF/The Pensions Regulator (2009) Purple Book, Table 3.5

The Purple Book also includes data on the funding status of these DB schemes, and these data are updated on a monthly basis. Table 5.11 shows the funding status of the PPF-eligible DB universe at 10 June 2010. The funding status shows the extent to which a pension fund's assets are greater (surplus) or less (deficit) than the promised DB pension liabilities. There were 2,233 schemes in surplus (34 per cent) and 4,420 in deficit (66 per cent) at 10 June 2010. The total deficit of these funds in deficit was £81 billion.

Table 5.11: PPF-eligible DB funding statistics at 10 June 2010

	Number of schemes	Percent of total	Assets (£billion)	Liabilities (£billion)	Balance (£billion)	Funding ratio (%)
Aggregate	6,643		901.5	923.3	-21.8	-2.39%
Deficit schemes	4,420	66%	469.2	550.2	-81.0	-15.89%
Surplus schemes	2,233	34%	432.3	373.1	59.2	14.69%

Where Funding ratio=Balance/((Assets+Liabilities)/2)
Source: PPF 7800 Website data

For the 34 per cent of schemes in surplus, we assume they will need to sell assets when retiring pensioners access their funds. Our estimates from Table 5.9, suggest that between £1.1 billion and £1.8 billion worth of funded DB assets will be liquidated in this way (calculated as 34 per cent of £3.3 billion or £5.5 billion, respectively), representing between 0.3 per cent and 0.5 per cent of the private sector's DB pension fund liabilities for those schemes in surplus. For those schemes in deficit, calculation of the CETV suggests that the pensioner withdrawing funds will be expected to bear part of the deficit. So that although the present value of the retiring cohort's pension liability entitlements are between £2.2 billion and £3.6 billion (calculated as 66 per cent of £3.3 billion or £5.5 billion, respectively), we predict that running down the assets will result in pension fund asset sales of between £1.9 billion and £3 billion (calculated as 84 per cent of £2.2 billion or £3.6 billion, respectively, given the funding ratio of -16 per cent for deficit funds).

Impact of change in compulsory annuitisation on public sector funded schemes

The major funded public sector pension scheme is, as mentioned above, the Local Government Pension Scheme (LGPS). The Audit Commission (2010) recently analysed the affordability, fairness and financial health of this scheme for England. Figure 2 in that report suggests that as at end-March 2010, assets cover about three-quarters of the pension liabilities in LGPS. Table 5.9 indicates that between £2.1 billion and £3.5 billion of pension liabilities in the public sector funded DB schemes could be accessed by the annual retiring cohort. In the case of the LGPS, in part this could be met by running down assets, but since the scheme is only 75 per cent funded, then the calculation of the CETV would suggest that the retiring scheme members would have to bear part of this deficit. We predict that the retiring cohort would be able to access between £1.6 billion and £2.6 billion of the claims on their pension fund which would be met by running down the LGPS's scheme assets.

Impact of change in compulsory annuitisation on public sector unfunded schemes

Table 5.9 indicates that there are around 3.8 million active members of unfunded public sector DB pension schemes, and this represents around 42% of the funds that could be accessed at retirement by the retiring cohort, and would add between £4.8 billion and £7.9 billion to the public sector deficit on an annual basis, if these implicit fund values were realised.

Summary

We suggest that the proposal to abolish the annuitisation requirement for DC pension schemes will have an effect on the DB pensions market, either through DB members demanding similar rights under their scheme or through pension transfers. We suggest that if the same rules on annuitisation above a Minimum Income Requirement in the DC market are applied to the DB market, between £10.2 billion and £16.7 billion of DB pension fund assets may be accessed each year by the retiring cohort. We suggest that if the Government does not intend its proposals on the relaxation of annuity rules for DC pensions to apply to DB pensions, it will need to legislate to prevent this.

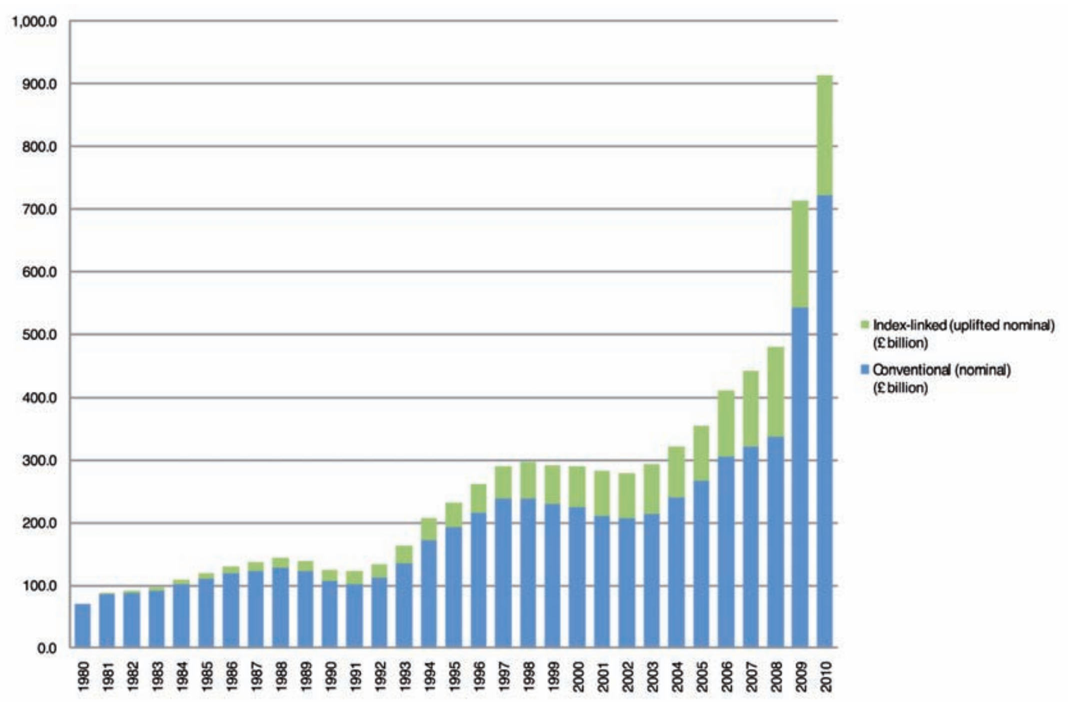
6. Impact of the proposal on long-term government bond markets

According to the DMO (2004: ¶ 6), the UK Government's debt management policy objective is:

> *"to minimize over the long term, the costs of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy."*

It achieves this objective and arrives at its issuance plans each year by taking into account: (i) the Government appetite for risk (both nominal and real in each year); (ii) cash management requirement for Treasury bills and other short term debt instruments; (iii) the shape of the yield curves (nominal and real) and the expected effect of issuance policy; and (iv) investors' demand for gilts. Figure 6.1 shows the size of the gilts market over time, and the split between conventional and index-linked bonds: index-linked bonds have continued to increase as a proportion of gilts issued since they were first issued in 1981. The total outstanding size of the gilts market in 2010 was approaching one-trillion sterling.

Figure 6.1: Size of the outstanding UK gilts market by bond-type



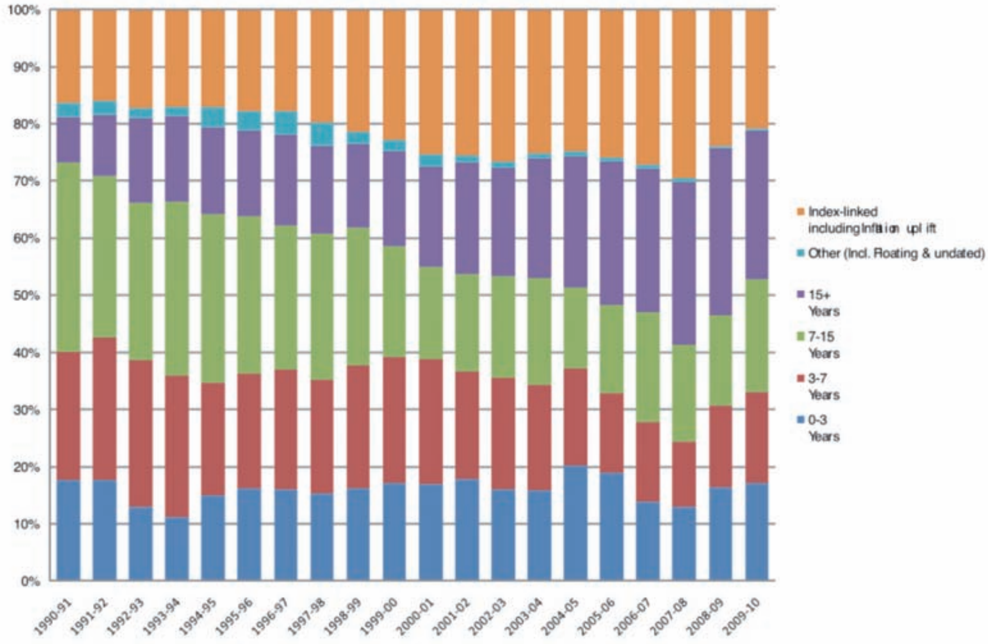
Source: DMO

Following calls from the pensions industry during 2004 for more and longer-dated debt, the DMO (2004) consulted with participants in the pensions industry. The consultation paper noted (¶ 11) that according to ONS data, pension funds and insurance companies were already the largest group of holders of gilts (64%) and their demand (¶ 8) reflected the UK Government's issuance of longer maturity bonds relative to other major governments.

The 2004 consultation paper recognised that the demand from pension funds for long-term bonds would increase in the future because of demographic trends, closer matching of assets and liabilities (i.e., switching from equities to bonds in pension fund portfolios) and "the likelihood that a shift from defined benefit to defined contribution schemes will increase demand for annuities" (¶ 11).

As a consequence of the consultation, a new 50-year maturity conventional gilt was issued in May 2005 and a new 40-year conventional gilt followed in May 2006. The first 50-year index-linked gilt was issued in September 2005.

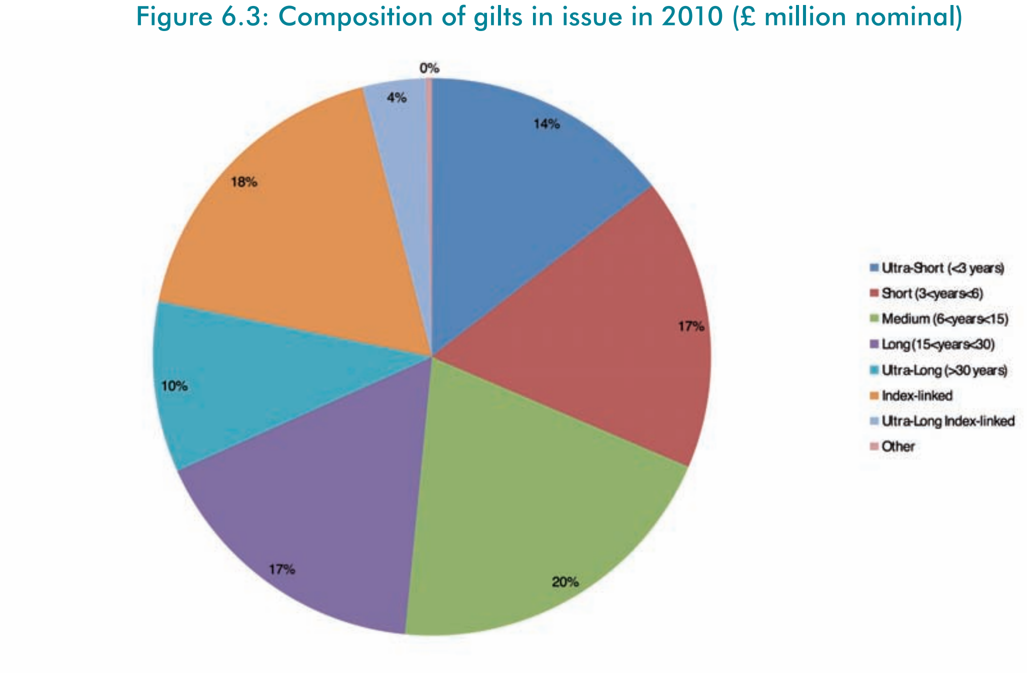
Figure 6.2: UK gilts market composition over time



Source: DMO

Figure 6.2 shows the changing composition of the Government's gilt issuance with the increasing emphasis on longer-term gilts: the percentage of index-linked and conventional bonds above 15 years' maturity has increased from less than 30 per cent in 1990-91 to nearly 50 per cent in 2009-10. Figure 6.3 shows a more detailed breakdown of the composition of gilts in 2010. This figure again emphasises the increasing importance of ultra-long gilts (both conventional and index linked) which comprise 15 per cent of the total amount of gilts outstanding of £963 billion.

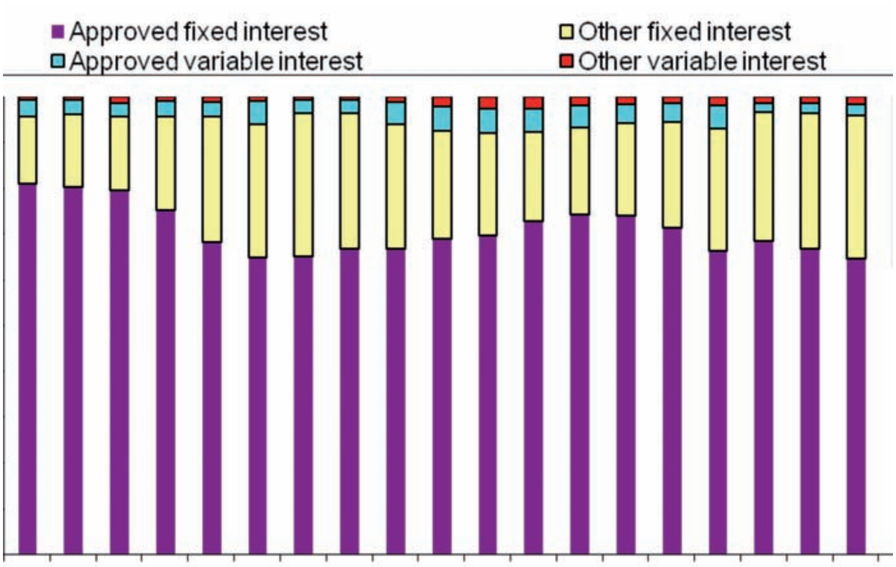
Figure 6.3: Composition of gilts in issue in 2010 (£ million nominal)



Source: DMO

Annuity providers use a combination of existing long-, medium- and short-term government bonds, as well as other financial instruments including swaps and other derivatives, to immunize their portfolio of annuity liabilities against interest-rate risk.

Figure 6.4: Type of debt instruments held by insurance companies



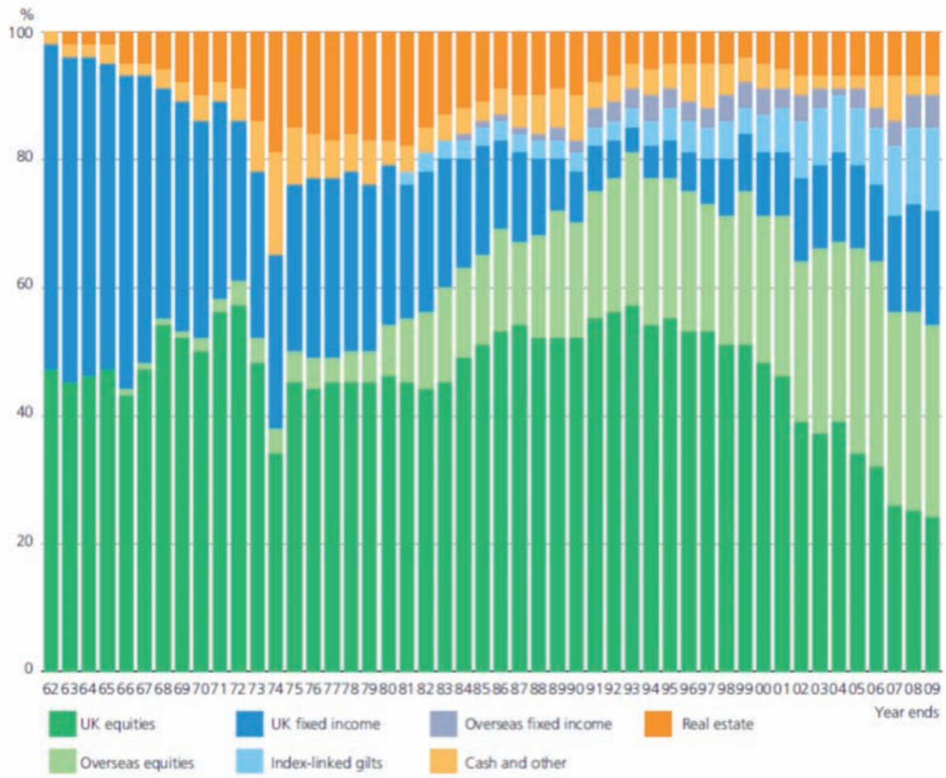
Source: FSA Insurance Returns

Figure 6.3 shows that the mixture of government bonds (approved) and corporate bonds (other) held by insurance companies has shifted over time: in 1985, life insurance companies held five times as many government bonds by value as corporate bonds; by 2005 this ratio was almost unity. The effect of abolishing compulsory annuitisation would be that on an annual basis life-insurance companies and pension funds would reduce their demand for long-term gilts, because of the contraction in the pensions annuity market discussed in Section 4 and the possible effects on the DB pensions market discussed in Section 5.

Life insurance companies and pension funds would sell off their holdings of long-term gilts, depressing gilt prices at the longer end and hence increasing yields. From our estimates in Table 4.5, we predicted that the existing annuity market would shrink by between £1 billion and £2.2 billion. The information in Figure 6.4 suggests that half of these funds are held in approved fixed-interest securities, so that insurance companies would sell off between £0.5 billion and £1 billion of gilts annually. This represents around 0.5% of the outstanding stock of ultra-long conventional and index-linked gilts.

Figure 6.5 shows the asset allocation of DB pension funds over almost fifty years, and we can see that by 2009, 31% of pension fund assets were held in UK fixed-interest securities (government and corporate bonds) and index-linked securities.

Figure 6.5: Asset allocation of average pension fund, 1962-2009



Source: UBS Pension Fund Indicators (2010)

From our estimates in Table 5.8, we predict that if the abolition of the annuitisation requirement were applied to occupational DB plans, then between £10.2 billion and £16.7 billion could be accessed annually by the retiring cohort if they wanted to access flexible drawdown above the MIR. Using the information in Figure 6.5, this implies that pension funds will annually liquidate between £3.2 billion and £5.2 billion of long-term government debt.

Individual pensioners would be unlikely to buy these long-term gilts, since the flexibility that these pensioners desire would probably be satisfied by a move into domestic and international equities.

The increase in yields at the long end in response to this sell off may also have an effect on yields at the shorter end, making it more expensive for the Government to issue debt at all maturities.

Summary

We argue that the proposal to abolish the annuitisation requirement will have an effect on the government bond market. If the retiring cohort of pensioners access their DC lump sums, we predict insurance companies will no longer need to hold government bonds in the same quantity to back their annuity products and would become net sellers of between £0.5 billion and £1.2 billion of gilts annually. Similarly, if DB pensioners also access the lump sum equivalent of their pensions at retirement, DB pension funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. This liquidation of government debt will occur at a time when the Government is attempting to fund a huge budget deficit by issuing bonds.

7. The optimal decumulation investment strategy and the cognitive problems that elderly people can face when dealing with investments

The consultation paper (¶ 2.14) suggests that capped drawdown will be available to all pensioners without any need to satisfy a MIR. However, in practice this is unlikely to be a suitable choice for most people. As FSA rules recognise, drawdown products are risky, and are only suitable for relatively wealthy individuals.[16] A number of studies have shown that the optimal decumulation investment strategy (i.e., the strategy to optimally run down in retirement the assets that have been accumulated during the working life) is highly complex (e.g., Blake et al. (2003), Blake (2003), Gerrard et al. (2004), Cairns et al. (2006) and Blake et al. (2009)). It will depend on factors such as anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. The optimal strategy might not involve the immediate purchase of an annuity, especially if risk aversion is low or the desire to make a bequest is high. In this case, the optimal strategy is income drawdown. However, there will come a time when the implicit return on an annuity exceeds the return on financial investments such as equities[17] and then it becomes optimal to annuitise remaining wealth. This typically occurs around the age of 80 for males. Another optimal strategy is to annuitise gradually. Although the studies cited here consider optimal investment strategies at high ages, they do not take into account the cognitive problems that elderly people can face when dealing with investments.

There have been a number of examples of mis-selling in the financial services industry in recent times. Two important examples have involved mortgage endowments and pensions mis-selling (Financial Services Authority, 2000, 2002).[18] The scale of the pensions mis-selling was enormous: "Offers (in relation to pensions mis-selling between 1988-1994) have been made to over one million consumers amounting to nearly £9 billion" (Financial Services Authority, 2002). The FSA took disciplinary action against 345 firms which involved fines totalling £9,507,250. The pensions mis-selling did not end in 1994. As late as 2008, the FSA was forced to announce "The FSA is taking action to improve the quality of advice given to customers to switch into a personal pension or self-invested personal pension (SIPP), following a review which found variable standards across a sample of 30 firms" (Financial Services Authority press release, 5 December 2008). This followed an FSA review which found that 16 per cent of 500 transfers into a new SIPP were based on poor advice.

A key point about the above mis-selling cases is that the people involved were still in work and many of them were relatively young. They could, therefore, have been expected to be relatively financially aware of the implications of the

16 The FSA MoneyMadeClear Guidelines on Income Withdrawal (January 2009) and the latest FSA guide to pension annuities and pension fund withdrawal emphasises that "Income withdrawal plans are complex and not suitable for everyone, for example if you have a small pension fund and no other assets or income to fall back on" (April, 2010). Earlier versions of the FSA guides to pension annuities recommended that "Income withdrawal involves extra costs and extra investment risk compared with buying an annuity straight away. For this reason, it is usually suitable only if you have a pension fund of over £100,000 (after taking any lump sum) or you have other assets and sources of income to fall back on" (January, 2004).

17 The technical condition is when the mortality drag exceeds the equity premium (Milevsky (1998)). The mortality drag is the proportion of people of a given age who die during the year.

18 The personal pensions mis-selling scandal took place between 29 April 1988 and 30 June 1994. Individuals who would have been financially better off at retirement in their employer's pension scheme were advised to leave their employer's scheme and transfer their pension benefits to a personal pension plan instead.

decisions they were being persuaded to take. But clearly this was not the case. An FSA (2006) survey of financial capability found that in a financial literacy quiz, the under-40's performed worse than their elders, but that the over-70s performed worst of all age groups. The problem is compounded when it involves elderly people who are unable to return to work in order to rectify the financial consequences of any mistakes they make.

A recent US study has examined the effect that cognitive impairment has on financial decision making. The susceptibility to dementia doubles every five years after age 60. Agarwal et al. (2009) discovered that around 50 per cent of people in their 80s experienced significant cognitive impairment (including dementia) and this prevented them from making sensible financial decisions.

Older adults also show a marked decline in "numeracy", the quantitative skill necessary to understand the meaning of numerical information such as percentages and probabilities. This meant that older people had considerable difficulty with comprehending even simple measures of risk. For example, when invited to say which of the following involved the greatest risk of getting a disease, 1 in 10, 1 in 100 or 1 in 1000, 29 per cent of a sample of 65-94 year-olds gave an incorrect answer (Peters, 2008).

As an illustration of the confusion that people can face when making annuity decisions, consider the US framing study of Brown et al. (2008). The study involved 1300 people over the age of 50 who were asked to select between one of two choices designed to have the same actuarial value:

1. an annuity paying $650 a month for life
2. a savings account containing $100,000 and paying 4 per cent interest.

Half the sample of participants in the study were offered the two options in a "consumption" frame where the annuity was explained as a vehicle for providing a secure income of $650 a month for life. Around 70 per cent of this subsample chose the annuity. The other half were offered the two choices in an "investment" frame where the annuity was explained as an investment generating a return of $650 a month. Just 21 per cent of the second subsample chose the annuity. This is because the annuity now appeared to be a risky investment since it would be lost if the individual died early: the option of having the $100,000 "invested" in the savings account was now interpreted as a much safer investment even though the savings account will not hedge an individual's longevity risk.

A key problem with the Government's proposal is that it changes the frame through which a pension scheme will be viewed and assessed. The main purpose of a pension scheme is to provide, for however long the pensioner lives, consumption in retirement sufficient to avoid a dramatic fall in living standards compared with when the pensioner was in work. The appropriate frame for viewing a pension scheme is therefore the "consumption" frame. After the implementation of the Government's proposal, a pension scheme will be viewed through an "investment" frame which will make the purchase of an annuity not only appear risky, but also very unfair to the pensioner's family who will now be denied their "right" to inherit the pension fund when the pensioner dies.

This is very well illustrated in a recent newspaper[19] article entitled "Can my wife inherit my pension if I die?" The newspaper interviewed a 57-year-old self-invested personal pension scheme member who is "delighted that he will no longer be forced to buy an annuity when he turns 75. … He plans to take out an income drawdown plan when he retires at 66, as he dislikes annuities. He says: 'I hate the idea of my money going to an insurance company instead of my kids. I am opting for income drawdown because I want the flexibility and control of my money…. The new rules mean we can pass our remaining pension straight to our children, even if they have to pay a 55 per cent tax charge.' " This illustrates that merely re-framing the presentation of the annuitisation decision can change behaviour.

Summary

Optimal decumulation investment strategies can be highly complex and need to take into account anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. Further, the optimal strategies are not static and involve complex choices about, say, the optimal timing of annuity purchases. However, these strategies typically fail to take into account the cognitive problems that elderly people can face when dealing with investments. The proposed change to the pensions annuity market represents a shift from a "consumption frame" to an "investment frame". We report that, whether as a result of cognitive impairment or an inappropriate framing of choices, many older adults will find it difficult to make sensible decisions about how to invest and spend their retirement savings. The Government could soon find itself embroiled in another mis-selling scandal and this time involving vulnerable elderly people.

19 By James Coney. http://www.dailymail.co.uk/money/article-1296335/Pension-reforms-Can-wife-inherit-pension-I-die.html. Accessed 20 July 2010.

8. Inheritance and savings decisions

Our discussion so far has concentrated on the consequences of removing the compulsory annuitisation requirement for pension wealth and for means-tested benefits. In this section, we consider two other questions: first, will wealth which is not annuitised be used for bequests; second, how might the change in policy affect the savings decisions of people who are not close to retirement? One of the reasons for the proposal is to encourage people to save more throughout their lifetime. For example, the "Introduction" to the consultation document states that "the current inflexibility in the pensions tax rules acts as a barrier to saving for some because people have very little choice in securing a retirement income and finding a solution that is best for them". In our discussion, we take account of the alternative tax-efficient savings vehicle (an ISA, with an annual limit of £10,200) which is more flexible than a pension as it is possible to access the funds before retirement.

We shall see that the benefits of the new policy depend largely on whether someone is a higher-rate or basic-rate taxpayer while in employment. In both cases, there is already an incentive to save in a pension fund because tax relief on contributions tends to be higher than the tax paid on income received from a pension.[20] In this section, we concentrate on the additional incentives to save other than those that exist already.

The consultation document states that "the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance. The Government will therefore ensure that the tax rate on unused funds remaining on death does not leave open incentives for pension saving to be used to reduce inheritance tax liabilities. The Government will monitor this closely and will take further action if there is evidence of such activity" (¶2.2).

Under current rules, there are penal tax rates (up to 82 per cent) on wealth which has not been annuitised by the age of 75 (i.e, for pensioners who choose the option of alternatively secured pension or ASP).[21] The proposed policy is that any unused funds payable on the death of a pensioner will be taxed at 55 per cent. A recovery charge of 55 per cent means that the Government approximately re-claims the tax privileges given to a higher-rate tax payer in the accumulation of the pension fund. This is because 25 per cent of the fund can be taken as a tax-free lump sum: the 41 per cent tax relief given to the entire pension fund must now be reclaimed from the remaining 75 per cent and $0.41/0.75 = 54.7$ per cent.[22]

Consider a higher-rate taxpayer who wishes to invest money which is then left as a bequest. The two simplest savings vehicles are the pension fund and an ISA.

20 In 2009-10, there were 3.1 million higher-rate taxpayers of whom 1.9 million had incomes less than £50,000 (Inland Revenue Statistics, 2010). Anyone with an income of £50,000 in employment is likely to have a pension of less than £43,875 and thus have a lower marginal tax rate on retirement, although these thresholds will change considerably over time. Basic-rate tax payers receive tax relief on NI contributions (11 per cent), but do not pay NI contributions on pension income.

21 An apparent anomaly is that if a pensioner dies before the age of 75 without accessing the pension fund at all, then the entire fund is free of both a recovery charge or inheritance tax: the consultation suggests that this policy will continue. Relatively poor pensioners in bad health who face steep withdrawal rates of means-tested benefits might then have an incentive not to take a pension but to pass on their fund. But the sums of money would be very small. Very rich pensioners with sufficient funds that they did not need to access their pension wealth would be a different matter, although such people are more likely to live beyond 75.

22 The situation is complicated by some higher-rate taxpayers having a 50 per cent tax band. The 41 per cent assumes 40 per cent income tax and 1 per cent National Insurance contributions.

Assuming the same pre-tax rate of return can be earned on both, the pension fund and the ISA are now perfect substitutes, since the investment returns are not taxed in either case and the additional tax relief on contributions to the pension fund are matched by the recovery charge. However, the pension fund has three additional advantages: first, it is accompanied by the 25 per cent tax-free lump sum; second, it is not liable to inheritance tax; third, the annual limit on the ISA is only £10,200. While not all higher-rate income tax payers will be liable for inheritance tax, many will be and the new policy is likely to be faced with this problem.

The consultation document suggests that this issue will be closely monitored, so that further action can be taken.[23] It is difficult to see how this will be monitored, except by analysing the sums of money which escape taxation in this way. Since this information will only be available when people die, which will be some considerable time in the future, an expectation to this entitlement will have accumulated and it may prove politically difficult to reverse.

The situation is different for basic-rate taxpayers. Most basic rate taxpayers will also be paying NI contributions of 11 per cent, so the effective rate of tax relief on pension contributions for these people will be 31 per cent. This suggests that the fairer recovery charge for such people should be 0.31/0.75 = 41 per cent, so a recovery charge of 55 per cent will be a penalty rate for them.

Table 8.1: Average post-tax cumulative return on pension wealth left as a bequest for a basic-rate taxpayer

Number of years money is invested	Personal pension	ISA account	Simple investment account
5	3.6	7	5.6
10	5.3	7	5.6
15	5.9	7	5.6
20	6.1	7	5.6
25	6.3	7	5.6
30	6.4	7	5.6
35	6.5	7	5.6
40	6.6	7	5.6

Source: Own calculations

Table 8.1 shows the effect of the recovery charge on any pension fund which remains on the death of a pensioner and which is passed on as a bequest. In all cases, we assume that there is no inheritance tax and that the investment earns 7 per cent gross per year. Money invested in an ISA receives 7 per cent and that outside an ISA is taxed at 20 per cent and has a net return of 5.6 per cent. Money in a personal pension receives tax relief of 31 per cent and pays a recovery charge of 55 per cent. Since basic-rate taxpayers are unlikely to exhaust their ISA limit of £10,200 per year, then it can be seen that the recovery charge is sufficiently high that there would be no incentive to try to use the pension fund for inheritance purposes relative to the ISA.[24]

23 The wording used in the consultation is almost identical to that of the previous Government's Paymaster General, Dawn Primarolo, (Hansard 21 Mar 2005 : Column 40WS) with reference to alternatively secured pension being used as a tax avoidance measure. That policy was reversed about a year later.

24 With short time horizons, using a pension scheme to avoid inheritance tax would be less efficient than a non-tax advantaged investment account.

A consequence of this is that the policy might appear to benefit higher-rate taxpayers considerably more than basic-rate taxpayers. There are a considerable number of basic-rate taxpayers whose income is sufficiently high that not all of their pensions savings will be needed to meet the MIR.[25] These people may feel it to be unfair that they are penalised for bequeathing their additional pension wealth to heirs when higher-rate tax payers appear not to be.

Summary

Allowing pensioners to avoid annuitisation will make it possible for pension fund wealth to be used to escape inheritance tax. The consultation proposes a 55 per cent recovery charge. Since this merely cancels the tax relief on pension contributions of a higher rate taxpayer, such a charge may be insufficient to prevent higher-rate tax payers using pension wealth for inheritance tax planning which may result in a loss of tax revenues. However, the 55 per cent recovery charge would be penal for basic rate taxpayers. Differential treatment in this way may be perceived as unfair and result in political pressure for further changes.

25 There are currently 26.7 million basic-rate tax payers with income above £30,000, although many of these are not in employment.

9. Policy recommendations

In this section we explicitly respond to the consultation questions which are listed in summary form on page 21 of the consultation document. The consultation requested views on the following points below. As our report makes clear, however, some of the most important consequences of the policy are not considered by these questions.

A.1 *The level of an appropriate annual drawdown limit for capped drawdown.*

Since the objective must be to avoid running out of pension assets before death, the annual drawdown limit should equal the annuitisation value of residual pension wealth (Blake et al. (2003)). The amount will rise from one year to the next if the equity premium exceeds that year's survival credit or mortality drag and fall otherwise.

A.2 *Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.*

See analysis in Section 8 above.

A.3 *What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.*

The consultation document proposes that the MIR should be indexed by LPI. We do not view this as entirely appropriate since annuity income will grow more slowly than limits for means-tested benefits and benefit entitlement will inevitably grow over time. However, without considerable financial innovation, it is impossible to provide alternative annuity products which would resolve this issue.

It is appropriate that employment income should not be counted as secure income to meet the MIR because pensioners' earned income will only be significant early in retirement. We believe that it would be difficult to frame appropriate rules for the MIR that allowed pensioners to access their pension wealth while continuing to work.

A.4 *What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.*

The immediate need for any MIR is that it is set at a high level to minimise entitlement to Pension and Guarantee Credits. Using two different methods of projecting wages and inflation, we calculate that the MIR for a 65-year-old individual should be £14,100 (including the BSP) and for a couple (male aged 65, female aged 63) should be £20,000 (including BSP) in 2010 and then grow in line with the LPI. If a pension unit secures the MIR at a later age then the MIR applying should be the MIR in force for the year in which income is secured.

Tables would have to be produced showing the MIR appropriate for each age in a given year. For reasons of space, we have not reported calculations of the appropriate MIR for someone aged other than 65 who annuitises in 2010. However, to adequately protect the public purse, any MIR also needs to take account of entitlement to other means-tested benefits and to people's actual expenditure requirements throughout retirement (both in absolute and relative terms) and, in particular, the impact of declining health on expenditure needs.

A.5 *Whether a different MIR should be set for individuals and couples.*

We suggest that the MIR should be different for individuals and for couples. We suggest that the MIR for a couple should be in the form of a life annuity with a reversion to the survivor. The level should commence at £20,000 (including the BSP) in 2010 for a 65-year old man with a wife aged 63, with a reversion to an income for the survivor of £14,100 in 2010, both figures updated in line with the LPI.

It is a moot point whether there should be one table of MIR values for couples based just on the age of the man or whether it should be based on the ages of both partners. The former has the merit of simplicity but is based on a model of family formation which is likely to be increasingly outdated. It may prove necessary to produce multiple sets of tables, including tables for civil partnerships where both partners are of the same gender.

A.6 *How often the MIR level should be reviewed.*

The current approach taken to calculate the Basic State Pension and other pension entitlements is to have a single value which applies to all pensioners regardless of age (i.e., different generations are treated the same). We have assumed here that the MIR will be treated in the same way. In the long run, this will be unsustainable since the BSP will be growing faster than the MIR, but this will be a political decision. The uncertainty in projecting the path of the MIR and the BSP is sufficiently low in the short term that these reviews could be at relatively infrequent intervals (e.g., every five years).

A.7 *How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.*

A major simplification will be to have one MIR in a given year which will apply to pensioners of all ages. However, such a rule will involve other inconsistencies which we have discussed above. The other major concern is how to frame a simple rule for how much income should be secured under the MIR when pensioners continue in employment, since it is essential that pensioners have incentives to carry on working.

A.8 *Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.*

No comment.

A.9 *How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.*

These bodies need to recognise three things: (i) the importance of good default decumulation strategies (i.e., those that attempt to replicate optimal decision making), (ii) the general ineffectiveness of financial education in improving outcomes[26] and (ii) the cognitive problems that elderly people can face when dealing with investments.

A.10 *Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.*

If the requirement to annuitise at age 75 above a MIR is abolished, we estimate that the compulsory purchase annuity market will shrink from its current value of £11 billion per annum to around £9 billion per annum. Further, the value of DC pension funds that could be accessed as a lump sum or drawdown product would be between £1 billion and £2 billion per annum.

We speculate that the proposal to abolish the annuitisation requirement for DC pension schemes will have an effect on the DB pensions market, either through lobbying or through pension transfers.

We suggest that if the same rules on annuitisation above a Minimum Income Requirement in the DC market are applied to the DB market, between £10.2 billion and £16.7 billion of DB pension fund assets may be accessed each year by the retiring cohort. We suggest that if the Government does not intend its proposals on the relaxation of annuity rules for DC pensions to apply to DB pensions, it may need to legislate to prevent this.

Our analysis suggests that the proposal to abolish the annuitisation requirement will have an effect on the government bond market. If the retiring cohort of pensioners accesses their DC lump sums, we predict insurance companies will no longer need to hold government bonds in the same quantity to back their annuity products and would become net sellers of between £0.5 billion and £1.2 billion of gilts annually. Similarly if DB pensioners also access the lump sum equivalent of their pensions at retirement, DB pension funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. This liquidation of government debt will occur at a time when the Government is attempting to fund a huge budget deficit by issuing bonds.

26 As Professor David Laibson of Harvard University has stated "Education no substitute for good default" (Pioneer Investment's European Colloquia 2007).

10. Conclusion

The proposals contained in HM Treasury's consultation document 'Removing the requirement to annuitise by age 75' released on 15 July 2010 will have, if implemented, a radical effect on pension provision in this country. We have examined the potential effects of this policy and some unintended consequences. We have identified a worst-case scenario, in relation to the impact on the existing annuity market, the impact of DB pensions and the effect on the government bond market. Perhaps large numbers of people will not wish to access their pension funds, but the temptation to dip into a large pool of cash may prove irresistible.

A good pension scheme has a two-fold purpose: (i) it provides consumption security in retirement for however long the scheme member lives and (ii) it allows the scheme member to enjoy a similar standard of living in retirement as they enjoyed prior to retirement.

The consultation document's proposals will change the frame through which pensions are viewed. Pensions will be viewed not through a "consumption frame" – which is how everyone views the Basic State Pension, for example – but rather through an "investment frame". People will begin to see not a stream of future pension payments, but instead will see a "pension pot", the present value of this stream of future pension payments. And, given human nature as well as their general poor understanding of longevity risk, people would rather like to be able to invest and spend their pension pot as they see fit. The consultation document's proposals encourage this view. They also encourage the view that it will be acceptable to live just above the breadline in retirement: having secured the MIR, it won't really matter how poorly the remaining pension pot is invested.

We should also emphasise that the objective of the MIR that we have calculated is to avoid a pensioner falling back on means-tested benefits (and we have only considered Pension Credit). The consultation document (e.g., ¶3.14) recognises that pensioners' needs will vary throughout retirement due to long-term care and health costs. Our MIR does not take account of such costs or changing circumstances. It is likely that some pensioners will find the MIR unacceptably low for some situations: the only way to avoid this would be to set the MIR at a much higher level.

The important message for policymakers from this report is that in practice the MIR may need to be greater because of the state's liability for other means-tested benefits, and because there is no guarantee that current Pension Credit levels will meet pensioners' income and expenditure needs throughout retirement.

Pension schemes are going to look increasingly like tax avoidance schemes for the well off. While the poor will still be required to annuitise, the rich will be given the flexibility to spend their tax-favoured pension pot as they wish, including bequeathing their unused funds to their children without any liability to inheritance tax.

Finally, the Government's proposals are likely to lead to an increase in the variability of outcomes for pensioners. As a consequence of this: (i) there is the risk of increasing long-term political pressure from the retired population for a larger share of the national cake and (ii) there is the risk of increased poverty among pensioners who make poor decisions with their wealth.

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Appendix

Summary of HM Treasury's consultation document 'Removing the requirement to annuitise by age 75' published on 15 July 2010

- The consultation recognises that for many an annuity will always remain the best product
- However the Government wishes to introduce greater flexibility in how people can take income to reflect the changing pensions and workplace environment, to encourage more pension saving and to encourage product innovation.
- The age 75 rules on annuitisation, value protection lump sums, tax free cash and trivial commutation lump sums will be removed.
- The age 75 rules on contributions and Lifetime Allowance checks will remain.
- Pension funds will be able to remain in a USP ("capped drawdown") indefinitely. ASPs will cease to exist.
- The USP maximum withdrawal limit may be reviewed. The current 120 per cent is probably too high at older ages and may have to be less than 100 per cent to avoid the risk of people exhausting their funds.
- There will be no minimum withdrawal requirement.
- Any withdrawals will be taxed as income.
- A USP customer will be able to access additional flexibility (in effect the permanent removal of the upper withdrawal limit) through "flexible drawdown" provided they have secured a minimum income (the Minimum Income Requirement). This minimum income will need to be a secure pension income for life and escalate by the lower of 2.5 per cent or inflation.
- The customer would then be able to withdraw up to 100 per cent of the remainder of their fund. This will be taxed as income.
- The minimum income required is not set out in the consultation paper.
- However they expect it to take account of not just current means-tested benefits, but also potential health costs and future expenditure needs.
- Restrictions on value-protection annuities will be removed.
- Lump sum death benefits will be taxed at 55 per cent to counteract tax relief given - this includes value-protection payments.
- The only exception is pension saving where no part has been used for an income when the saver dies before 75 where the pot will be tax free.

Previous Pension Institute Reports

'Delivering DC? Barriers to participation in the company-sponsored pensions market', by Debbie Harrison, Alistair Byrne, and David Blake, October 2004.

'Pyrrhic Victory? The unintended consequences of the Pensions Act 2004', by Debbie Harrison, Alistair Byrne, Bill Rhodes and David Blake, October 2005.

'Annuities and Accessibility: How the industry can empower consumers to make rational choices', by Debbie Harrison, Alistair Byrne and David Blake, March 2006.

'Dealing with the reluctant investor: Innovation and governance in DC pension investment', by Alistair Byrne, Debbie Harrison and David Blake, April 2007.

'An unreal number: How company pension accounting fosters an illusion of certainty', by David Blake, Zaki Khorasanee, John Pickles and David Tyrrall, January 2008.

'And death shall have no dominion: Life settlements and the ethics of profiting from mortality', by David Blake and Debbie Harrison, July 2008.

'Ending compulsory annuitisation: What are the consequences?', by David Blake, Edmund Cannon and Ian Tonks, July 2010.

Statement by Prudential UK & Europe

Established in 1848, Prudential remains one of the country's best known financial institutions, and one of the UK's leading providers of pension, savings and retirement income products. With over 7 million customers in the UK we are well placed to understand the issues that people face, and to help in developing solutions to current and future challenges.

We are pleased to sponsor the publication of this second report from the Pensions Institute on the impact of removing the 'age 75 rule'. We believe this report is an important contribution to the debate on retirement income reform and provides valuable insight for policymakers as they consider their next steps.

People approaching or in retirement experience many opportunities but also face many risks. For society the impact of an ageing population represents an unprecedented challenge to existing social, political and fiscal arrangements.

Creating a pensions and retirement income regime that supports and sustains individuals and society in this environment is a challenge that demands earnest attention. We are keen to play our part in creating such a regime, and supporting this report is a contribution towards that.

Prudential UK & Europe
September 2010

About the Pensions Institute

The objectives of the Pensions Institute (www.pensions-institute.org) are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance, and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions.

As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to the complex problems that arise in this field.

Objectives

The Pensions Institute undertakes research in a wide range of fields, including:

Pension Microeconomics
The economics of individual and corporate pension planning, long-term savings and retirement decisions.

Pension Fund Management and Performance
The investment management and investment performance of occupational and personal pension schemes.

Pension Funding and Valuations
The actuarial and insurance issues related to pension schemes, including risk management, asset-liability management, funding, scheme design, annuities, and guarantees.

Pension Law and Regulation
The legal aspects of pension schemes and pension fund management.

Pension Accounting, Taxation and Administration
The operational aspects of running pension schemes.

Marketing
The practice and ethics of selling group and individual pension products.

Macroeconomics of Pensions
The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy (e.g., corporate, public and international sectors).

Public Policy
Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastricht Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute may include views on policy but the Pensions Institute itself takes no institutional policy positions.

ENDING COMPULSORY ANNUITISATION

Quantifying the consequences?

A Pensions Institute report for policymakers, financial advisers, and pension scheme members

David Blake
Edmund Cannon
Ian Tonks

September 2010

Ending compulsory annuitisation: Quantifying the consequences?

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List of abbreviations

ASP	Alternatively Secured Pension
BSP	Basic State Pension
CETV	Cash Equivalent Transfer Value
CFEB	Consumer Financial Education Body
CPI	Consumer Price Index
DB	Defined Benefit
DC	Defined Contribution
DMO	Debt Management Office
DWP	Department for Work and Pensions
EET	Exempt-Exempt-Taxed
FSA	Financial Services Authority
HMRC	Her Majesty's Revenue & Customs
ISA	Individual Savings Account
LPI	Limited Price Indexation
LGPS	Local Government Pension Scheme
MIR	Minimum Income Requirement
NEST	National Employment Savings Trust
NI	National Insurance
NRA	Normal Retirement Age
RPI	Retail Price Index
SERPS	State Earnings Related Pension Scheme
S2P	State Second Pension
SIPP	Self-invested Personal Pension
USP	Unsecured Pension

Foreword

This is the eighth[1] of our series of reports that focus on pensions issues of direct relevance to policymakers, financial advisers, and pension scheme members.

The Conservative–Liberal-Democrat Coalition Government that came to power on 11 May 2010 announced that it was going to end the requirement for pension scheme members to purchase annuities by the age of 75.

We felt that would some serious unintended consequences of this proposal and wrote to *The Times* on 27 May 2010:

> Sir, The new Government has confirmed manifesto promises to remove the requirement that individuals use their pension fund to buy an annuity at retirement. Such a policy would be popular, easy to implement and generate much-needed tax revenues. However, we have grave concerns that this will have serious consequences for the security of pensioners' retirement incomes and the public finances.
>
> Without an annuity, retired people risk outliving their resources and also bear the responsibility of managing their financial assets. If things go wrong, they will surely turn to the taxpayer for help. The Conservatives propose a minimum annuity purchase, so pensioners never become eligible for means-tested benefits. We suspect that estimating such a minimum will be difficult, since benefits are calculated according to individual circumstances and these circumstances, together with the level of state support, are likely to change considerably over the next 30 years.
>
> The proposal could lead to significant changes in the nation's savings decisions and tax payments. It could also encourage members of occupational pension plans - including those in the public sector - to access their entire fund as a lump sum rather than receive it as income. This would turn the current steady decline in defined-benefit pension plans into a rout, as pension fund sponsors - and that would include the Government - had to find cash immediately, instead of gradually over a long period into the future.
>
> We suggest that the seriousness of the unintended consequences of their pension policy is fully recognised and that the policy proposal is re-examined.
>
> Professor David Blake, Director, Pensions Institute, Cass Business School
> Dr Edmund Cannon, University of Bristol
> Professor Ian Tonks, University of Exeter
>
> http://www.timesonline.co.uk/tol/comment/letters/article7137165.ece

Following publication of the letter, we were approached by the Prudential and invited to prepare two reports that expanded on the ideas that were contained in the letter.

The first of these reports ‘Ending compulsory annuitisation: What are the consequences?’ published in July 2010 was designed to stimulate the debate about the proposal to end the mandatory requirement to purchase annuities in pension schemes as formally announced in the Budget Statement on 22 June 2010 and subsequently expanded upon in the HM Treasury consultation document ‘Removing the requirement to annuitise by age 75’ released on 15 July 2010.

[1] Previous reports are listed at the end of this document.

This second report 'Ending compulsory annuitisation: Quantifying the consequences?' is intended to provide a quantitative assessment of the issues raised in the first report. We also provide policy recommendations in relation to this proposal.

This research was sponsored by the Prudential and we are extremely grateful for their support. The Prudential has not sought to influence the conclusions of the report and they may not share or endorse the views expressed here. Furthermore, the Prudential have not imposed any conditions or requirements on the contents of the report.

We should also stress that the views in the report are those of the authors and not necessarily those of the Pensions Institute, which itself takes no policy position.

David Blake, Edmund Cannon and Ian Tonks
September 2010

Executive summary

1. The Government intends to end the requirement for defined contribution personal pension scheme members to annuitise their pension fund by the age of 75. This report provides a quantitative analysis of some of the key consequences of this policy.

2. We have calculated the level at which the Minimum Income Requirement would need to be set to have a *minimal* effect on demand for Pension Credit. We suggest that the total pension would need to be initially around £14,100 for an individual (including the BSP) and around £18,800, for a couple (including the BSP), rising in line with inflation. Further calculations which take account of uncertainty about wages and prices suggest that these levels are conservative and that there is a high probability that pensioners who annuitise to these levels will still receive significant amounts of benefits. We have not attempted to evaluate whether the total pension figures shown would meet people's actual expenditure needs throughout retirement. Given the complexity of the state benefit system and the variability in people's personal circumstances we are unable to quantify the impact on demand for other means-tested benefits.

3. We estimate that 28 per cent of retiring pensioners with private pension savings would have sufficient pension wealth to secure a MIR at the levels described above. We also estimate that the minimum cost of the pension credit alone that these pensioners might eventually be able to claim is £83 million per annum (£1.7 billion in present value terms). This figure does not include the cost arising from other means-tested benefits that we have been unable to quantify. It is crucially important for policymakers to recognise that these cost estimates are highly sensitive to the assumptions chosen, and that there is therefore a considerable risk to the public finances in setting the MIR too low. Using different but still plausible different actuarial assumptions, for example, would double the cost of Pension Credit estimated above. So although this figure is uncertain it is likely to be an under-estimate.

4. If the requirement to annuitise at age 75 above the MIR is abolished, and if instead individuals access flexible drawdown, we estimate that the compulsory purchase annuities market will shrink from its current value of £11 billion per annum to between £8.9 billion and £10 billion per annum. Further, the value of DC pension funds that could be accessed as a lump sum or drawdown product would be between £0.95 billion and £2.1 billion.

5. We suggest that the proposal to abolish the annuitisation requirement for DC pension schemes will have an effect on the DB pensions market, either through DB members demanding similar rights under their scheme or through pension transfers. We suggest that if the same rules on annuitisation above a minimum income requirement in the DC market are applied to the DB market, between £10.2 billion and £16.7 billion of DB pension fund assets may be accessed each year by the retiring cohort. We suggest that if the government does not intend its proposals on the relaxation of annuity rules for DC pensions to apply to DB pensions, it will need to legislate to prevent this.

6. We argue that the proposal to abolish the annuitisation requirement will have an effect on the government bond market. If the retiring cohort of pensioners accesses their DC lump sums, we predict insurance companies will no longer need to hold government bonds in the same quantity to back their annuity products and would become net sellers of between £0.5 billion and £1.2 billion of gilts annually. Similarly if DB pensioners also access the lump sum equivalent of their pensions at retirement, DB pension funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. This liquidation of government debt

will occur at a time when the Government is attempting to fund a huge budget deficit by issuing bonds.

7. Optimal decumulation investment strategies can be highly complex and need to take into account anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. Further, the optimal strategies are not static and involve complex choices about, say, the optimal timing of annuity purchases. However, these strategies typically fail to take into account the cognitive problems that elderly people can face when dealing with investments. The proposed change to the pensions annuity market represents a shift from a “consumption frame” to an “investment frame”. We report that, whether as a result of cognitive impairment or an inappropriate framing of choices, many older adults will find it difficult to make sensible decisions about how to invest and spend their retirement savings. The Government could soon find itself embroiled in another mis-selling scandal and this time involving vulnerable elderly people.

8. Allowing pensioners to avoid annuitisation will make it possible for pension fund wealth to be used for inheritance tax purposes. To prevent this the consultation proposes a 55 per cent recovery charge. Since this merely cancels the tax relief on pension contributions of a higher rate taxpayer, such a charge may be insufficient to prevent higher-rate tax payers using pension wealth in this way and this may result in loss of tax revenue. However, the 55 per cent recovery charge would be penal for basic rate taxpayers. Differential treatment in this way may be perceived as unfair and result in political pressure for further changes.

1. Introduction

The Conservative–Liberal-Democrat Coalition Government that came to power on 11 May 2010 announced that it intended to end the requirement for defined contribution pension scheme members to purchase annuities by the age of 75. This was formally confirmed in the Budget Statement of 22 June 2010. The Finance Bill 2010 of 1 July announced that the minimum age for annuitisation would be raised to 77 years as a transitional measure to defer compulsory annuitisation while further consultation on rule changes takes place. On 15 July 2010, HM Treasury published a consultation document, 'Removing the requirement to annuitise by age 75', which outlined the government's proposals. The consultation paper emphasises that the tax treatment of pension savings should continue to follow the "exempt-exempt-taxed" (EET) model, but suggests three important changes: (i) there will be no requirement to annuitise DC pension funds at age 75, and instead individuals can either choose to access their pension funds through capped drawdown (similar to the current unsecured pension) or access their funds as a lump sum through flexible drawdown; (ii) in the case of flexible drawdown, the intention is to establish a minimum required annuitisation level, based on a minimum income requirement (MIR), ; and (iii) the introduction of a tax relief recovery charge on capital withdrawals at death to recover the value of the tax relief made available during the accumulation phase of the pension scheme.

In an earlier report 'Ending compulsory annuitisation: What are the consequences?' published in July 2010, we attempted to identify some of the issues and consequences of the Government's decision to end compulsory annuitisation. We argued that these consequences fell into two categories, those that affect individuals and those that affect the wider society in terms of claims on the public purse.

It is difficult for rational, well informed individuals to run down retirement assets at the appropriate rate: spending too quickly results in exhausting assets and lower welfare in later retirement, while spending too slowly results in under-consumption and leaving unintended bequests. The advantage of an annuity is that it overcomes both of these problems. The advantages are even larger for individuals who have low levels of financial literacy, poor understanding of longevity risk or are less than completely rational, since an annuity protects them from making serious mistakes. It also prevents them from gaming the system to increase entitlement to means-tested benefits.

The consequences of the policy change for taxpayers could be equally devastating. Not only could there be a huge increase in claims for means-tested benefits. There could also be demand from defined benefit scheme members, including public sector workers in unfunded schemes, to have their pension as a lump sum rather than as an income. There will also be new opportunities to use the pension system to create tax loopholes and there is likely to be a fall in the demand for long-term government bonds which will occur at precisely the time the Government is issuing debt to plug the hole in the Government finances. To mitigate these problems, the Government is proposing a minimum annuitisation requirement to satisfy a minimum income requirement, such that the minimum would be set at a sufficiently high level that pensioners could never fall back upon means-tested benefits. While this goes some way to dealing with the consequences we highlight a number of problems with determining what the minimum level should be, chief among these being the wide differences in individual circumstances.

Existing pension policy is premised on tax exemptions being given to pension funds in exchange for those funds being used to generate a pension income: compulsory annuitisation was quid pro quo for tax relief. It is worth asking why the policy should be changed now. Willetts (2010) has observed that the baby boomer generation seems to have benefited at the expense of both previous and younger generations. We know that previous generations accepted compulsory annuitisation. The projections of pensions for future generations look poor: younger generations tend to have very little pension savings and many are likely to have to annuitise all of their pension funds under the minimum income requirement. This might lead to the strange result that the relaxation of the compulsory annuitisation requirement only really benefited the generation coming up to retirement (and only a subset of that generation). This might be perceived as generationally unfair. In addition, there is a risk that many people will substitute income for capital and will be less likely to spend that capital to meet day-to-day expenses. This will lead to further demands for state support in areas such as health care, long-term care and winter fuel payments. The reforms may also result in a greater disparity of outcomes as a result of poor investment choices or excessive expenditure. This would lead to further demands for state support in addition to any demand for support from existing means-tested benefits.

One possible answer to this is that by allowing individuals to avoid annuitisation they are able to pass on more wealth to their heirs. In fact the consultation document makes it clear that "the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance" (¶2.2). But even if the policy did allow more wealth to be passed to the future generation by inheritance, only the relatively rich would benefit and this would contribute to the UK's twin problems of increasing inequality and falling social mobility, precisely one of the points that Willetts sees as an intergenerational problem.

The importance of this point is difficult to quantify and for the rest of this follow-up report we concentrate on quantifying the more strictly economic effects of the policy of removing the annuitisation requirement. In particular, we will address the following issues, providing quantitative assessments where possible:

(i) determining the likely size of the Minimum Income Requirement (Section 2);

(ii) estimating the numbers of pensioners expected to satisfy the MIR and the value of the means-tested benefits they might eventually claim (Section 3);

(iii) quantifying the impact on annuity markets (Section 4);

(iv) quantifying the impact of the proposal on DB schemes (Section 5);

(v) quantifying the impact of the proposal on the long-term government bond markets (Section 6);

(vi) examining the cognitive problems that elderly people can face when dealing with investments (Section 7);

(vii) considering the effect of the 55 per cent recovery charge on future savings decisions and inheritance (Section 8);

(viii) Based on this analysis, Section 9 provides our responses to the questions posed in the consultation document.

2. Calculating the Minimum Income Requirement

Chapter 3 of the HM Treasury consultation document considers the Minimum Income Requirement (MIR). The primary purpose of the MIR is to ensure that a pensioner does not "exhaust their pension savings prematurely and subsequently fall back on the state" (¶ 3.2). Given the complexity of the state benefit system, it is impossible to devise a MIR which completely precludes pensioners receiving means-tested benefits and the consultation document recognises this by stating that the MIR must be a "reasonable proxy" which ensures that the "probability of falling back on the state is minimal" (¶ 3.12).

A further complication is that calculation of the MIR is dependent upon the future path of inflation and earnings. Based on projections of these variables over the next 35 years, we first calculate the MIR that ensures a pensioner would receive no Pension Credit or Guarantee Credit before the age of 100. We then consider a more sophisticated approach which quantifies the uncertainty surrounding projections so far into the future and use this to calculate an alternative MIR.

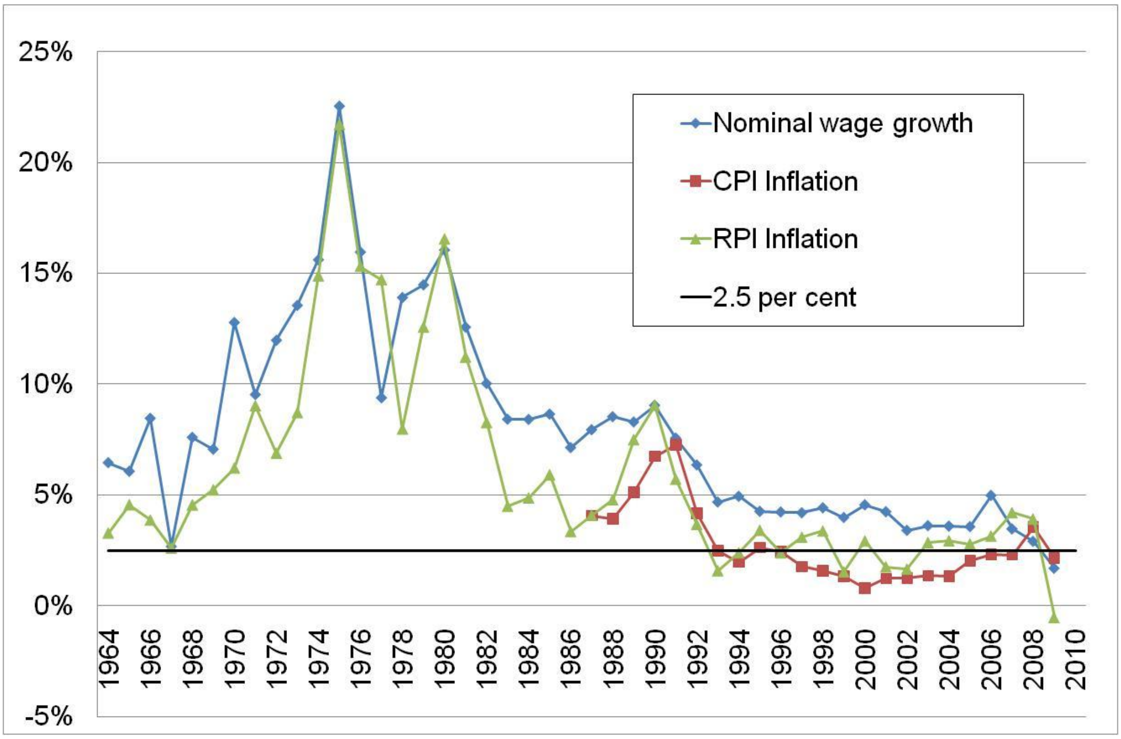
Benefits such as Housing Benefit and Attendance Allowance are dependent on tenancy and health status, respectively. The interaction of these benefits with other benefits, pension income and wealth is complicated and we ignore them in this analysis. For the MIRs that we calculate, the change in these other benefits is likely to be relatively small. However the impact in other areas such as Council Tax Benefit and long-term care costs are potentially much more significant.

2.1 The MIR based on fixed projections of future inflation and earnings

Pensioners who have made a full set of National Insurance contributions throughout their working life will receive the full Basic State Pension (BSP), which is currently £97.65 per week for individuals and £132.60 per week for couples (respectively, £5,077.80 and £6,895.20 per year). However, Guarantee Credit ensures that the minimum income actually received is £156.15 for individuals and £202.40 for couples (£8,119.80 and £10,524.80 annually) and Pension Credit ensures that they receive benefits if their pension income (excluding the BSP) is less than £9,620 and £14,130.

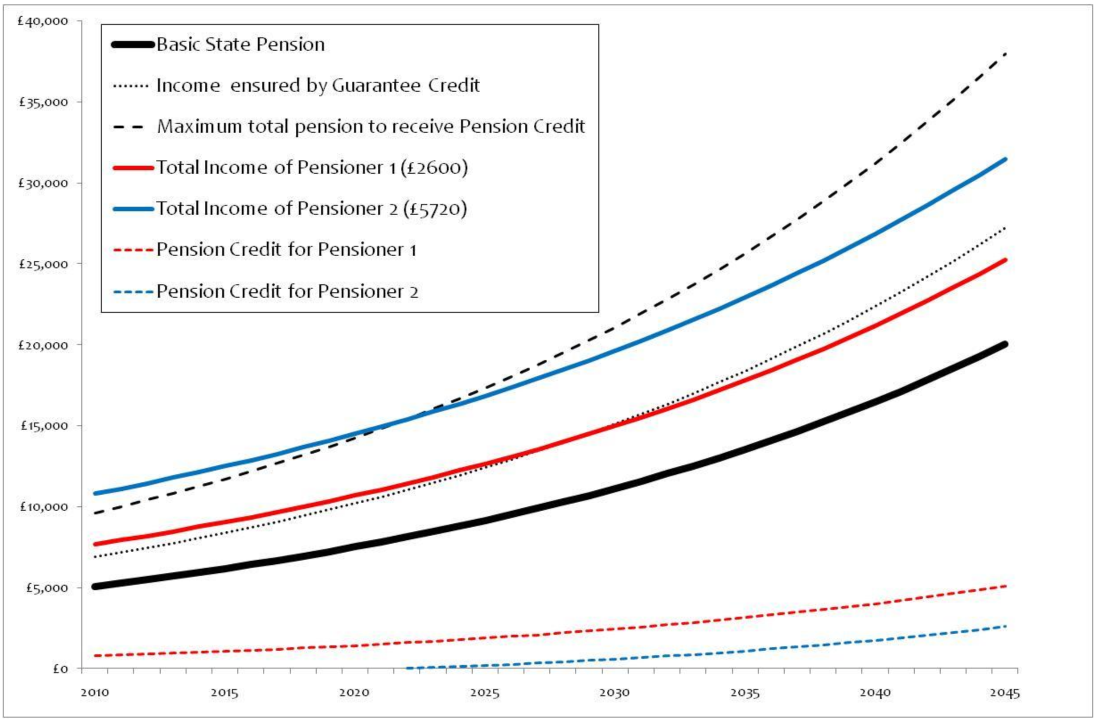
The June 2010 Budget announced a “triple guarantee” that BSP and entitlement levels would rise at the minimum of average earnings, 2.5 per cent or inflation (measured using the CPI). We show the history of these variables since 1964 in Figure 2.1, together with the RPI measure of inflation as the CPI is not available before 1988. Nominal wages have grown faster than prices in every year of the period 1993-2009 except 2009, when both wage growth and inflation were less than 2.5 per cent and 2007-8 when RPI was above wage growth. The average rate at which pensions would have grown over this period were the new policy to have been in place since 1964 is almost exactly 4 per cent per year.

Figure 2.1: Wage growth and price inflation



Assuming this 4 per cent growth in pensions continues into the future, we illustrate what might happen to the BSP and the entitlement limits in Figure 2.2 for the next 35 years (i.e., for the case of a pensioner currently aged 65 until they are 100). The solid black line shows what might happen to the BSP over the period; the dotted line shows the minimum income assured by Guarantee Credit; and the dashed line shows the maximum level of total pension income that a pensioner can have without receiving any Pension Credit.

Figure 2.2 Evolution of Pension Benefits



We now consider what would happen to a pensioner's private pension. For the purposes of this analysis we mean this to include the sum of any occupational or personal pensions that an individual has and in addition include any SERPS or S2P.[2] In the consultation document (¶ 3.8, ¶ 3.9) suggest that the MIR would include the caveat that the income would grow in line with Limited Price Inflation (LPI). LPI is defined as the lower of 2.5 percent and CPI-based inflation. From the data in Figure 2.1, the CPI-based measure of inflation has

[2] The state second pension is based on two factors: (i) the number of years that an individual has paid NI contributions while not contracted out into an occupational pension (ie they are alternatives not complements); (ii) a measure of career average income (where salaries earned in earlier years are adjusted for inflation to make them comparable). Such pensions have only been in existence since 1978 when the policy was introduced as the State Earnings Related Pension Scheme (SERPS): significant changes were made in 2002 when it was renamed the State Second Pension. This means that the maximum number of qualifying years earned so far is 32. Since the pension is 20% of the career average income (which is itself limited by a cap) the maximum S2P is only about £3000. In the data sources we use below it is difficult to separate the S2P from the BSP. Any SERPS or S2P will contribute to the MIR automatically, since it rises in line with inflation.

averaged 2 per cent over the period 1993-2009, and we assume that the pension grows at the same rate going forward.

Because the triple guarantee means that state pension entitlements can never grow by less than 2.5 per cent and since LPI means that private pensions need not grow by more than 2.5 per cent, it is inevitable that state pension entitlements will grow faster than any LPI-linked secured income used to meet the MIR. Figure 2.2 illustrates this for two hypothetical pensioners. In both cases, we assume that they have no income other than their pension (i.e., they have no earnings and their total non-pension savings are less than £10,000).

Pensioner 1 has a relatively small pension fund and purchases an LPI-linked annuity starting at £2,600 per year (£50 per week). Together with the BSP this means that his total pension income is £7,678: the growth of total BSP and private pension income is illustrated by the red line. Given his low pension income, he receives both Guarantee Credit and Pension Credit. Over time, his income falls and by about 2029 it is less than the minimum guaranteed. His means-tested benefits become gradually more generous over time (growing at an average of 5.5 per cent per year).

Pensioner 2 has a larger pension fund and is able to purchase an LPI-linked annuity starting at £5,720 per year (£110 per week); combined with the BSP this makes a total of £10,798 per year (illustrated by the blue line). This means that his pension income is sufficiently high that he is not eligible for means-tested benefits. Because Pensioner 2's pension grows more slowly than the state entitlement cut-offs, he will be eligible for Pension Credit by 2022.

The key issue here is that the cut-offs for means-tested benefits will typically grow at the rate of (nominal) earnings and this will nearly always be higher than the rate of growth for a pension indexed by LPI.[3] We may establish the MIR with reference to the pension income streams in Figure 2.2. We need to identify a total pension income stream that intersects the maximum total income that just receives pension credits (the dashed line in Figure 2.2), for a pensioner aged 100 in 2045. This intersection establishes that such a pensioner would just fall into the entitlement to Pension Credit. We then track this level of pension income back to 2010.

Under the assumptions we have made so far about earnings and the LPI, we estimate

- the MIR for a 65-year old individual in 2010 would be £14,100.

[3] One solution to this problem would be that pensions had to grow in line with wages to meet the MIR. Such annuity products are currently unavailable and it is difficult to see how life insurers could provide them in the absence of earnings-linked bonds (currently only RPI-linked bonds are available). We do not consider this possibility further.

This figure is inclusive of the BSP or £9,000 per year (£173 per week) on top of the Basic State Pension. It will ensure that he is ineligible for Pension Credit before the age of 100. The probability of a 65-year old man living to be more than 100 is currently projected to be 8 per cent.

It might be argued that to pay means-tested benefits to 8 per cent of the population is a sufficiently small cost that it would satisfy the condition in the consultation document that the costs be *minimal*. However, the probability of a 65-year old woman living to 100 is currently projected to be 26 per cent: there is an 8 per cent probability that the woman could live to 107. To ensure that only 8 per cent of women received means-tested benefits, it would be necessary to have an annuity whose initial payment was £10,300, 14 per cent higher than for a man.

So far we have been talking in terms of individual pensioners. But most pensioners at retirement at least, are in couples and for them the BSP and the entitlement cut-offs are different. Using similar analysis to the above, we estimate that

- the MIR for a couple should be £18,800 including the married couple's state pension.

We suggest that a couple would have to buy a joint annuity initially paying £11,900, but which would revert to £9,000 (the same as for an individual) upon the death of the first partner.

2.2 The MIR based on stochastic projections of future inflation and earnings

All of our analysis so far ignores the random nature of earnings and prices and the resulting uncertainty in predicting the future paths of pensions. As Figure 2.1 makes clear, wage and price inflation has in certain years been both considerably higher and considerably lower than the 4 per cent average we have used for the fixed projections.

What we propose to do now is to project the future paths of inflation, earnings and pensions assuming the same the level of variability in inflation and earnings that was observed in the period 1993-2009: this period can be considered to be one of reasonably price stability.

Based on these data, we estimated a simple econometric model of real wages and the CPI and use it to simulate possible growth paths for nominal wages and inflation. This allows us to calculate the pension payments that would be made for each growth path.[4]

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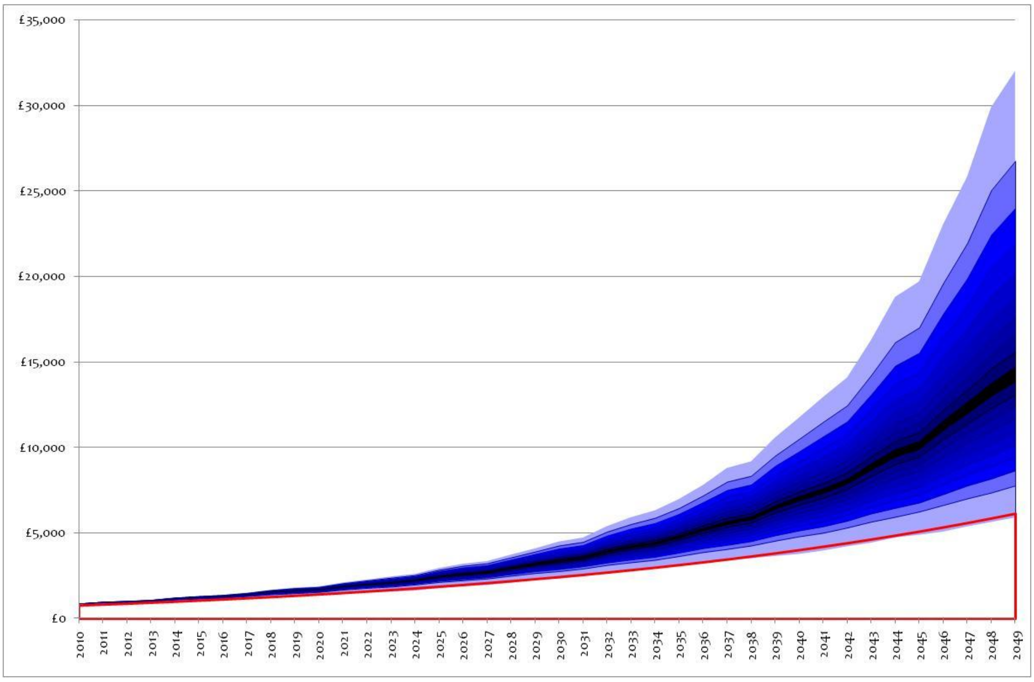
[4] The technical details are as follows: we modelled real wages rather than nominal wages since nominal wages are so highly correlated with inflation. The model was a two-lag vector autoregression (VAR) model which included real wage growth, CPI inflation and RPI inflation

Our results are illustrated in the form of a blue fanchart in Figure 2.3 for Pensioner 1 from the example above. Recall that Pensioner 1's initial private pension income is £2,600 and grows by LPI. The black line in the middle is the central estimate (i.e., the median) and successively lighter shades of blue reflect lower probabilities.[5]

Fig 2.3: Simulations of distribution of means-tested benefits for Pensioner 1



The bright red line at the lower end of the fan chart is the line taken from Figure 2.2 which assumed complete certainty. Note that almost the entire fan chart lies above this line. The reason for this is that the effect of uncertainty is a one-way bet: LPI means that the private pension nearly always increases by less than 2.5 per cent (bounded below by zero), whereas the state benefit cut-offs nearly always increases by more than 2.5 per cent and can increase by quite a lot more.

Given the upsided nature of the risk to means-tested benefit levels when inflation uncertainty is taken into account, this suggests that the MIR should be set at a considerably higher level

(for comparison purposes of RPI-linked pensions). The use of two lags was based upon the finding that the second lag was significant in all regressions. The model implicitly makes identifying assumptions that real wages and prices are I(1) but are not cointegrated. Projections were based on the parameter estimates from the VAR (treated as certain) with Monte Carlo disturbances drawn from a multivariate Normal distribution whose covariance matrix was taken directly from the VAR estimation. All the programming was done in OX.

[5] Each successive change in colour is the boundary of a 5-percentile range (on some computers it may be difficult to distinguish all of the colours).

than that indicated in the model above assuming fixed future inflation. Our criterion then was to set the MIR to ensure that no benefits would be received before age 100. When we account for risk, we need a different criterion, so instead we look at the expected present value of means-tested benefits that an individual pensioner will receive if they buy an LPI-indexed annuity. Our results are shown in the second column of Table 2.1.

Table 2.1: Means-tested benefits payable to 65-year-old pensioners with different starting pensions

Starting LPI-linked pension payment (£ per year)	**Expected present value of Pension Credit**		
	Male using "Lives" (PML92, sc)	Males using "Amounts" (PMA92, sc)	Females using "Amounts" (PFA92, sc)
520	39,146	48,129	61,398
1,560	32,684	40,783	52,937
2,600	26,222	33,437	44,475
3,640	19,760	26,092	36,013
4,680	13,298	18,746	27,552
5,720	8,240	12,819	20,520
6,760	5,184	8,955	15,606
7,800	3,335	6,389	12,077
8,840	2,201	4,648	9,479
9,880	1,501	3,455	7,543
10,920	1,054	2,618	6,074
11,960	761	2,019	4,945
13,000	562	1,581	4,065
14,040	425	1,257	3,371
15,080	327	1,010	2,816

The figures in the first column arise from putting weekly amounts on to an annual basis (i.e. they are multiples of 52).

Table 2.1 shows that the expected present value of all means-tested benefits to Pensioner 1 is £26,222, given his initial pension of £2,600. This might seem a relatively small sum compared with the potentially large sums that could be paid out in future years as shown in Figure 2.3. But Figure 2.3 takes no account of the fact that payments made a long way in the future will be discounted heavily and that the probability of making those payments is small because the further ahead these payments are due, the less likely the pensioner is to be alive to receive them. So although Figure 2.3 shows the median means-tested benefit payable to Pensioner 1 in 2045 (when he is 100) to be over £10,000, the probability of Pensioner 1 being alive then is about 8 per cent and the effect of discounting £1 paid in 2045 to today's values reduces it to about 24 pence. So the expected present value of the possible £10,000 payment in 2045 is about £192.

Given this, Table 2.1 provides a method for setting the MIR, once it has been decided the maximum acceptable level of means-tested benefits. Suppose £1,000 per year would be acceptable for example: then the MIR for a single male should be set at about £16,000 per year, including Basic State Pension.

This is a relatively high level of pension and anyone receiving such a high pension is likely to have a much higher life expectancy than a typical pensioner. We therefore re-calculated the net present value of Pension Credit using “Amounts” rather than “Lives” tables and report our results in column 3 of Table 2.1. We calculate the corresponding figures for women and these are in column 4.[6] This results in much higher figures. Although we do not use these in our analysis below, their intention is to show that our estimates are likely to be conservative and the costs to the tax payer may eventually be much higher.

2.3 The MIR and employment income

The consultation document makes it clear that the MIR must be in payment if the pensioner is to be allowed to access the rest of their pension fund and is confined to pension income (¶¶ 3.6 and 3.7): earnings (similarly non-pension investment income is excluded). This is clearly correct since a pensioner will eventually choose or be forced to stop work and there is therefore no guarantee that they will continue to meet the MIR once employment ceases.

While many pensioners receive income from employment, and this number is likely to increase with the removal of the default retirement age, the raising of the state pension age and the need for people with insufficient pension savings to continue to work.

It is difficult to see how a simple policy could be framed that allowed a pensioner to use earned income to meet the MIR in the short run without then creating a significant risk that they will fall back on means-tested benefits when employment ceased. For this reason we support the proposal that the full MIR should be secured upon accessing the pension fund, regardless of employment income.

2.4 Means-tested benefits in the short run

Current pension policy allows pensioners to purchase a level annuity (i.e., one that is not indexed to any measure of inflation). For a given purchase price, these provide a much higher level of starting income. Were policy to make it compulsory to purchase a LPI-indexed annuity it would result in many personal pensioners having a lower retirement income initially,

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[6] The “Lives” tables calculate the simple average mortality of private pensioners. The “Amounts” tables weight by size of pension, so that richer (and longer-lived) pensioners have a disproportionate effect on life expectancy. Details can be found in Cannon and Tonks (2008).

although since it will be growing they will have a higher income in the future than if they had bought a level annuity.

A consequence of this would be that relatively poor pensioners are likely to receive more means-tested benefits upon annuitising because they will have a lower income than they would have had if they had purchased a level annuity. This may be compensated for by them having less means-tested benefits in the future. This effect will be amplified over time with the shift towards DC pensions meaning that the long-term impact on demand for means-tested benefits (and therefore the potential interaction with the MIR) will be greater.

The total effect on means-tested benefits, measured by the expected net present value, is likely to be roughly neutral, but means-tested benefits will certainly rise in the short run. We have not attempted to quantify this because of the difficulty in finding information on proportions of pensioners with different types of indexing arrangements.

Summary

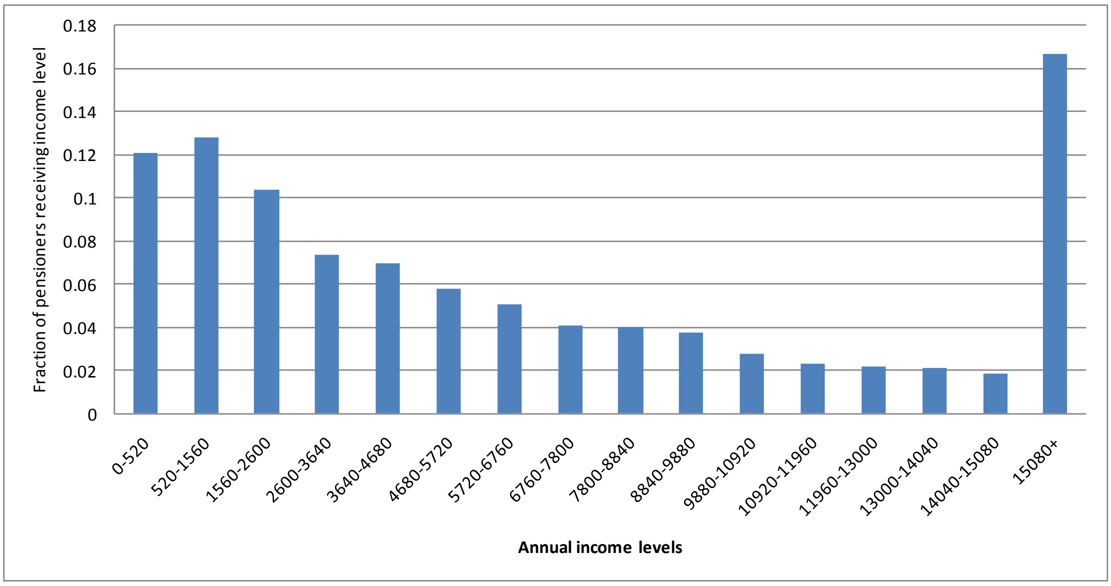
We have calculated the level at which the Minimum Income Requirement would need to be set to have a *minimal* effect on demand for Pension Credit. We suggest that the total pension would need to be initially around £14,100 for an individual (including the BSP) and around £18,800, for a couple (including the BSP), rising in line with inflation. Further calculations which take account of uncertainty about wages and prices suggest that these levels are conservative and that there is a high probability that pensioners who annuitise to these levels will still receive significant amounts of benefits. We have not attempted to evaluate whether the total pension figures shown would meet people’s actual expenditure needs throughout retirement. Given the complexity of the state benefit system and the variability in people’s personal circumstances we are unable to quantify the impact on demand for other means-tested benefits.

3. Numbers of pensioners expected to satisfy the MIR and the value of the means-tested benefits they might eventually claim

In this section we estimate the number of pensioners likely to satisfy the MIR and the likely cost of means-tested benefits that will be payable if the MIR is set at the level suggested in Section 2.

The mean average annual private pension income for recently retired pensioners who have a private pension is £3,536 for individuals and £9,568 for couples. From the data sources available, we are unable to separate the distribution of the recently retired from all pensioners or to separate couples from individuals. Nevertheless, it is clear from Figure 3.1 that the distribution of private pension income is very highly skewed to the right. In numerical terms, the median pension is only 61 per cent of the mean.

Figure 3.1: Distribution of total private pension income (weekly income)



Source: DWP(2010) Pensioners' Income Series

It is also clear from this figure that most pensioners have less than our estimates of the annual MIRs of £9,000 and £11,800, for individuals and couples, respectively.[7]

[7] These figures are calculated from the weekly averages for occupational and personal pension income in Table 2.3 of DWP (2010). These figures under-estimate the total pension figure that we need since they do not include pension income from SERPS/S2P which is aggregated with the BSP in the Table.

Because of the deficiencies of Figure 3.1, we combine the information in this figure with that in DWP (2010, Tables 2.3, 2.4 and 3.9). This suggests that the mean of the distribution of pensioner income is £168 per week and that the means of recently retired pensioner couples are £184 and individuals £68. We use these figures to make simple mean shifts to the *distribution in Figure 3.1 and then calculate the resulting proportions of these distributions*

There are likely to be compositional effects in the distribution, which this assumption ignores, and this should be borne in mind when interpreting the subsequent calculations. A summary of our results is shown in Table 3.1.

Table 3.1: Estimates of number of pensioners affected and cost of means-tested benefits

	Number of Pensioners (000)	Proportion with private pension	Proportion with income in excess of MIR	Total Expected NPV of means-tested benefits (£million)
Male individual	120	54%	17%	£10.8m
Female individual	68	54%	5%	£2.8m
Couples	248	75%	32%	£3.6m
Survivors	derived from actuarial model and initial number of couples			£66.2m
Total			28%	£83.4m

For example, there are approximately 120 thousand male single pensioners of whom 54 per cent have a private pension. From our estimate of the distribution of pensions for single males we estimate that 17 per cent of those with a pension would not receive pension credit if they annuitised all of their pension wealth but by annuitising less (just sufficient to meet the MIR) they will receive some pension credit. We perform the same calculations for female individuals and also for couples. The total proportion of all retiring individuals who have pension savings (so a couple counts twice) affected is 28 per cent.

We now do a further calculation to estimate the costs. We assume that individuals remain individuals but recognise that couples are likely to become individuals as one partner dies (we ignore family creation and divorce, etc). We construct a simple actuarial model to work out the time path of the number of survivors from couples where one member dies.[8]

[8] This is based on actuarial tables PM/FL92 short cohort and assumes independence of deaths. All of the calculations in this section are based on "Lives" mortality.

From actuarial tables we can forecast the expected number of individuals, couples or survivors that will remain at any point in the future. Using the model of inflation and earnings described in section 2.2 we generate a series of tables analogous to Table 2.1 for males, females, couples and survivors using the appropriate amounts from the distribution as starting values and sum across the distribution. So, for example, the increase in the expected present value of pension credit to male individuals is £10.8 million per annual cohort that retires. This sum may sound rather small, but consider: many male individuals would have received means-tested benefits anyway; some individuals die before receiving any means-tested benefits; those who do receive means-tested benefits tend to receive them a long way into the future and so the present value is small.

The figure is even smaller for female individuals, mainly because female individuals have such small pensions to start with that they are likely to receive means-tested benefits regardless of the new policy. The group which is most likely to receive pension credit despite having the MIR is couples, although by the time that they receive the money one of the members of the couple is likely to have died and so only the survivor will benefit.

Summing across the different groups we see that the total cost for a single year's retirees is about £83 million. The total cost of the policy is the cost of all future years' retirees summed together (and appropriately discounted). However, the distribution and level of private pensions is likely to vary considerably between cohorts. Given data limitations we have not attempted to calculate this directly but use an annuity factor of twenty to obtain a total cost in the region of £1.7 billion.

However, we believe this figure to be an under-estimate for two reasons. First, we have omitted some of the means-tested benefits that pensioners would receive (Attendance Allowance, etc). The reason for doing this is that limitations on data are too restrictive for us to perform reliable calculations: as detailed in our first report the rules for receiving such benefits are complicated and depend upon both income and wealth. Furthermore existing data would only be of limited help since some of the benefit rules changed in the June budget.

Secondly, we have calculated the expected present value of benefits based on mortality which is appropriate for the whole population, but those who escape the annuitisation requirement are likely to be longer lived than normal. Comparison of the Lives and Amounts calculations in Table 2.1 suggests that using Amounts data would lead to twice as large an increase in cost as suggested.

Summary

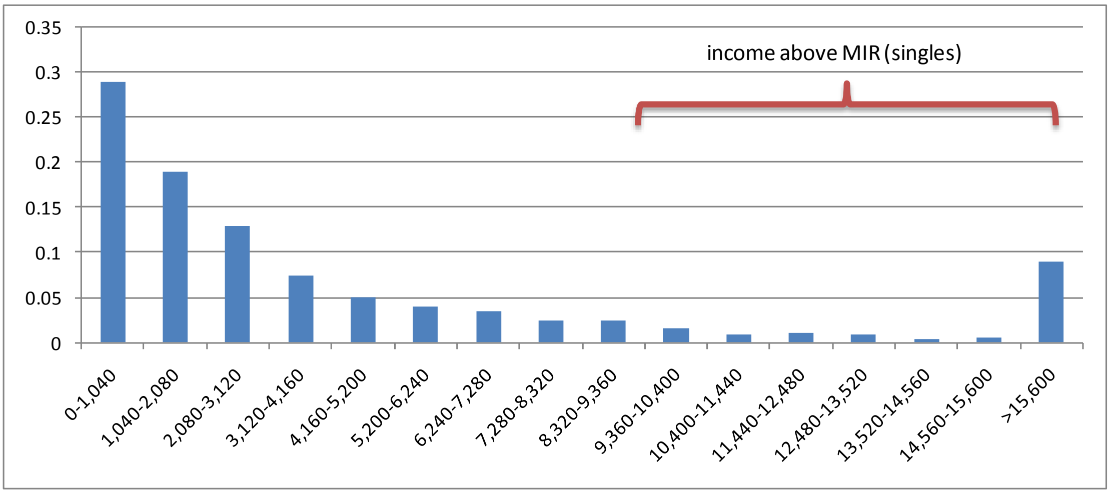
We estimate that 28 per cent of retiring pensioners with private pension savings would have sufficient pension wealth to secure a MIR at the levels described above. We also estimate that the minimum cost of the pension credit alone that these pensioners might eventually be able to claim is £83 million per annum (£1.7 billion in present value terms). This figure does not include the cost arising from other means-tested benefits that we have been unable to quantify. It is crucially important for policymakers to recognise that these cost estimates are highly sensitive to the assumptions chosen, and that there is therefore a considerable risk to the public finances in setting the MIR too low. Using different but still plausible different actuarial assumptions, for example, would double the cost of Pension Credit estimated above. So although this figure is uncertain it is likely to be an under-estimate.

4. The impact of the proposal on the UK annuity market

According to figures from the ABI, in 2009 the UK's new pension annuity market consisted of 465,000 policies with a value of £11 billion, so that the average policy value is around £23,655. We will examine the effect of the proposal to remove compulsory annuitisation of DC schemes on this market, taking into account that those individuals below the MIR will still be required to purchase an annuity.

The DWP's *Pensioners' Income Series* gives details of pensioners' incomes based on information collected in the Family Resources Survey (FRS). This survey provides a breakdown of pensioner income from the state pension, other benefits, investment income, earnings occupational and personal pensions. Figure 4.1 shows the distribution of pensioners' incomes from personal pensions for those in receipt of it. In 2008-09, the mean personal pension income for the recently retired was £97 per week (£5,044 p.a.).

Figure 4.1: Distribution of annual income (£p.a.) from personal pensions in 2008-09 of "recently retired"



Source: DWP (2010) Pensioners' Income Series

Relaxing the requirement to annuitise affects those individuals above the MIR, and to examine the effect of the proposal on the UK annuity market we may take the pensioners' incomes from personal pensions above the MIR, for those pensioners who are retiring each year, and convert into an annuity value using the formula:

$$\textit{Annuity Value} = \textit{No. pensioners} \times \textit{Annuity Income} \times \textit{capitalisation factor}$$

To estimate this annuity value we need to know the number of persons retiring each year, along with their ages and gender; the personal pension income received by these groups; and a capitalisation factor that converts pension payments into a lump sum equivalent value. We discuss each component of this calculation in turn.

Number of pensioners

The *DWP (2010) Pensioners' Income Series* gives details of the number of "recently retired pensioner units" (about 2,000,000 units with 1,100,00 couples and 900,000 singles) in 2008-09, where "recently retired" is defined as pensioner units where the head is less than 5 years over state pension age, namely, single women between 60 and 64, single men between 65 and 69, and pensioner couples where the head is between 65 and 69 if male, or between 60 and 64 if female. Therefore, to obtain an estimate of the number retiring each year, we need to take a proportion of these figures, allowing for the fact that these five-year aggregates will include a disproportionate number of those pensioner units who have retired in the first year, and a disproportionate number of single females. We allow for these effects in Table 4.1.

Table 4.1: Numbers of retiring persons per year

	Numbers	**Numbers receiving personal pension**
Married couples	248,534	62,134
Single males	67,503	8,775
Single females	119,856	15,581
Total Number of retiring units in 2010	435,892	86,490

Sources: DWP (2010) Pensioners' Income Series, and own calculations

The last column is obtained from the proportion of recently retired pensioner couples and single units receiving a personal pension given in the Pensioners' Income Series as 25 percent and 13 percent respectively

Pensioners' incomes

The *DWP (2010) Pensioners' Income Series* breaks down the income received from personal pension schemes, by recent retirees, and into couples and singles, and by gender. In Table 4.2, we report the mean and median amounts of personal pensions received by type of pensioner household.

Table 4.2: Average amount of personal pension income of recently retired for those in receipt in 2008-09

	Mean personal pension (£)		**Median personal pension (£)**	
	per week	per year	per week	per year
Married couples	109.0	5,668	48	2,496
Single males	145	7,549	69	3,605
Single females	45	2,323	21	1,109

Source: DWP (2010) Pensioners' Income Series, Table 3.7, and gender split from Table 2.6

We can combine the distribution of personal pension income from Figure 4.1 with the average amounts received by household type to obtain a distribution of personal pensions by household type, under the assumption that the entire distribution is shifted up or down to match the average pension for that type. There are likely to be compositional effects in the distribution, which this assumption ignores, and this should be borne in mind when interpreting the subsequent calculations.

Capitalisation factor

All that remains is to apply a capitalisation factor to obtain the value of these personal pensions. We use standard actuarial methods to compute the present value of a £1 annual annuity income, by age and gender, assuming survival probabilities of each group taken from the Continuous Mortality Investigation (2002) life office pensioner tables PMA92 and PFA92 with the short and long cohort corrections.[9]

Table 4.3: Capitalisation factors for a pension of £1 per annum payable for life

	Survival probabilities	
	short cohort	long cohort
Panel A: Single annuity for 65-year-old male		
Level	13.6	14.4
Escalating at 2.5%	17.6	19.1
Real	19.2	21.1
Panel B: Single annuity for 60-year-old female		
Level	16.3	16.9
Escalating at 2.5%	22.6	24
Real	25.3	27.1
Panel C: Joint annuity for 65-year old male, reverting 60% to 63-year old female		
Level	15.4	16.2
Escalating at 2.5%	20.7	22.5
Real	23	25.1

Source: CMI (2002) life office pensioner tables PMA92 and PFA92

The retiring cohort of pensioner units is made up of couples and singles, and we assume that couples purchase a joint life annuity, with the annuity payment reduced to 60 per cent on the death of the male. We assume couples consist of a 65-year old male married to a 63-year old female (based on an assumption of a 2.4 year difference in the ages of the couple[10]). Single women pensioners are assumed to be aged 60, and singles male pensioners are assumed to be aged 65.

Annuity values for the retiring cohort

We now combine the information in Tables 4.1, 4.2 and 4.3 to produce estimates of the annuity values implied by the personal pension incomes that are accessed by the retiring

[9] Further details of such calculations can be found in Cannon and Tonks (2008)
[10] *Social Trends* (2010), page 19/20.

cohort. We first estimate the implied annuity values without making allowance for the MIR, i.e., by assuming that the present value of all personal pension income could be accessed at retirement.

This would be the situation if all of the retiring cohort with DC pensions accessed the capped drawdown option as explained in the consultation paper (¶ 2.14).

Table 4.4: Estimated present values of personal pensions for annual retiring cohort before applying the MIR

	Numbers receiving personal pensions	Mean pension (£ per annum)	Total present value of personal pensions (£ million)	
Capitalisation factor assumption			level/short	real/long
Married couples	62,134	5,668	5,423	5,705
Single males	8,775	7,549	901	954
Single females	15,581	2,323	590	612
Total value			6,914	7,271

Source: Own calculations based on Pensioners' Income Series

According to Gunawardena et al (2008), 87 per cent of annuity products sold, are level annuities, and for this reason we use the capitalisation factor in Table 4.3 for level annuities. The final two columns of Tables 4.4 provide estimates of the value of annuities on the basis that the products sold are level annuities. These estimates suggests that depending on the assumptions made about survival probabilities (short and long cohort projections), the total present value of personal pension income is between £6.9 billion and £7.3 billion.

However, as previously mentioned, the ABI estimate of the size of the pensions annuity market in 2009 is £11 billion, so, using our approach, we appear to have under estimated the size of this market. This under-estimation may be due to a number of factors: (i) although the modal age for annuity purchase is age 65, many people access their personal pension income before this date, which would increase the value of their annuities; (ii) some of the pension annuity market will represent annuitisation of occupational DC pensions, which are not included in the *Pensioners' Income Series* personal pension income figures; (iii) some of the annuities purchased are escalating or real annuities, and as Table 4.3 shows, this would involve a higher capitalisation factor; (iv) we have already mentioned that there will be compositional effects in the distribution of the data on personal pensions, in particular single females are likely to form a greater percentage of the lower incomes; and (v) there may be errors in the reporting of pension incomes.

The consultation paper suggests that only funds above those necessary to sustain an MIR may be accessed under flexible drawdown, and provided that the recipient has annuitized up to the MIR in an escalating annuity (¶ 2.15; ¶ 3.3, ¶ 3.9). Our earlier calculations have suggested that the MIR for a single person might be £14,100 (including the Basic State

Pension of £5,077.80), meaning that only individuals receiving above £9,000 per annum from a DC pension may access flexible drawdown, and only having first annuitised their funds to receive an inflation protected pension of £9,000 per annum. Similarly for a couple the MIR might be £18,800 per annum (again including the married couples pension of £6,895.20), meaning that only couples receiving above £11,900 from a DC pension and having annuitised to receive this pension may access flexible drawdown. We may apply a cut-off at the MIR to the distribution of personal pension income, as illustrated in Figure 4.1, to estimate the annuity value of personal pension income above the MIR, under the assumption that these individuals are only in receipt of personal pension income in addition to the basic state pension. In other words, they are not receiving any other additional pension income (either occupational or SERPS/S2P). To the extent that individuals are receiving other secure sources of pension income this would enable greater amounts of personal pension income to be accessed under flexible drawdown. Table 4.5 shows the size of the annuity market that could be accessed at retirement above the MIR.

Table 4.5: Estimated annuity values of personal pensions for annual retiring cohort above the MIR

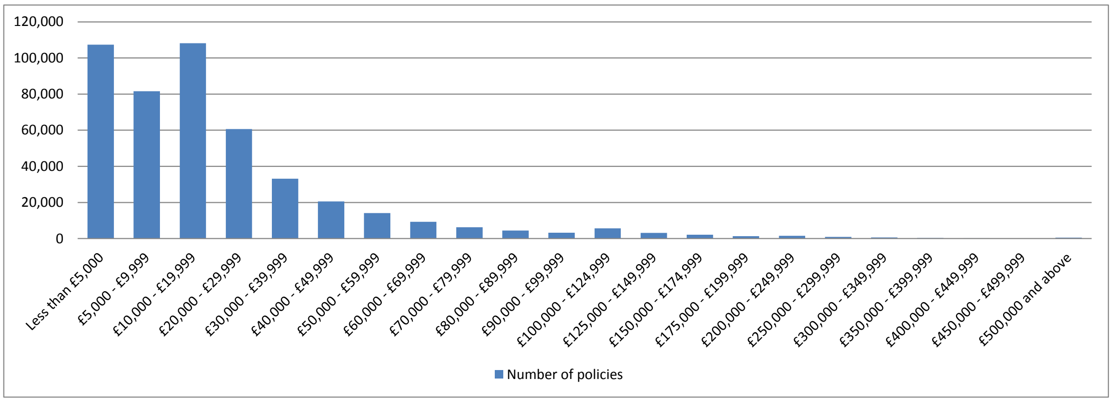
	Numbers receiving personal pensions above MIR	**Mean pension above MIR (£ per annum)**	**Total present value for personal pensions above MIR (£ million)**	
Capitalisation factor assumption			level/short	level/long
Married couples	7,767	13,200	1,078	1,067
Single males	2,325	14,711	266	271
Single females	1,402	2,909	11	0
Total value			1,354	1,339
Total Value after scaling adjustment			2,155	2,025

Own calculations based on Pensioners' Income Series

The numbers in Table 4.5 are calculated on the basis that individuals whose personal pension income is above the MIR, are required to purchase an escalating annuity (using the relevant capitalisation factors from Table 4.3) up to the MIR. The estimates in Table 4.5 indicate that the total value of personal pension income above the MIR is between £1.3 billion and £1.35 billion. This is around 19 per cent of the total annuity market that was estimated in Table 4.4. We suggested that our estimates in Table 4.4 under-estimate the ABI data on the size of the annuity market. Applying a scaling adjustment to our estimates, we predict that abolishing the requirement to annuitise DC pension funds above the MIR, will cause the remaining compulsory purchase pensions annuity market to shrink from its current size of £11 billion to between £8.8 billion and £9 billion, and that the value of DC pension funds that could be accessed as a flexible drawdown product would be between £2.0 billion and £2.2 billion per annum.

As an additional check on these calculations, we may also use the ABI figures on the distribution of pension annuities sold by fund size as illustrated in Figure 4.2. We will assume in this dataset that individuals have no more than one policy, though in practice it is possible for individuals to have more than one policy: this figure then shows the number of individuals buying annuities for various fund sizes.

Figure 4.2: Distribution of pension annuities sold in 2009 by size of fund



Source: ABI Annuity Sales Data

We may calculate the implied fund size necessary to satisfy the MIR, under alternative assumptions about the capitalisation factor, and in particular whether the annuity providers are using the long or short cohort corrections in Table 4.3.

Table 4.6: Additional estimated values of personal pension funds of annual retiring cohort

Panel A	**MIR (above BSP)**	**Fund size necessary to satisfy MIR (£ million)**	
Capitalisation factor		level/short	level/long
Married couple	£11,800	181,720	191,160
Single male	£9,000	122,400	129,600
Single females	£9,000	146,700	152,100
Panel B	**Numbers receiving personal pension above MIR**	**Total present value for personal pensions above MIR (£ million)**	
Capitalisation factor		level/short	level/long
Married couples	3,242	493	465
Single males	1,707	207	195
Single females	2,152	302	290
Total Value		1,001	949

Own calculations based on ABI Annuity Sales Data

In Panel A of Table 4.6, we compute the minimum fund size necessary to satisfy the MIR for couples and single males and females, where we make the previous assumptions on the ages of the retiring cohort. We can see that the implied fund size various depending on the relevant group from £122,400 for single 65-year old males using the short-cohort correction, to a fund size of £191,160 for a married couple. In panel B, we apply these minimum fund sizes to the distribution of funds in Figure 4.2, to obtain the potential fund sizes that could be released if these individuals accessed flexible drawdown. We assume that the distribution of these fund sizes across the type of pensioner unit is given by the ratios in Table 4.1, which again may lead to compositional errors in our calculations. The estimates in Table 4.6 suggest that the pension annuity market will shrink by between £949 million and £1 billion.

These estimates are smaller than our estimates in Tables 4.5. Both sets of estimates have been computed under different approaches: the first takes data on the distribution of pensioner incomes, and imputes fund values (Table 4.5); the second takes the existing fund values of annuity policies, and makes assumptions about the distribution of pensioner types. We suggest that using both approaches provides an upper and lower bound on the likely effect of the flexible drawdown option on the existing pensions annuity market.

Finally we note some caveats on the effects of the policy change on the annuities market. Our estimates have assumed that individuals who are able to access the flexible drawdown market will do so. This is an extreme assumption to illustrate the magnitude of the potential effects, and is a worse-case scenario. In fact currently individuals with large pension funds who could choose an unsecured pension, in fact choose to annuitise, and further they annuitise between the ages of 60-65. These individuals seem to have a demand for annuities, and it is possible that even if they were able to access flexible drawdown they would still choose to annuitise. In addition some individuals are currently accessing USP, and it is possible that if these individuals were able to access flexible drawdown they would be willing to annuitise up to the MIR in order to access their funds above the MIR. This would represent a boost to the current annuities market.

Summary

If the requirement to annuitise at age 75 above the MIR is abolished, and if instead individuals access flexible drawdown, we estimate that the compulsory purchase annuities market will shrink from its current value of £11 billion per annum to between £8.9 billion and £10 billion per annum. Further, the value of DC pension funds that could be accessed as a lump sum or drawdown product would be between £0.95 billion and £2.1 billion.

5. The impact of the proposal on DB schemes

Abolishing the compulsory annuitisation requirement for DC schemes is likely to have implications for both occupation DB and DC schemes. The Impact Assessment in the consultation document mentions the impact of the proposed change on occupational DB and DC pension schemes and paragraph 20 suggests that relatively few occupational schemes will make the required rule changes in the short-term. We question this assessment.

The Government Green Paper (DWP, 2002) carried the message that the complexity of the previous pensions regime hindered an individual's ability to make sensible savings decisions. A key proposal (subsequently enacted on A-day in April 2006) was to simplify the pensions taxation system with a move to a new system based on a lifetime allowance. According to HM Treasury/Inland Revenue (2002), a guiding principle in simplifying the tax rules for pensions included *"consistency: to give people confidence that everyone has equivalent rights and opportunities*" (paragraph 3.5) and *"By eliminating the complexity of multiple sets of overlapping rules, people will be freed to make clear and confident decisions about savings for retirement without the need for expensive advice. In the new single, unified regime there will be no need to distinguish between defined benefit and defined contribution schemes, allowing savers and employers sponsoring schemes to make arrangements for pensions to suit their career patterns and the needs of the labour market."* (Paragraph 3.6)

The implementation of the lifetime allowance by HMRC, has meant that both DB and DC pensions, are deemed to have an underlying fund value. In the case of a DC scheme, this is explicit; for DB schemes this is implicit; so that for tax purposes these two types of occupational pensions are treated the same. Assuming that the desire for equality of treatment between DB and DC schemes continues, then abolishing the compulsory annuitisation requirement for DC schemes may also apply to DB schemes. In fact, the transfer rights of members of DB schemes would also imply that an individual member of a DB scheme has the right to transfer into a DC scheme.[11] FSA (2010) provides advice on the risks associated with pension transfers. Under current rules, there has been little point in DB scheme members switching to a DC scheme since it would still be compulsory to annuitise 75 per cent of the pension fund by age 75. Given transactions costs and the fact that the pension wealth transferred may be calculated at unfavourable actuarial rates for all except

[11] Pension transfers are seen as necessary for ensuring an efficient labour market (Becker, 1964) although the government is currently consulting on proposals that would abolish transfers between contracted-out defined benefit and defined contribution schemes and is seeking an amendment to the *Occupational Pension Schemes (Contracting-out) Regulations 1996* and *The Contracting-Out (Transfer and Transfer Payments) Regulations 1996*.

those with health problems, the benefit to following this strategy has only been used by a small minority of people in particular circumstances.

Removing the annuitisation requirement could change the situation dramatically. Currently, there is a puzzle as to why individuals in a DB scheme seem content to convert their implicit pension fund into a regular pension income, whereas many individuals whose savings are in a DC scheme are reluctant to annuitise.[12] One reason relates to behavioural psychology and suggests that the annual reporting of the size of the DC pension fund, rather than the amount of pension that the fund will generate, plays a role in this puzzle. With annual pension statements in DB schemes now showing the cash value of DB pensions (in order for individuals to be informed that they are within their lifetime limit), the removal of the need to annuitise, when combined with the presentation of a cash value for accrued benefits, may have significant behavioural consequences. In simple terms, it may lead DB members to prefer taking the fund over the pension. Further, financial advisors may have an incentive to contact retiring members of DB schemes, pointing out that they are now able to access their pension fund values. We will now provide estimates of the potential quantum here. We wish to emphasise that this is a potential unintended consequence of the proposal to relax the annuitisation requirement, but the government may need to legislate to prevent DB scheme members also accessing flexible drawdown

Table 5.1 shows the numbers of active, deferred and pensioner members of occupational pension schemes. There are a total of 27 million members of occupational pension schemes, split roughly equally between active members, deferred members and pensioners. Of the 9 million active members, 5.4 million are in the public sector, and 3.6 million in the private sector.

Table 5.1: Number of members of occupational pension schemes in 2008

Type of member		**Numbers (millions)**
Active members		9.0
Private sector	3.6	
Public sector	5.4	
Pensions in payment		8.8
Private sector	5.0	
Public sector	3.9	
Deferred pension entitlements		9.9
Private sector	6.7	
Public sector	3.2	
Total		27.7

*Source: OPSS (*2009, Table 2.1*)*

[12] Selection effects might explain these preferences, since individuals who choose to join a DC scheme may have different characteristics from individuals who opt for a DB scheme.

Table 5.2 shows the 9 million active members divided across DC and DB schemes, and by size of the firm sponsoring the pension, in terms of number of employees: 7.2 million active members are in occupational schemes in which the sponsoring firm employs more than 10,000 employees, illustrating that occupational pension schemes are typically arranged by large employers.

Table 5.2: Number of active members of occupational pension schemes in 2008, by size, sector and benefit structure (millions)

Size of unit	**Private sector**			**Public DB**	**Total DB**	**Total**
	DB	DC	Total			
10,000+	1.6	0.4	2.0	5.2	6.8	7.2
1,000-9,999	0.7	0.4	2.4	5.3	7.1	7.7
100-999	0.2	0.1	0.4	0.0	0.2	0.4
<100	0.0	0.1	0.1	0.0	0.0	0.1
Total	2.6	1.0	3.6	5.4	8.0	9.0

*Source: OPSS (*2009, Table 2.6*)*

Public sector workers are covered by a variety of occupational pension schemes which are implicitly or explicitly underwritten by the Government. Table 5.3 shows the number of active members in the major public sector pension schemes

Table 5.3: Major public sector pension schemes

Funding status	**Sectors**	**Numbers of active members (millions). Source: Pensions Commission (2004)**	**Numbers of active members (millions). Source: Audit Commission (2010)**
Unfunded	Civil Service, armed forces, police, fire	1.04	0.98
Notionally funded	NHS, teachers	2.02	2
Funded	Local government	1.5	1.65
Funded quasi-public sector	Universities	0.1	0.1
Total		4.66	4.73

Source: Pensions Commission (2004) Table 3.2; and Audit Commission (2010) Figure 1

All of the private sector schemes in Tables 5.1 and 5.2 are funded, although it is only the local government scheme in the public sector that is funded. If compulsory annuitisation of DC pension schemes is abolished, there is a real possibility that a large number of public service workers from both funded and unfunded schemes would also demand their pension as a lump sum and thereby dramatically bring forward payments from the Government. In the case of unfunded public sector schemes, effectively, off-balance sheet public pension liabilities would be brought onto the balance sheet immediately, since the Government would have to issue additional bonds to make these pension payments.

A similar problem would also be felt by private sector pension funds which would be faced with raising additional funds to finance pension lump sums or would have to sell financial assets to make the cash payments.

Combining Tables 5.3 and 5.1, suggests that around 6.65 million employees are members of a funded pension scheme. Table 5.4, taken from UBS (2010), shows the estimated value of pension fund assets in self-administered DB and DC schemes, insurance company administered pension schemes, and also personal pension schemes for comparison at the end of 2009.[13] The reported values are market values and hence will fluctuate as the value of stock and bond markets fluctuate.

Table 5.4: Market value of total assets in UK pension funds at end 2009

Type of pension scheme	**£ billions**
Occupational self-administered DB	805
Occupational self-administered DC	270
Insurance company administered	245
Total occupational schemes	1,320
Personal pension schemes	305
Total all pension assets	1,625

Source: UBS Pension Indicators (2010)

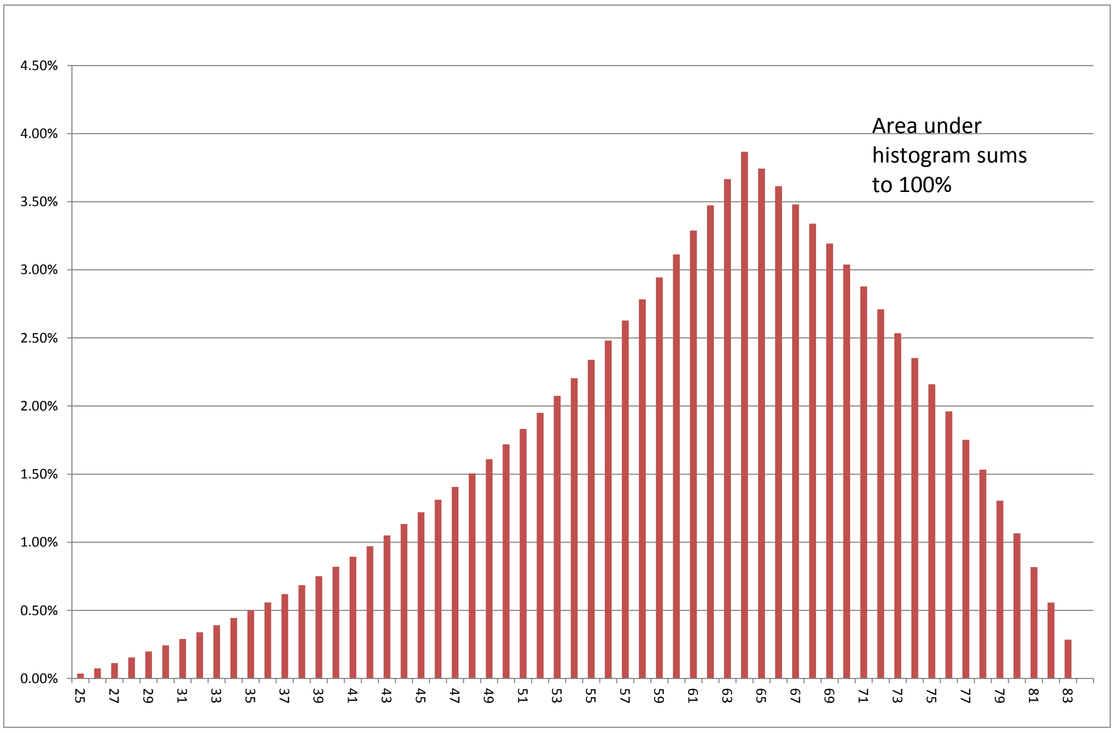
The table shows that the total value of assets held by UK occupational pension schemes at the end of 2009 was £1,320 billion. If compulsory annuitisation is abolished, the 6.65 million active members of pension schemes would be able to access their share of these funds at retirement.

In a funded pension scheme, an individual and their employer make regular contributions, and these contributions are compounded at the fund's rate of return. At retirement, the accumulated funds are decumulated to pay the pension of the members. Assume that annual contributions are £1, starting when the member is age 25 and continue for 40 years. The member retires at 65, and is expected to live until age 85, and draws down the fund to zero by this age. The annual return on pension fund assets is assumed to equal the long-term

[13] More detailed information on these fund values can be obtained from ONS (2010), publication MQ5 on investment by pension funds, insurance companies and trusts.

government bond rate of 4.2 per cent.[14] Figure 5.1 shows the percentage of the total fund value that has accrued by each age between 25 and 85.

Figure 5.1: Percent of pension fund total value credited to each annual cohort



Source: Own calculations

Unsurprisingly, this percentage is maximised at age 65, which means that the cohort that is retiring can access 3.87 per cent of the total fund value. Applying these calculations to the self-administered pensions in Table 5.3 suggests that the retiring cohort will be able to access £31 billion of DB and £10 billion of occupational DC accumulated pension funds each year. This provides our first initial estimates of the amount of money that can be accessed under flexible drawdown (before taking into account the MIR), and if flexible drawdown was applied to occupational pensions. We should note that some of these DC pension assets are annuitised in the pensions annuity market, and have already been accounted for in Section 4.

In order to provide a more sophisticated computation of the impact of DB pensioners accessing flexible drawdown, and allowing for a threshold above the MIR, we will follow the same approach taken in Section 3, and estimate implicit pension fund values based on current occupational pension income data. To obtain an estimate of the value of DB pension funds for the annual cohort of retiring pensioners, we again use the formula:

[14] Bank of England yield curves, available at http://www.bankofengland.co.uk/Statistics/yieldcurve/index.htm

Value of fund = No. pensioners x DB pension income x capitalisation factor

As in Section 4, to estimate this value we need to know the number of persons retiring each year, their occupational pension income and an appropriate capitalisation factor. We discuss each component of this calculation in turn.

Number of pensioners

In addition to the *Pensioners' Income Series*, as a robustness check on our previous estimates, we will also use ONS population estimates, so that we have two sets of estimates for the number of new pensioners each year.

The population estimates give the numbers of males and females for each age cohort for the entire UK population. We take the number of males retiring from the number of male 65-year olds, and split this group into couples and singles, based on the population estimates by marital status. Again, we assume that 65-year old males are married to 63-year old females, and the percentage of single women retiring (at an assumed age of 60) is then computed from the data in the *Pensioners' Income Series* as 27.5 per cent of retiring units.

Table 5.5: Numbers of retiring persons per year: Two sets of estimates

Panel A: From ONS population estimates	**Numbers**	**Numbers receiving occupational pension**
In 2010, number of males aged 65 retiring	312,720	
Of which: Married couples (aged 65/63)	245,926	152,474
Single males (aged 65)	66,794	31,393
Single females (aged 60) (27.5% of total)	118,598	55,741
Total number of retiring units in 2010	431,318	

Panel B: From Pensioners' Income Series	**Numbers**	**Numbers receiving occupational pension**
Married couples	248,534	154,091
Single males	67,503	31,726
Single females	119,856	56,332
Total number of retiring units in 2010	435,892	

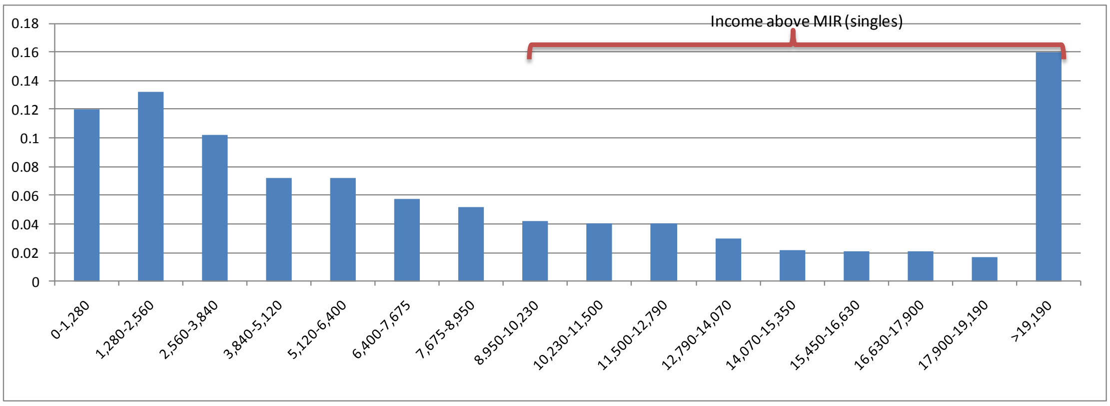
Sources: ONS Population Estimates (2009); ONS Mid-2008 Marital Status Estimates; DWP (2010) DWP (2010) Pensioners' Income Series, and own calculations

The proportion of recently retired pensioner couples and individuals receiving an occupational pension are given in the *Pensioners' Income Series* as 62 percent and 47 percent respectively, and these definitions of occupational pension income includes both DB and DC pension income.

Pensioners' incomes

DWP (2010) Pensioners' *Income Series* gives estimates of the distribution of DB and occupational DC pension income. The mean for all pensioner units is £168 per week (£8,736 p.a.), while for the recently retired it is £206 per week (£10,715 p.a.). The distribution of occupational pension income, for those pensioners in receipt of it, is given in Figure 5.2.

Figure 5.2 Distribution of annual income (£p.a.) from occupational pensions in 2008-09 of "recently retired"



Source: DWP (2010) Pensioners' Income Series

DWP (2010) Pensioners' *Income Series* further breaks down the income received from occupational pension schemes, by recent retirees, and into couples and singles, and by gender. In Table 5.6, we report the mean and median amounts of occupational pensions received by type of pensioner household.

Table 5.6: Average amount of occupational pension income of recently retired for those in receipt in 2008-09

	Mean occupational pension (£)		**Median occupational pension (£)**	
	per week	per year	per week	per year
Married couples	255.0	13,260	158	8,216
Single males	171	8,907	93	4,833
Single females	114	5,938	62	3,222

Source: Pensioners' Income Series, Table 3.7, and gender split from Table 2.6

We combine the distribution of occupational pension income from Figure 5.2, with the average amounts received by household type to obtain a distribution of each occupational pension by household type, under the assumption that the entire distribution is shifted up or down to match the average pension for that type.

Capitalisation factor

We use the capitalisation factors in Table 4.3 to obtain the value of DB pensions.

Pension fund values for retiring cohort

We combine the information in Tables 5.5, 5.6 and 4.3 to produce estimates of the value of the occupational pension fund that could be accessed by the retiring cohort. Table 5.7 suggests that depending on the assumptions made about survival probabilities and the type of pension received, the estimated total value of pension funds imputed to the retiring cohort varies between £40.3 billion and £66.1 billion.

Table 5.7: Estimated values of occupational pension funds of annual retiring cohorts before applying the MIR

	Numbers receiving occupational pension	**Mean pension (£ per annum)**	**Total present value of pension funds (£ million)**	
Panel A: From ONS population estimates				
Capitalisation factor assumption			level/short	real/long
Married couples	152,474	13,260	31,136	50,747
Single males	31,393	8,907	3,803	5,900
Single females	55,741	5,938	5,395	8,970
Total value			40,334	65,618
Value of occupational DB			24,604	40,027
Panel B: From Pensioners' Income series				
Married couples	154,091	13,260	31,466	51,286
Single males	31,726	8,907	3,843	5,963
Single females	56,332	5,938	5,453	9,065
Total value			40,762	66,314
Value of occupational DB			24,865	40,451

Source: Own calculations

These estimates in the row labelled “Total value” represent the value of funds attributable to the annual retiring cohort across all occupational pension assets, estimated as £1,320 billion in Table 5.4. As we have already mentioned, some of these DC pension funds are annuitised in the pension annuity market, and we need to be careful of double counting these estimates. The numbers in Table 5.4 suggest DB schemes represents 61% of all occupational pension fund assets, and so in Table 5.7 we estimate the value of occupational DB pension funds attributable to the retiring cohort as between £24.6 billion and £40.4 billion.

We now repeat these calculations to estimate the value of pension funds above that necessary to sustain an MIR in addition to the BSP, which we set as £9,000 pa for a single person, and £11,900 pa for a couple. Table 5.8 shows the estimated value of occupational DB pension funds that could potentially be accessed at retirement above the MIR.

Table 5.8: Estimated values of occupational DB pension funds of annual retiring cohorts for pensions above the MIR

	Numbers receiving occupational pension above MIR	Mean pension above MIR (£ per annum)	Total present value of pension funds (£ million)	
Panel A: From ONS population estimates				
Capitalisation factor assumption			level/short	real/long
Married couples	59,922	14,892	13,742	22,398
Single males	11,019	10,212	1,530	2,374
Single females	12,207	7,344	1,461	2,429
Total value			16,734	27,202
Value of occupational DB			10,208	16,593
Panel B: From Pensioners' Income Series				
Married couples	60,558	14,892	13,888	22,636
Single males	11,136	10,212	1,547	2,400
Single females	12,337	7,344	1,477	2,455
Total value			16,911	27,490
Value of occupational DB			10,316	16,769

Source: Own calculations

These calculations assume that those individuals above the MIR, still take an occupational DB pension up to the MIR. In the subsequent calculations, we will use two sets of figures from Table 5.8 to assess the impact of retiring pensioners accessing the values of their pension funds above the MIR. At the lower end, under the assumption of level future pensions, with life expectancy given by the short cohort projections, we estimate the DB pension fund values that can be accessed as £10.2 billion. At the upper end, under the assumption of real index-linked pensions, and assuming the long cohort projections for life expectancy, pension fund values that can be accessed are £16.8 billion.

Using the numbers of active members in different types of pension schemes from Tables 5.1, 5.2, and 5.3, we can allocate the estimated values in Table 5.8 across these schemes.

Table 5.9: Estimated size of DB occupational pension fund liabilities of retiring cohort across schemes above MIR, across types of scheme

Type of Scheme	No. active members (millions)	Percentage of Total	Value of pension liabilities (level/short: £ million)	Value of pension liabilities (real/long: £ million)
Private funded DB	2.6	33%	3,317	5,450
Public funded (LGPS)	1.65	21%	2,105	3,459
Public unfunded	3.8	47%	4,785	7,861
Total	8	100%	10,208	16,769

Source: Own calculations. Note we do not include private sector occupational DC schemes in this table.

The numbers in the final two columns of Table 5.9 show how the pension liabilities estimated in Table 5.8 are divided across the different types of DB pension scheme: private sector DB, public sector funded and public sector unfunded. We will now consider the impact of these fund value calculations on: private sector funded schemes, public sector funded schemes, and public sector unfunded schemes.

Impact of change in compulsory annuitisation on private sector funded schemes

We estimate that between £3.3 billion and £5.5 billion of pension liabilities in private sector DB schemes could be accessed by the annual retiring cohort. Since October 2008, the value of transfers from defined benefit schemes have to be calculated in accordance with the Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008. The cash equivalent transfer value (CETV) should broadly equal what it would cost a scheme to provide a leaving member's benefits (both accrued and discretionary) plus the value of any options the member has. The trustees can choose whether or not to include discretionary benefits. Options might include the right to commute part of the pension for a cash lump sum, the right to a higher spouse's benefit in exchange for a lower member's benefit, and the right to draw the pension before the scheme's normal retirement age (NRA). The scheme actuary, who will calculate the CETV, is entitled to take into account the likelihood of these options being exercised.

The Regulations require certain economic, financial and demographic assumptions to be made in order to calculate the CETV. These will be based on the actual scheme membership, but can be adjusted in the light of external information. The scheme's investment strategy will also influence the size of the CETV. Other things equal, a higher equity weighting in the scheme will lower the CETV, since a smaller initial investment is needed to achieve a target fund size when investment returns are assumed to be higher (as they are with equities in comparison with bonds, for example). Finally, the trustees can reduce the CETV in proportion to the size of any scheme deficit. However, they must do this on the basis of an Insufficiency Report prepared by the scheme actuary.

In order to assess the impact of allowing members of private DB schemes to access the value of their pension fund at retirement, we will use information on funding from the *Purple Book*, published jointly by the Pension Protection Fund and The Pensions Regulator. It is estimated that there is a universe of 7,400 PPF-eligible DB funded schemes in the private sector. Table 5.10 provides estimates of the membership of these schemes, and these membership numbers are comparable with the private sector numbers in Tables 5.1 and 5.2. The figure of 2.6 million active members in private sector occupational DB schemes in Table 5.2 is consistent with the 2.57 million in Table 5.11. The figure in Table 5.1 showing occupational pensions membership in all schemes is slightly higher than the figure in Table 5.11 and this is presumably due to members who are in occupational DC schemes and smaller DB schemes outside of the PPF-eligible universe.

Table 5.10: Membership of PPF-eligible DB universe (7,400 private sector schemes at 31 March 2009)

Type of member	Number of members
Active members	2.57
Pensioners	5.33
Deferred members	4.47
Total	12.37

Source: PPF/The Pensions Regulator (2009) Purple Book, Table 3.5

The *Purple Book* also includes data on the funding status of these DB schemes, and these data are updated on a monthly basis. Table 5.11 shows the funding status of the PPF-eligible DB universe at 10 June 2010. The funding status shows the extent to which a pension fund's assets are greater (surplus) or less (deficit) than the promised DB pension liabilities. There were 2,233 schemes in surplus (34 per cent) and 4,420 in deficit (66 per cent) at 10 June 2010. The total deficit of these funds in deficit was £81 billion.

Table 5.11: PPF-eligible DB funding statistics at 10 June 2010

	Number of schemes	Percent	Assets (£billion)	Liabilities (£billion)	Balance (£billion)	Funding ratio
Aggregate	6,643		901.5	923.3	-21.8	-2.39%
Deficit schemes	4,420	66%	469.2	550.2	-81.0	-15.89%
Surplus schemes	2,233	34%	432.3	373.1	59.2	14.69%

Where Funding ratio=Balance/((Assets+Liabilities)/2)
Source: PPF 7800 Website data

For the 34 per cent of schemes in surplus, presumably they will need to sell assets when retiring pensioners access their funds. Our estimates from Table 5.9, suggest that between £1.1 billion and £1.8 billion worth of funded DB assets will be liquidated in this way (calculated as 34 per cent of £3.3 billion or £5.5 billion), representing between 0.3 per cent and 0.5 per cent of the private sector's DB pension fund liabilities for those schemes in surplus. For those schemes in deficit, calculation of the CETV, suggests that the pensioner withdrawing funds will be expected to bear part of the deficit. So that although the present value of the retiring cohort's pension liability entitlements are between £2.2 billion and £3.6 billion (calculated as 66 per cent of £3.3 billion or £5.5 billion), we predict that running down the assets will result in pension fund asset sales of between £1.9 billion and £3 billion (calculated as 84 per cent of £2.2 billion or £3.6 billion, given the funding ratio of -16 per cent for deficit funds). Further we note that The Pensions Regulator might anticipate these withdrawals from the deficit funds, and require the scheme's sponsors to make good these deficits.

Impact of change in compulsory annuitisation on public sector funded schemes

The major funded public sector pension scheme is, as mentioned above, the Local Government Pension Scheme (LGPS). The Audit Commission (2010) recently analysed the affordability, fairness and financial health of this scheme for England. Figure 2 in that report suggests that as at end-March 2010, assets cover about three-quarters of the pension liabilities in LGPS. Table 5.9 indicates that between £2.1 billion and £3.5 billion of pension liabilities in the public sector funded DB schemes could be accessed by the annual retiring cohort. In the case of the LGPS, in part this could be met by running down assets, but since the scheme is only 75 per cent funded, then the calculation of the CETV would suggest that the retiring scheme members would have to bear part of this deficit. We predict that the retiring cohort would be able to access between £1.6 billion and £2.6 billion of the claims on their pension fund which would be met by running down the LGPS's scheme assets.

Impact of change in compulsory annuitisation on public sector unfunded schemes

Table 5.9 indicates that there are around 3.8 million active members of unfunded public sector DB pension schemes, and this represents around 42% of the funds that could be accessed at retirement by the retiring cohort, and would add between £4.8 billion and £7.9 billion to the public sector deficit on an annual basis, if these implicit fund values were realised.

Summary

We suggest that the proposal to abolish the annuitisation requirement for DC pension schemes will have an effect on the DB pensions market, either through DB members demanding similar rights under their scheme or through pension transfers. We suggest that if the same rules on annuitisation above a minimum income requirement in the DC market are applied to the DB market, between £10.2 billion and £16.7 billion of DB pension fund assets may be accessed each year by the retiring cohort. We suggest that if the government does not intend its proposals on the relaxation of annuity rules for DC pensions to apply to DB pensions, it will need to legislate to prevent this.

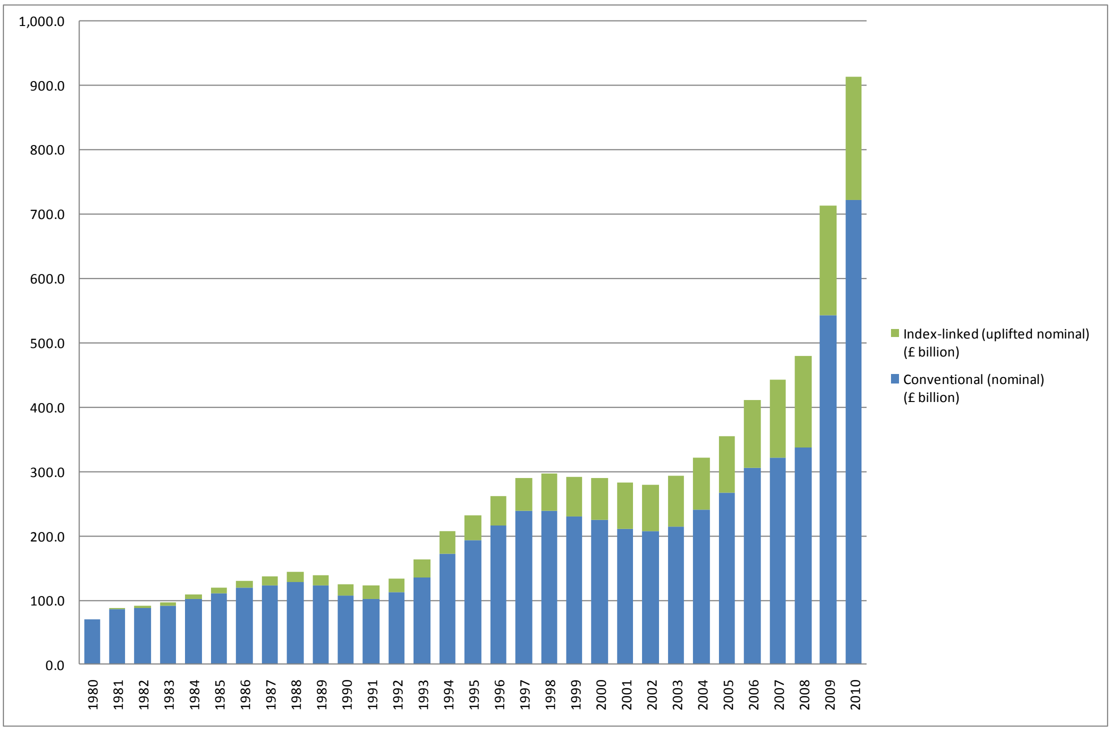
6. Impact of the proposal on long-term government bond markets

According to the DMO (2004: ¶ 6), the UK Government's debt management policy objective is:

"to minimize over the long term, the costs of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy."

It achieves this objective and arrives at its issuance plans each year by taking into account: (i) the Government appetite for risk (both nominal and real in each year); (ii) cash management requirement for Treasury bills and other short term debt instruments; (iii) the shape of the yield curves (nominal and real) and the expected effect of issuance policy; and (iv) investors demand for gilts. Figure 6.1 shows the size of the gilts market over time, and the split between conventional and index-linked bonds: index-linked bonds have continued to increase as a proportion of gilts issued since they were first issued in 1981. The total outstanding size of the gilts market in 2010 was approaching one-trillion sterling.

Figure 6.1: Size of the outstanding UK gilts market by bond-type



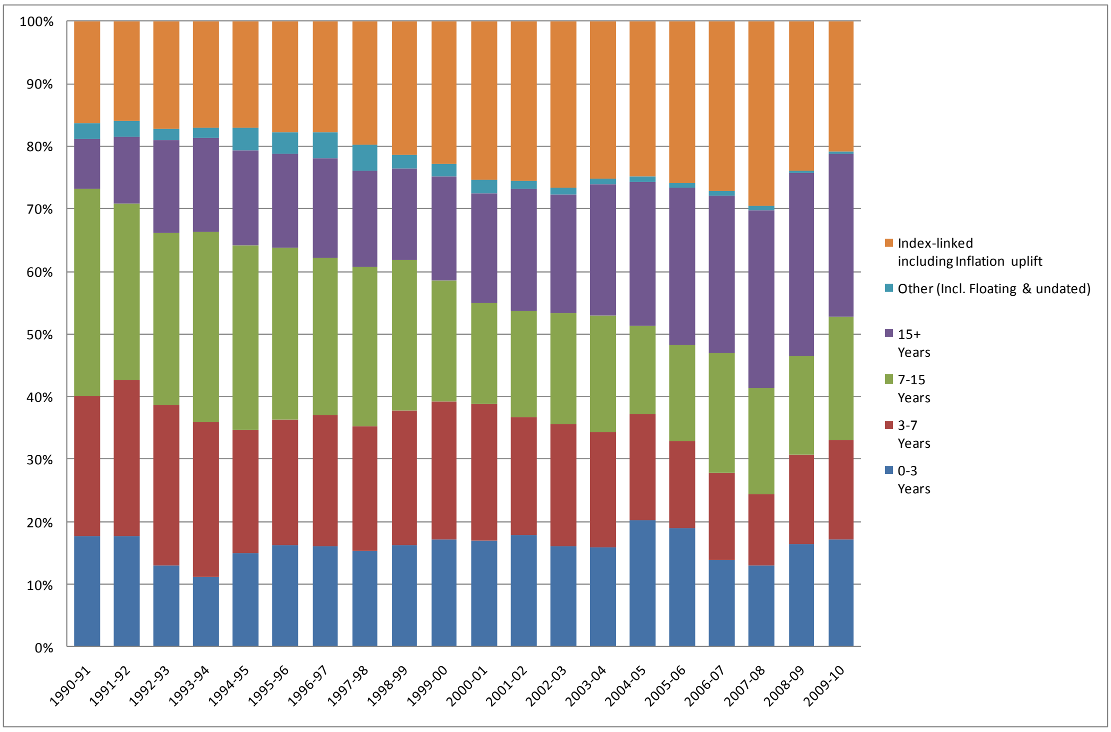
Source: DMO

Following calls from the pensions industry during 2004 for more and longer-dated debt, the DMO (2004) consulted with participants in the pensions industry. The consultation paper noted (¶ 11) that according to ONS data, pension funds and insurance companies were already the largest group of holders of gilts (64%) and their demand (¶ 8) reflected the UK Government's issuance of longer maturity bonds relative to other major governments.

The 2004 consultation paper recognised that the demand from pension funds for long-term bonds would increase in the future because of demographic trends, closer matching of assets and liabilities (i.e., switching from equities to bonds in pension fund portfolios) and *"the likelihood that a shift from defined benefit to defined contribution schemes will increase demand for annuities"* (¶ 11).

As a consequence of the consultation, a new 50-year maturity conventional gilt was issued in May 2005 and a new 40-year conventional gilt followed in May 2006. The first 50-year index-linked gilt was issued in September 2005.

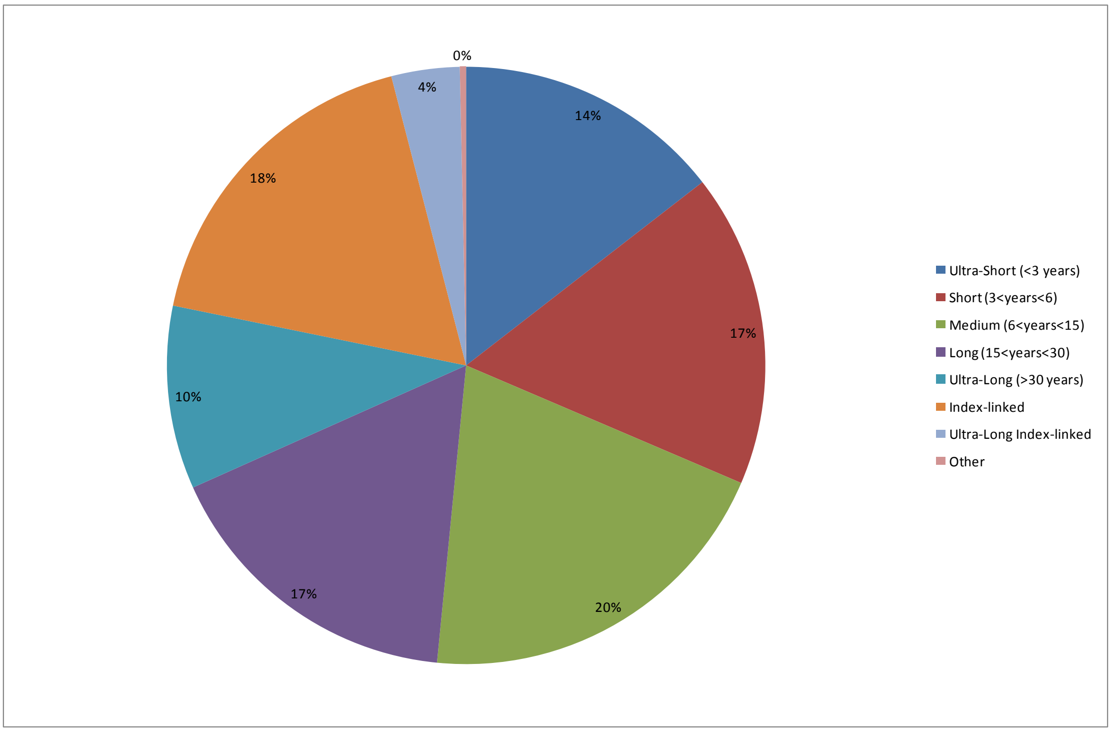
Figure 6.2: UK Gilt market composition over time



Source: DMO

Figure 6.2 shows the changing composition of the Government's gilt issuance with the increasing emphasis on longer-term gilts: the percentage of index-linked and conventional bonds above 15 years' maturity has increased from less than 30 per cent in 1990/91 to nearly 50 per cent in 2009/10. Figure 6.3 shows a more detailed breakdown of the composition of gilts in 2010. This figure again emphasises the increasing importance of ultra-long gilts (both conventional and index linked) which comprise 15 per cent of the total amount of gilts outstanding of £963 billion.

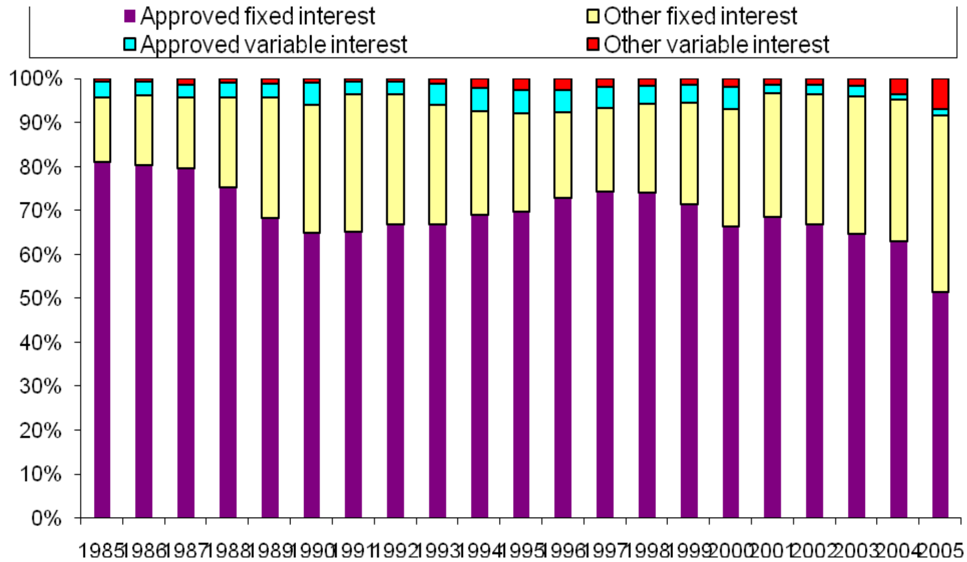
Figure 6.3: Composition of gilts in issue in 2010 (£ million nominal)



Source: DMO

Annuity providers use a combination of existing long-, medium- and short-term government bonds, as well as other financial instruments including swaps and other derivatives, to immunize their portfolio of annuity liabilities against interest rate risk.

Figure 6.4: Type of debt instruments held by insurance companies



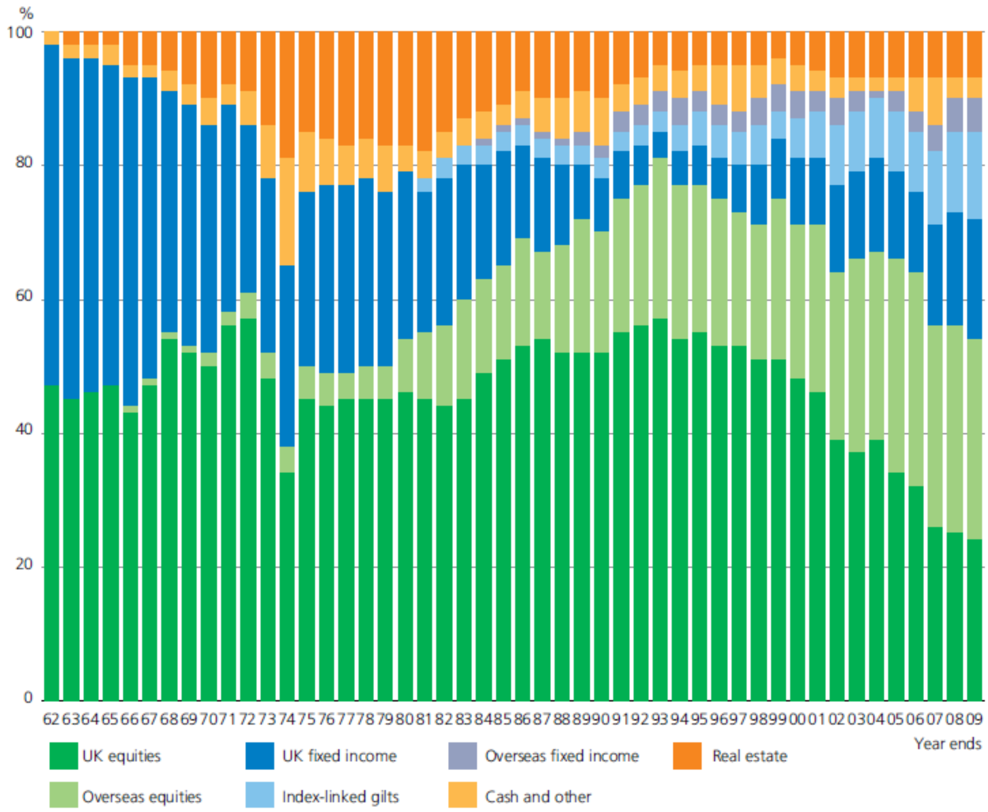
Source: FSA Insurance Returns

Figure 6.3 shows that the mixture of government bonds (approved) and corporate bonds (other) held by insurance companies has shifted over time: in 1985, life insurance companies held five times as many government bonds as corporates; by 2005 this ratio was almost unity. The effect of abolishing compulsory annuitisation would be that on an annual basis life-insurance companies and pension funds would reduce their demand for long-term gilts, because of the contraction in the pensions annuity market discussed in Section 4, and the possible effects on the DB pensions market discussed in Section 5.

Life insurance companies and pension funds would sell off their holdings of long-term gilts, depressing gilt prices at the longer end, and hence increasing yields. From our estimates in Table 4.5, we predicted that the existing annuity market would shrink by between £1 billion and £2.2 billion. The information in Figure 6.4 suggests that half of these funds are held in approved fixed interest securities, so that insurance companies would sell off between £0.5 billion and £1 billion of gilts annually. This represents around 0.5% of the outstanding stock of ultra-long conventional and index-linked gilts.

Figure 6.5 shows the asset allocation of DB pension funds over almost fifty years, and we can see that by 2009, 31% of pension fund assets were held in UK fixed interest securities (government and corporate bonds) and index-linked securities.

Figure 6.5: Asset allocation – average pension fund 1962-2009



Source: UBS Pension Fund Indicators (2010)

From our estimates in Table 5.8, we predict that if the abolition of the annuitisation requirement was applied to occupational DB plans, then between £10.2 billion and £16.7 billion could be accessed annually by the retiring cohort if they wanted to access flexible drawdown above the MIR. Using the information in Figure 6.5, this implies that pension funds will annually liquidate between £3.2 billion and £5.2 billion of long-term government debt.

The increase in yields at the long end may have an effect on yields at the shorter end, making it more expensive for the Government to issue debt. Individual pensioners would be unlikely to buy these long-term gilts, since the flexibility that these pensioners desire would probably be satisfied by a move into domestic and international equities.

Summary

We argue that the proposal to abolish the annuitisation requirement will have an effect on the government bond market. If the retiring cohort of pensioners accesses their DC lump sums, we predict insurance companies will no longer need to hold government bonds in the same quantity to back their annuity products and would become net sellers of between £0.5 billion and £1.2 billion of gilts annually. Similarly if DB pensioners also access the lump sum equivalent of their pensions at retirement, DB pension funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. This liquidation of government debt will occur at a time when the Government is attempting to fund a huge budget deficit by issuing bonds.

7. The optimal decumulation investment strategy and the cognitive problems that elderly people can face when dealing with investments

The consultation paper (¶ 2.14) suggests that capped drawdown will be available to all pensioners without any need to satisfy a minimum income requirement. However, in practice this is unlikely to be a suitable choice for most people. As FSA rules recognise, drawdown products are risky, and are only suitable for relatively wealthy individuals.[15] A number of studies have shown that the optimal decumulation investment strategy (i.e., the strategy to optimally run down in retirement the assets that have been accumulated during the working life) is highly complex (e.g., Blake et al. (2003), Blake (2003), Gerrard et al. (2004), Cairns et al. (2006) and Blake et al. (2009)). It will depend on factors such as anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. The optimal strategy might not involve the immediate purchase of an annuity, especially if risk aversion is low or the desire to make a bequest is high. In this case, the optimal strategy is income drawdown. However, there will come a time when the implicit return on an annuity exceeds the return on financial investments such as equities[16] and then it becomes optimal to annuitise remaining wealth. This typically occurs around the age of 80 for males. Another optimal strategy is to annuitise gradually. Although the studies cited here consider optimal investment strategies at high ages, they do not take into account the cognitive problems that elderly people can face when dealing with investments.

There have been a number of examples of mis-selling in the financial services industry in recent times. Two important examples have involved mortgage endowments and pensions mis-selling (Financial Services Authority, 2000, 2002).[17] The scale of the pensions mis-selling was enormous: "Offers (in relation to pensions mis-selling between 1988-1994) have been made to over one million consumers amounting to nearly £9 billion" (Financial Services Authority, 2002). The FSA took disciplinary action against 345 firms which involved fines totalling £9,507,250. The pensions mis-selling did not end in 1994. As late as 2008, the FSA

[15] The FSA MoneyMadeClear Guidelines on Income Withdrawal (January 2009) and the latest FSA guide to pension annuities and pension fund withdrawal emphasises that "*Income withdrawal plans are complex and not suitable for everyone, for example if you have a small pension fund and no other assets or income to fall back on*" (April, 2010). Earlier versions of the FSA guides to pension annuities recommended that "*Income withdrawal involves extra costs and extra investment risk compared with buying an annuity straight away. For this reason, it is usually suitable only if you have a pension fund of over £100,000 (after taking any lump sum) or you have other assets and sources of income to fall back on*" (January, 2004).

[16] The technical condition is when the mortality drag exceeds the equity premium (Milevsky (1998))

[17] The personal pensions mis-selling scandal took place between 29 April 1988 and 30 June 1994. Individuals who would have been financially better off at retirement in their employer's pension scheme were advised to leave their employer's scheme and transfer their pension benefits to a personal pension plan instead.

was forced to announce "The FSA is taking action to improve the quality of advice given to customers to switch into a personal pension or self-invested personal pension (SIPP), following a review which found variable standards across a sample of 30 firms" (Financial Services Authority press release, 5 December 2008). This followed an FSA review which found that 16 per cent of 500 transfers into a new SIPP was poor advice.

A key point about the above mis-selling cases is that the people involved were still in work and many of them were relatively young. They could, therefore, have been expected to be relatively financially aware of the implications of the decisions they were being persuaded to take. But clearly this was not the case. An FSA (2006) survey of financial capability found that in a financial literacy quiz, the under-40's performed worse than their elders, but that the over-70s performed worst of all age groups. The problem is compounded when it involves elderly people who are unable to return to work in order to rectify the financial consequences of any mistakes they make.

A recent US study has examined the effect that cognitive impairment has on financial decision making. The susceptibility to dementia doubles every five years after age 60. Agarwal et al. (2009) discovered that around 50 per cent of people in their 80s experienced significant cognitive impairment (including dementia) and this prevented them from making sensible financial decisions.

Older adults also show a marked decline in "numeracy", the quantitative skill necessary to understand the meaning of numerical information such as percentages and probabilities. This meant that older people had considerable difficulty with comprehending even simple measures of risk. For example, when invited to say which of the following involved the greatest risk of getting a disease, 1 in 10, 1 in 100 or 1 in 1000, 29 per cent of a sample of 65-94 year-olds gave an incorrect answer (Peters, 2008).

As an illustration of the confusion that people can face when making annuity decisions, consider the framing study of Brown et al. (2008). The study involved 1300 people over the age of 50 who were asked to select between one of two choices designed to have the same actuarial value:

1. an annuity paying $650 a month for life
2. a savings account containing $100,000 and paying 4 per cent interest.

Half the sample of participants in the study were offered the two options in a "consumption" frame where the annuity was explained as a vehicle for providing a secure income of $650 a month for life. Around 70 per cent of this subsample chose the annuity. The other half were offered the two choices in an "investment" frame where the annuity was explained as an investment generating a return of $650 a month. Just 21 per cent of the second subsample chose the annuity. This is because the annuity now appeared to be a risky investment since it would be lost if the individual died early: the option of having the $100,000 "invested" in the savings account was now interpreted as a much safer investment even though the savings account will not hedge an individual's longevity risk.

A key problem with the Government's proposal is that it changes the frame through which a pension scheme will be viewed and assessed. The main purpose of a pension scheme is to provide, for however long the pensioner lives, consumption in retirement sufficient to avoid a dramatic fall in living standards compared with when the pensioner was in work. The appropriate frame for viewing a pension scheme is therefore the "consumption" frame. After the implementation of the Government's proposal, a pension scheme will be viewed through an "investment" frame which will make the purchase of an annuity not only appear risky, but also very unfair to the pensioner's family who will now be denied their "right" to inherit the pension fund when the pensioner dies.

This is very well illustrated in a recent newspaper article entitled "Can my wife inherit my pension if I die?" The newspaper interviewed a 57-year-old self-invested personal pension scheme member who is "delighted that he will no longer be forced to buy an annuity when he turns 75. … He plans to take out an income drawdown plan when he retires at 66, as he dislikes annuities. He says: 'I hate the idea of my money going to an insurance company instead of my kids. I am opting for income drawdown because I want the flexibility and control of my money…. The new rules mean we can pass our remaining pension straight to our children, even if they have to pay a 55 per cent tax charge.' " This illustrates that merely re-framing the presentation annuitisation decision can change behaviour.

Summary

Optimal decumulation investment strategies can be highly complex and need to take into account anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. Further, the optimal strategies are not static and involve complex choices about, say, the optimal timing of annuity purchases. However, these strategies typically fail to take into account the cognitive problems that elderly people can face when dealing with investments. The proposed change to the pensions annuity market represents a shift from a "consumption frame" to an "investment frame". We report that, whether as a result of cognitive impairment or an inappropriate framing of choices, many older adults will find it difficult to make sensible decisions about how to invest and spend their retirement savings. The Government could soon find itself embroiled in another mis-selling scandal and this time involving vulnerable elderly people.

8. Inheritance and savings decisions

Our discussion so far has concentrated on the consequences of removing the compulsory annuitisation requirement for pension wealth and for means-tested benefits. In this section we consider two other questions: first, will wealth which is not annuitised be used for bequests; secondly, how might the change in policy affect the savings decisions of people who are not close to retirement? One of the reasons for the proposal is to encourage people to save more throughout their lifetime. For example, the Introduction to the consultation document states that "the current inflexibility in the pensions tax rules acts as a barrier to saving for some because people have very little choice in securing a retirement income and finding a solution that is best for them". In our discussion we take account of the alternative tax-efficient savings vehicle (an ISA, with an annual limit of £10,200) which is more flexible than a pension as it is possible to access the funds before retirement.

We shall see that the benefits of the new policy depend largely on whether someone is a higher-rate or basic-rate taxpayer while in employment. In both cases there is already an incentive to save in a pension fund because tax relief on contributions tends to be higher than the tax paid on income received from a pension.[18] In this section we concentrate on the additional incentives to save other than those that exist already.

The consultation document states that "the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance. The Government will therefore ensure that the tax rate on unused funds remaining on death does not leave open incentives for pension saving to be used to reduce inheritance tax liabilities. The Government will monitor this closely and will take further action if there is evidence of such activity" (¶2.2).

Under current rules, there are penal tax rates (up to 82 per cent) on wealth which has not been annuitised by the age of 75 (i.e. for pensioners who choose the option of alternatively secured income).[19] The proposed policy is that any unused funds payable on the death of a

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[18] In 2009-10 there were 3.1 million higher-rate taxpayers of whom 1.9 million had incomes less than £50,000 (Inland Revenue Statistics, 2010). Anyone with an income of £50,000 in employment is likely to have a pension of less than £43,875 and thus have a lower marginal tax rate on retirement, although these thresholds will change considerably over time. Basic-rate tax payers receive tax relief on NI contributions (11 per cent) but do not pay NI contributions on pension income.

[19] An apparent anomaly is that if a pensioner dies before the age of 75 without accessing the pension fund at all, then the entire fund is free of both a recovery tax or inheritance tax: the consultation suggests that this policy continue. Relatively poor pensioners in bad health who face steep withdrawal rates of means-tested benefits might then have an incentive not to take a pension but to pass on their fund. But the sums of money would be very small. Very rich

pensioner will be taxed at 55 per cent. A recovery charge of 55 per cent means that the Government approximately re-claims the tax privileges given to a higher-rate tax payer in the accumulation of the pension fund. This is because 25 per cent of the fund can be taken as a tax-free lump sum: the 41 per cent tax relief given to the entire pension fund must now be reclaimed from the remaining 75 per cent and 0.41/0.75 = 54.7 per cent.[20]

Consider a higher-rate taxpayer who wishes to invest money which is then left as a bequest. The two simplest savings vehicles are the pension fund and an ISA. Assuming the same pre-tax rate of return can be earned on both, the pension fund and the ISA are now perfect substitutes, since the investment returns are not taxed in either case and the additional tax relief on contributions to the pension fund are matched by the recovery charge. However, the pension fund has three additional advantages: first, it is accompanied by the 25 per cent lump sum; second, it is not liable to inheritance tax; third the option of investing in an ISA may be unavailable since there is an annual limit of £10,200. While not all higher-rate income tax payers will be liable for inheritance tax, many will be and the new policy is likely to be faced with this problem.

The consultation document suggests that this issue will be closely monitored so that further action can be taken.[21] It is difficult to see how this will be monitored, except by analysing the sums of money which escape taxation in this way. Since this information will only be available when people die, which will be some considerable time in the future, an expectation to this entitlement will have accumulated and it may prove politically difficult to reverse.

The situation is different for basic-rate taxpayers. Most basic rate taxpayers will also be paying National Insurance contributions of 11 per cent, so the effective rate of tax relief on pension contributions for these people will be 31 per cent. This suggests that the appropriate recovery charge for such people should be 0.31/0.75 = 41 per cent, so a recovery charge of 55 per cent will be a penalty rate for these people.

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pensioners with sufficient funds that they did not need to access their pension wealth would be a different matter, but such people are more likely to live beyond 75.

[20] The situation is complicated by some higher-rate taxpayers having a 50 per cent tax band. The 41 per cent assumes 40 per cent income tax and 1 per cent National Insurance contributions.

[21] The wording used in the consultation is almost identical to that of the previous government's paymaster general, Dawn Primarolo, (Hansard 21 Mar 2005 : Column 40WS) with reference to alternatively secured income being used as a tax avoidance measure. The policy was reversed about a year later.

Table 8.1: Average post-tax cumulative return on pension wealth left as a bequest for a basic-rate taxpayer

Number of years money is invested	**Personal pension**	**ISA account**	**Simple investment account**
5	3.6	7	5.6
10	5.3	7	5.6
15	5.9	7	5.6
20	6.1	7	5.6
25	6.3	7	5.6
30	6.4	7	5.6
35	6.5	7	5.6
40	6.6	7	5.6

Source: Own calculations

Table 8.1 shows the effect of this recovery charge on any pension funds which remain on the death of a pensioner and which are passed on as a bequest. In all cases we assume that there is no Inheritance Tax and that the investment earns 7 per cent gross per year. Money invested in an ISA receives 7 per cent and that outside an ISA is taxed at 20 per cent and has a net return of 5.6 per cent. Money in a personal pension receives tax relief of 31 per cent and pays a recovery charge of 55 per cent. Since basic-rate taxpayers are unlikely to exhaust their ISA limit of £10,200 per year, then it can be seen that the recovery charge is sufficiently high that there would be no incentive to try to use the pension fund for inheritance purposes relative to the ISA.[22]

A consequence of this is that the policy might appear to benefit higher-rate taxpayers considerably more than basic-rate taxpayers. There are a considerable amount of basic-rate taxpayers whose income is sufficiently high that not all of their pensions savings will be needed to meet the MIR.[23] These people may feel it to be unfair that they are penalised for bequeathing their additional pension wealth to heirs when higher-rate tax payers appear not to be.

[22] With short time horizons, using a pension scheme to avoid inheritance tax would be less efficient than a non-tax advantaged investment account.

[23] There are currently 26.7 million basic-rate tax payers with income abover £30,000, although many of these are not in employment.

Summary

Allowing pensioners to avoid annuitisation will make it possible for pension fund wealth to be used for inheritance tax purposes. To prevent this the consultation proposes a 55 per cent recovery charge. Since this merely cancels the tax relief on pension contributions of a higher rate taxpayer, such a charge may be insufficient to prevent higher-rate tax payers using pension wealth in this way and this may result in loss of tax revenue. However, the 55 per cent recovery charge would be penal for basic rate taxpayers. Differential treatment in this way may be perceived as unfair and result in political pressure for further changes.

9. Policy recommendations

In this section we explicitly respond to the consultation questions which are listed in summary form on page 21. The consultation requested views on the following points below. As our report makes clear, however, some of the most important consequences of the policy are not considered by these questions.

A.1 The level of an appropriate annual drawdown limit for capped drawdown.

Since the objective must be to avoid running out of pension assets before death, the annual drawdown limit should equal the annuitisation value of residual pension wealth (Blake et al. (2003)). The amount will rise from one year to the next if the equity premium exceeds that year's survival credit or mortality drag[24] and fall otherwise.

A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

A.3 What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

The consultation document proposes that the MIR should be indexed by LPI. We do not view this as entirely appropriate since annuity income will grow more slowly than limits for means-tested benefits and benefit entitlement will inevitably grow over time. However, without considerable financial innovation, it is impossible to provide alternative annuity products which would resolve this issue.

It is appropriate that employment income should not be counted as secure income to meet the MIR because pensioners earnings will only be significant early in retirement. We believe that it would be difficult to frame appropriate rules for the MIR that allowed pensioners to access their pension wealth while continuing to work.

A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

The immediate need for any MIR is that it is set at a high level to minimise entitlement to Pension and Guarantee Credit. Using two different methods of projecting wages and inflation, we calculate that the MIR for a 65-year old individual should be commence at £14,100 (including the BSP) and for a couple (male aged 65, female aged 63) should be £18,800

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[24] The proportion of people of a given age who die during the year.

(including BSP) in 2011 and then grow in line with the LPI. If a pension unit secures the MIR at a later age then the MIR applying should be the MIR in force for the year in which income is secured.

Tables would have to be produced showing the MIR appropriate for each age in a given year. For reasons of space, we have not reported calculations of the appropriate MIR for someone aged other than 65 who annuitises in 2011.

However to adequately protect the public purse any MIR also needs to take account of entitlement to other means-tested benefits and to people's actual expenditure requirements throughout retirement (both in absolute and relative terms) and, in particular, the impact of declining health on income and expenditure needs.

A.5 Whether a different MIR should be set for individuals and couples.

We suggest that the MIR should be different for individuals. We suggest that the MIR for a couple should be in the form of a life annuity with a reversion to the survivor. The level should commence at £18,800 (including the BSP) in 2011 for a 65-year old man with a wife aged 63, with a reversion to an income for the survivor of £14,100 in 2011, both figures updated in line with the LPI.

It is a moot point whether there should be one table of MIR values for couples based just on the age of the man or whether it should be based on the ages of both partners. The former has the merit of simplicity but is based on a model of family formation which is likely to be increasingly outdated. It may prove necessary to produce multiple sets of tables, including tables for civil partnerships where both partners are of the same gender.

A.6 How often the MIR level should be reviewed.

The current approach taken to calculate the Basic State Pension and other pension entitlements is to have a single value which applies to all pensioners regardless of age (i.e. different generations are treated the same). We have assumed here that the MIR will be treated in the same way. In the long run this will be unsustainable since the BSP will be growing faster than the MIR, but this will be a political decision. The uncertainty in projecting the path of the MIR and the BSP is sufficiently small that review could be at relatively infrequent intervals (e.g. every five years).

A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

A major simplification will be to have one MIR in a given year which will apply to pensioners of all ages. However, such a rule will involve other inconsistencies which we have discussed above. The other major concern is how to frame a simple rule for how much income should be secured under the MIR when pensioners continue in employment, since it is essential that pensioners have incentives to carry on working.

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

A.9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.

These bodies need to recognise three things: (i) the importance of good default decumulation strategies (i.e. those that attempt to replicate optimal decision making), (ii) the general ineffectiveness of financial education in improving outcomes[25] and (ii) the cognitive problems that elderly people can face when dealing with investments.

A.10 Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

If the requirement to annuitise at age 75 above a minimum income level is abolished, we estimate that the compulsory purchase annuities market will shrink from its current value of £11 billion per annum to between £8.9 billion and £10 billion per annum. Further, the value of DC pension funds that could be accessed as a lump sum or drawdown product would be between £0.95 billion and £2.1 billion.

We speculate that the proposal to abolish the annuitisation requirement for DC pension schemes will have an effect on the DB pensions market, either through lobbying or through pension transfers.

We suggest that if the same rules on annuitisation above a minimum income requirement in the DC market are applied to the DB market, between £10.2 billion and £16.7 billion of DB pension fund assets may be accessed each year by the retiring cohort. We suggest that if the government does not intend its proposals on the relaxation of annuity rules for DC pensions to apply to DB pensions, it may need to legislate to prevent this.

Our analysis suggests that the proposal to abolish the annuitisation requirement will have an effect on the government bond market. If the retiring cohort of pensioners accesses their DC lump sums, we predict insurance companies will no longer need to hold government bonds in the same quantity to back their annuity products and would become net sellers of between

[25] As Professor David Laibson of Harvard University has stated "Education no substitute for good default" (Pioneer Investment's European Colloquia 2007).

£0.5 billion and £1.2 billion of gilts annually. Similarly if DB pensioners also access the lump sum equivalent of their pensions at retirement, DB pension funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. This liquidation of government debt will occur at a time when the Government is attempting to fund a huge budget deficit by issuing bonds.

10. Conclusion

The proposals contained in HM Treasury's consultation document 'Removing the requirement to annuitise by age 75' released on 15 July 2010 will have, if implemented, a radical effect on pension provision in this country. We have examined the potential effects of this policy, and some unintended consequences. We have identified a worst-case scenario, in relation to the impact on the existing annuities market, the impact of DB pensions and the effect on the government bond market. Perhaps large numbers of people will not wish to access their pension funds, but the temptation to dip into a large pool of cash may prove irresistible,

A good pension scheme has a two-fold purpose: (i) it provides consumption security in retirement for however long the scheme member lives and (ii) it allows the scheme member to enjoy a similar standard of living in retirement as they enjoyed prior to retirement.

The consultation document's proposals will change the frame through which pensions are viewed. Pensions will be viewed not through a "consumption frame" – which is how everyone views the Basic State Pension, for example – but rather through an "investment frame". People will begin to see not a stream of future pension payments, but instead will see a 'pension pot', the present value of this stream of future pension payments. And, given human nature as well as their general poor understanding of longevity risk, people would rather like to be able to invest and spend their pension pot as they see fit. The consultation document's proposals encourage this view.

We should also emphasise that the objective of the MIR that we have calculated is to avoid a pensioner falling back on means-tested benefits (and we have only considered Pension Credit). The consultation document (e.g., ¶3.14) recognises that pensioners' needs will vary throughout retirement due to long-term care and health costs. Our MIR does not take account of such costs or changing circumstances. It is likely that some pensioners will find the MIR unacceptably low for some situations: the only way to avoid this would be to set the MIR at a much higher level.

The important message for policymakers from this report is that in practice the MIR may need to be greater because of the state's liability for other means-tested benefits, and because there is no guarantee that current Pension Credit levels will meet pensioners' income and expenditure needs throughout retirement.

Finally, pension schemes are going to look increasingly like tax avoidance schemes for the well off. While the poor will still be required to annuitise, the rich will be given the flexibility to spend their tax-favoured pension pot as they wish, including bequeathing their unused funds to their children without any liability to inheritance tax.

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Appendix: Summary of HM Treasury's consultation document 'Removing the requirement to annuitise by age 75' published on 15 July 2010

- The consultation recognises that for many an annuity will always remain the best product
- However the Government wishes to introduce greater flexibility in how people can take income to reflect the changing pensions and workplace environment, to encourage more pension saving and to encourage product innovation.
- The age 75 rules on annuitisation, value protection lump sums, tax free cash and trivial commutation lump sums will be removed.
- The age 75 rules on contributions and Lifetime Allowance checks will remain.
- Pension funds will be able to remain in a USP ("capped drawdown") indefinitely. ASPs will cease to exist.
- The USP maximum withdrawal limit may be reviewed. The current 120 per cent is probably too high at older ages and may have to be less than 100 per cent to avoid the risk of people exhausting their funds.
- There will be no minimum withdrawal requirement.
- Any withdrawals will be taxed as income.
- A USP customer will be able to access additional flexibility (in effect the permanent removal of the upper withdrawal limit) through "flexible drawdown" provided they have secured a minimum income (the Minimum Income Requirement). This minimum income will need to be a secure pension income for life and escalate by the lower of 2.5 per cent or inflation.
- The customer would then be able to withdraw up to 100 per cent of the remainder of their fund. This will be taxed as income.
- The minimum income required is not set out in the consultation paper.
- However they expect it to take account of not just current means-tested benefits, but also potential health costs and future expenditure needs.
- Restrictions on value-protection annuities will be removed.
- Lump sum death benefits will be taxed at 55 per cent to counteract tax relief given - this includes value-protection payments.
- The only exception is pension saving where no part has been used for an income when the saver dies before 75 where the pot will be tax free.

Previous Pension Institute Reports

‘Delivering DC? Barriers to participation in the company-sponsored pensions market’, by Debbie Harrison, Alistair Byrne, and David Blake, October 2004.

‘Pyrrhic Victory? The unintended consequences of the Pensions Act 2004’, by Debbie Harrison, Alistair Byrne, Bill Rhodes and David Blake, October 2005.

‘Annuities and Accessibility: How the industry can empower consumers to make rational choices’, by Debbie Harrison, Alistair Byrne and David Blake, March 2006.

‘Dealing with the reluctant investor: Innovation and governance in DC pension investment’, by Alistair Byrne, Debbie Harrison and David Blake, April 2007.

‘An unreal number: How company pension accounting fosters an illusion of certainty’, by David Blake, Zaki Khorasanee, John Pickles and David Tyrrall, January 2008.

‘And death shall have no dominion: Life settlements and the ethics of profiting from mortality’, by David Blake and Debbie Harrison, July 2008.

‘Ending compulsory annuitisation: What are the consequences?’, by David Blake, Edmund Cannon and Ian Tonks, July 2010.

Statement by Prudential UK & Europe

Established in 1848, Prudential remains one of the country's best known financial institutions, and one of the UK's leading providers of pension, savings and retirement income products. With over 7 million customers in the UK we are well placed to understand the issues that people face, and to help in developing solutions to current and future challenges.

We are pleased to sponsor the publication of this second report from the Pensions Institute on the impact of removing the 'age 75 rule'. We believe this report is an important contribution to the debate on retirement income reform and provides valuable insight for policymakers as they consider their next steps.

People approaching or in retirement experience many opportunities but also face many risks. For society the impact of an ageing population represents an unprecedented challenge to existing social, political and fiscal arrangements.

Creating a pensions and retirement income regime that supports and sustains individuals and society in this environment is a challenge that demands earnest attention. We are keen to play our part in creating such a regime, and supporting this report is a contribution towards that.

Prudential UK & Europe
September 2010

About the Pensions Institute

The objectives of the Pensions Institute (www.pensions-institute.org) are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance, and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions.

As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to the complex problems that arise in this field.

Objectives

The Pensions Institute undertakes research in a wide range of fields, including:

Pension Microeconomics
The economics of individual and corporate pension planning, long-term savings and retirement decisions.

Pension Fund Management and Performance
The investment management and investment performance of occupational and personal pension schemes.

Pension Funding and Valuations
The actuarial and insurance issues related to pension schemes, including risk management, asset-liability management, funding, scheme design, annuities, and guarantees.

Pension Law and Regulation
The legal aspects of pension schemes and pension fund management.

Pension Accounting, Taxation and Administration
The operational aspects of running pension schemes.

Marketing
The practice and ethics of selling group and individual pension products.

Macroeconomics of Pensions
The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy (e.g., corporate, public and international sectors).

Public Policy
Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastricht Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute may include views on policy but the Pensions Institute itself takes no institutional policy positions.

Removing the requirement to annuitise by age 75 is welcomed as it will succeed in giving greater flexibility in retirement planning. However, we would urge the government to avoid the complex rules and regulatory requirements that have often accompanied similar attempts to bring greater flexibility in the past.
>
> We agree that all people should have more choice over the use of their pension savings but we are aware that increased flexibility with complex rules and requirements often requires specialist financial advice and there is a concern, especially with the introduction of Retail Distribution Review, that this flexibility might not be available to those less well-off and unable to pay for such advice.
>
> A typical USP product would usually require an investment in excess of £100,000 but a good proportion of customers do not have this level of pension fund available.
>
> The removal of the age 75 limit on pension commencement lump sums and trivial commutation lump sums (2.25 refers) is welcomed. Whilst the Lifetime Allowance test is proposed to remain at 75, it must be recognised that there are many circumstances when a Pension Provider must make assumptions in the absence of any contact from customers.
>
> We assume that this legislation will be permissive and would be at Pension Providers' discretion to permit existing pension contracts (or Rules) to make use of these easements. Many contracts carry valuable guarantees that may be lost should contracts continue past their original maximum expiry age (75). Many Providers do not, under their Scheme Rules, permit a USP option.
>
> HMRC have provided specific guidance on non-responders and untraceable customers and we assume that guidance will now be extended to later ages.
>
> To respond to the Questions in Annex A
>
> Chapter 2
>
> A1 - In order to maintain the appeal of USP (as it stands) for the main groups of retirees, it is suggested that keeping the 120% GAD is appropriate for the income requirements of those groups.
>
> A2 - As discussed above, the proposals under 2.25 are welcomed. There is a concern that, should someone choose not to retire at age 75, an accurate LTA test may not be feasible if that person chooses not to furnish the Provider with all relevant information. Receiving all information for a LTA test is usually most successful when a customer chooses to take a benefit. Assumptions will need to be made for untraceable customers or non responders.
>
> It is difficult to envisage these changes alone will give rise to more people making use of alternatives to annuity purchase.
>
> Chapter 3
>
> The level of MIR would need to be significantly higher than means tested benefits. It should also be relatively simple to calculate to aid implementation.
>

> Chapter 4
>
> Further development of the ABI Best Practice for retirements and the CFEB leaflets would assist in people making appropriate choices. Wider education via media etc should also be considered."
>
Kind regards

> SEAN LLOYD
> PENSIONS PRODUCT MANAGER
> THE PHOENIX GROUP

Earlier in the year you expressed an interest for reform of the shopping around process for retiring investors. The age 75 consultation document from the Treasury invites opinion on this issue. Following the leak of an ABI email to the media, it is apparent that some insurers are still seeking to preserve the status quo. It is a relatively small number of companies which do want to protect their profits and to continue promoting uncompetitive annuities to ill-informed customers, however those few companies are amongst the biggest in the industry and their lobbying power outweighs the majority who would welcome reform. The ABI has also recently published a research document entitled 'Annuity Purchasing Behaviour' which appears to be a thinly disguised attempt to legitimise their arguments.

I have set out below some of the commonest arguments put forward by the insurance lobbyists for rejecting reform, as well as the reasons why these arguments should not be listened to.

Many people's pots are too small to shop around

It is true that some 20% of individual pension pots are valued at £5,000 or less and at this level choice is limited.

This is not a reason to reject reform of the system though, both because many people will have more than one pot and because average values will rise in the future.

According to HMRC, in 2007/08 there were 10.8 million individuals holding personal and stakeholder pensions, including those who are not currently contributing as well as those who are currently contributing to their pensions. In the same tax year there were 7.1 million contributing members of personal and stakeholder schemes. In addition there were nearly 1 million contributing members of Retirement Annuity Contracts. There were also around 1 million members of Money Purchase Occupational schemes and around 500,000 Sipp investors. Inevitably there will be some overlap within these figures. This means that some of those people who did only have a small pension pot will also have had a separate money purchase pot elsewhere.

The ABI research ignores the potential benefits to investors of consolidating their pension pots before retirement, as this would undermine the legitimacy of their argument. If more people did consolidate, then it is likely that more people would shop around.

The following list illustrates how choice expands as the investor's pot size increases.

Under £5000: 2 Companies

Under £10,000: 8 Companies

Over £10,000: 10 Companies

As the trend towards final salary scheme closures progresses and more individuals are auto-enrolled into a workplace pensions the chances of someone arriving at retirement with a money purchase pot of just £5000 or less will steadily diminish.

Over 90% of investors know about the OMO

They may know about it but it doesn't mean that they understand the implications of not using it. For example looking at the brochure issued by the Prudential, one of the better companies at communicating with investors the front cover states

'A guide to choosing your income for life – choosing the best pension annuity for you'.

So even on the front cover an assumption is being made that the investor doesn't need to shop around for non-lifetime annuity alternatives.
The brochure includes on pages 4 and 5 a *'step by step guide to buying your annuity from us'*. The brochure talks through the different types of annuity that the Prudential can sell the investor, including a with-profits annuity, the death benefits options, trivial commutation and passing reference to drawdown on page 15. Only on page 16 is the investor informed that;

'you can buy your pension annuity from another company if you want to. This is called the "Open Market Option". By shopping around you may be able to find a better deal. This means you can ask other providers for retirement quotes to compare with ours. Different annuity providers will offer different annuity options and different annuity rates, so it's possible you may be able to get a higher level of income from another provider.'

So the investor has been told of their choice, but only after 15 pages of sales pitch for all the annuities Prudential could sell them.

The ABI claim that only 4% of investors were unaware of the OMO. Not only are we sceptical of this claim as our own qualitative research refutes it but in addition, we also believe that whilst many people may when prompted respond affirmatively to the question 'do you know about the OMO and the right to shop around?' this is not the same as an investor being both fully cognisant of their rights **and of the implications of not exercising those rights in terms of the lost income.**

67% of investors shop around already

The ABI claims that 67% of investors shop around already but that around half of them choose not to move their money. The ABI claims this research as evidence that the system is working. The ABI's research posits several reasons as to why people shop around but choose not to move, these include:

- Because they feel comfortable with the brand
- That it is too much hassle to shop around
- They don't want to pay the cost of advice.

- We have even seen an insurance company argue recently that a comparison can be drawn with a car buyer going back to a familiar manufacturer because it is less hassle than trying out a new car.

All of these arguments are misleading and should be ignored.

The ABI's research showed that the top four reasons for not shopping around were:

- Easier to stay with existing provider 73%
- My pension provider has a good reputation 60%
- It was a small part of my total retirement income 56%
- I didn't think the time and effort was likely to be justified 51%

None of these are reasons not to reform the system, indeed if these are the reasons why investors chose not to shop around then the system is clearly in need of reform.

The ABI failed to challenge investors who allegedly shopped around but stayed put over exactly what they did to shop around. Unless an investor took reasonable steps to consider the different types of retirement income available to them and used a comparison service (with or without advice) to compare the terms on offer, then they can't really be said to have shopped around. We don't know whether they did this or not because the ABI's research failed to ask this question.

The comfort with the brand argument looks like investors rationalising inertia. The ABI's own research shows that nearly half the people eligible for an enhanced annuity didn't even know one existed. Undoubtedly there is some hassle involved in shopping around and this may put some people off. The simple answer is to make the system more conducive to shopping around and then people will be more likely to do so, as demonstrated by PICA's own qualitative research.

Investors are already paying the cost of advice in the annuity they buy from their existing pension provider, even if they receive no advice. The cost of advice is built in to the annuity rate; they don't get better terms if they go direct to the insurance company, in fact as we have highlighted in some cases they get less. We have even come across an example of an insurance company offering one rate to its existing maturing customers, and a more attractive rate to those customers who chose to use that same company's own shopping around service!

In terms of annuity rates, the only thing that matters is the net income to the investor, if they have received advice - or guidance from a broking service, paid for by commission, and they get a better rate then they are still better off.

<u>Rates don't vary much between companies</u>

This is wrong for two reasons. Firstly because it isn't just about the rate, the shape of income is at least as important. Has the investor considered the death benefit options,

enhanced annuities, inflation proofing, temporary annuities and drawdown? Making the shopping around process the default would address these questions.
In addition, whilst the best companies do indeed tend to cluster together, offering rates that vary by only a few per cent, there are still many pension companies selling default annuities to their existing customers which never appear on the radar. They aren't on any comparison sites, such as the FSA tables and they aren't even pretending to be competitive yet investors do still buy from them because they know no better. Investors who buy from these companies may be losing 10% income for life even if they aren't eligible for any further enhancement, for example for medical reasons.

None of these arguments justify delaying any longer a fundamental reform of the shopping around process. PICA's proposals, involving making shopping around the default and using the Pensions Passport will increase pensioners' incomes, simplify retirement planning and generate additional economic activity. We urge you to incorporate into the forthcoming pension legislation a provision that companies have to confine their at-retirement communication to their investors to providing information about shopping around. We believe that we can work with the Treasury, HMRC and other stakeholders to ensure that these proposals deliver the anticipated benefits.

The Pension Income Choice Association

(PICA)

We support the government proposals to remove the requirement to annuitise by age 75.

The 8 year experiment with the Open Market Option has been a failure. As part of the proposed reforms it is essential that the Treasury makes the shopping around process the default option for all investors as they approach retirement.

It is not necessary to 'force' investors to shop around, nor is it necessary to make every one pay for expensive financial advice. By focusing the communication emphasis on the importance of shopping around and by making it as easy as possible for investors to do so it is possible for the Treasury to improve the value that investors enjoy from their pension, to simplify the retirement process and to boost economic activity.

We recommend a cautious approach to the capped drawdown income limit. Income withdrawals should be set at no more than 100% of the income payable from a single life level annuity. It will be necessary to scale back the maximum income withdrawals for very high ages in order to avoid the risk that a combination of high withdrawals and poor investment performance erode the fund.

In addition, income limit reviews should be conducted more frequently than the current quinquennial reviews for USP. We propose 3 yearly reviews up to age 75 and yearly reviews thereafter, in line with current ASP rules.

We propose a Minimum Income Requirement of £13,000 a year, taking account of the following factors:

- State pension, Final Salary pension, inflation-linked lifetime annuities and the guaranteed element of investment linked annuities

The MIR should be uprated in line with the rate of increase in the Basic State Pension.

There should be just one level of MIR for individuals and for couples.

To help minimise the burden on industry, investors should be able to request that their pension income provider produce an MIR statement for them in a standard single page format. This would be similar to the lifetime allowance statement which pension schemes already produce.

The proposed tax charge on death in unsecured pension is too high. For investors in capped drawdown, a tax charge of 55% will be perceived as punitive and will act as a deterrent from holding money in drawdown. For this reason, anyone eligible for flexible drawdown would hold money in pre-retirement pensions until age 75 (no tax on death) and will then use flexible DD to strip their pension as rapidly as possible. Very few investors pay IHT and very few investors pay 50% income tax in retirement – most will be able to draw their funds paying just 20% tax. 55% tax will therefore present a strong disincentive for holding money in a pension past age 75 for those people who are able to exercise choice.

For those who can't – investors in capped drawdown, a 55% tax charge is even less appropriate since they are extremely unlikely to be liable for IHT or 40% income tax in retirement.

We recommend a tax charge of 45% as representing a more appropriate balance.

About PICA

Pensions Income Choice Association (PICA) is a membership funded group set up in July 2009, representing product providers, Independent Financial Advisers and Employee Benefit Consultants in the annuities and retirement market. The Association is composed of a management group which consists of Living Time, LV=, MGM Advantage, Partnership, and Bluefin Group. Tom McPhail, Hargreaves Lansdown, is chairman.

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HM Treasury

Removing the requirement to annuitise by age 75

Response from The Pensions Management Institute

Pensions Management Institute
ACHIEVING PENSIONS EXCELLENCE

PMI's response to the consultation from HM Treasury on removing the requirement to annuitise by age 75

Introduction

The Pensions Management Institute (PMI) is the professional body for people working in the pensions sector. The PMI's members (currently over 4,200) work as pensions managers, consultants and technical specialists in consultancies and insurance companies. Many are also actuaries, pensions lawyers or company secretaries. Their experience is therefore wide ranging and has contributed to the thinking expressed in this response.

Background

The Finance Act 2004 introduced an option for all members of Defined Contribution (DC) pensions which had previously only been available to members of Small Self Administered Schemes (SSASs). This option, if adopted by a scheme, allowed retiring members to avoid using their accrued fund to purchase an annuity and to draw an income directly from the fund. This option, known under the new tax regime as Unsecured Pension (USP), was subject to strict rules in order to reduce the possibility that members using this option might exhaust their fund during their lifetime. Additionally, on attaining age 75, members were effectively subject to compulsory annuitisation. Although it was technically possible to continue to draw an income from the fund rather than to purchase an annuity under provisions called Alternatively Secured Pension (ASP), the terms under which this would be permitted were restrictive to the point where conventional annuitisation was commonly perceived to be a preferable alternative. ASP was not intended to be a viable alternative to a Lifetime Annuity but was permitted as a concession to those whose religious convictions were opposed to the principle of annuitisation.

From the outset, the new rules were subject to criticism. There has been vociferous criticism from many quarters of Compulsory Purchase Annuities, which are commonly perceived as representing poor value for money and offering no scope for variation following the annuity's purchase. This became a particularly significant issue when interest rates fell to their current low level. Many also argue that the Government should permit inter-generational transfer of unused DC pension funds. In an environment when improved longevity will mean that many people will survive long beyond their seventy-fifth birthday, consensus has developed that reforms to the existing USP regime had become necessary.

In its Budget Statement of 22 June 2010, the current Government announced that it intended to permit a reformed form of USP to apply on an indefinite basis, meaning that ASP would in effect be abolished. The PMI welcomes the Government's commitment to making these changes. However, we share the Government's concern that any new regime should include prudent controls to ensure that any replacement regime does not facilitate the exhaustion of members' funds or the abuse of the tax system. We are also keen to ensure that any new regime should be practical and efficient to administer. These issues are reflected in our response to the specific consultation queries.

The PMI's Response
Developing a new tax framework for retirement (Chapter 2)

A.1 The level of an appropriate annual drawdown limit for capped drawdown.

Under current rules, the maximum permitted level of USP is 120% of the Basis Amount as calculated using tables prepared by the Government Actuary's Department. The member's USP maximum is subject to quinquennial review, but cannot extend beyond the member's 75^{th} birthday. Under the proposed new rules, USP will in effect be permitted to continue indefinitely and a Pension Commencement Lump Sum will (subject to the overall 25% maximum) be permitted at any age.

Allowing capped drawdown to continue beyond age 75 will expose members to far higher levels of investment and longevity risk than is the case currently, and consequently a cautious approach would be necessary. We believe it would be logical to match the revised maximum more closely to actuarial projections. Additionally, this option is more likely to be selected by those with smaller total incomes. In the interests of caution, therefore, we believe that 100% of the Basis Amount would now be appropriate. Alternatively, a limit of 110% might be also be acceptable if capped drawdown were to be subject to review more frequently than quinqennially.

Although these options are more restrictive than the existing regime, there will in future be the alternative of flexible drawdown for those who are confident about drawing down larger amounts.

A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

We agree with the Government's approach to reforming the pensions tax framework.

Minimum Income Requirement (Chapter 3)

A.3 What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

We believe the following types of income should be considered 'secure' for the purposes of the MIR:

- State Pension Benefits
- Scheme Pensions provided by Registered Pension Schemes
- Payments made by the Pension Protection Fund (PPF)
- Lifetime Annuity payments
- Purchased Life Annuity payments

Ideally, secure income should be linked to National Average Earnings rather than Limited Price Indexation (LPI) if it is to retain its value in real terms indefinitely. Whilst this will be possible in the case of State pension benefits, it will not apply in the case of pensions from occupational schemes or annuity payments. PPF payments are only subject to indexation when made in respect of benefits accrued since 1997.

The Government is currently proposing to adopt the Consumer Prices Index (CPI) as the benchmark for pensions indexation in place of the Retail Prices Index (RPI). Adopting 2.5% Limited Price Indexation as a requirement for secure income will not alone adequately protect MIR.

We suggest that in the interests of flexibility, any form of lifetime annuity income should be included in assessing MIR – including that from non-escalating annuities. To ensure that levels of secure income remain adequate, we suggest that MIR be subject to formal review at least quinquennially. This may require members to annuitise more funds as they grow older. This should however be regarded as a small price to pay and would ensure that government policy promotes prudence.

A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

In a report published in July 2010, the Joseph Rowntree Foundation estimated that a single person of below pension age currently requires an annual income of £14,400 to achieve a ‘basic but acceptable’ standard of living. Many people seeking to use a flexible drawdown arrangement will be below State Pension Age (which is to be raised over time to 70), so we believe it would be prudent to base the MIR on this figure rather than on figures calculated in respect of those below retirement age. The MIR should be set at a level which would provide most of the required target figure.

Following on from this, we believe that it would be appropriate to set the MIR as a multiple of the Basic State Pension (BSP). This would be administratively convenient. It would also ensure that in future the MIR would be indexed in line with National Average Earnings and so would retain its value in real terms. With this in mind, we suggest that the MIR be set at a level of two times the BSP. Based on current levels, this would be an annual figure for a single person of £10,155.60. Whilst this figure may appear high, it is important to ensure that members have adequate alternative resources before entering flexible drawdown. It also corresponds roughly to the proposed Personal Allowance which the Coalition Government is seeking to introduce. Encouraging partial annuitisation in order to achieve compliance with the requirements of flexible drawdown will also help reduce the degree to which the member will have uncrystallised benefits at death.

People in their fifties tend to have income from a number of different sources. As they age, their income requirements tend to fall, but their sources of income reduce. Additionally, as the cost of surviving a year increases if an annuity has not been purchased, and investment risk increases if an individual continues to rely on return-seeking assets. On a year-on-year basis, this increases the risk that an individual may fail to meet the MIR over the following year. In view of this, we believe it would be prudent not to reduce the MIR for older ages.

A.5 Whether a different MIR should be set for individuals and couples.

We believe it would be appropriate to set a different MIR for individuals and couples. Again, using a multiple of the BSP is a convenient way of achieving this. In the interests of simplicity, we suggest that the level of MIR for couples be set at three times the single person's BSP. At current rates, this would give a level of £15,233.40 pa.

A.6 How often the MIR level should be reviewed.

As the BSP is to be revalued in line with National Average Earnings, it is to be expected that an MIR based on it will retain its value, in real terms, on a year-on-year basis. However, regular review would remain appropriate. If capped drawdown arrangements are to be reviewed on a five-yearly basis, it would be consistent to review the MIR at the same interval. In keeping with current arrangements, it would be appropriate for flexible drawdown arrangements to be tested against the MIR every five years.

A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

In our response to A.3, we have suggested sources of income which are easily identifiable. In many cases, the information required would be the same as that required for a tax return. In some cases, a P60 would be adequate.
We also believe that it would not be appropriate to require occupational schemes to offer a drawdown facility.

The UK annuity market (Chapter 4)

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

The concept of flexible annuities has not been greeted with much enthusiasm in the UK, and it is difficult to see if further reforms would do much to change public perceptions.

A.9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.

Workplace remuneration packages are becoming increasingly sophisticated, and the development of the Corporate Wrap can provide employees with a vast range of benefits via their employer. One benefit that would surely be beneficial is access to regular financial advice. It would be helpful if this could be provided as part of an employer's benefit package without being taxable to the employee as a benefit in kind.

A.10 Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

We do not see that the proposed reforms will have any adverse consequences for the UK annuity market. Drawdown arrangements will not be suitable for all members of DC pension schemes. Moreover, the advent of auto-enrolment from 2012 is to be expected to stimulate higher levels of pension scheme membership. It is further to be expected that the significant majority of those who are auto-enrolled will join DC schemes, and so this in turn will ensure continued demand for annuities.

Current rules prevent members who have accrued Protected Rights from transferring benefits from a SSAS; we believe it would now be appropriate for this restriction to be removed.

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PENSIONS POLICY INSTITUTE

PPI

Response to HMT consultation: removing the requirement to annuitise by age 75

Summary

I. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

II. The previous Labour Government required individuals to use any private pension savings they had remaining by age 75 (after taking a 25% tax-free lump sum) to secure an income, generally through the purchase of a lifetime annuity.

III. The current Government has proposed to remove the effective requirement to use private pension savings to purchase an annuity by age 75. The Government's stated policy objective is to make pension saving more attractive by giving individuals greater choice over how they can provide a retirement income for themselves. The Government's proposed approach would allow individuals to:

- purchase an annuity;
- invest their pension savings in an income drawdown arrangement, with a cap on the maximum allowed withdrawal, for their entire retirement (capped drawdown); or,
- withdraw unlimited amounts from their pension savings from age 55 until death (flexible drawdown), provided they can demonstrate that they have secured a minimum income sufficiently high to prevent them from exhausting their savings prematurely and falling back onto means tested benefits.

- The Government is consulting on the detail of how the new approach might work. This response outlines the evidence that the PPI considers relevant to the Government's consultation and focuses especially on the trade-offs between risks and flexibilities for individuals that could result from the new approach.

IV. The Government's proposed approach would provide individuals with greater flexibility than under the current effective requirement to purchase an annuity by age 75. However the current proposed approach would also expose individuals who choose not to buy an annuity to risks that they would not have previously been exposed to (eg. longevity risk).

V. If the Government proceeds with the current proposed approach to accessing pension savings then it will need to carefully consider what level to set the caps for

capped drawdown at and at what level to set the MIR. Both of these decisions will have implications for the level of risk individuals choosing these options are exposed to. These decisions will also affect the level of risk posed to the Government of people falling back on to means-tested benefits during their retirement.

VI. A limit, at any level, on the amount that people can withdraw in capped drawdown will involve a trade-off between: setting the cap low enough to ensure that individuals do not run out of money before the end of their retirement (and end up relying on the state through means tested benefits); and, setting the cap high enough so that individuals are not made to forgo consumption.

VII. Simple, fixed limits are more likely to pose risks to individuals. Research shows that simple limits may not provide as much insurance against longevity risk and the risk of forgoing consumption as more flexible approaches to drawing down income. For example:

- Using a limit of *a fixed percentage of the equivalent available annuity rate* (as under the current system) can lead to the danger of running out of funds before the end of retirement.
- Using a limit of *a fixed percentage of the fund size* hedges more longevity risk than using a fixed percentage of the equivalent available annuity rate, but this approach often involves very small withdrawals of fund capital and therefore might lead individuals to forgo some consumption.

VIII. Complex withdrawal strategies, such as withdrawal strategies that vary with age and fund performance, are more effective at ensuring that individuals do not deplete their funds, or run the risk of forgoing consumption. However complex approaches to withdrawal will not be easy to regulate using simple cap limits and require high levels of financial knowledge from consumers or an ability to pay for ongoing advice and fund management.

IX. The Government will need to carefully consider how to define the Minimum Income Requirement (MIR), what level to set it at and what income should be allowed to qualify.

X. There are three main means-tested benefits which pensioners may be eligible for: Pension Credit (Guarantee Credit + Savings Credit), Housing Benefit and Council Tax Benefit.

XI. If the Government wishes to set the MIR at a level, which would keep people off Guarantee Credit, then they could set the MIR at or above the current Guarantee Credit Level of £132.60 per week in 2010. Assuming that inflation increases at expected levels, many pensioners would be able to meet this MIR for a 30-year retirement if they had full BSP entitlement and at least half of the maximum S2P entitlement. Pensioners with full BSP entitlement, no S2P entitlement and no other occupational pension entitlement may be able to remain above an MIR set at the Guarantee Credit level by purchasing an RPI-linked annuity with around £55,000, or by purchasing a level annuity with around £85,000.

XII. If the Government wishes to set the MIR at a level which would keep people off Pension Credit (Guarantee Credit + Savings Credit), then they could set the MIR at the minimum income level above which people are no longer eligible for Pension Credit, £183.90 per week in 2010. An individual with no occupational pension entitlement may be able to stay above an MIR at this level by purchasing an RPI-linked annuity with between £35,000 and £165,000 or by purchasing a level annuity with between £55,000 and £240,000 depending on their state pension entitlement. Around 15% of current annuity purchases are above £40,000 suggesting that some individuals would be able to meet an MIR set at the Pension Credit level.

XIII. Pensioners with some Occupational pension entitlement (which are predominantly Defined Benefit pensions) may find it easier to meet an MIR without purchasing an annuity. For example, an individual receiving a full BSP (£97.65) and the median level of occupational pension entitlement (£104) would begin retirement with a weekly income of £201.65 and would be able to satisfy an MIR for around 10 years, set at Pension Credit level (£183.90 in 2010) with just their state and occupational pension income. To satisfy the MIR for 30 years they would need around £59,000 to purchase an RPI-linked annuity (or around £85,000 to purchase a level annuity). However an MIR set at the Pension Credit level would not necessarily keep people from becoming eligible for Housing Benefit and Council Tax Benefit.

XIV. Individuals who have incomes high enough to make them ineligible for Pension Credit may still be eligible for Housing Benefit or Council Tax Benefit. If the Government wishes to set the MIR at a level which would keep most people off Pension Credit, Housing Benefit and Council Tax Benefit, then they could set the MIR at an income level above which the majority of people are no longer eligible for these benefits, between £600 and £770 per week in 2010.[1] An individual with no occupational pension entitlement may be able to stay above an MIR at the level needed to stay off Pension Credit, Council Tax Benefit and Housing Benefit by purchasing an annuity with between £860,000 and £1.3m depending on their state pension entitlement and whether they purchased an RPI-linked or level annuity. As less than 1% of current annuity purchases are £200,000 and above (Table 4) it is unlikely than many people would be able to afford to purchase an annuity that would satisfy an MIR at this level.

XV. Larger than anticipated changes in inflation might cause the income threshold for means-tested benefits to rise. The Government may wish to include an extra level of required income in the MIR, above calculations of means-tested benefit eligibility, as insurance against inflation increasing above average levels.

[1] Based on average eligible rents and maximum eligible rents

Introduction

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

2. This response focuses on the evidence that the PPI considers relevant to the Government's decision making in relation to removing the effective requirement to annuitise by age 75.

3. The PPI is currently undertaking a research project (the Retirement Income and Assets Project), comprised of a series of reports, exploring how people can use income and assets to meet their needs in retirement. The fifth report in the series explores the implications of lifting the effective requirement to purchase an annuity by age 75 and is being sponsored by a consortium made up of: the Association of British Insurers, the Department for Work and Pensions, the Investment Managers Association, Partnership, Prudential UK and Europe, and Which? This response draws on the research from the Retirement Income and Assets Project.

Needs in retirement

Private pensions are one of the sources of income that individuals use to support their income needs, which generally vary during retirement

4. The primary purpose of pension savings is to provide retirement income for individual's needs in retirement and therefore a consideration of potential options for accessing pension savings must be placed within the context of individual's income needs in retirement.

5. Though there are several ways to approach a calculation of income needs in retirement, it is difficult to calculate a single figure that will meet income needs for all individuals for their entire retirement. Needs and preferences can vary for pensioners several times during their retirement as their mobility and health levels change

6. While the vast majority of pensioners (95%) receive some income from state pensions in retirement, many pensioners use a varied basket of assets and income to support themselves (including other savings and investments, private pensions, state benefits and earnings).[2]

[2] DWP (2010) *The Pensioners' Incomes Series 2008-09*

7. The way individuals access and use their different income sources in retirement will depend on:
   - the options available to them,
   - individual's needs for income, and
   - individual spending preferences.

Risks associated with accessing private pension savings

Different methods of accessing pension savings pose different levels of risk and offer different levels of flexibility

8. There are three main methods by which individuals could theoretically access private pension savings in retirement, though regulatory systems (and, to some extent, employer decisions) affect the way individuals in different countries and with different kinds of private pensions can access their pension savings. The three main methods for accessing private pension savings are:
   - *Securing a lifetime income* – securing a guaranteed lifetime income, for example, through purchasing an annuity.
   - *Scheduled withdrawals* – withdrawing income at set or varying levels (without a lifetime guarantee) often with the option to continue to grow the capital fund, (for example, through income drawdown, or through a variable annuity).
   - *Withdrawing pension savings as a lump sum* – withdrawing all or a portion of the pension savings as a lump sum to either spend or re-invest

9. Each method of accessing private pension savings poses varying levels of 'income-related' risk for individuals. The main income-related risks that are associated with accessing private pension savings are:
   - *Longevity risk* - the risk that individuals run out of money before their death.
   - *Inflation risk* – The risk that one's income may lose value relative to the price of the goods and services purchased to meet needs in retirement.
   - *Investment risk (of capital loss)* - the risk that market fluctuations or poor investment strategies will deplete the investment capital.
   - *Risk of missing out on investment growth* – the risk that a fund will be under-exposed to equities and miss out on investment growth.
   - *Mortality drag* – the risk (incurred when one defers purchasing an annuity) of an invested pension fund yielding less investment return than required to make up for missing out on the mortality cross-subsidies contained in an annuity pool (see paragraph 29 for an in-depth explanation of mortality drag and mortality cross-subsidies.)
   - *Risk of forgoing consumption* - the risk that individuals might under-spend due to worries over running out of money.

- *Time-of-purchase risk*[3] – the risk, especially relevant to lifetime annuities, that one is locked into a product with poor returns because rates are unfavourable at the time of purchase.
- *Irrevocable decision risk* - The risk of making a purchase decision that is irrevocable (for example, purchasing a lifetime annuity) which does not turn out to best meet income needs or cannot meet needs that change (for example, when health problems develop) because of illiquidity.

10. The above list is not exhaustive. Accessing private pension savings can carry many other risks for individuals including:
    - the risk of pension provider insolvency,
    - the risk of changes in need or personal circumstances,
    - the risk of not recouping the initial purchase price of a retirement income product due to an early death.

11. One of the main retirement income related risks for individuals is the risk of having insufficient income in retirement to have an adequate standard of living (as a result of not saving or not saving enough). However, in the interests of brevity and focus, this response has focused on the main risks that are associated with accessing pension savings.

12. Some risks are more serious than others. Risks that relate to losing the entire pension fund (*investment risk of capital loss*), or relate to depletion of the fund before the end of retirement (*longevity risk*) could result in an individual experiencing more financial hardship than risks which relate to receiving a lower income in retirement or relate to missing out on growth or inflation increases.

13. Therefore, if an individual uses a method of accessing pension savings which protects them against *longevity risk* and the *investment risk of capital loss*, but exposes them to other risks, then this individual would usually be in less danger of severe poverty or low income than individuals who access pension savings using a method which exposes them to *longevity risk* and/or the *investment risk of capital loss* (regardless of the other risks that they are protected against).

14. Using pension savings to secure an income, generally through a lifetime annuity, is the only method of accessing pension savings, which protects individuals against both *longevity risk* and the *investment risk of capital loss.*

15. The following table (Table 1) examines the 3 main methods of accessing pension savings and assesses the degree to which each method protects against the main risks to individuals when accessing private pension saving.

[3] Antolin (2008) Policy Options for the Payout Phase: OECD Working Papers on Insurance and Private Pensions, No. 25 OECD

Table 1: the three main methods of accessing private pension savings and their level of protection against different types of risk (x = no protection, ✓ = low, ✓✓ = medium, ✓✓✓ = high protection)

	Longevity risk	**Inflation risk**	**Investment risk of capital loss**	**Risk of missing out on investment growth**	**Mortality drag**	**Risk of forgoing consumption**	**Time-of-purchase risk**	**Irrevocable decision risk**
Secure income (e.g. annuities)	✓✓✓	✓ this risk depends on whether the annuity is indexed, and what it is indexed to	✓✓✓	✓ some annuities are investment linked	✓✓ the amount of protection depends on when the annuity is purchased	✓✓✓	✓ consumers may have some choice over when to purchase an annuity	x
Scheduled withdrawals (e.g., drawdown)	✓ the level of longevity risk is determined partly by the level of withdrawals allowed	✓ ✓ funds may be depleted or investments may not grow with inflation	x	✓✓✓	x	✓ individuals may not withdraw enough to meet consumption needs	✓✓ individuals may miss out on purchasing an annuity when rates are favourable	✓✓✓
Withdrawing pension savings as a lump sum	x	✓✓ The level of inflation risk will depend on whether and how the lump sum is reinvested	✓ any lump sum portion invested may be vulnerable to investment risk	✓✓ If the lump sum is invested it has the opportunity to grow	x	x	✓✓ individuals may miss out on purchasing an annuity when rates are favourable	✓✓ people may spend their lump sum early in retirement

Individuals look for varying levels of flexibility in accessing and using their pension savings

16. There is variation in the levels of flexibility individuals look for from their pension savings. For the majority of individuals, the primary purpose of saving in a pension fund will be to provide themselves with an income in retirement. However, for some individuals it is important that they have flexibility regarding:
    - when they access their pension savings (before and during retirement),
    - how much income they are allowed to withdraw,
    - whether they are able to continue to grow their savings during retirement, and
    - whether they are able to leave any remaining savings as inheritance after their death.

17. The level of flexibility allowed by the different methods of accessing pension savings can be measured by examining the extent to which each method allows freedom for:
    - *Level of withdrawal* - choice in the amount of money withdrawn
    - *Growth* - Potential to grow the capital
    - *Bequest* - Potential to leave money as inheritance

18. However there is generally a trade-off between flexibility and risk, the more flexibility a method allows the more the individual is generally exposed to income related risks during their retirement. The following table shows the trade-off between flexibility and risk in the three main methods.

Table 2: the three main methods of accessing private pension savings and the trade-off between level of risk and level of flexibility

Method	Risks exposed to	Risks protected against	Flexibilities
Secure income (e.g. annuities)	*Risk of missing out on investment growth* though some annuities are investment linked *Time-of-purchase risk* *Irrevocable decision risk* *Inflation risk* – unless annuity is index linked	*Longevity risk* *Investment risk (of capital loss)* *Mortality drag: if purchased in time* *Risk of forgoing consumption*	*Level of withdrawal:* **low level of flexibility –** there will be a range of options at time of annuity purchase *Growth:* **low flexibility** - unless it is an investment linked annuity *Bequest:* **no flexibility** - (except for guaranteed annuities)
Scheduled withdrawals (e.g., drawdown)	*Longevity risk* *Investment risk (of capital loss)* *Risk of forgoing consumption*	**Partial protection from the following risks:** *Risk of missing out on investment growth* *Time-of-purchase risk* *Irrevocable decision risk* *Inflation risk*	*Level of withdrawal:* **medium level of flexibility** - within maximum and minimum withdrawal caps *Growth:* **high flexibility** - to grow fund *Bequest:* **medium flexibility** - level of effective flexibility to leave as bequest dependent on tax treatment
Withdrawing pension savings as a lump sum	*longevity risk* *Risk of forgoing consumption* The level of *inflation risk, risk of capital loss and risk of missing out on investment growth* will depend on whether lump sum is reinvested	**Partial protection from the following risks:** *Risk of missing out on investment growth* *Time-of-purchase risk* *Irrevocable decision risk*	*Level of withdrawal:* **High flexibility** *Growth:* **High flexibility** *Bequest:* **High flexibility**

The Government is lifting the effective requirement to annuitise by age 75

19. The previous Labour Government required individuals to use any private pension savings they had remaining at age 75 (after taking a 25% tax-free lump sum) to secure an income. This was generally done through the purchase of a lifetime annuity though, since 2006, people have been allowed to invest their fund in Alternatively Secured Pension (ASPs).[4] High taxes on the bequest of ASP funds and a low cap on the amount individuals can withdraw have made ASPs an unattractive option for many pensioners.

20. The current Government has temporarily lifted the requirement to effectively annuitise by age 75, as a transitional measure until the Government's new approach has been determined and new regulations are put in place.

21. The Government has proposed to remove the effective requirement to purchase an annuity by age 75 and has proposed to put regulations in place which will allow individuals to:
    - Invest their pension savings in an income drawdown arrangement, with a cap on the maximum allowed withdrawal, for the entirety of an individual's retirement. The Government is calling this approach *'Capped Drawdown'*.
    - Withdraw unlimited amounts from their pension savings, provided that they can demonstrate that they have met a minimum income requirement. The Government intends the level of minimum income requirement to be high enough to prevent individuals from exhausting their savings prematurely and becoming eligible for means-tested benefits. The Government is calling this approach *'Flexible Drawdown'*.

22. The Government has sought views on:
    - What level of cap to use in capped drawdown,
    - How to appropriately reform the pensions tax framework,
    - How high to set the Minimum Income Requirement (MIR),
    - What income should be considered for the MIR,
    - How often the MIR should be reviewed,
    - Whether the MIR should differ for individuals of different ages and household groups,
    - How the changes might affect the UK annuity market,
    - Whether there may be any unintended consequences of the changes.

23. This response outlines the evidence that the PPI considers relevant to the Government's consultation and focuses especially on the trade-offs between risks and flexibilities for individuals that could result from the new regulations.

[4] ASPs were initially intended only for those with principled religious objections to the pooling of mortality risk, though take-up has spread beyond the target group that ASPs were intended for

Setting a drawdown cap

Capped Drawdown allows individuals more flexibility but poses more longevity risk for individuals than conventional lifetime annuities

24. The Government intends to place a cap on the amount of income individuals can withdraw from their capped drawdown arrangements if they have not satisfied the MIR. The purpose of the cap is to ensure that individuals do not withdraw at such high levels that they deplete their savings during their retirement and end up relying on the state through means tested benefits.

25. **A limit, at any level, on the amount that people can withdraw will involve a trade-off between: setting the cap low enough to ensure that individuals do not run out of money before the end of their retirement; and, setting the cap high enough so that individuals are not made to forgo consumption.**

26. **Simple, fixed limits are more likely to pose risks to individuals.** Research[5] shows that simple limits may not provide as much insurance against **longevity risk and the risk of forgoing consumption** as more flexible approaches to drawing down income. For example:
    - Using a limit of *a fixed percentage of the equivalent available annuity rate* (as under the current system) can lead to the danger of running out of funds before the end of retirement.
    - Using a limit of *a fixed percentage of the fund size* hedges more longevity risk than using a fixed percentage of the equivalent available annuity rate, but this approach often involves very small withdrawals of fund capital and therefore might lead individuals to forgo some consumption.

27. **Complex approaches to drawdown, such as withdrawal strategies that vary with age and fund performance, are more effective at ensuring that individuals do not deplete their funds, or run the risk of forgoing consumption.**[6] However complex approaches to withdrawal will not be easy to regulate using cap limits and require high levels of financial knowledge from consumers or an ability to pay for ongoing advice and fund management.

28. **When assessing the potential implications of different drawdown strategies there is a trade-off between withdrawal strategies that provide simplicity and are easy to understand, but bring greater risks, and withdrawal strategies, which provide more security but are more complex and difficult to understand.**

29. If individuals remain in capped drawdown instead of buying an annuity they face risks that annuities would have provided protection against. The main risks that individuals in capped drawdown will be exposed to are:

[5] IMA (2008) *Research Paper: modelling income drawdown strategies*
[6] IMA (2008) *Research Paper: modelling income drawdown strategies*

- *Longevity risk* – the risk that an individual lives for longer than they expect to, and have made financial provision for, and deplete their pension savings before their death.
- *Mortality drag* – when an individual purchases a lifetime annuity, they benefit from *mortality cross-subsidies*. This is because those who purchase lifetime annuities and then live for less than average life expectancy *subsidise* those who purchase annuities and live for longer than average life expectancy. The longer an individual remains in drawdown, the more they miss out on the mortality cross-subsidies they would have received from a lifetime annuity. The amount of yearly loss grows with age, as does the amount of investment return that an individual would need to make up for the lost cross-subsidy. By the time an individual is aged 74, they could need to receive around 6.5% in investment growth (per year) from drawdown to make up for the lost cross-subsidy.[7]

30. The effect is compounded by the fact that average (total) life expectancy increases with age, e.g. a 70 year old purchasing annuity will *not* automatically be expected to live for 5 years less than a 65 year old purchasing an annuity. The 70 year old will have a higher average life expectancy than the 65 year old and may be expected to live, for example, 3 or 4 years less than a 65 year old. As a result, the annuity rate that people receive will be affected by the age at which they purchase their annuity and the provider's calculations of life expectancy.

31. In order to compensate for the longevity risk and for missing out on the mortality cross-subsidy, an individual in a drawdown arrangement might need a cap on withdrawals that is lower than 100% of what they would have received from an equivalent annuity.

Age related caps might prevent smoothing consumption during retirement

32. One of the concerns regarding capped drawdown is that individuals using drawdown are at risk of running out of money before the end of their retirement. Therefore, one possible option would be to place a low initial cap on withdrawals that increases as individuals age, in order to prevent people from withdrawing too much of their fund in early retirement.

33. However a strategy, which allows people higher caps in later retirement, may still put individuals at risk of fund depletion, particularly as any withdrawals are likely to be larger relative to the size of the remaining fund. Caps that increase with age may also unfairly disadvantage those who, for reasons of health, location or social class, have lower life expectancies than others of their same age.

34. An alternative option would be to allow people a higher cap when they are younger and then reduce the cap as they age when the mortality cross-subsidies in an equivalent annuity would be higher. However this strategy would reduce

[7] www.williamburrows.com/dd/mortalitydrag.aspx

the amount of income people could receive from their fund as they aged, and could result in very low caps being imposed in later retirement in order to make up for the higher caps at the start,[8] making it difficult to smooth consumption during retirement.

35. **An option, which would compromise between the different risks, could be to have a steady, low cap, which allowed people to draw income at similar levels throughout their retirement.**

36. **Individuals in capped drawdown arrangements may forgo consumption in an attempt to preserve their capital fund.** There is evidence from the US,[9] that allowing more flexibility in accessing pension savings can motivate individuals to forgo consumption in order to preserve their capital. Capped drawdown arrangements provide less security than a lifetime annuity. The lack of security could lead to individuals compensating by withdrawing at lower amounts than are needed to meet basic needs in retirement.

37. **The level of risk that using capped drawdown poses will be relative to the level of savings and assets held by an individual**. For individuals with large pension pots and substantial savings and assets the risk of capped drawdown leading to depleting savings before the end of retirement, or the risk of forgoing consumption to the point of serious deprivation, are likely to be reduced.

38. **Capped drawdown allows more flexibility than conventional annuities,** and gives individuals more flexibility than conventional annuities to:
- withdraw income in variable amounts and therefore meet changing needs for income during retirement,
- grow their funds,
- leave some of their funds as inheritance.

Setting the MIR

39. **What income should count towards a Minimum Income Requirement?**
The Government would like to give individuals more flexibility in accessing their pension savings, while also ensuring that individuals do not deplete their savings too quickly and end up becoming eligible for means-tested benefits during their retirement. Therefore, the Government's Consultation proposes to require that individuals secure an income [the Minimum Income Requirement (MIR)] sufficiently high to keep them above eligibility for means-tested benefits throughout their retirement, before being allowed to access their pension savings without a cap.

[8] According to simulations run by Partnership
[9] Gale, *et .al.* (2009) *Automatic. Changing the Way America Saves* Brookings Institute Press, Washington D.C.

40. The Government is consulting on the scope of what income should be allowed to constitute 'secure income' and they have specified that they would like MIR income to:
    - be currently in payment (i.e. not a deferred entitlement)
    - be guaranteed for life, and
    - take into account reasonable expectations of the future cost of living.

41. The Government intends to require MIR income to be currently in payment in order to avoid the situation of individuals securing an MIR through deferred income and then becoming eligible for means-tested benefits before their secure income comes in to payment. **However, disallowing deferred income might result in a situation in which some individuals are not allowed to access their pension savings until their sixties when they have reached SPA and/or the age at which their occupational pension comes into payment.**

42. Some individuals may have non-secure income and assets at such a high level that they are very unlikely to become eligible for means-tested benefits. **An alternative would be to allow non-secure income and assets above a certain level to count towards the MIR if individuals can prove that they will, in future, have a secure source of income at the MIR level.** This would be similar to the Irish system in which qualifying individuals with savings above a certain level are allowed flexible access to pension savings if they put aside a certain amount of their savings in an 'approved fund' (similar to a drawdown fund).

43. The consultation document specifies that income used to satisfy the MIR will need to take account of increases in the cost of living. The document states that the Basic State Pension (BSP) and Additional State Pensions will both count towards the MIR.

44. The Government also proposes that Occupational Pension income in payment that is uprated annually by a minimum of Limited Price Indexation (LPI) will also count towards the MIR.

45. The Government has proposed that income from escalating annuities would count towards the MIR, provided that it increases by at least LPI but that income from a level annuity will not count towards the MIR at all. This seems at odds with the fact that the vast majority of annuities currently purchased are level annuities. There may well be an argument for discounting the value of the level annuity income more heavily than income from an escalating annuity, in order to reflect the fact that inflation will erode the value of the level annuity. However, to exclude income from level annuities altogether risks creating market distortions in the demand for level and escalating annuities.

How should the Government set the MIR level?

46. Setting the MIR level is not straightforward. The Government has stated that the appropriate level of the MIR should protect the Exchequer from the risk of an individual falling back on the state. The level of the MIR could therefore be linked

to the levels of income that individuals or households would need to have to make it very unlikely that they would fall back onto state benefits.

47. There are three main means-tested benefits that pensioners can currently claim. The Pension Credit which is composed of Guarantee Credit + Savings Credit, Housing Benefit and Council Tax Benefit.

48. Table 3 illustrates how much an individual might need to have in savings in order to purchase an annuity that would allow them to remain above the MIR, for a 30 year retirement, set at four different levels of means-tested benefit entitlement. These calculations assume that people have different levels of state pension entitlement and that individuals have no other sources of occupational pension income (e.g. defined benefit pensions) that would count towards the MIR. Para 59 shows how the situation differs for a pensioner with a median amount of occupational pension income.

49. The individuals in Table 3 are all able to stay above a means-testing threshold throughout their retirement with a level annuity of a high enough value. **It could be an option, therefore, to allow individuals to secure their income with a level annuity, or with income that increases by a different index than earnings, if they secure the income at a high enough level to remain above a means-testing threshold for the entirety of their retirement.**

Table 3: Level of income and size of annuity purchase required to keep pace with inflation of the MIR set at 3 different levels of means-tested benefit entitlement

Level of BSP and S2P[10]	Guarantee Credit[11]		Pension Credit (Guarantee Credit + Savings Credit)		Average eligible rent (£288)[12] Pension Credit + Housing Benefit+ Council Tax Benefit		Maximum eligible rent (£400)[13] Pension Credit + Housing Benefit + Council Tax Benefit	
	Required weekly income **2010:** £132.60 **2040:** £496.63		Required weekly income **2010:** £183.90 **2040:** £688.76		Required weekly income **2010:** £596.20 **2040:** £2,178.54		Required weekly income **2010:** £768.50 **2040:** £2,802.73	
	RPI-linked annuity	Level annuity	RPI-linked annuity	Level annuity	RPI-linked annuity	Level annuity	RPI-linked annuity	Level annuity
Full BSP (£97.65) No S2P	£55,000	£85,000	£165,000	£240,000	£985,000	£1,450,000	£1,330,000	£1,955,000
Full BSP (£97.65) ½ S2P (£63.50)	£0	£0	£100,000	£145,000	£920,000	£1,355,000	£1,265,000	£1,860,000
Full BSP(£97.65) Full S2P (£127)	£0	£0	£35,000	£55,000	£860,000	£1,260,000	£1,200,000	£1,770,000

[10] BSP increased by greater of earnings, CPI or 2.5%, S2P increased by CPI
[11] Uprated by earnings
[12] Assumes maximum Housing Benefit eligible rent of £288 (based on average over 65 eligible rent, DCLG table 735) assumes eligible rent is only uprated by CPI
[13] Assumes Housing Benefit eligible rent is capped at £400 maximum (maximum cap for a 4 bedroom house), assumes eligible rent is only uprated by CPI

The Government could set the MIR at the level of the Guarantee Credit, £132.60 per week in 2010.

50. If the Government wishes to set the MIR at a level, which would keep people off Guarantee Credit, then they could set the MIR at or above the Guarantee Credit Level of £132.60 per week in 2010. Assuming that inflation increases at expected levels, many pensioners would be able to meet this MIR for a 30-year retirement if they had full BSP entitlement and at least half of the maximum S2P entitlement. Pensioners with full BSP entitlement, no S2P entitlement and no other occupational pension entitlement may be able to remain above an MIR set at this level by purchasing an RPI-linked annuity with around £55,000, or by purchasing a level annuity with around £85,000.

51. However, individuals may have income above the Guarantee Credit level and still be eligible for the means-tested benefits of Savings Credit, Housing Benefit and Council Tax Benefit.

The Government could set the MIR at the level needed to reduce the likelihood of individuals falling back onto Pension Credit, at £183.90 per week in 2010

52. If the Government wishes to set the MIR at a level which would keep people off Pension Credit (Guarantee Credit + Savings Credit), then they could set the MIR at the minimum income level above which people are no longer eligible for these benefits, £183.90 a week in 2010. An individual with no occupational pension entitlement may be able to stay above an MIR at this level by purchasing an RPI-linked annuity with between £35,000 and £165,000 depending on their state pension entitlement. Alternatively, an individual who purchased a level annuity with between £55,000 and £240,000 would also be able to meet an MIR set at the Pension Credit level, depending on their state pension entitlement.

53. Individuals who have incomes high enough to make them ineligible for Pension Credit may still be eligible for Housing Benefit or Council Tax Benefit. The level of income at which people are still eligible for Housing Benefit and Council Tax Benefit is much higher than the level at which people cease to be eligible for Pension Credit. This is because Housing Benefit eligibility is related to the rent people pay. Eligibility for Housing Benefit is only gradually withdrawn as people's incomes rise.

The Government could set the MIR at the level needed to reduce the likelihood of individuals falling back onto Pension Credit, Council Tax Benefit or Housing Benefit at average levels of rent, at £600 per week in 2010

54. The MIR could be calculated based on the level of weekly income needed to reduce the likelihood of individuals falling back onto Pension Credit, Housing Benefit or Council Tax Benefit.

55. An MIR set at this level, using average levels of rent eligible for Housing Benefit, would be very high at around £600 per week in 2010. An MIR set at this level may not insure that all people who secure an MIR will never need to rely on means-

tested benefits, but would reduce the likelihood of people falling back onto Housing Benefit, when compared to an MIR set at the Pension Credit level.

56. An individual with no occupational pension entitlement may be able to stay above an MIR at £600 a week in 2010 by purchasing an RPI-linked annuity with between £860,000 and £985,000, depending on their state pension entitlement.

If the Government wants to set the MIR at a level above a calculation of maximum entitlement for all means-tested benefits then it may be higher than most people could afford, at around £770 per week in 2010

57. If the Government wishes to set the MIR at a level, which would completely keep people off Pension Credit, Housing Benefit and Council Tax Benefit, then they might need to set the MIR at around £770 per week in 2010. This weekly income required to remain ineligible for Housing Benefit is very high because the maximum allowed eligible rent for Housing Benefit is £400 per week.[14] An individual with no occupational pension entitlement may be able to stay above an MIR at this level by purchasing an RPI-linked annuity with between £1.2m and £1.3m depending on their state pension entitlement.

58. As less than 1% of current annuity purchases are above £200,000 (Table 4) it is unlikely than many people would be able to afford to purchase an annuity that would satisfy an MIR at this level.

Table 4:[15] Average percentage of annuities purchased, by size of annuity purchase, between 2001 and 2009

Size of annuity purchase	Average percentage of annuities purchased between 2001 and 2009[16]
Less than £5,000	29%
£5,000 - £9,999	17%
£10,000 - £19,999	22%
£20,000 - £29,999	12%
£30,000 - £39,999	6%
£40,000 - £49,999	4%
£50,000 - £59,999	3%
£60,000 - £69,999	2%
£70,000 - £79,999	1%
£80,000 - £89,999	1%
£90,000 - £99,999	1%
£100,000 - £199,999	3%
£200,000 and above	1%

[14] Eligible rent levels for Housing Benefit rise in line with CPI from 2013/14
[15] ABI stats, cash figures by year
[16] Figures add up to more than 100% due to rounding

59. Pensioners with some Occupational Pension entitlement (which are predominantly Defined Benefit pensions) may find it easier to meet an MIR without purchasing an annuity. For example:
    - We assume that an individual receives:
        - Full entitlement to BSP (£97.65)
        - No entitlement to S2P[17]
        - The median level of occupational pension entitlement (£104)[18]
    - This individual begins retirement with a weekly income of £201.65 and would be able to satisfy an MIR for around 10 years, set at both Guarantee Credit and Pension Credit level (£183.90 in 2010) with just their state and occupational pension income. To satisfy the MIR for 30 years they would need around £59,000 to purchase an RPI-linked annuity (or around £85,000 to purchase a level annuity).
    - However, this individual would not be able to satisfy an MIR set at a level above eligibility for Pension Credit, Housing Benefit and Council Tax Benefit using only their state and occupational pension income.

60. An alternative approach that could be considered by the Government is to link the MIR to a measure of the minimum expenditure needed for retirement income. The JRF's Minimum Income Standards suggest that a single person may need an income of £147 a week before housing costs for a single person, or £222 a week after housing costs for a couple.[19] However, at an MIR at these levels there will still be risks that individuals or households could fall back onto state benefits, particularly in later retirement if retirement income is not fully protected against inflation.

61. **Setting the MIR will involve consideration of the trade-off between:**
    - minimising the risk of individuals becoming eligible for means-tested benefits but placing the MIR so high as to exclude many individuals from the option of satisfying it, and
    - placing the MIR low enough to give more individuals the option of satisfying it, but exposing the Government to more risk of individuals becoming eligible for means-tested benefits in retirement.

It might be worth considering the future costs of Long Term Care when calculating where to set the MIR.

62. Today's 65 year olds will need care costing, on average, £30,000 during their retirement.[20] Care for someone in a residential home might cost around £12,500 per year on average for care, plus around £14,000 per year for the cost of

[17] The majority of DB scheme members are contracted out of S2P
[18] DWP (2010) *The Pensioners' Incomes Series 2008-09,* calculations assume occupational pension is uprated by LPI
[19] Joseph Rowntree Foundation (2008) using data from the 2008 Expenditure and Food Survey, ONS
[20] HM Government (2009) *Shaping the Future of Care Together* TSO

accommodation.[21] Some pensioners might be able to satisfy the MIR when they are younger and healthier but may then need to rely on the state when their care costs become high in later retirement.

It could be unfair to disabled people to include entitlement to disability benefits in MIR calculations

63. Some individuals may develop disabilities or health problems during later retirement. Eligibility for means-tested benefits can be higher for people who have a limiting disability or health problem. Therefore it might seem that an option would be to consider the potential cost of disability related benefits when setting the level of the MIR.

64. However it could be unfair to disabled people to include entitlement to disability related increases or benefits in an MIR calculation. **Disability benefits are intended to pay for needs over and above the standard cost of living and should not be included in assessments of the income people need to meet basic needs.**

Varying the MIR by age or household status may make sense but it could introduce further complexity to the system

65. **Individuals of different ages will face different levels of risk in retirement, and one potential option would be to link MIR to age.** An individual aged 55, might need a high MIR in order to provide against longevity risk, i.e., the risk of having a long retirement or the risk of having income needs that change during retirement (for example, as a result of developing health problems) and to provide against the risk of high inflation rates during retirement. An individual aged 80 or above will face less longevity and inflation risk as their remaining retirement is likely to be shorter than that of a younger individual. Younger individuals, in their fifties and sixties may need a higher level of protection against risk, through having a higher MIR, than those in their seventies, eighties and nineties. However, varying the MIR by age could introduce greater complexity into the system.

66. **Couples and single individuals might have different income needs in retirement.** Pensioners in a couple will generally need less income per person than single pensioners, in order to meet their needs. Therefore there may be an argument for allowing pensioners in couples to have a lower MIR than single pensioners. However, this introduces greater complexity into the system.

It will be important that the MIR is reviewed regularly to account for cost of living changes. The timing of the reviews could be linked to changes in indices associated with the MIR.

67. The timing of the MIR reviews should reflect changes in MIR indexation, for example:

[21] Forder J, Fernández J L. (2009) *Analysing the costs and benefits of social care funding arrangements in England: technical report*, www.pssru.ac.uk p. 20, Table 13.

- If the MIR is linked to Guarantee Credit then the MIR should be reviewed when the Guarantee Credit level is changed.
- If the MIR is linked to the Minimum Income Standard then the MIR should be reviewed when the Minimum Income Standard is reviewed.
- If the MIR is linked to inflation, for example, expenditure or earnings, then the MIR should be reviewed when there are substantial changes in inflation rates.

68. Larger than anticipated changes in inflation might cause the income threshold for means-tested benefits to rise. The Government may wish to include an extra level of required income in the MIR, above calculations of means-tested benefit eligibility, as insurance against inflation increasing above average levels.

Advice and information

The new proposals give consumers greater choice but consumers will need to decide which option or options they wish to use, which has implications for the provision of advice and information

69. Removing the effective requirement to annuitise means that individuals will have to choose between purchasing an annuity, entering capped drawdown or securing a minimum income and withdrawing the rest of their savings flexibly.

70. **Allowing more flexibility in accessing pension savings may mean that some individuals might make decisions that do not best meet their income needs (as a result of either receiving inappropriate advice, or lacking the necessary information).** It will be extremely important that providers of advice and information (including the Money Guidance programme) deliver accessible, correct and sometimes tailored advice and information to individuals in order to ensure that individuals do not select a withdrawal option that could jeopardise their pension savings or result in pensioners experiencing a lower standard of living. Individuals with similarly sized pension pots may have different advice needs and may face different risks. For example,
    - An individual with a large pension savings pot but very little other savings and assets might be eligible to satisfy the MIR and flexibly withdraw their remaining pension savings. This individual may benefit from a careful approach to withdrawal, in order to avoid depleting the remainder of their savings before the end of their retirement as the MIR may not be sufficient to provide them with a standard of living which matches the one they experienced in working life.
    - However, an individual with a similarly sized savings pot and a substantial amount of other savings and assets may be running fewer risks if they satisfy the MIR and then flexibly withdraw their remaining savings because they will have other assets to fall back on if they deplete their savings

71. **Even if individuals receive the correct advice and information, the negative perception of annuities could lead some individuals to choose to enter capped drawdown or to satisfy the MIR and withdraw the remainder of their savings**

flexibly, when a lifetime annuity would have been the best option for them. Annuities will still be the best option for the majority of individuals, who have relatively modest pension pots, because the alternative option of capped drawdown is likely to be too expensive for many people to manage. Individuals with small pots are also exposed to more risks in drawdown than individuals with larger pots as small pots are at greater risk of depletion before the end of retirement and may be less able to deal with market fluctuations. However, the negative associations many consumers have with annuities might mean that some individuals don't make the annuity choice when they come to access their pension savings.

72. **It is essential that advice and information providers work to ensure that the public image of annuities does not prevent those for whom an annuity is the best option from purchasing them.**

73. **It will be important to ensure that individuals do not see capped drawdown and annuities as an 'either/or' choice.** For some individuals it might be appropriate to have some of their savings in capped drawdown and use some to purchase an annuity. Research suggests that some individuals may be able to increase their consumption levels, while incurring very little risk, if they invest the majority of their savings at the beginning of retirement and switch savings over into annuities progressively during their retirement.[22]

<u>Unintended consequences</u>

New regulations on accessing pension savings may have unintended consequences for the choices consumers make and for the provision of retirement income products

74. There are several potential unintended consequences that could arise from the Government's proposed approach to accessing pension savings.

75. The lifting of the requirement to annuitise may result in some individuals declining to purchase an annuity even if an annuity is the best option for them. This could be as a result of receiving incorrect advice or because individuals have a negative perception of annuities.

76. A reduction in annuity purchases by those for whom an annuity would be the best option could lead to:
- *Some pensioners receiving lower incomes in retirement from capped drawdown than they would have if they had purchased a lifetime annuity* - This could be as a result of low caps, fund depletion or as a result of pensioners withdrawing below maximum levels in order to preserve their fund capital.
- *Some pensioners becoming eligible for means-tested benefits* - Pensioners who enter capped drawdown and then lose too much fund capital due to market

[22] Maurer, R. Somova, B. (2009) *Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?*

fluctuations or higher than expected longevity might become eligible for means tested benefits in later retirement.

- *Some pensioners paying more to manage their pension funds* – the costs of managing a drawdown account could be much higher than the one-off commission paid when purchasing an annuity, as drawdown accounts require ongoing management.

77. **Some individuals may purchase escalating annuities even when a level annuity would better provide for their needs in retirement if, as proposed, the MIR only recognises escalating annuities.** The consultation document suggests that the MIR will need to take into account reasonable expectations of the future cost of living, and suggests an intention to require that an annuity purchased in order to satisfy the MIR be escalating. If it becomes a requirement that individuals purchase an escalating annuity in order to satisfy the MIR, individuals may start to think that escalating annuities are the best option for them, however for some individuals, (individuals with shorter life expectancies or with incomes only just above a means-tested benefit level), a level annuity will often be a better option.

78. **If many individuals start to buy escalating annuities in order to satisfy the MIR or because they believe as a result of the new regulations that escalating annuities are the best type of annuity to purchase, then the cost of escalating annuities might rise**. This would mean that for each £1,000 spent on purchasing an annuity, the rate of pension income would be lower. Government issued index-linked gilts, of which there is a low supply, back escalating annuities. A higher demand might cause the Government to offer lower returns on the gilts which, in turn, could cause the price of annuities to increase and the amount received relative to purchase price of annuity may be lowered

79. A potential, positive consequence of the Government's proposed approach may be that many individuals with higher incomes, and therefore often higher life expectancies, might leave the annuity market and access their pension savings through capped or flexible drawdown arrangements. A reduction of the average life expectancies of those in annuity pools could result in an improvement in the annuity rates on offer, if the annuities are priced correctly and pension incomes are raised.

80. **The regulations could have a knock-on effect for members of DB schemes.** There is some scope for the new approach to make DB schemes seem relatively inflexible in comparison to DC schemes in future, and therefore less attractive to DB scheme members. In an extreme scenario, members of DB schemes may leave their schemes for more 'flexible' DC arrangements.

81. **Individuals are going to require education to help them understand and navigate the new system of accessing pension savings.** The cost for providers of this education (including internal retraining costs) could be very high. This may especially impact upon providers of free advice and education e.g., charities and advice services.

1 - A BRIEF WALKTHROUGH

PROPOSED GOVERNMENT LEGISLATION TO
REMOVE COMPULSORY ANNUITY PURCHASE AT 75
AND
THE REASONED OPPOSITION OF A GROUP OF
PENSION HOLDERS TO THE INTRODUCTION OF A 55% DEATH TAX

Prepared by :
Julian Russell,
Pensions Reform Action Group

August 2010

2 – The New Legislation

OBJECTIVE

“To re-invigorate private pensions saving, by giving people greater flexibility to choose the retirement options that are best for them”

MAIN ELEMENTS OF PROPOSED LEGISLATION

- Ending of the COMPULSION to purchase an Annuity at age 75 (or at any other age)
- Abolition of “Alternatively Secured Pensions”(ASPs) and their associated tax rules, thus permitting the continuation of USPs beyond age 75.
- New method for calculating maximum permissible income p.a. for “capped drawdown”
- Method for determining “Minimum Income Requirement” (MIR) in order to qualify for“flexible drawdown”
- 55% death benefit tax charge on residual funds   (current rate 35%)

3 - Government concerns and caveats

- Must not result in additional costs to the Exchequer
- Must prevent pensioners from prematurely exhausting their funds and then having to fall back on the state
- New rules must not be exploitable as a means of (IHT) tax avoidance
- New rules must avoid unnecessary complexity or administrative burden
- Past tax concessions granted to pension holders should not be passed on as a death benefit to non-dependant beneficiaries

4 - Pensioner reaction

- Generally, enthusiastic welcome
- Support and understanding of the Government's concerns and caveats
- Disagreement with the Government that 55%, rather than 35%, would be an appropriate deferred tax recovery charge
- Remainder of this presentation explains why the proposed 55% rate would be both ineffective from a tax collection perspective and would undermine the Government's objectives and concerns

5 - Deferred tax recovery charge

Proposed Policy

“On death , pension savings that have been accumulated with the help of tax relief should be taxed at an appropriate rate to recover past tax relief by means of a deferred tax recovery charge”

Elements of Tax Relief

- Pension contributions
- Fund investment growth
- The 25% “tax free cash”

Commentary

- Intention to claw back tax not made clear at the outset
- No explanation for change in present 35% rate offered by HMT
- No explanation for the proposed 55% has been offered
- Independent advice has confirmed that the 35% rate will achieve full recovery

6 - Contribution of tax relief to pension funds

Calculation of the proportion of an average pensioner's residual fund which can be attributed to past tax concessions.

Tax Relief Element	Attributable %
pension contributions	7.0
25% "tax free" cash	7.5
investment growth	20.5
Total	35.0

Assumptions

- Based on a "Mr Average" pensioner profile
- Starts work at 20, retires at 60 and dies at 85
- Starting salary £15,000 rising progressively to £45,000 at age 60.
- Pension contributions -10% of salary
- Av. compound growth of pension fund - 7% p.a.
- Income in retirement equal to average annual growth in fund i.e. fund balance remains constant between 60 and 85
- Av. tax rate at which relief was granted - 30 %

7- A Fair Policy ?

Tax concessions are granted to all DC pension holders but only one category is required to repay

Situation at Death	Recovery Charge
1 - Drawdown not started	nil
2 - Pension Annuitised	nil
3 - Pension Money Exhausted	nil
4 - Money Moved out of Pension	nil
5 - Money Remaining in Pension	55%

Commentary

- Discriminatory - punishment for saving too much?
- 55% tax in category 5 will create incentive to ensure situation at death falls into categories 2,3, or 4
- Runs counter to Government's objectives concerns and caveats
- Ineffective as a tax collection policy

8 -Tax on Pension v Non-Pension Funds

Pension Funds - 55% tax on all of it
Non-pension funds – first £650,000 is tax free, 40% standard IHT rate on balance

Commentary

- Moving funds from a pension into an estate is charged at income tax rates – which will subsequently be tax free if within IHT Nil Rate Band (NRB) allowances
- Pension fund charges of 55% creates an incentive to pay income tax "up front" and move the money out of the pension (35% does not)
- The consequence is that building up pension funds becomes something to avoid
- Very wealthy individuals seeking to exploit pensions in order to avoid/reduce IHT could be deterred by means of a higher rate tax above a fund value of current life time allowance level

9 - Conclusions

1. A tax recovery charge of 55% would be excessive. No more than 35% is necessary to recover all “deferred tax”
2. A 35% charge would have no negative impact on Exchequer cost because this is the rate already being charged
3. Higher than 35% will drive surplus money out of pension funds, with the following consequences:
   - Higher risk of prematurely running out of money
   - Consumer preference to save outside of pensions, or not save at all
   - Excessive focus on tax mitigation issues
   - Perception of continuing “annuity bias”
   - Reduced opportunities for tax collection
   - Government objectives not met

Age 75 Consultation

Firstly, many thanks for inviting me to take part in the meeting at the Treasury on Wednesday last which was very helpful in a number of ways.

The discussion raised some issues which we did not adequately cover in our formal Response Document, so I have included further comment below for your consideration

1) Although I was there representing about 1,000 of our members, it was a pity that mine was the only voice putting the pensioners' point of view as opposed to the large majority of other voices that were representing the industry. This lack of balance may be difficult to avoid but it highlights the need to distinguish between what the industry might or might not wish to sell, and what consumers actually wish to buy. No doubt the industry would say it too represents pensioners and it does to an extent, but on occasion the interests of pensioners and the interests of the industry do not coincide.

This was well illustrated by the discussion on flexible drawdown, where the lack of enthusiasm from the industry representatives stood in marked contrast with the views of the people I represent, who strongly welcome the opportunities that flexible drawdown will offer.

Whilst the industry may have commercial reasons for their reservations, their views can not and must not be taken to represent those of the pension holders themselves, whose needs they are there to serve. A stronger customer voice, and more flexibility, is critical to the future strength of the industry.

Flexible draw down will allow prudent pension savers to draw down lump sums of their own savings from time to time as they see fit within the safeguards provided by the MIR requirements.

Flexible draw down will also appeal to future generations of pension savers, who will respond to the flexibility of the arrangement as opposed to being told they can not draw on their own savings as and when they please even though they could satisfy the MIR requirements.

We believe there will be a far greater take up of flexible draw down than the industry representatives were saying at the meeting. This will result in sums being drawn down earlier than would otherwise be the case providing an earlier tax collection point for government, much of it at higher rates of taxation, an added stimulus to the economy and no risk to the state which will be protected by the MIR requirements. In short, we believe the proposals for flexible draw down set out in the consultation document are admirable, allowing the pensioner more freedom and flexibility which is, after all, one of the principal objectives.

2) We are at one with the industry in opposing the proposed 55% rate on the following grounds:

a) for most pension holders, it would be a gross over-assessment of the tax relief they had actually received

b) it would create a powerful deterrent for future generations to save by means of pensions

c) it would not produce revenue for the government due to migration of funds

My impression was that this point was taken on board by you and your colleagues and we therefore await the draft legislation with interest.

3) The narrowness of what is to be counted for the purposes of secure income was fully discussed and we are at one with the industry in recommending that other discounted products and some gilts should be considered for inclusion. .
In addition, there are those pensioners who have a great many non-pension assets that are not "secure" as defined in the document. We feel that consideration should be given to including such assets within the MIR calculations albeit discounted to some extent.

4) Clearly, the PRAG-recommended figures are well apart from the industry when it comes to agreeing the fair and appropriate level of MIR. The figures contained in our document are based on the current pension credit threshold whereas the industry, and I believe your department, considers that other elements of possible cost such as housing benefit and long term care should also be included. We would simply sound the warning that, if the level of MIR is set too high, only the very rich will qualify and the perception may well be that it is a return to the previous government's strategy of forcing the majority of pensioners into the annuity route. This will provide a difficult actuarial assessment and we look forward to receiving your conclusions.

5) It was depressing to hear the industry saying they could not be ready for new legislation in time for April 2011. I do hope the government and your own department will not be too swayed by these appeals. You have obviously worked very hard and very quickly to get these proposals as far as you have which has been most impressive particularly when set against the previous government's attempts to revise pension legislation – it would be a great pity if this government suffered the same ignominy of having to postpone it.

Once again, thank you for your time and attention.

Michael Baker
Regards

Michael

Michael Baker

RESPONSE TO HM TREASURY CONSULTATION DOCUMENT ISSUED JULY 2010

TITLE : "REMOVING THE REQUIREMENT TO ANNUITISE BY AGE 75"

Prepared by :
The PENSIONS REFORM ACTION GROUP (PRAG)

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INTRODUCTION

This paper is submitted on behalf of the Pensions Reform Action Group (PRAG), in response to the Government's consultation regarding the removal of the effective requirement to purchase an annuity by age 75, from April 2011, announced at the Emergency Budget in June 2010.

PRAG representatives have already registered their interest in attending a meeting with HM Treasury representatives as part of the consultation process, and will be attending the meeting scheduled for 8 September 2010.

We wish to offer our sincere thanks and appreciation that the Government has shown such determination to reform an area of pensions legislation which has long been seen as illogical, unfair, discriminatory, and highly unpopular with pension holders. We generally support the new legislation that the Government is seeking to introduce, although there are certain aspects where we believe further consideration would be beneficial to all concerned

In this paper we have as far as possible confined our comments to those aspects where the consultation paper has specifically requested views. However, we have included below a brief introduction to PRAG and its membership because this will help to clarify the context in which our views have been expressed.

The Pensions Reform Action Group represents the views of its members all of whom are, or would have become, victims of the present legislation. Those under 75 hold a SIPP, SSAS, PPP, or similar pension and for the most part wish to continue managing their pension funds as they see fit for the indefinite future. Members already over 75 of necessity hold ASPs and we share their outrage at the prospect of having up to 82% of their pension fund being confiscated through taxation after their death.

Our membership of about 1000 people does not place us among the big battalions, but it covers a very broad spectrum of working backgrounds including plumbers, electricians, doctors, architects, solicitors, estate agents, retailers, clergy, and family business owners. We are therefore confident that our collective views represent those of a substantial proportion of all Direct Contribution (DC) pension holders.

It is a feature of the pensions industry that the supply side is dominated by a few very large pension providers and adviser networks, whilst the consumer side - the pension holders themselves - tends to be poorly organised and inadequately represented. This is particularly the case for those in the DC pensions sector.

We therefore believe that pensioner groups such as PRAG have a particularly strong claim to be both heard and heeded if a balanced consultation process is to be achieved.

RESPONSES TO GOVERNMENT'S REQUEST FOR VIEWS

In expressing our views we have used the same structure as the Summary of Questions document in Appendix A of the consultation paper

DEVELOPING A NEW TAX FRAMEWORK FOR RETIREMENT (CHAPTER 2) : A.1 *Level of appropriate drawdown limit for capped drawdown*

The main objective is to ensure that pension holders do not prematurely exhaust their pension funds and then have to fall back on the state for income.

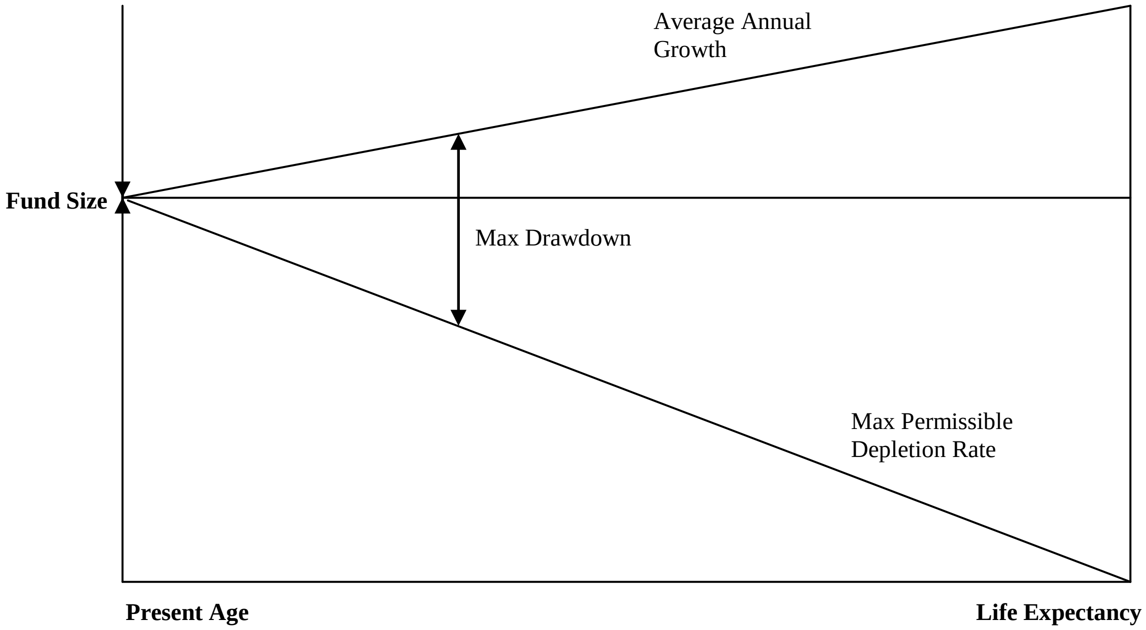
Calculation of the capped limit can therefore be derived from

- the size of the fund
- the present age and life expectancy of the pension holder

and hence the maximum permissible depletion rate of the fund to ensure that its balance remains positive throughout life.

The maximum permissible income must also take account of the expected average annual growth and nature of the invested funds. The drawdown limit is therefore the sum of the annual growth and the maximum permissible depletion rate, as illustrated in Figure 1 below

Figure 1



We believe this to be the logically correct method of calculating the income cap, but we accept that it may be more practical to use the existing and well-established method (120% of the equivalent annuity) because this produces a similar result and appears to be uncontroversial. However, where an individual is certified to be in poor health the cap should be based on his/her medically opined life expectancy, as in an Impaired Life Annuity, rather than an actuarial figure.

Our recommendation is that the present method of calculation be retained, but with flexibility to cater for exceptional cases such as the example referred to above.

DEVELOPING A NEW TAX FRAMEWORK FOR RETIREMENT (CHAPTER 2) : A.2 *The intended approach to reforming the pensions tax framework, in line with the commitment to end the effective requirement to purchase an annuity at age 75.*

The two essential reforms to which the Government is committed are :

- ending the *COMPULSION* to purchase an annuity at age 75 (or at any other age)

- abolition of ASPs and their associated rules, thus permitting (in effect) continuation of USPs beyond age 75.

We are pleased to note that the new framework will achieve this. We confirm our agreement to the five principles set out in Box 2.A. This includes Principle 5 which states :

"On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant."

We do however strongly disagree with the suggestion that 55% represents an "appropriate rate" because :-

1. the existing charge rate applicable to USP pensions is 35% and the proposed new legislation will permit USPs (under whatever name) to continue without age limit when compulsory annuities and ASPs are abolished. The impact of this on the Exchequer is acknowledged to be neutral, and potentially positive. The consultation paper offers no explanation why the existing rate of 35% needs to be increased. This is the current HMRC assessment of "deferred tax" relating to USP holders and we see no reason why its extension to pensioners aged 75 and over creates any case for an uplift.

2. Despite our various approaches to HMT for supporting evidence and calculations, we have been denied access to any Government information which might be used to demonstrate 55% to be a reasonable assessment of deferred tax. It appears that, whilst we are free to express our own views, the Government feels under no obligation to justify its own conclusions to those who are most directly and personally affected.
   We believe that it goes to the heart of transparent consultation that a charge rate commensurate with the value of "deferred tax" should be openly – and preferably independently – derived.

3. With assistance from independent financial advisers and tax accountants we have ourselves researched what proportion of an average pension fund can be attributed to past tax concessions. Our calculations are set out in Appendix 1. These show that, including contribution to growth, no more than 30-35% can be attributed to deferred tax.

4. If the tax recovery charge is set at 55% (or anywhere near that level) it will prove to be a futile exercise because it will just incentivise pension holders to migrate their pension funds (after payment of income tax) into other non-pension investments within their estate. Whilst this could result in a further 40% IHT liability at death, in practice the Nil Rate Band allowances will ensure that all but the very wealthy will largely escape this. The outcome will therefore be that the Treasury collects less rather than more tax as a direct result of setting the recovery charge too high.

It is unrealistic to expect that pension holders will not take into account both their pension and non-pension assets when planning for their retirement, and that they will use these to achieve whatever balance between lifetime income and bequeathable assets best suits their family circumstances, and will do so in as tax-efficient a manner as possible. If the potential tax liability on pension funds is perceived to be harsher than on investments held outside the pension, an outflow from the pension will occur. Indeed this seems to be part of the greater flexibility that the Government is seeking to encourage.

Attempting to ring-fence pension funds with their own tax regime, whilst at the same time promoting more flexibility, is bound to fail, so we were particularly interested in the Irish approach described in Annex B of the consultation paper (International Comparisons). Both Ireland and the UK operate an EET tax model, but in Ireland a pension fund upon death is treated as part of an individual's estate and taxed accordingly.

This model appears to have the virtue of simplicity and to eliminate the need to shuffle money around between pension and non-pension funds in order to mitigate tax liabilities.

As a longer-term solution we recommend that serious consideration be given to adopting these essential features of the Irish model.

In the meantime however, we recommend that the present tax recovery charge of 35% be retained because it has been shown to be an appropriate measure of the tax concessions previously granted.

MINIMUM INCOME REQUIREMENT (CHAPTER 3). A.3 *What income should be considered for the purposes of the MIR and whether the proposals for the life annuity income that can be considered for the MIR are practical and appropriate.*

The elements which contribute to MIR must in total provide the Government with an effective guarantee that the pension holder will not fall back on the state.

The consultation paper states that only pensions income will be considered for the purposes of the MIR.

It further states that to be “secure” this pension income should

- be currently in payment
- be guaranteed for life
- take into account reasonable expectations of the future cost of living

Pension incomes which satisfy these criteria include the following :

- Basic State Pension and additional State Pension
- Scheme Pension in payment from an occupational pension with annual uplift not less than the LPI (lesser of annual increase in prices or 2.5%)
- Index-linked annuities or escalating annuities with a minimum 2.5% annual increase

We believe that the above list is unnecessarily restrictive and that the following additional categories should be added to the list on the basis that they fully satisfy the stated criteria :

- Scheme pensions in payment from an occupational pension without guaranteed escalation, PROVIDED they still satisfy the MIR test allowing for a notional discounting by 2.5% per annum from the date of application to, say, age 85 (i.e expected life span)
- Non-escalating annuities PROVIDED they still satisfy the MIR test allowing for a notional discounting by 2.5% per annum from the date of application to, say, age 85.

We further recommend that consideration be given to non-pension products if they can be shown to fully satisfy the required criteria, for example :

- Long term gilts or guaranteed income products (indexed or discounted by 2.5% p.a.) that cannot be disposed of during the individuals lifetime, i.e. their retention is enforced by the pensions administrator
- Insurance products which indemnify the Government against an individual falling below the MIR level (not yet invented – but watch this space!)

A.4 *What an appropriate level of MIR should be and how the MIR should be adjusted for different ages*

The stated purpose of MIR is to guarantee that, if an individual were to exhaust his (or her) pension fund, then other guaranteed income would be sufficient to disqualify him (or her) from claiming Pension Credit (or similar income benefits) from the state

We understand the present Pension Credit threshold for a single person is £132.60 per week (£6895.20 p.a.) and £202.40 per week (£10,524.80 p.a.) for a couple.

If qualifying for Pension Credit is the most appropriate threshold at which an individual is deemed to be eligible to “fall back on the state” then the current MIR level would be £6895.20 p.a. for a single person and £10,524.80 p.a. for a couple.

Regarding age-related MIR calculations, we believe that genuine assessment of age-related risk would require an extremely complex form of analysis and would be open to accusations of age discrimination. We therefore recommend that a single MIR figure should be applied regardless of age.

A.5 *Whether a different MIR should be set for individuals and couples*

We would recommend and support MIR being calculated for individuals and couples separately - see our response to A.4 above

A.6 *How often the MIR Level should be reviewed?*

Once every three years.

A.7 *How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR*

By avoiding over-frequent reviews and making maximum use of self-assessment procedures

THE UK ANNUITY MARKET (CHAPTER 4) : A.8 to A.10

We are not qualified to comment on the questions relating to this Chapter 4.

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APPENDIX 1

SAMPLE CALCULATIONS TO ASSESS AN APPROPRIATE TAX "RECOVERY CHARGE" ON RESIDUAL FUNDS

POTENTIAL CATEGORIES OF "DEFERRED TAX"

A : HMRC "Contributions" - tax deferred on contributions into the pension fund'
Taxed either at the standard rate (20%) or higher rate (40%) depending on income level. In these calculations the standard rate of 20% has been used because they relate to the salary of "Mr. Average" (see below).
FORMULA : HMRC contributions = 0.2 x total contributions over Mr. Average's working life.

B : HMRC Contribution to Fund Growth - that portion of the total fund value which would not have occurred if no tax relief on contributions had been granted.
FORMULA : 0.2 x total value of the fund at age 60
By way of analogy, if contributions were equivalent to share purchases, then HMRC's "share" of the investment would be equal to 20% of the total fund value.

C : HMRC Recovery of Tax Relief Given on 25% "Tax Free Cash" - The Tax that the pension holder would have had to

pay at retirement if it had been treated as initial drawdown income.
FORMULA : 0.2 x 0.25 x total value of the fund at retirement
NOTE : ALTHOUGH THIS CATEGORY HAS BEEN INCLUDED IN OUR CALCULATIONS WE QUESTION HMRC's ENTITLEMENT TO RECOVER TAX FROM WHAT THE CONSULTATION PAPER DESCRIBES AS A "TAX FREE CASH" PAYMENT.

MR. AVERAGE - PROFILE

Mr. Average is assumed to have a career, salary, and contributions typical of self-invested pension holders, except for those at the extreme ends of the income spectrum.
Mr. Average starts full-time employment at age 20, retires at age 60, and dies at age 85. His average annual salary in each decade of his working life, and the total pension contributions paid in each decade, assuming either 5.5% or 10% of gross salary, are shown below :-

Age	Av. Salary £ p.a.	Total contributions over decade @ 5.5%	@10%
20-29	18,000	9,900	18,000
30-39	27,000	14,850	27,000
40-49	35,000	19,250	35,000
50-60	40,000	22,000	40,000
Total career-long contributions		66,000	120,000
Fund Value at age 60 :			
(a) assuming 5% c.a.g		179,011	325,475
(b) assuming 7% c.a.g		284,871	517,946

On retirement at 60, Mr. Average decides to draw down pension income each year equal to the average annual growth in the fund so that, in effect, the fund balance remains constant at its “age 60” level until he dies at age 85.

Obviously, there are no further pension contributions during his years of retirement, and any increased value in the fund is taken as income, on which income tax is paid.

A summary of HMRC “recovery entitlements” for each of the recovery categories is shown in the table overleaf : -

CALCULATIONS

Recoverable by HMRC	Contibutions @ 5.5%		Contributions @ 10%	
	5% cag	7% cag	5% cag	7% cag
Cat. A	13,200	13,200	24,000	24,000
Cat. B	35,802	56,974	65,095	103,589
Cat. C	8,950	14,243	16,274	25,897
TOTAL	57,952	84,417	105,369	153,486
Residual Fund Value at Death	179,011	284,871	325,475	517,946
Recovery Charge Rate	32.4%	29.6%	32.4%	29.6%

COMMENTS AND CONCLUSIONS

The assessment methods we have used above are not tax calculations per se, but rather they are a series of “fairness tests” to assess what proportion of the fund’s exit value (under various assumptions) can be attributed to past tax concessions

In the calculations shown we have

(a) returned the original HMRC “contributions” in full
(b) returned to HMRC the full benefit of their “share” of the fund value after 40 years of growth within the pension.
(c) returned to HMRC the tax which would have paid if the 25% “tax free cash” had been taken at 60 as drawdown income (although we dispute HMRC’s right to treat this as “deferred tax”)

We have also tried alternative assessment methods e.g. comparison of exit fund value with what it would have been if no tax concessions had been granted or taken (not shown) but in all cases the assessments demonstrate that 30-35% is a fair, arguably overstated, assessment of the required recovery tax rate.

If the 25% tax free cash category were excluded from the recoverable tax calculations shown above, the Recovery Rate Charges would be reduced by 5% , to 27.4% and 24.6% respectively.

APPENDIX 2

SUMMARY OF RECOMMENDATIONS

A.1 The present method of calculating the maximum annual income cap should be retained (i.e 120% of the equivalent annuity)

A.2 The present exit tax recovery charge of 35% (pre-75) should be retained irrespective of age. In the longer term we recommend that serious consideration be given to treating exit funds as a normal part of an individual's estate and taxed in accordance with IHT legislation.

A.3 Pensions in payment which satisfy MIR criteria should include those with non-escalating income if they still satisfy the MIR test allowing for a notional discounting by 2.5% per annum from the date of application to, say, 85 (i.e expected lifespan). The same should be allowed for non-escalating annuities. Likewise for long-term gilts or other financial/insurance products if they fully meet the guaranteed income criteria set out in the consultation paper.

A.4 We recommend that a single MIR figure should be applied regardless of age, but that there should be one rate for single people and a different rate for couples.
We also recommend that the MIR level should be reviewed once every three years.

Removing the requirement to annuitise by age 75: Consultation response from Prudential

Established in 1848, Prudential is one of the leading providers of retirement saving and income products with over 7 million customers in the UK. In 2009 we paid £2.4 billion in retirement income to around 1.4 million people. We are therefore particularly well-placed to understand and comment on issues affecting the retirement income market in the UK.

General comment

We believe the proposals outlined in the Consultation Paper provide a sensible basis for reforming the retirement income rules. We believe they offer more flexibility to people either approaching or in retirement while protecting a key pillar of pension saving – that those savings are used to provide an income in retirement.

We welcome the recognition that, for most people, an annuity remains the most suitable means of providing an income in retirement. However we believe that care is needed to ensure that this position is recognised by consumers who want to safeguard their pensions and convert them into an income for life.

There are points of detail or concern with the proposals which we have covered in our responses to specific questions. Our most significant concern is the proposal to increase the tax on death benefits under a secured pension to 55 per cent (up from 35 per cent). We believe the Government needs to consider this carefully because it risks hitting basic rate taxpayers particularly hard. The proposed tax charge on death would far exceed the tax relief received on their pension savings, or the tax they would have paid on their pension income had they not had the misfortune to die.

Summary

1. We believe the proposals provide an appropriate framework for greater flexibility in the provision of retirement income while protecting the public purse. However care is needed that the proposed framework does not lead to unintended consequences.

2. We believe that it is important to ensure that the income needed to meet the Minimum Income Requirement is set at an appropriate level to reduce the risk of pensioner poverty in later retirement and additional calls for state support.

3. We agree with the analysis in the Consultation Paper of the factors that need to be taken into account when determining a sustainable minimum income for life. In particular that any minimum income requirement needs to reflect the income that people will need to maintain a sustainable living standard throughout retirement. In practice we believe this means that, to reflect the impact of declining health on expenditure needs at older ages, the Minimum Income Requirement will need to ensure that from age 80 a single person is receiving an income of at least £450 per week and a pensioner couple is receiving household income of at least £500 per week.

4. We welcome the ability to provide a Money Back Guarantee Annuity option. However, we do not believe the proposed 55% tax charge on death is appropriate for those on lower incomes. With over 90% of annuity funds falling below £50,000, we believe that a tax charge of 20% on the first £50,000 of any lump sum and 55% thereafter would ensure that those on lower incomes incur a more appropriate tax charge on death.

5. We believe it is appropriate to exclude non-pension assets and savings from the definition of secure income where those assets could be exhausted, cashed-in, decline in value or have their ownership transferred at any point, leading to individuals then falling back on the state.

6. We believe the MIR basis should be reviewed every five years to assess whether it remains at the appropriate level, given expectations about inflation, actual and relative living standards and the level of current and future means-tested benefits.

7. We believe that it must be the responsibility of the individual to establish whether he meets the MIR and to provide evidence and make a declaration to their pension provider before taking income under flexible drawdown. If it subsequently emerges that the individual did not qualify for flexible drawdown all responsibility should sit with the individual and not the pension provider.

8. We believe there is a need to review the conditions that should apply to flexible and investment-linked annuities to establish an appropriate framework that reflects changing consumer needs and supports product innovation within the Lifetime Annuity and Secured Pension environment.

9. We believe there is an increased risk that people will take inappropriate decisions regarding their retirement income provision. Therefore it will be necessary to ensure that appropriate regulatory safeguards are in place to protect consumers. In particular there is a significant risk that people will be encouraged to enter the unsecured pension environment without understanding the level and type of risks involved. In order to protect individuals and society we believe it is necessary to ensure that access to the unsecured pension environment is only available on a fully-advised basis through an appropriately Authorised adviser.

10. In addition we believe there is a risk that people will choose to transfer out of Defined Benefit schemes (including public sector schemes) in order to convert their 'pension promise' into a cash sum under capped or flexible drawdown. This is a risk to public finances, to DB schemes investment strategies and cash flows, and to consumers.

11. We believe that in order to reduce the risk that people will take inappropriate decisions a concerted education and information programme will be needed to ensure people understand the benefits and risks of different retirement income options.

12. We do not believe that the proposed reforms will affect the market's ability to supply annuities or prevent the market from meeting the demand for annuities, provided that the MIR is set at a realistic level.

<u>Responses the Questions raised in the Consultation Paper.</u>

A.1 The level of an appropriate drawdown limit for capped drawdown.

1.1. There is a significant risk of running out of income at later ages if too much money is withdrawn from funds under capped drawdown. We have developed a spreadsheet that models the impact of various rates of withdrawal on income levels in the later years of retirement. The model is also able to take account of the impact of sudden reductions in fund values such as might occur with a stock market crash.

1.2 Based on our analysis it is clear that in order to ensure people have a sustainable income for life if continuing in capped drawdown past age 75, the maximum GAD limit needs to be adjusted at older ages.

1.3 To provide a sustainable income the maximum income under capped drawdown the GAD limits should be:

120% of GAD from age 75-80
100% of GAD from 80-84
80% of GAD from age 85

Even this basis requires strong investment returns and the avoidance of significant market shocks if it is to continue to provide a sustainable income. In all circumstances people living into their 90s will experience low levels of income if relying on capped drawdown.

It is also important to note that there are no existing GAD rates at older ages. The rates shown above are approximate assuming a yield of 3.5%p.a. and using the 100%PNMA00 mortality table with medium cohort improvements starting in 2010. If the actual GAD rates for older ages are calculated on a different basis, the % of GAD limits at different ages could be different.

A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

2.1 We believe the proposals provide an appropriate framework for greater flexibility in the provision of retirement income while protecting the public purse. However care is needed to ensure that the proposed framework does not lead to unintended consequences.

2.2 In particular we believe that it is important to ensure that the income needed to meet the Minimum Income Requirement is set at an appropriate level to reduce the risk of pensioner poverty in later retirement and additional call for state support. In addition we believe regulatory safeguards need to be in place to ensure consumers do not take inappropriate decisions regarding their retirement income provision.

2.3 We note that the rules for capped drawdown allow for nil withdrawals to be made from a fund until death. This does not appear to be consistent with Principle 1 of the new tax framework which states that the purpose of tax-relieved pension saving is to provide an income in retirement. We are concerned that, by allowing pension funds to be accumulated and then retained for redistribution on death, the effect could be to undermine a fundamental principle of tax-relieved pension saving – that tax-relief is given to encourage people to make provision for their own income in retirement.

2.4 There are also points of detail within the proposed framework which we believe need to be reconsidered. In particular we believe that the proposed 55% recovery tax charge on all death benefits represents an inequitable and penal tax charge on those who received only Basic Rate tax relief on their pension contributions, and who would have paid no more than Basic Rate income tax on their pension income.

2.5 We note also that the new tax charge represents a 20% tax increase from 35% to 55% for those on lower incomes who choose a value protected annuity and die early in retirement. We do not believe this increase is justifiable or appropriate and the proposed tax charge needs to be reconsidered.

2.6 With over 90% of annuity funds falling below £50,000, we believe that the use of a tiered charge for those who choose to take a value protected annuity would ensure that low earners are subject to a more appropriate level of taxation. A tax charge of 20% on the first £50,000 of any lump sum and 55% thereafter would address the serious anomaly in the current proposals.

2.7 Where people have multiple funds the use of an event reporting requirement would ensure that the appropriate level of tax was charged for those whose aggregate funds exceeded the £50,000 threshold.

For example:

Provider A £25,000

Provider B £30,000

Provider C £30,000

Each provider would deduct 20% tax from their lump sum payment and report the event to HMRC who would then amalgamate the reports to identify the individual's total liability.

Total death benefit payable = £85,000

Total tax charge due = £29, 250 i.e. (£50,000 x 20%) + (£35,000 x 55%).

Tax paid to date = £17,000 (£85,000 x 20%)

Further tax charge due from estate = £12,950.

In practice most people who took out a value protection annuity would not have aggregate funds in excess of £50,000.

2.8 We believe that there is a risk that the rules proposed for flexible drawdown could be abused for the purposes of reducing tax liability. Specifically that someone could temporarily become resident in a country with a low income tax rate and a double taxation agreement with the UK. Having secured the MIR they could then access the balance of their fund as a cash sum under flexible drawdown while subject to the lower tax rate applying in their country of residence.

A.3 What income should be considered 'secure' for the purposes of the Minimum Income Requirement and whether proposals for the life annuity income that can be considered for the MIR (minimum of LPI up to 2.5%) are practical and appropriate.

3.1 We believe it is correct to exclude non-pension assets and savings from the definition of secure income where those assets could be exhausted, cashed-in, decline in value or have their ownership transferred at any point, leading to individuals then falling back on the state. In addition including other assets and savings would probably require a complex, costly and potentially intrusive monitoring requirement to ensure an individual met, and continued to meet, the minimum income requirement.

3.2 In addition to income provided by secure pensions and conventional annuities, investment-linked retirement income options could also be considered for the purposes of the Minimum Income Requirement, provided they contained a suitable guaranteed minimum income floor.

3.3 We believe there are a number of issues with approaches similar to that adopted in Ireland whereby a specified sum cannot be accessed before age 75. In particular:

- It would be difficult to guarantee that the income provided by the fund from age 75 will be sufficient to meet future lifetime expenditure needs or to avoid access to means-tested benefits.
- There appears to be continuing investment risk and/or inflation risk applying to the value of the retained fund.
- There is a risk that the individual would be unable to meet their income needs before age 75 and therefore want to access the fund at an earlier date.

A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

4.1 We agree with the analysis in paragraphs 3.12 - 3.14 of the Consultation Paper about the factors that need to be taken into account when determining a sustainable minimum income for life. In particular it is essential that any minimum income requirement reflects the income that people will need to maintain a sustainable living standard throughout retirement.

4.2 In practice we believe this means that the Minimum Income Requirement will need to ensure that from age 80 a single person is receiving an income of at least £450 per week and a pensioner couple is receiving household income of at least £500 per week. This level of income would reflect the impact of declining health and energy levels on income and expenditure needs at older ages.

4.3 Although paragraph 3.15 of the Consultation Paper suggests that the MIR should be lower at older ages, in practice, the starting income needed to provide this level of income from age 80 would be lower at younger ages because of the effect of revaluation over the period to age 80. However the actual income that needs to be secured to meet the MIR is likely to be lower at older ages because of the impact of State pension(s) and other pensions in payment.

This can be represented in a table as follows (assuming 2.5% p.a. revaluation):

Age at securing MIR	Single MIR (per week)	Net of BSP	Couple's MIR (per week)	Net of BSP
55	£245		£270	
56	£251		£277	
57	£257		£284	
58	£264		£291	
59	£270		£298	
60	£277		£305	
61	£284		£313	
62	£291		£321	
63	£299		£329	
64	£306		£337	
65	£314	216.35	£346	150.70
66	£321	223.35	£354	158.70
67	£329	231.35	£363	167.70
68	£338	240.35	£372	176.70
69	£346	248.35	£382	186.70
70	£355	257.35	£391	195.70
71	£364	266.35	£401	205.70
72	£373	275.35	£411	215.70
73	£382	284.35	£421	225.70

74	£392	294.35	£432	236.70
75	£401	303.35	£442	246.70
76	£411	313.35	£453	257.70
77	£422	324.35	£465	269.70
78	£432	334.35	£476	280.70
79	£443	345.35	£488	292.70
80	£454	356.35	£501	305.70

An age-based MIR on the basis of the table outlined above provides a simple and effective means of implementing the reform proposals while minimising the risk of someone exhausting their pension savings and falling back on the State.

4.4 In addition to ensuring that individuals have a sustainable income for life, the level of the MIR needs to take account of other potential unintended consequences that could arise.

These include:

(i) The risk that people will choose to transfer out of Defined Benefit schemes (including public sector schemes) in order to convert their 'pension promise' into a cash sum under capped or flexible drawdown. This is a risk to public finances, to DB schemes investment strategies and cash flows, and to consumers.

(ii) The risk that members of DB schemes who meet the minimum income requirement will use the new rules for tax-advantaged financial planning by washing non-pension savings through a pension scheme and then extracting them through flexible drawdown at a lower tax rate.

For example, on 5 April a Higher Rate Taxpayer with £25,000 p.a. in accrued DB pension rights could pay £20,000 in savings into a personal pension. The fund would be immediately boosted to £24,000 by tax relief and the individual would also receive a tax rebate of £4,000. If he retires on 6 April his DB pension income of £25,000 will allow him to meet the MIR. He can then withdraw £6,000 as tax free cash from his personal pension and take £12,400 as income under flexible drawdown to keep below the Higher Rate tax threshold. The following April 6 he can withdraw the remaining £5,600 from his fund.

The net effect is that the pension taxation system would enable an individual to convert a cash sum of £20,000 into a net cash sum of £24,400 in just over one year – equivalent to a net investment return of around 22%.

Initial investment = £20,000 HRT relief refund = £4,000

Pension fund = £24,000 Tax Free Cash = £6,000

Flexible Drawdown income

Year 1 = £12,400 Net of BRT = £9,920
Year 2 = £5,600 Net of BRT = £4,480

Total net payments received = £24,400.

A.5 Whether a different MIR should be set for individuals and couples.

5.1 All other things being equal the total living expenses of a couple will be higher than those of a single person. Therefore the MIR for a pensioner couple will need to be higher than that for a single pensioner.

5.2 On the death of the first partner living expenses will usually fall. However it is not possible to provide a secure income vehicle that reflects the revised MIR that would apply on the death of one of the partners. This is due to a number of reasons, but in particular because it is not possible to identify in advance the level of income that will be needed on the first death to meet the MIR for the surviving individual.

5.3 Therefore, in practice any MIR for couples would have to either be secured on a 100% Joint life basis where only one partner has pension provision at the level of the MIR, or both partners would need to secure the Single MIR on a Single Life basis in order to meet the MIR requirement.

A.6 How often the MIR level should be reviewed.

6.1 The MIR table shown above in response to question A.4 reflects an assumed inflation rate of 2.5% pa. If this reflects long-term expectations about inflation an age specific MIR would not need to change on an annual basis. However the MIR basis should be reviewed every five years to assess whether it remains at the appropriate level (for example, given expectations about inflation, actual and relative living standards and the level of means-tested benefits etc).

A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

7.1 Establishing the level of income that an individual or household would need to secure to reduce the risk of falling back on state support is potentially very complex because of the number of variables involved.

These factors include:

- age and health of pensioner and any partner,
- single or shared household,
- the level of income from state and private pension(s),
- the rate of annual increase applying to those pensions
- homeowner or a tenant,
- any continuing mortgage liability,
- the current and future level and range of means-tested benefits,
- the impact of inflation,
- the relative living standards of the working and retired population.

For practical purposes the MIR therefore needs to be set at a level which reduces the likelihood that these factors need to be assessed for every individual starting to receive retirement benefits. In simple terms, the MIR should be set at a level that makes it clear to individuals and providers whether someone is likely to meet the MIR and therefore able to take flexible drawdown.

7.2 Legislation should make it clear that it is the responsibility of the individual to establish whether he meets the MIR and to provide evidence and make a declaration to their pension provider before taking income under flexible drawdown. If it subsequently emerges that the individual did not qualify for flexible drawdown all responsibility should sit with the individual and not the pension provider.

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide customers with more attractive products without incurring fiscal or avoidance risks.

8.1 The current Regulations permitting income from Lifetime Annuities to vary (SI 2006/508) were introduced in order to allow the investment-linked annuity products existing at that time to continue under the post A-day pension taxation regime.

8.2 Although these Regulations remain relevant, the scope to develop new Lifetime Annuity products is restricted because the Regulations governing such contracts were not intended to provide a framework for developing new products.

8.3 We believe that there is now a need to review the conditions that should apply to flexible and investment-linked annuities. The aim would be to establish an appropriate framework that reflects changing consumer needs and supports product innovation within the Lifetime Annuity and Secured Pension environment within which over 90% of pension savers are likely to take income.

A.9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of a requirement to purchase an annuity by age 75.

9.1 We are concerned that, without adequate safeguards, there is a significant risk that a lack of understanding of the risks involved could lead some people to inappropriately enter or continue with unsecured pensions as an alternative to buying an annuity. This would ultimately result in people running out of income and falling back on the state.

9.2 In order to protect consumers and society from this risk we believe it is essential that someone should only be able to enter the unsecured pension environment on a fully-advised basis through an appropriately Authorised adviser. In addition, to avoid the risk that someone could continue in unsecured pensions at older ages through inertia, rather than as a result of a conscious decision, we recommend that at each review date after age 75 the consumer is required to confirm that they wish to continue with an unsecured pension. If no confirmation is received by the appropriate date the contract should be automatically converted to a Lifetime Annuity.

9.3 We believe industry, Government and bodies such as CFEB have an important role to play in educating consumers in a number of areas:

(i) To demonstrate to consumers what annuities do, how they do it and why an annuity is likely to be the best way of providing retirement income for most people.

(ii) To reassure consumers with modest funds that securing their income through an annuity is not an inferior option to unsecured pensions or flexible drawdown and why DIY income provision is unlikely to be an appropriate choice for most people.

(iii) To specifically address the myths about annuities, to help consumer understanding and to encourage people to engage with pension saving and retirement income provision.

(iv) To provide information about the potential benefits and risks of deferring lifetime annuitisation, including the impact of mortality drag and the mortality cross-subsidy.

(v) To build on the work the ABI and pension providers have already done to ensure people have the information they need to plan for their retirement and to make an informed choice regarding their retirement income options.

(vi) To help people engage with the retirement process by providing them with storylines or case studies that allow them to ‘see how it is done’.

(vii) To recognise that consumers have different needs and preferences when making their retirement income decisions and to ensure that people have access to a range of alternative options for exercising their choices at retirement.

(viii) To help remove the ‘fear factor’ from the retirement income decision and to help consumers approach the exercise of their retirement choice in the same way as they would any consumer purchase.

A.10 Whether the proposed reforms have unintended consequences that may affect the market’s ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

10.1 We do not believe that the proposed reforms will affect the market’s ability to supply annuities or prevent the market from meeting the demand for annuities, provided that the MIR is set at a realistic level. However if the MIR is set unrealistically low and significant numbers choose to take their pension fund as cash then there will be a negative impact on annuity rates and the annuities market. This will be because fixed costs of writing business will be spread over fewer customers, providers will face increased selection risk, and because providers will withdraw from the market reducing the impact of competitive pressure on prices.

10.2 If the MIR is linked to the lower of RPI or 2.5% we would expect most people to opt for a 2.5% fixed escalation annuity. In this event there is unlikely to be a significant increased demand for RPI-linked assets. However there would be a significant risk that the secured income level did not reflect actual inflation experience.

10.3 We believe it is important to recognise that it cannot be assumed that people will be able to buy an annuity from age 85 onwards because the volatility in life expectancy and the shortage of mortality data at older ages may exceed providers’ risk threshold.

Prudential UK & Europe
10 September 2010

I have reviewed the consultation document with interest and broadly welcome the proposals although I see little need for the accelerated withdrawal of funds from pension schemes.

I would like to respond specifically to the question raised in Chapter 2, paragraph 2.17.

My company provide advice and administration services to predominantly trust based DC schemes. I believe that we are currently unique in promoting a drawdown alternative to annuity purchase from within the trust based pension scheme. For schemes that operate this flexibility the this is now the default position.

This has been very well received by members and acts to overcome the disincentive from saving that the perceived poor value from annuities provides.

For Trustees to be comfortable in offering this option to members we need to materially limit the downside risk of having to reduce income to pensioners from one year to the next.

One of the techniques adopted to achieve this is to impose an initial maximum annual drawdown amount of only 80% of GAD.

This produces income levels comparable to annuities containing either dependant's protection or built in increases.

However, we will use the 120% of GAD figure at subsequent annual reviews if this is necessary to maintain income levels at their previous level.

We will though only allow an increase from a previous level if it can be provided from the 80% of GAD figure.

I would be uncomfortable to lose this flexibility although I do appreciate that the full 120% is not wise as an initial figure.

We also allow members to spread their tax free cash over time so that it effectively provides tax free income. This recognises that the primary need for people reaching retirement is for replacement income not cash and that most people retiring from defined contribution schemes at present will not have adequate replacement income. Providing some income which is tax free to supplement their taxable income therefore helps to address this. Where used for this purpose we calculate 80% of GAD on the full uncrystallised plus crystallised fund values and only provide sufficient tax free income as is necessary to provide the required income.

Again, this is increasing in popularity and I would prefer to see the existing flexibility to phase retirement retained.

The above model is available to all members although the trustees can impose a minimum fund size to ensure that remaining funds remain above about £5,000 - the level at which annuity purchase becomes far less competitive.

In summary, I am delighted at the proposal to remove compulsory annuitisation at age 75.

I would like to retain the flexibility to use 120% of GAD figures but only as a renewal figure to ensure continuation of previous income levels.

I would be happy to provide more information.

Regards

[Quantum Advisory - The Actuaries and Employee Benefit Consultants]<http://www.quantumadvisory.co.uk/

Consultation response

Removing requirement to annuitise at age 75

Retirement Angels Ltd is pleased to respond to HM Treasury on its consultation paper dated July 2010 in relation to its proposals to remove the requirement to annuitise by age 75.

We welcome the broad nature of the consultation and trust that work on the Open Market Option (OMO) reform is being considered alongside these changes.

<u>Summary of key points</u>

We are neutral on the proposal to remove the obligation to annuitize at age 75. Given though the limited advantages and the potential disadvantages, we feel that it would be better to move the age from 75 to age 85.

In removing the requirement altogether, we feel the creation of an additional drawdown regime is unnecessarily too complex. We favour reforming the capped drawdown regime to mitigate the risks of people:

- falling back on the State

- being unable to access their savings to pay care cost

We are concerned that removing the obligation to buy an annuity significantly increases the risk that even more people will make poor choices with their pension savings at retirement. There are known structural weaknesses in the regulation of defined contribution (DC) pension provision that need to be addressed.

We suggest consideration is given to the following three areas.

1. Improve & simplify mandatory information at retirement

2. Remove holes in regulation that currently allows no-one to be held accountable for poor retirement outcomes

3. Plan to proactively monitor compliance and emerging outcomes and take action where needed to ensure policy objectives are met

It is vital that the proposed changes which will benefit a small minority of relatively wealthy savers do not prejudice the outcomes for millions of people who already have inadequate pension provision.

Consultation questions

A1: What is the appropriate level for capped drawdown?

Government needs to consider the possibility that many people who currently annuitise will be tempted into capped drawdown

Drawdown will facilitate taking more income than an annuity provides in the early years of retirement as well as preserving funds in the event of early death. Many will be attracted to this.

The downsides are that the expenses of running a drawdown policy are usually higher than running an annuity. The investment and longevity risks are higher leading to a wide distribution of potential outcomes. For these reasons, drawdown is not usually regarded as suitable for the mass market where 90% of people have less than £50,000 in pension savings.

To manage the risks of mis-selling drawdown, we would suggest a minimum fund size in the region of £100,000 - £200,000 is established. Clients with smaller pots than this minimum should be obliged to have advice which confirms suitability including confirming that the likelihood of falling back on means tested benefits is low. Providers of drawdown should have to require evidence of suitability before selling the product below the minimum.

Without adequate safeguards, it is going to be very hard to set a safe level of capped drawdown that will achieve the policy aim of preventing people falling back on the State. Restricting the flexibility within drawdown, i.e. lowering the upper level of the cap will remove the value of this product for many people for whom it is suitable.

The existence of means tested State benefits can tempt people to take more money now to maintain something close to their pre-retirement standard of living now and hope that the State will look after them when they run out of money at an older age. Regulators should make it clear to financial advisers that the availability of means tested benefits many years in future should not be portrayed as a guaranteed level of income just because it is payable now.

A2: Reform of framework

The proposals seem logical. Was age 75 really set for the point of annuitisation as the end of working life? Logically, it feels appropriate to set the age to secure an income towards the end of a retired life. Given the improvements in longevity since age 75 was set, we feel that moving the requirement to annuitize back to age 85 would be simpler solution.

A3-A7: Flexible drawdown & consequences

We have a problem with uncapped flexible drawdown. It is aimed at the relatively wealthy. The paper estimates around 8000 people. It will require substantial changes to systems and processes to implement. We see limited demand for this beyond those who will use it as a tax planning not a pension saving vehicle. We do not see why HM Treasury has proposed this option.

We see the need to accelerate income beyond capped limits for people who find that they need to pay for care or other increased expenses as a consequence of a clear reduced expectation of life. They could simply buy an impaired annuity with the balance of their drawdown policy. As policy intent is not to force annuitisation at any age, then we would support flexing the upper limit where it can be shown that a reduced expectation of life exists and care funding is needed.

We think this needs a different policy approach than the uncapped flexible drawdown and so do not comment further on the proposed regime.

A8: Legislative or regulatory barriers

<u>Allow more flexibility within annuity regime</u>

Government should review regulations to permit guaranteed income shapes beyond flat or escalating pensions. Research shows that U-shaped income curves are theoretically suited. It is very difficult to achieve this under current rules,

Allowing annuities to be bought with longer protection periods than 10 years will place annuities on a level playing field with drawdown. We recommend increasing it to 20 to be consistent with the maximum period allowable under drawdown.

<u>Information at retirement</u>

Regulators have effectively required a huge amount of information to be provided at the point of sale of a retirement product to the consumer. The mass of information stops most consumers from reading the document; it hampers understanding and is a major contribution to people making poor choices at retirement. Reform is needed to present information at retirement in a standard form promoting solely the key messages in plain English to the consumer. Detailed information needed to make decisions or take advice on should be in a separate document.

<u>Duopoly of regulation</u>

Contract based DC schemes set up by employers over the last 20 years are now producing an increasing number of retirements. In contrast with trust based schemes, the contract is between the employee and the pension company and there is no governance protection for the employee. It is the pension company who benefits from poor choices made by the employee. Employers who make advice available find that inertia and ignorance often means that very few people actually take up the advice.

Trust based pension schemes are not covered by FSA regulation. There is little protection for members where trustees do not put in place arrangements to support members making appropriate choices.

Many consumers receive either no advice at all or no regulated advice beyond a process that guides them to make choices they are ill informed to make.

Government should ask the FSA and TPR to consider how the regulation of both types of DC arrangements can be arranged so as to encourage equally good outcomes for consumers regardless of the source of the DC fund.

A9: Other changes

CFEB focus on information & guidance

We suggest that CFEB should provide impartial, clear, expert information for consumers. Their priority should be to encourage people to make informed decisions at retirement rather than to provide advice themselves.

A10: Unintended consequences

Decisions individuals have to make at and in retirement are complex and involve significant risk of financial loss. We are highly concerned that the removal of the requirement to annuitise at 75 will be presented to the public or interpreted by them as an endorsement that somehow annuities are less valuable than they really are.

People do not understand pensions and often place too much emphasis on cash today versus long term guarantees. Annuities are often described as poor value, even in the broadsheet press, and we believe this is a popular misconception amongst the public.

If Government and Regulators are not extremely vigilant, then significant mis-selling is likely to occur. People who should really annuitise at, say, 65 may be more easily persuaded to defer doing so. Removing the ability for employers to make occupational pension scheme membership a condition of employment alongside the creation of personal pensions in 1988 created an environment which led to significant mis-selling.

We recommend that Regulators monitor closely compliance in the at retirement area. It should seek to collect evidence that outcomes at retirement are improving. There is a clear linkage here with the work being done to improve take up of the OMO and we trust policy thinking in this area is being connected.

Without appropriate safeguards, the new rules will reduce the amount of annuity business written. Pension providers increasingly are finding the capital requirements of providing annuities onerous. Focus is on providing innovative third-way annuities and flexible drawdown arrangements. We encourage and support innovation in this area. With the increased proliferation of choice and increasing transfer of risk from industry to vulnerable, old people, we urge the Government to be vigilant to prevent a major mis-selling problem which will inevitably see more pensioners falling back on the State.

About Retirement Angels Ltd

We are newly formed financial advisory firm that aims to deliver advice to the mass market who by large have inadequate private pension savings for their need. They will rely on income from other sources such as State benefits (including means tested), property equity, inheritances and other savings to provide an adequate retirement income.

Planned reforms by regulators are likely to increase the trend where no commercial financial advisers will be willing to advise the 90% of savers with less than £50,000 of pension savings.

Retirement Angels seeks to fill that void promoting better outcomes at retirement for vulnerable people who will otherwise be seduced into buying products that:

- are unsuitable for their needs;
- are poorly priced
- expose them to risks they cannot afford to take

The business is run by Alan Higham, a Fellow of the Institute and Faculty of Actuaries and Don Grant, a chartered accountant. Alan has formerly advised DWP on pension policy concerning the Financial Assistance Scheme. He was until recently a partner in PriceWaterhouse Coopers. Don and Alan both have significant experience of identifying financial failures in pensions & insurance. At Higham Dunnett Shaw, they helped resolve failures and mis-selling problems affecting millions of consumers across personal pensions, occupational pensions, income drawdown and mortgage endowments. Using leading edge technology and processes delivered by staff specifically trained for the purpose these services were provided at a low unit cost and forms the basis for full advice to the mass market.

ROCKINGHAM
Retirement

Age 75 Consultation
Pensions and Pensioners Team
Room 2/SE
HM Treasury
1 Horse Guards Parade
London, SW1A 2HQ

10th September 2010

Dear Sir,

Response to consultation on removing the requirement to annuitise by age 75

Rockingham Retirement welcomes the opportunity to offer its responses to the questions raised in the above consultation document. We agree wholeheartedly with the general proposal to abolish the requirement for individuals to utilise their retirement fund to purchase an annuity once they reach an arbitrary age of 75; a requirement that may not be appropriate to an individual's lifestyle or other personal circumstances at the time. We trust that the new coalition government will honour the principle of *pension simplification* in deeds as well as words.

Our response will take the form of individual responses to the specific questions raised in the consultation document.

Consultation Question: The Government welcomes views on the level of an appropriate annual drawdown limit for capped drawdown.

Rockingham Response: Although in principle we welcome the proposed changes to the drawdown rules we feel that the introduction of a single annual drawdown limit for all ages may not be the most appropriate. It would be expected, in order for the Government to achieve its objective of individuals not exhausting their pension funds to early, and therefore falling back on the Exchequer, that a single limit would be closer to the existing ASP limit of 90% of the GAD basis amount. This will clearly have a significant impact on those individuals who are already in Unsecured Pension as it will result in a reduction of up to 25% in the amount of income they can draw from their pension fund up to age 75. Younger individuals in drawdown are at less risk of needing to fall back on the state than those in the later years of retirement. Not only are their funds likely to be much higher, they are expected to have a longer period in which to adjust their future income / change their investment strategies to meet their future needs.

We would therefore propose that the current two tier upper caps on the amount of income that can be taken each pension year from an individual's retirement fund are retained. That is the upper limit for capped drawdown remains at 120% of the GAD Basis Amount for individuals up to age 75, reducing to 90% thereafter.

Consultation Question: The Government welcomes views on what income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

Rockingham Response: The principal of allowing individuals to access their retirement savings at a level that is appropriate to them is to be welcomed, and we support the inclusion of State pension benefits in the assessment. We do have concerns however regarding the exclusion of pension benefits, both scheme pension and lifetime annuity, which are not subject to a minimum of LPI escalation. This is particularly prevalent in the provision of lifetime annuities where the majority of annuities are sold on a level, non-escalating, basis.

This could potentially lead to a situation where an individual with a lifetime annuity in payment of £12,000 a year, which is due to increase at 2.5% a year, can count this annuity in support of their MIR, but an otherwise similar individual with a level annuity of £25,000 a year cannot; even though this level annuity will still be paying a higher level of income nearly 30 years later. Some allowance should therefore be made to allow level annuities to count towards an individual's MIR.

This could take the form of an actuarial reduction factor that is applied to the level annuity, discounting it back from an anticipate date of death at 2.5% a year. In the above example, if the individual was aged 65 and was expected to live for a further 25 years, then the current value of their level annuity would be £13,485 and this figure could count towards their MIR.

Consultation Question: The Government welcomes views on what an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

Rockingham Response: The level of the MIR should reflect the level of income required to meet a minimum standard of living as a proxy for a suitable level of income to avoid the individual needing to make a claim for any means tested benefits. This clearly excludes using the level of the guaranteed Pension Credit as additional state benefits may be payable on top of this, but the MIR should not take into account any income requirements to support expenditure over and above that required to meet basic living costs.

For example, in order to provide an annuity meeting a minimum income of £423 a week, (identified as the average peak expenditure levels by the Centre for Economics and Business Research) would require a pension fund in excess of £400,000 for an individual aged 60, before any surplus could be accessed.

We suggest that an appropriate report is commissioned to assess the minimum level of income (including housing and healthcare costs) and this is used to determine the MIR.

For the sake of simplicity, we do not recommend that the MIR should be adjusted for different ages. If such an adjustment is deemed appropriate however, we would welcome a simple formula applying an age related multiplier to a basic MIR appropriate to the age that an individual wishes to draw down their pension fund at levels over and above those allowed by the capped drawdown limits.

Consultation Question: The Government welcomes views on whether a different MIR should be set for individuals and couples.

Rockingham Response: Our view is that the MIR should be based solely on an individual basis. There is no requirement for the 'secure' income to provide a spouse's pension (which we also support). It would be inconsistent with this to require their marital status at the time of the assessment is made to affect the level of MIR. As this is a one-time assessment, and therefore only takes a snapshot of an individual's circumstances, it is unable to reasonably reflect the individual's marital status at some point in the future.

Consultation Question: The Government welcomes views on how often the MIR level should be reviewed.

Rockingham Response: The MIR level should be reviewed on a five yearly basis, with indexation applied at; say 2.5% a year, for each year since the previous level was set to reflect increases in the cost of living in the meantime.

Consultation Question: The Government welcomes views on how to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

Rockingham Response: Any such provisions will lead to additional burdens on both individuals and product providers; however these are to some extent unavoidable. We are however keen that these are kept to a minimum and clear rules on the information that is required to make an assessment, and the number of adjustment factors that are to be considered in the assessment are not excessive.

Consultation Question: The Government welcomes views on its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity to age 75.

Rockingham Response: In general we support the proposals put forward. We do not support the potential increase in the level of taxation to be applied on the payment of lump sum death benefit for 35% to 55% for individuals who die before age 75. We would suggest that ideally the rate of tax should remain at 35% for all ages but, at the very least, the increased tax rate should only apply to deaths after age 75.

Consultation Question: The Government welcomes views on whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

Rockingham Response: We have no additional comments.

Consultation Question: The Government welcomes views on how the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.

Rockingham Response: The remains an existing requirement that individuals must be notified of their options under a DC arrangement around six months before their intended retirement date, or age 75 if this is not defined. We recommend that these requirements are not changed.

We also recommend that the Government consider other alternative methods of highlighting the availability of the Open Market Option in line with the recommendations made by the Pension Income Choice Association (PICA) to counteract the currently lack of take up of the open market option when this is clearly in the majority of retirees favour.

Consultation Question: The Government welcomes views on whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

Rockingham Response: We have no additional comments.

Rockingham Retirement is one of the UKs largest independent annuity broker, offering individuals a route to the open market option via a direct offer approach. We also operate our own, low cost, Self Invested Personal Pension, bringing the opportunity to participate in income drawdown to a wider audience.

If you have any questions on our response, please do not hesitate to contact me.

Yours sincerely,

Andy Yates FPMI
Technical Manager

Tel: 01832 770457
e-mail: andy.yates@rockinghamretirement.co.uk

Dear Sirs

My job is selling company pensions to staff in small companies. The schemes that are offered usually have an employer contribution to match the employee contribution and therefore offer great value for the staff.
However, surprisingly, even with a matching employer contribution the take up rate is often only around 50% of the workforce. The reason for the low take up is usually one of the following:

1. The individual is "skint" and cannot afford to join regardless of how good the deal is.
2. They ask what happens when I die? I say either the insurance company takes the lot (if annuity purchased) or HMRC takes 55% in tax(drawdown).

The objective of the Government should be to bring pensions back into fashion after a disastrous period of medaling. A 55% death tax on drawdown is not fair on people who have already chosen this option and also will be considered penal by anyone making a decision to start saving for retirement.

You should be aware that this tax will alter the perception of pensions for everyone and therefore will be very negative. Do not obsess about the rich trying to avoid IHT, the current tax rate is 35% and there is a limit to the fund size. HMRC should be happy with that.

Otherwise the changes are good.

My view is that the proposed increased death tax is an pure example of what is wrong with pension savings and that is:

* You lose control of your money and Governments then move the goalposts.

Please do not continue in the same way as the last government and give people like me some good news on pensions.

Thanks for reading this.

Yours

Roger Carter

Graham Carter & Co, 2 City Road, Chester, CH1 3AE.

Removing the requirement to annuitise by age 75

Russell Investments' response to HMT's consultation paper

9th September 2010

Russell Investments

Russell Investments

Russell Investments is an adviser to large pension funds around the world with assets of over £1,000 billion at December 2009. It provides research and advice on investment strategies for both DB and DC schemes, and assists the funds in choosing competent and cost-efficient investment managers and other service providers. Russell's research, not only in the UK but also in North America, Australia and elsewhere, addresses among other things the issues of accumulation for retirement income, and of post-retirement investment choices.

As well as advising pension funds, Russell works closely with partners who advise individuals on retirement planning and on savings in general. Russell has no direct or indirect involvement in the purchasing or supply of annuities, but sees a strong public interest in greater freedom for individuals to exercise informed choice.

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Introduction

0.1 We commend this proposal for "giving people greater flexibility to choose the retirement options that are best for them." We appreciate the opportunity to comment on it.

0.2 The consultation paper listed ten specific questions on which responses are sought. We have thoughts on many of them, but not all. Before we respond to those issues, permit us the opportunity to express support for the "EET" taxation model for pensions – or, as we think of it, the E, E, 0.75T model, since it provides the option to take 25% of the pension pot in a tax-free lump sum. This is a very attractive feature, and the goal of re-invigorating private pension saving would be compromised without it.

0.3 The consultation paper refers, in its title, to the removal of the requirement to annuitise by age 75. This is, of course, technically correct. But most people annuitise at age 65, and eschew the open market option and simply purchase their annuities from the insurance company they are dealing with. It seems clear to us, therefore, that most people are unaware of their options, and would probably feel ill-equipped to exercise them. One way to open up the issue, and in so doing partially educate the public, would be to recognise that the proposal is not just to remove the requirement to annuitise at age 75 but to remove the requirement to annuitise at all.

Question A1: The level of an appropriate annual drawdown limit for capped drawdown

1.1 It is a fundamental principle to ensure that pension savers will not exhaust their savings prematurely and fall back on the state. This is very sensible, as the experience of other countries demonstrates. Australia is an example of a country that typically pays out lump sums at retirement. Its government, roughly three years ago, felt it necessary to introduce tax incentives to persuade people to take a so-called qualified income stream instead of a lump sum, in order to discourage the premature consumption of retirement savings.

The proposed mechanism to achieve this is to define a Minimum Income Requirement that must be met, through the purchase of an annuity. We will support, later, the notion that the MIR should be inflation-indexed. Once that is achieved, however, is there not a case to be made to permit any remaining value in the pension pot to be taken at once, if the individual so chooses? It should not hurt taxation: if the remainder is taken in a lump sum, it will be fully taxed as income in the year in which it is taken, and EET will be satisfied. This will certainly simplify the choices and the administrative procedures involved in defining the annual drawdown limit and ensuring that it is not exceeded. It is similar to the rule in Chile, where market-based defined contribution arrangements for the population were pioneered.

1.2 The one reason we can think of for not permitting total flexibility in the treatment of the remaining pension pot, after the MIR has been satisfied, is a fear that social conditions will change in the future and make it desirable to hold a contingency reserve in each saver's remaining pension pot. For example, if the MIR definition includes state support, and that level of state support is reduced in the future, then after that change a saver may no longer have enough to live on and may fall back on the state for further support. No doubt this possibility informed Question A6 on how often the MIR should be reviewed.

1.3 In that case, we suggest a very simple rule for the cap on the annual drawdown, much simpler than the current complex set of formulae. Have the Government Actuary's Department (GAD) officially list the future life expectancy for males and females each year, or periodically. For an individual the annual cap should be equal to the remaining pension pot divided by the future life expectancy. For a couple, the denominator should be the greater of the two single life expectancies for the couple. No doubt this rule can be elaborated with greater precision, but it will ensure that the pot itself can never be exhausted, and investment returns on the remaining pot should go some way (if with much less than perfect correlation) to helping the saver cope with inflation.

1.4 This rule is very similar to the rule used in the USA, except that there the formula defines the minimum drawdown requirement, the intent being to ensure that some minimum amount each year is subject to taxation. Since the intention in this case is to preserve rather than force a drawdown of the pension pot, using the rule to define an annual cap makes sense.

Question A2: The intended approach to reforming the pensions tax framework, in line with the commitment to end the effective requirement to purchase an annuity at age 75

2.1 The current tax system brings chance into the equation. Consider an individual who elects an alternatively secured pension (ASP) at age 75. If that individual had died the day before turning 75, the entire fund would be paid out as a tax-free lump sum. If, instead, the individual had elected an unsecured pension arrangement (USP) the day before death, the fund would be taxed at 35%. And if the individual dies the day after age 75, the fund would be taxed at 70% plus potentially a further 40% IHT on the remaining 30%, making a tax rate (as you correctly calculate in your document) of 82%. With tax rates of 0%, 35% and 82% resulting from death a couple of days apart, this is a system that needs correction.

2.2 The present proposal is to eliminate the ASP altogether, permitting the USP arrangement at any age (as an alternative to a purchased annuity). Any amounts withdrawn under the USP will be taxed as income, in the same way as annuity payments. This is consistent.

2.3 The proposed treatment of payment of the remaining pension pot on death remains inconsistent. It leaves tax-free any pension pot from which no drawdown has taken place, but if death occurs one day after the first USP drawdown, the balance will be taxed at 55% (which is the Government’s estimate of the rate necessary to recover forgone taxes). There will be no IHT on any balance. We point out two things. One is that the tax-free disbursement of a virgin fund is inconsistent with all other rates of taxation. The second is that taxation at 55% rather than the normal income tax rate is unreasonable: the government is proposing to take all the gain from the invested deferred tax, when after all it has taken a free ride on the investment returns of the taxpayer.

2.4 We note that it is not proposed to make any changes to the contribution limit, to the age at which the LTA (Lifetime Allowance) test must be conducted or to the lump sums associated with these rules. However, changes in the tax rates that apply to these numerical amounts are tantamount to tax changes.

Question A3: What income should be considered “secure” for the purposes of the Minimum Income Requirement (MIR) and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate

3.1 It is proposed that the only income that will be considered secure is income with three characteristics: it is currently in payment, it is guaranteed for life, and it takes into account future inflation in a reasonable way (and it is suggested later that an index-linked life annuity, or an escalating life annuity with 2.5% annual increase would qualify). We think all of these characteristics make sense.

3.2 It is also proposed that only three sources can effectively guarantee these characteristics: the state, insurance companies and occupational pension schemes. Again, we believe these are sensible conditions. It is difficult to imagine what other easily verifiable source can offer the same guarantees; and the regulatory regimes for insurance companies and occupational pension schemes make their promises as secure as is feasible (and indeed more secure than a promise by the state, which confers no property rights).

3.3 We also believe that indexed pensions will become the automatic default, for those individuals who want to take advantage of the new flexibility, because it will be pointless, under these rules, to spend part of the pension pot on a traditional fixed annuity. This has potential consequences that we mention later in our response to Question A9.

Question A4: What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages

4.1 The consultation document cites expenditure needs from the ONS, and analyses by the Joseph Rowntree Foundation and the Pensions Policy Institute, in connection with expenditure levels and their post-retirement patterns. These seem to have all the right characteristics. Although we profess no detailed expertise in this area, the notion of expenditure needs brings to mind the approach we take in helping our business partners advise individuals and couples about financial planning in retirement. We recommend that they think of their goals in three layers, with the acronym ELE (for essentials, lifestyle and estate). The estate layer is perhaps not directly relevant to retirement options within the context of this consultation paper; but the MIR relates to essentials, and the rest of the pension pot to lifestyle. We recommend that the assets backing the essentials (necessities such as food, shelter and transportation) should be the most conservatively invested, with longevity protection and inflation protection among the crucial considerations; and in estimating how much money they will need for their essentials, the first source is pre-annuitised wealth: state benefits and defined benefit schemes. Clearly, we find your thinking entirely consistent with our own.

4.2 We offer three general comments.

4.3 The first is that the MIR should be set at a level that is at least as high as the level below which the individual or couple has a current entitlement to supplementary state resources.

4.4 The second is that it is reasonable, given the uncertainty of future state policy, to raise this level by a contingency margin. After all, the MIR is for people who have savings. The arbitrary level of a 20% addition seems to us to be easy to support.

4.5 The third relates to post-retirement expenditure patterns. Our understanding, from the literature, is that post-retirement spending falls into three phases. In the early phase people tend to be more active and are likely to travel and explore personal interests. In the second phase they tend to slow down, downsizing their activities and possibly their homes. In the third phase they typically limit their activities and their expenses are increasingly driven by ill health and disability. If the MIR is set in relation to the first phase, it should automatically cover the second phase, with no adjustment. It is the third phase that causes a potential financial problem for the state. Partly this could be covered by the contingency margin we suggested in paragraph 4.4. It may be reasonable to insist that some further margin be retained for the third phase. Administratively this could be met very simply by whatever remains of the pension pot, if in fact there is to be a ceiling on the annual drawdown limit (Question A1). It seems unreasonable to insist on anything beyond this, because under the current forced annuitisation regime there has never been any further protection against the individual falling back on the state.

Question A5: Whether a different MIR should be set for individuals and couples

5.1 Yes. The point at which state supplements are provided differs for individuals and for couples. Since avoidance of reaching that level is the MIR's goal, the MIR should take marital status into account.

Question A6: How often the MIR should be reviewed

6.1 As infrequently as possible. Administratively it will be a nightmare if people satisfy the MIR and then, years later, are told that they need to buy a further annuity to satisfy a new, higher MIR. If the Government genuinely wants to offer flexibility of choice, then it must recognize that choices have consequences, and sometimes those consequences cannot be reversed. If instead there is only a conditional choice that is not only reversible by the government, but explicitly planned in advance to be reversible, then it is a sword over people's heads, and this exercise will have little practical effect.

6.2 In practice, therefore, the MIR should be applied to each individual only once, at the time of initiating withdrawals. This would leave the government able to review MIR at intervals of (say) five years, and at interim points that coincide with any major change in conditions related to state supplementary support. These subsequent changes in MIR would apply to those individuals who have not yet made an election.

Question A7: How to minimize unnecessary burdens for individuals and industry in the assessment of the MIR

7.1 We have no further comments to add to those in paragraphs 6.1 and 6.2.

Question A8: Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks

8.1 We do not know.

Question A9: How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75

9.1 We have three comments.

9.2 The first is that the need for consumer education on annuities is huge – and this is recognised explicitly in the document. There is room for the CFEB to play a role in this education. Currently its website gives a lot of basic information, which is a good start. But education itself can never be a substitute for advice: somebody has to make a decision. One cannot prevent people from making sub-optimal, perhaps even unwise, decisions. That is why the idea of the MIR is a good one.

9.3 We ourselves propose to help with this education. In the course of our retirement initiative we will make a number of contributions, including a paper on understanding annuities. No doubt many other firms will do something similar.

9.4 A particularly useful notion is to give consumers an idea (and it always astonishes them, in our experience) of how large a lump sum is required to generate a reasonably secure lifetime income. What we call "the rule of the £20 note" is key here: as a rule of thumb, every £1 a year that you want as income from age 65 requires a pension pot of £20 to support it. Given that a weekly income and weekly expenditures are the way in which many people often keep track of money, another way to communicate the £20 rule is: every £1,000 in your pension pot will generate £1 a week for you. This may be the single most important piece of education that anyone can give to the average saver. We would be happy to explain this further, noting that is very rough, it takes into account self-insurance rather than annuitisation for longevity protection, and it actually makes annuity rates appear appealing.

9.5 Our second comment relates to other ways of providing longevity protection that attempt to overcome objections to buying lifetime income annuities. There is, for example, the American government approach (inferior, in our view, to the proposed MIR) which permits an alternative to annuity purchase: the retiree must draw down, each year, a floor amount, equal to the amount of the remaining pension pot divided by the retiree's future life expectancy each year (as supplied by their equivalent of the GAD). Like the flexibility you propose, this permits retirees to pursue whichever investment policy best fits their circumstances. A further innovation in North America is the GMWB ("guaranteed minimum withdrawal benefits") insurance policy, under which some payment level for life is guaranteed, in conjunction with flexibility in the investment policy selected for the pension pot. There is also the ALDA (advanced life deferred annuity), which is a deferred annuity that only commences if the retiree survives to (for example) age 85. None of these are (currently) big sellers in North America. But that is not our point. Our point is that, as the volume of money requiring annuitisation or some alternatives grows enormously in the next decade, consumer education will be needed, and the industry will innovate.

9.6 Our third comment relates to the concept of money's worth. The document cites the excellent study by Cannon and Tonks to the effect that the money's worth of British annuities has been around 90%, which is a high level, because it means that 90% of the lump sum charged to provide a given level of pension income is for the "pure risk" and only 10% for expenses, margins and profit. The paper goes on to say, of the 90% figure: "This represents good value in comparison with other insurance products."

9.7 We strongly believe that this comparison is neither correct nor relevant.

As far as relevance is concerned, the flexibility proposed is not between annuitisation and buying other insurance products. It is between annuitisation and self-insurance. So the relevant comparison is this: if this is good value, does it save the purchaser money relative to self-insurance? It should, because annuitisation, with its pooling of longevity risk, should be the cheapest way to provide for income that lasts for life.

Our calculations show that, at age 65, a male annuitant focused on self-insurance ought to set aside roughly 35% more than the lump sum that the "pure risk" requires, in order to have a pretty good (95%) chance of not outliving the pension pot. This means that, of a £100 pension pot, roughly £75 represents the present value of an income stream up to the life expectancy, and the remaining £25 is required as a reserve against the risk of outliving the life expectancy. That shows the value of pooling longevity risk: with an annuity purchase (if it represents 100% money's worth) the extra £25 buys additional lifetime income, and that means more money going to the retiree. But if the £25, in an annuity purchase, is consumed by insurance company loadings, there is no income benefit to the purchaser from buying an annuity. In fact, Cannon and Tonks report that for index-linked annuities (which, as we have stated, we believe will become the default), the money's worth in 2007 was between 70% and 80% – dramatically below that for level annuities – and it has fallen by 15 percentage points over the previous five years. Therefore all the benefit from annuitisation rather than self-insurance vanishes. This will make annuity purchases even more unpopular and misunderstood than they are today. They will represent not only poor value, but no advantage at all from pooling longevity risk.

As far as accuracy is concerned, it is not right to proclaim annuities to represent "good value" when the money's worth number on which you base this assessment is not at all representative of index-linked annuities, the likeliest type of default annuity that the proposal for flexibility will lead to.

Question A10: Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market from being able to meet likely demand for annuities

10.1 We return to our observation that the definition of the MIR (of which, as we said before, we approve) will lead to index-linked annuities becoming the default, for savers who wish to take advantage of the new flexibility you are offering. We believe that one consequence will be an increased demand for index-linked gilts to be issued. They are the most secure way for insurance companies to acquire a cash flow stream index to inflation.

Indeed, it is likely that any restriction in the supply of index-linked gilts will be a limiting factor in the market for indexed annuities. In turn, a new demand for these securities that is not met by an additional supply will inevitably lead to artificially, and unnecessarily, low real interest rates in them, and those real interest rates will affect the pricing of index-linked annuities. In effect, the exacerbated supply-demand imbalance will constitute an unnecessary and hidden tax on purchasers of index-linked annuities.

Today the proportion of escalating annuities is roughly 6-7% of the total market, according to figures from the ABI Annuity Survey 2007. Since this figure includes both index-linked and fixed-escalation annuities, the proportion of genuinely index-linked annuities is even lower. This low volume may itself be a contributory factor to the low money's worth of index-linked annuities. The situation is bad enough; it will become worse unless the supply of index-linked gilts increases appropriately.