Pointmaker

AUTO-PROTECTION AT 55

MICHAEL JOHNSON

SUMMARY

- The 2014 Budget abolished the obligation to annuitise pension pots (as originally proposed in 2010 by the author of this paper).
- While this liberalisation is welcome, there are legitimate concerns that some people may fail to purchase suitable retirement income products. For example, some may take lump sums, meaning that they may run out of money before death (perhaps to fall back on the state); some might fail to appreciate the risks involved in any decision about retirement savings (the main risks being inflation, investment and longevity); others might succumb to fraudsters.
- A simple reform ("auto-protection") could do much to address these concerns: namely, to introduce a default option for people approaching private retirement age whereby their pension pot would be automatically enrolled in a not-for-profit national auction house for annuities.
- HM Treasury could be permitted to participate, writing annuities as a funding alternative to the gilts market. Then, perhaps via agents, it could offer default private pensions as Post Office Pensions and National Savings Pensions.
- Savers would still be free to opt out of auto-protection if they so wished. There is no desire to prevent people doing what they wish with their own savings.
- However, those who accept the default pension, but defer taking it until at least five years after the private pension age, say, could also be rewarded with a pension exempt from Income Tax, paid for by a reduction in upfront tax relief.
- Today's private pension age is currently 55, and is set to rise to 57 in 2028. This is an anachronism that is out of step with improvements in life expectancy. It should be rapidly raised to 60 in 2024, i.e. by a year every two years, commencing in 2016.
- The tax-free status on the first 25% of a pension pot actively discourages people securing a reasonable pension at the age of 55 and is wholly ineffective. This should be abolished (with accrued rights protected).
- Seven proposals are outlined overleaf.

SEVEN PROPOSALS

Proposal 1: The Government should establish a not-for-profit national annuities auction house to automate the process of shopping around, adding to pricing tension and transparency. This would be similar to making the exercise of the Open Market Option mandatory. All aspiring annuity providers (which could include the state) would be required to participate. Initially, only a limited number of standardised single- and joint-life, inflation-protected lifetime and deferred annuity contracts would be listed. Pre-auction aggregation of small pots by the house would encourage stronger bids.

Proposal 2: The Government should introduce a pension pot decumulation default when savers reach the private pension age: "auto-protection". Ideally, it would take the form of an inflation-linked pension, joint-life for married savers. Savers would be free to opt out to pursue alternatives, consistent with the liberalisations announced in the 2014 Budget.

Proposal 3: Today's private pension age of 55 (rising to 57 in 2028) should be rapidly raised to 60 in 2024, i.e. by a year every two years, commencing in 2016. In addition, politicians should be preparing people for 65 by 2030-35.

Proposal 4: Those who defer taking a default pension until at least five years after the private pension age could be rewarded with a pension exempt from Income Tax, paid for by a reduction in upfront tax relief.

Proposal 5: The guidance guarantee should form an integral part of the auto-protection process, to help savers select the most appropriate form of pension (including whether to defer for a tax-free pension, and determining eligibility for health-related enhancement) or, indeed, whether to opt out altogether.

Proposal 6: The state should be free to offer default private pensions, perhaps via the Post Office and National Savings (acting as agents for the Treasury).

Proposal 7: Access to the 25% tax-free lump sum should be delayed until the age of 60 or 65. Alternatively, it should be scrapped, with accrued rights to it protected.

FOREWORDS

A PENCHANT FOR PENSIONS

Lord Holmes of Richmond

Pensions are a very good idea, conceptually and in practice. To plan, to prepare for retirement, incentivised through the tax system, to take care, to take responsibility, all very good. And a pension needs to do its job, which is to provide a lifetime income, no matter how long you live. For many with small savings, it is a vital social service.

The problem is that people have stopped saving for their pension, notwithstanding that pensions, both contract- and trust-based, offer valuable protections to the individual, against longevity, inflation and investment risks. Indeed, "pension" has become a dirty word, or at least from a bygone age. It has diminishing appeal to Generation X and means pretty much zippo to Generation Y. Instead, we are witnessing the development of alternative "retirement saving vehicles" from simple savings to exotic (i.e. speculative) asset classes (such as art, cars and wine).

And no wonder: pension annuities are costly to buy (notwithstanding today's low interest rates). Against this backdrop, the 2014 Budget's liberalisation in respect of the annuitisation requirement shines a new light upon pensions. It does, however, introduce potential uncertainty and risk for those who may struggle to decide what to do with their pots when reaching 55 (and particularly for those with smaller pots).

This paper eruditely addresses these issues, and without compromising the liberalisation intent. Indeed, just as NEST was established to make auto-enrolment work, the central theme of Michael Johnson's paper is to make annuity liberalisation safe. He also focuses attention on the watershed between accumulation and decumulation, at the age of 55. Given rising expectations for life expectancy, and allied changes in employment and society, one could conclude that this is far too early.

The author, who comes from no particular political perspective and has no pensions or annuitisation axe to grind, has offered a challenging call; it is to set in place a safe default system for pension protection, while challenging the market to produce a still better service for its clients. It is likely to garner support from both the industry (it could provide a shot in the arm for annuitisation) and politicians, irrespective of political hue. If the proposals were implemented, they would benefit the baby boomer tail end, as well as subsequent generations.

DECUMULATION NEEDS CONSENSUS

Nigel Stanley, Head of Campaigns and Communications at the TUC

The Chancellor was right to see that the annuity market was not working, and that there is more than one way to turn savings built up while you are working into income when you retire. His Budget announcement of the freedom and choice agenda certainly hit the headlines the next day.

But good budget headlines can melt away when policies are tested. The worry must be that leaving new solutions to a combination of market innovation and individual responsibility is likely to be a triumph

of hope over experience. This, we should not forget, was the approach to pensions reform in the 1980s that failed in two ways.

First, it was a textbook example that real people do not act like the idealised ones described in the simpler economics textbooks. All of us find it hard to weigh up the benefits of giving up income today in order to take cash later in life. Combine that with the complexity and multiple choices involved in buying financial products that you cannot even tell whether or not are a good buy for decades resulted in a decline in pensions saving, only reversed by auto-enrolment.

Second, failed markets result in consumers getting ripped off. The 1980s and 1990s saw record mis-selling from which the industry's reputation has yet to fully recover. The OFT recently described the DC pensions market as one of the most dysfunctional they had ever studied. And if the annuity market is not working – when at least it is relatively easy to see what you will get and compare products – it is unrealistic to think that a more complex product market will do better. A guidance session – however welcome – cannot fix this.

In reforming the spending part of the pensions journey, it would have been better to learn from the Pensions Commission who in establishing auto-enrolment and NEST quietly built a wide consensus across the political spectrum around profound changes in the way that we save. But it is now not possible to undo freedom and choice, even if we wanted to.

The question therefore is how can we make it work in ways that benefit consumers and give them what they want from a pension, which for the vast majority is a predictable income that lasts until they die. And that means doing what we can to mitigate what could very well go wrong: people running up big unexpected tax bills by rashly taking cash, people running out of pension before they die and people too frozen by the difficulties of deciding what to do to enjoy the retirement they deserve.

As Michael Johnson recognises in this stimulating paper, there are two key elements that we have to get right. Firstly, we should recognise that retirement is increasingly a process and not a cliff edge. And secondly, we should recognise the power of defaults. Let people have all the freedom and choice they want to move away from those defaults, but savers need a starting point for making their decisions that is designed to provide good value and fulfil the basic tasks of a pension - a lifetime income. You do not have to agree with the detail of all of Michael's policy suggestions – and I don't – to sign up to his broad analysis of why we need good defaults and longevity pooling to get retirement right.

I talk to people across the political spectrum and from a range of pension interests, and my sense is that even without a Pensions Commission to steer us, we are all coming to pretty similar conclusions about how to make decumulation work. Consensus is important in making pensions policy work as it has to last. This pamphlet will help shape that new consensus.

"By providing financial protection against the major 18th and 19th century risk of dying too soon, life insurance became the biggest financial industry of that century... Providing financial protection against the new risk of not dying soon enough may well become the next century's major and most profitable financial industry."

Peter Drucker,
Innovate or die, The Economist,
25 September 1999

INTRODUCTION

In 2010 the author proposed the abolition of the requirement to annuitise, *provided* that both the state and the individual were protected from downside risks.[1] The former comes into effect in April 2015, but the latter would appear to have been forgotten. This is unfortunate.

Several recent surveys have asked people about their intentions for their defined contribution (DC) retirement savings. One found that nearly 70% expressed a desire for a "steady, secure income" in retirement, without the risk of outliving their savings, i.e. a lifetime annuity, although few people describe it as such.[2] Another reported that the majority of DC pot holders aged over 55 want a guaranteed income for life, particularly an income protected against inflation.[3] It also found that only 50% of people understood how to obtain this from their pots: the word "annuity" does not resonate.

It would appear that *most* people do not appreciate that an annuity *is* a pension. In addition, when it comes to insuring against longevity risk (the risk of outliving our assets), there is no directly comparable product. This, combined with the rapacious behaviour of some within the financial services industry, is an open invitation for today's situation concerning annuities: market failure. But this does not mean that annuities *per se* are the issue.

1. ANNUITISATION: CHALLENGING

1.1 The foibles of being human

The annuity market's dysfunctionality is aided and abetted by consumer behaviour (as well as the media, which feeds in the trough of the aggrieved). A litany of human foibles means that sub-optimal pricing is sometimes self-imposed. In addition to not shopping around for the best annuity (through laziness, complacency or a lack of curiosity), short-termism is so deeply embedded that, for many people, it occludes any fear of poverty in retirement. A lump sum today can look very attractive when compared to a small annuity.

Annuities are an insurance against the risk of outliving our assets, which we undervalue partly because, on money matters, people are inherently over-optimistic. Consequently, the risk is irrationally dismissed. Confusingly, we are naturally inclined to be pessimistic of our own life expectancy, i.e. we underestimate it. But the risk is the same: that of running out of money before dying. This is part of the price of being human, rather than a lack of analytical skills, financial acumen or access to information.

---

[1] *Simplification is the key; stimulating and unlocking long-term saving*, Michael Johnson, CPS, June 2010. Downside risks including running out of money, and falling back on the state.

[2] *In a brave new pensions world, what will DC members really want?* Aon DC Member Survey, Aon Hewitt and Cass Business School, December 2014.

[3] International Longevity Centre-UK; *Making the system fit for purpose: How consumer appetite for secure retirement income could be supported by the pension reforms,* January 2015.

1.2 Technical issues

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

- low, and declining, annuity rates, due to low interest rates (largely because of quantitative easing, "QE"), poor investment returns (over the last decade) and increasing longevity;
- product complexity and inflexibility;
- a lack of annuity contract standardisation, which renders price comparison websites ineffective and misleading. This encourages widespread distrust of the financial services industry;
- the mis-appreciation of longevity risk by customers, leading them to undervalue lifetime annuities, in particular;
- rising regulatory and capital requirements;
- weak consumer protections, in respect of non-advised sales, including a lack of recourse to the Financial Ombudsman Service (FOS);[4] and
- the difficulty in assessing an annuity's value for money, not least because life expectancy is such a lottery. (Conversely, providers with oversight of whole risk pools are able to gauge whether they are offering, collectively, value for money to their customers… but commercial sensitivities inhibit putting such information into the public domain.)

There is also a growing awareness that the annuity market is "hugely unfair and opaque" and "toxic", perhaps depriving retirees of up to £1 billion of income each year.[5] But, in understanding the root causes of criticism, we should be careful to distinguish between background "noise" and more permanent "signals". For example, today's exceptionally low interest rate environment is noise (albeit unusually enduring): one day, real interest rates will rise, which should feed through to better annuity pricing.

1.3 Annuities: in the regulatory spotlight

The parlous state of the UK's annuities market has increasingly come under scrutiny. Immediately prior to the 2014s Budget, the Financial Conduct Authority (FCA) cited a "disorderly market", rightly castigated the insurers for unfairly taking advantage of their existing customers to pump up profits.[6] It also assessed 13 price comparison websites, deeming every one of them guilty of "poor practices" (some are atrocious).

In addition, the FCA pointed out that half of all annuitants accept sub-optimal pricing because they fail to make use of their Open Market Option (OMO), which allows consumers to shop around for the best annuity rate and the most appropriate product. Indeed, one third of the over-55s have "never heard" of the OMO, a problem compounded by 70% of adults not understanding what an annuity is.[7] The FCA estimated that of the 60% of annuitants who simply take whatever deal is offered to them by their current provider, 80% of them could have got a better annuity on the open market.[8] More recently, it has found that the

[4] In event of insurer failure, annuitants benefit from the Financial Services Compensation Scheme (FSCS), which pays 90% of the value of an annuity, with no upper limit.

[5] NAPF; *Treating DC scheme members fairly in retirement?*, February 2012.

[6] Financial Conduct Authority; *Thematic review of annuities*, February 2014.

[7] Based on research conducted by MGM Advantage.

[8] The FCA found that someone with an average £17,700 pension pot living a further 30 years would benefit by more than £2,000 by shopping around (7% better than otherwise). For those with health problems, 91% could

ABI Code of Conduct on Retirement Choices ("the ABI Code", concerning treating customers fairly) is often ignored.[9] This is particularly the case where its requirements lack prescription, leaving insurers free to make judgements on matters in which they have a commercial interest.

Shortly before publication of the FCA's report, the Financial Services Consumer Panel also recommended *urgent regulatory and government-led reforms*, to prevent millions of annuitants losing out.[10] *The many examples of poor practice mean that the general outcome for consumers can be akin to a lottery*. Andrew Tyrie MP, chairman of the Commons Treasury Select Committee, supported the FCA's findings, and hinted that action is required.

The FCA also identified two groups of consumers particularly at risk of not getting a good deal: those with small pension pots, and those eligible for an enhanced annuity.

(a) The small pots problem

It is commercially logical that insurers will offer lower annuity rates on small pots. Margins are lower, and there are fewer providers competing for pots below £10,000. Martin Wheatley, the FCA's Chief Executive, has said there was *virtually no market whatsoever* for people with small pots. The FCA found that most customers with small pots would get the best deal available to them from their existing pension provider. The issue is more about how the market serves these customers, rather than a lack of shopping around. Pension minister Steve Webb's "pot follows member" initiative is intended to address some of the issues with small pots, but it is limited to the automatic consolidation of workplace pension pots, as workers move from one job to another.[11] Consequently, past employment pots, private pension pots (SIPPs, etc.) and the self-employed are ignored.[12]

(b) Enhanced annuities

The primary cause of enhanced annuities' poor pricing is consumers failing to shop around. This first requires them to appreciate that they may be eligible for an enhanced annuity, which is often not the case. Unsurprisingly, the industry's salesmen harness inertia selling and exploit behavioural and ignorance arbitrages, knowing full well that some customers are lazy, and also that unless messages are repeated, the significance and value of the OMO will not sink in.

2. DECUMULATION: RISKS TO THE FORE

2.1 The 2014 Budget

The Government has, for some time, been well aware of the problems with annuities, announcing a dramatic liberalisation of annuity purchasing requirements in the 2014 Budget. From April 2015, individuals aged at least 55 will be able to access their private DC pension savings as they wish, regardless of pot size.[13] This essentially leaves people with three choices: full withdrawal (taxed at their marginal rate, less a 25% tax-free lump sum), some kind of income drawdown product (which could

get a more favourable deal on the open market, and the potential improvement would be larger.

9 Financial Conduct Authority; *Thematic review of annuities sales practices,* December 2014.

10 Financial Services Consumer Panel; *Annuities: Time for Regulatory Reform*, December 2013.

11 *Pensions Act 2014*, May 2014.

12 The author shares the minister's scaling up objective, but disagrees with him on how to achieve it. See *Aggregation is the key*, Michael Johnson, CPS, September 2013.

13 The age threshold will rise to 57 in 2028, coinciding with the increase in State Pension age to 67.

include doing nothing for a while) or an annuity purchase, or any combination thereof.[14] So, what to do?

2.2 Guidance available... but advice wanted

From April 2015, Citizens Advice Direct (CAD) will deliver free and impartial face-to-face Pension Wise guidance, with The Pensions Advisory Service (TPAS) performing the same role over the phone.[15] Guidance is intended to help individuals approaching retirement understand their options, but it will not signpost *specific actions*, i.e. which transactions to execute, and with whom. But this is what many people want to be told: in practice, they want to be advised what to do.

The distinctions between "guidance" and "advice" are very hard to grasp; they are certainly not intuitive. Even if a definition could be agreed upon, it is likely to be so nuanced as to be nigh impossible to communicate simply. The confusion is reinforced by the existence of the word "advice" in the name of each of CAD and TPAS, and the much-derided Money Advice Service (MAS), none of which can give "advice" as understood by the industry.

2.3 The House of Lords: on the case

The consequences for consumers of their failing to shop around have not been lost on some members of the House of Lords. Several peers, notably Baroness Drake, Lord Bradley and Lord Hutton, have made it clear that pension savers require additional protections (beyond guidance) when purchasing an annuity, to ensure that it is good value for money and appropriate to need. Amendment 1 in the Committee stage debate of the Pension Schemes Bill proposed placing an independent annuity broker between the saver and his scheme provider to ensure that the former cannot buy directly from the latter.[16] The amendment was withdrawn after assurances that there would be an opportunity to revisit the theme at a later stage of the debate.

2.4 Mind the gap

Notwithstanding the confusion between "advice" and "guidance", "advice" has historically been the provenance of the Independent Financial Adviser (IFA). Following decades of self-serving client abuse, IFAs collectively surrendered the initiative to the state, in the guise of the Retail Distribution Review (RDR, implemented January 2013). Subsequently, the "advice gap" has widened as the number of advisers has declined, and few of those who remain are interested in the (low margin) mass market. The RDR did not consider the downstream impact on lower-value customers. In addition, for many, the IFA label remains an irretrievably damaged brand which should be consigned to history (perhaps in favour of "financial planner"); this matters, because the associated trust deficit deters consumer engagement.

2.5 In practice, abandoned at 55?

There is a substantial risk that after an initial guidance contact with CAD or TPAS, many people, lacking an adviser to lead them through the process (perhaps distrustful of IFAs, or simply unwilling to pay for advice) will wallow in decumulation indecision. TPAS itself has pointed out that *guidance, in itself, does nothing; it is what the customer does with the*

---

[14] See HM Treasury; *Freedom and choice in pensions,* March 2014, and the Taxation of Pensions Act, December 2014.

[15] *Ibid.* This entitles everyone with a DC pension fund to access to free (at the point of delivery), impartial guidance. It will be delivered under the brand "Pension Wise".

[16] Moved by Lord Bradley, Hansard, 7 January 2015.

guidance that matters. The success of guidance can only be achieved by the whole industry working together.[17]

Given the advice gap, many 54 year olds could (from April 2015) face the "what next?" question on their own; more specifically, a crucial, once-in-a-lifetime decision regarding how to manage investment, inflation and longevity risks over the remainder of their lives. This could occur after decades of being encouraged to save for retirement by a combination of defaults (notably employer contributions, becoming more prevalent with auto-enrolment) and tax-based incentives. Consequently some people will have become accustomed (conditioned) to not making major retirement-related financial decisions for themselves.

The specific nature of the decisions will also be unfamiliar. Most people are accustomed to making spending decisions related to receiving a regular income, but not the arrival of large lump sums. In this light, de-emphasising annuitisation (i.e. a regular income) does not feel like a sensible policy. Indeed, it is risky, and potentially dangerous.

2.6 Fraud to the fore?

By removing the default requirement to purchase an annuity, the 2014 Budget has (unintentionally) dumped many people into a feeding ground of charlatans and fraudsters preying on the pension pots of 54 year olds who, by their own admission, have no interest in (or understanding of) matters financial. Australia, for example, which has a large self-managed fund sector, has a substantial fraud problem:[18] the 2014 Budget's liberalisations are not risk-free.

3. PENSIONS AND POLITICS

3.1 An ideological battleground

The 2014 Budget's liberalisation of the annuitisation requirement was a politically shrewd move. It has proved popular with the public, not least because the benefits are pretty immediate, notably a pot of cash at retirement rather than, for most people, a small annuity until death. In addition, it will benefit the Treasury, which expects the additional tax revenue in the first few years (over £1 billion per year, by 2018-19, care of additional consumption taxes), but lower revenues in the longer term.[19] Such short-termism perhaps raises a question over the Chancellor's real motivation for the liberalisation although, to be fair to him, the tax gain is probably too modest to be the prime driver.

The surprise initiative sowed confusion amongst those who are naturally inclined to socialise risks. Thus, it helped to establish a clear political divide between the Conservative's philosophy of individual freedom, liberty and choice, and those who instinctively favour collective solutions, notably the Labour Party. Such policy blue water between the two main parties is, today, relatively rare.

3.2 Coalition confusion

The liberalisation will lead to a significant shrinkage of the country's largest source of risk pooling: insurers' annuity books. Yet, eleven weeks after the Budget, enabling legislation for collective DC (CDC) schemes, incorporating risk pooling amongst members, was announced in the Queen's Speech (as part of the Private Pensions Bill). So, does the Government embrace risk pooling, or not? Such policy

---

[17] Michelle Cracknell, TPAS Chief Executive, Gleneagles 2014 presentation; *Advice, guidance and engagement.*

[18] Australian savings fraud is concentrated in property schemes, leveraged funds, collectibles (wine, cars) and other real economy assets. Local consultants report that the most effective deterrent is to ban particular asset classes (e.g. property in SIPPs), or to impose punitive taxation on them.

[19] HMRC; Budget 2014 Red Book, Table 2.1, item 5.

confusion is perhaps one price of coalition government, although it should be noted that whereas the Budget was driven by the Conservative Chancellor, CDC is owned by the LibDem pensions minister, Steve Webb.

3.3 Short-term gain, long-term pain?

But, politics aside, which approach to providing a retirement income is in the best interests of the individual? The political calculation behind the annuity liberalisation is that *in the short-term* everyone (passing through the age of 55) stands to gain by having more choice, but thereafter the outcome depends upon wealth. Those blessed with large pension pots can probably afford to make poor decisions at 55 without serious adverse consequences in the long-term. But for the other 85% of the population, the long-term risks are substantial, both to the individual and the Treasury (i.e. other taxpayers).

Culturally, the British general public lacks an affinity with investing (and the skills to do so, prudently). In 2013-14, 78% of the 13.5 million adults who subscribed to ISAs opted for cash rather than stocks and shares ISAs, hinting at our discomfort with the investment challenges of income drawdown.[20] Running out of money could mean falling back on the state, raising the issue of moral hazard.[21] Consequently, the Treasury should have a considerable interest in a prudent decumulation framework that prioritises better long-term outcomes for *everyone*.

Obviously we do not know the long-term consequences of the 2014 Budget liberalisations but, fortunately for the UK, other developed countries have been running control experiments on our behalf, albeit unwittingly.

4. AN INTERNATIONAL PERSPECTIVE

4.1 Australia

Australia has been at the forefront of pensions reform, ever since it introduced the state-sponsored Superannuation Guarantee ("Super G") compulsory saving programme in 1992.[22] Australia has no annuitisation requirement. Overall, only 10% (at most) of DC pension assets are used to purchase a lifetime annuity, a figure dominated by large pots: 75% of those over A$100,000 are converted into some form of retirement income stream. Conversely, the vast majority of smaller pots are cashed out.

Recognising that there is always room for improvement to Australia's financial system, every few years a Treasury-commissioned report emerges, the latest being the "Murray Inquiry". The interim report (July 2014) highlights operational flaws in Australia's pensions system, with pots not being efficiently converted into retirement incomes due to a lack of strong price-based competition and insufficiently diverse risk-pooling. In addition, the report identifies an over-reliance on individual account-based pensions, rather than workplace schemes (such as NEST) which are better positioned to harness economies of scale. Other key findings include some potentially salutary lessons for the UK:

20 HMRC; *Individual Savings Account (ISA) Statistics, Table 9.4,* August 2014.

21 i.e. the risk that people exhaust their pension pots and subsequently receive means-tested benefits. This includes people who will receive a full single-tier State Pension (from April 2016): they will still be eligible for various benefits, including council tax and housing benefits.

22 The compulsion only falls on employers, to contribute 9.5% of employees' wages to an approved fund (rising to 12% in 2025).

- 50% of benefits in retirement are paid as lump sums, and nearly 75% of this is used it to either pay off housing and consumer debts or to make additional allied purchases; and, consequently,
- more than a third of pension pot assets are being quickly consumed, rather than being used to provide incomes through retirement. 25% of people with a pension pot at age 55 have depleted their balance by the age of 70.

The Australian state pension is means-tested, so as people exhaust their own pots they are able to fall back on the state, adding to the significant longevity risk already borne by taxpayers. Consequently, the interim report considers compulsory annuitisation. This was subsequently watered down in the final report, which recommends "soft" compulsion via the introduction of a default option whereby trustees should pre-select an income product for members' retirement.[23] The objective would be to give members longevity protection and a stable income in retirement. In other words, an annuity. Thus, based upon an experience of not having had a tradition of annuities, Australia is now inclined to introduce an annuity-like default for members.

4.2 New Zealand: an annuity-free zone

In the early 1990s New Zealand got rid of all tax-based savings incentives; they were seen as grossly unfair and distortionary (similarly, pensions tax relief in the UK). Savings rates declined, so a form of auto-enrolment (into KiwiSaver) was introduced in 2007, to reverse the trend.[24] Today, nearly 60% of the total population belongs to KiwiSaver, and attention is now turning to the issue of decumulation which, to-date, has been ignored.

In 2012, a total of three annuities were sold in the whole of New Zealand.[25] Without any historic mandatory annuitisation, it is unsurprising that there is no local annuity market capability. This is now seen as a problem and, without mandatory annuitisation, the private sector is reluctant to assume the inherent risks of longevity and inflation.

A role for the state beckons, which potentially includes subsidising a fledgling market. It is now recognised that collective action will be required to meet people's requirement for a regular income in retirement, notably in respect of sharing longevity risk. In addition, New Zealand may take the opportunity to simultaneously tackle another pressing issue of an aging society: long term care. One idea that has been floated is to embed long-term care insurance within annuities, so that they triple should the retiree enter care.

Meanwhile, New Zealanders are looking at the UK pondering whether we risk throwing the baby out with the bathwater. It is not only geography that diametrically separates the UK from our Antipodean cousins.

4.3 Switzerland

(a) Cultural advantage… and much more

Annuitisation is the default option in Switzerland and, despite an (opt out) alternative to take a lump

[23] *Financial Systems Inquiry Final Report,* November 2014. See Chapter 2: Superannuation and retirement incomes.

[24] KiwiSaver is a New Zealand version of NEST which, unlike NEST, is designed to cover the entire population.

[25] Professor Susan St John, Retirement Policy and Research Centre, University of Auckland, interview, Pensions Insight, February 2014.

sum, the Swiss have the world's highest rate of *voluntary* annuitisation: 80% of DC pension assets. This is partly explained by their ingrained financial conservatism and risk aversion, and a deliberate policy not to overwhelm potential annuitants with choice: the majority of annuities are joint-life, with indexation being at the discretion of the provider, and no mandatory scheme offers deferred or fixed term annuities.[26]

Crucially, however, Swiss annuity prices are regulated by the state: rates are well above "market" (i.e. reflecting interest rates, longevity expectations and investment returns). In addition, there is a pricing bias towards small pots, which have to be annuitised at a rate of 6.8%.[27] The accumulation and decumulation phases are integrated, so scheme members have to buy their retirement product from their existing provider. Consequently, providers are able to subsidise their high annuity rates with sub-market returns during accumulation.

Unsurprisingly, Swiss annuities are seen as a "good deal", and they have a high Money's Worth Ratio (MWR), a method of quantifying an annuity's actuarial fairness.[28] Other countries offering high MWRs include Chile, Israel and Singapore; each has some form of pricing regulation or state subsidy… and high rates of annuitisation.

(b) The lump sum: negative nudges

Opting out of annuitisation, to take a lump sum, requires applications to be submitted three years in advance, with signatures of the member *and* their spouse: negative nudges (slaps?), which effectively encourages the alternative: annuitisation.

4.4 Elsewhere

In general, people in countries with low annuitisation rates are found to have a poor understanding of the potential benefits of annuities, their own retirement needs and their life expectancy. But there are growing concerns in these countries (notably Canada and the US) that retirees are running down their pension savings too quickly.

5. WHITHER ANNUITIES?

5.1 Full steam backwards?

In 2013, ABI members sold 353,000 annuities in the UK, down 16% on 2012, worth £11.9 billion.[29] The average annuity was bought with a pension fund of around £35,600, but 50% of purchases were with pots of less than £20,000. Post-Budget, it is estimated that sales may half, probably prompting annuity pricing to deteriorate further, and not just because of falling demand. As with the Australian experience, a rise in adverse selection is likely to further weaken pricing, as people with relatively low life expectancy, in particular, take advantage of new pension freedoms by not buying annuities. Consequently, the subsidy that they provide to lifetime annuities books then reduces and the risk pool becomes more concentrated with relatively healthy (and wealthy), longer-living customers. Less diversity of risk drives up pricing so that a viscous circle of decline then ensues, as some providers price themselves out of the market, curtailing

[26] Oxera for the FCA; *The retirement income market: country analysis,* September 2014.

[27] The Government has proposed to lower this to 6%, but it would still be generous.

[28] The MWR is calculated as the discounted present value of the annuity's expected future payments, divided by its cost. Liquidity or other risk factors (notably the insurer's credit risk) are ignored.

[29] ABI statistics; *The UK Annuity Market: Facts and Figures,* 2013.

competition. (Diminishing diversity in risk pools could ultimately lead to the death of actuarial principles).

5.2 Annuities: no competitor product

Australia and New Zealand are both experiencing *mea culpa* in respect of their lack of annuitisation: the UK should learn from their experiences. It addition, we have to face up to a stark reality: when it comes to hedging longevity risk, which we cannot ignore, annuities have no competitor product.

In the long term, annuity volumes are likely to slowly recover as millions of auto-enrolled employees eventually reach retirement age (and real interest rates may be much higher a decade hence, leaving scope to improve pricing). In addition, the total pot conversion market is expected to expand considerably, from £16 billion to perhaps £50 billion in 2023, fuelled by the ballooning DC market and continuing closures to future accrual of defined benefit (DB, final salary) schemes.[30] Consequently, notwithstanding the 2014 Budget and the temporary loss of demand, the problems in the annuities market still have to be addressed.[31]

There are two distinct aspects to consider: changing the market mechanism to improve pricing and transparency, and introducing defaults and incentives (nudges), to encourage more people to annuitise. They are intended to work together, to restore the public's faith in annuities and, given that an annuity *is* a pension, pensions.

6. REFORMING THE MARKET MECHANISM

6.1 Call time on the industry

Any form of structural intervention in the operation of a market should be seen as the last resort. Unfortunately, industry trade bodies (the ABI in this case) are masters are doing just enough to keep the show on the road, but not enough to address the main issues at hand: the principal-agent problem (misaligned interests, facilitated by information asymmetry), high costs, and a culture of opacity. This is, of course, partly why the Government acted as it did with the 2014 Budget; the industry has been the agent of its own misfortune.

It is clear that nudging (such as the Open Market Option, OMO) has not worked. It is time to start shoving, and for the Government to lead.

6.2 An annuities auction house

(a) Automation of OMO

The behaviour of both the industry and consumers needs to change: one approach would be to automate the process of shopping around (akin to making the exercise of the OMO mandatory). This could be achieved by establishing an annuities auction house; essentially, a marketplace within which all annuity providers would participate (perhaps through the purchase of a tradable licence). It would be open to individuals' DC pots as well as those within workplace schemes.

(As an aside, Australia's Murray Inquiry also discussed a formal competitive process to improve industry effectiveness, albeit in a different context; the automatic allocation of new workforce entrants to the better performing pension funds.)

---

30 Towers Watson projection.

31 This point is reiterated by a Pensions Policy Institute paper that emerged as this paper is being sent to the CPS for publication: *Supporting DC members with defaults and choices up to, into, and through retirement: qualitative research with those approaching retirement,* January 2015.

(b) Operation
One month prior to a customer's 55th birthday, the savings pot administrator would submit a standard lifestyle/medical questionnaire to the auction house, detailing:

(i) the type of annuity required (guaranteed, index-linked, joint life, etc.); and

(ii) any ill-health issues (to confirm eligibility for an enhanced annuity).

This would, of course, require prior communication with the customer, including sending him details of the Pension Wise guidance service and how to obtain independent advice.

Annuity providers could then bid on a daily basis for annuity business, with unsold annuities being retendered the following day (perhaps with an end-of-week "sweep"). This process should introduce pricing tension and, with all transaction prices being published online at the end of the day, the transparency that is currently lacking. (Enhanced annuities would have to be codified to facilitate transparent pricing.)

Safeguards would be required to ensure that successful bidders are credit-worthy institutions (perhaps incorporated in the licence eligibility criteria). Annuitants should also be permitted to specify a preferred annuity provider. In such cases, they should receive the details of the winning bid as well as those of their preferred provider's bids, if different.

(c) Pre-auction bundling of small pots
The market's pricing efficiency could be improved by packaging together small capital sums (i.e. pension pots) ahead of bidding. This would introduce economies of scale to the process (including lowering providers' administration costs), as well as facilitating the collectivisation (pooling) of risk (notably longevity), thereby encouraging stronger bids. Large occupational schemes (including the likes of NEST), acting on behalf of thousands of members, could assist in this process.

(d) Contract standardisation
As a pre-condition to participating in the auction house, annuity providers should adhere to a limited set of simple, standardised annuity contracts; templates created by the industry to improve transparency. Initially, the industry's usual clamour of complaint, concerning the inequity of limiting choice, should be given short shrift. The auction house should be given time to establish itself by offering only a few basic annuity structures, including single- and joint-life, inflation-protected lifetime annuities and deferred annuities. These would meet the needs of the majority of annuitants.

(e) Later… tailored annuities
Subsequently, the auction house could accommodate product innovation (anticipated following the 2014 Budget liberalisation), subject to there being sufficient demand. It could ultimately list bespoke annuities containing embedded optionality linked to one or a combination of various fixed term maturities; ill-health and care protection; investment performance; early death legacies; non-linear pay-out profiles; immediate needs (such as a guaranteed income to fund long-term care); capital or income guarantees; and interest rates other than CPI. The evolution of the market could be similar to that of the banks' Treasury products: vanilla interest rate and currency swaps books ultimately spawned a huge array of derivative products, including options, over lengthening maturities.

A word of warning concerning retirement product innovation. The insurance industry is likely to lose significant profitable business following the 2014 Budget liberalisation, which

could trigger a flurry of innovation. This would provide for competitive advantage and help justify high charges, but the additional complexity and opacity is rarely in customers' best interests.

(f) DB pension scheme de-risking

In addition to serving individuals, the auction house could also offer bulk annuities to DB pension schemes seeking to de-risk (or, indeed, re-risk). Given the hundreds of billions of pounds of pension assets, this could add considerable volume to the annuity market, aiding liquidity.

(g) A secondary market

The auction house could also provide a platform to facilitate a secondary market in annuities, an idea recently floated by the pensions minister (January 2015). His target audience is the five million pensioners who are already locked into an annuity, and therefore not able to benefit from the 2014 Budget liberalisations.

6.3 Implementation: a role for the state

The national interest is for a properly functioning annuities market, not least because the Treasury has a strong vested interest: sub-market annuities increase the prospect of people falling back on the state. Ideally, the auction house should be set up and operated by the industry, on a mutual, not-for-profit basis and adhering to the ethos of a public obligation service. But years of prodding from government, regulators, consumer groups and think tanks (including the author), and others, have proved fruitless, so the Government should facilitate it.[32]

Proposal 1: The Government should establish a not-for-profit national annuities auction house to automate the process of shopping around, adding to pricing tension and transparency. This would be akin to making the exercise of the Open Market Option mandatory. All aspiring annuity providers (which could include the state) would be required to participate. Initially, only a limited number of standardised single- and joint-life, inflation-protected lifetime and deferred annuity contracts would be listed. Pre-auction aggregation of small pots by the house would encourage stronger bids.

6.4 State participation

The annuity market is open to some form of state intervention, which could include participation by the Treasury itself (perhaps via National Savings & Investments, NS&I or the Post Office). This would provide a funding alternative to the gilts market, and would not be unprecedented. The 1864 Government Annuities Act permits the sale of small annuities to the public through Post Offices, a practiced that ceased in 1928.

7. A DEFAULT AT AGE 55

7.1 Auto-protection

The two different political ideologies (section 3) could be summed up by one question: *how much responsibility should individuals take for their own actions*? As discussed, the Left is more inclined to state direction and collectivisation (i.e. risk pooling), the Right more towards individualism. In the context of the debate around the 2014 Budget's removal of any requirement to annuitise, these are not mutually exclusive positions. Both could be accommodated by a decumulation default nudge at 55 to protect those in society who are particularly exposed to the downside of running out of money, with the right to opt out. This could be characterised as auto-annuitisation, to

[32] See *A market-orientated solution to the problem with annuities,* Michael Johnson, CPS, February 2012. Prior to this, David Mowat MP suggested a national annuity support and brokerage service, and in late-2013 the Financial Services Consumer Panel called for a national annuity service.

complement auto-enrolment. However, the word "annuity" has an image problem: it is unpalatable to politicians and public alike. "Auto-annuitisation" needs to be reframed for presentational purposes: hence "auto-protection".

7.2 Auto-protection: design

(a) A pension

The auto-protection decumulation default should be the conversion of DC pension pots into a regular income stream until death. When asked, most people approaching retirement say this is what they want from their savings, often without reference to the word "pension" or "annuity" (and, to be clear, a pension *is* an annuity). The challenge is to determine the precise structure of the default pension.

> **Proposal 2:** The Government should introduce a pension pot decumulation default when savers reach the private pension age: "auto-protection". Ideally, it would take the form of an inflation-linked pension, joint-life for married savers. Savers would be free to opt out to pursue alternatives, consistent with the liberalisations announced in the 2014 Budget.

(b) The dilemma of choice

One purpose of a default mechanism is to minimise the scope for confusion or prevarication, so a default that offers choice would be contradictory. However, countries which require people to buy a retirement income product have recognised that no single pension structure is ideal for everyone. Singapore, for example, offers two standard products: a deferred lifetime annuity or a more expensive, "longevity insurance".[33] Joint-life, index-linked or other escalating annuities are not available. 70% of Chileans annuitise at retirement: their choices are limited to either a deferred or immediate lifetime annuity.

In addition to limiting the range of choice, an auto-protection default pension should, ideally, include some mandatory features that are today optional. Both inflation-linkage (to protect people from rises in the cost of living), and joint-life for all married savers, would appear to be fair and sensible (and are mandatory in all Chilean annuities, for example). Inflation-linkage is a common feature of DB occupational pensions, but it is rare for deferred annuities to include it. This is partly because of a lack of supply, due to insufficient availability of inflation-linked assets required for hedging purposes.

There are also some technical considerations, required to maximise value for money. For example, the structure of providers' regulatory costs are such that the fixed term element of an annuity should continue until as late as possible, with deferral of the lifetime guarantee element until perhaps the age of 80. In summary, the default pension could include one or a combination of the following:

- a choice of commencement ages;
- inflation-linkage, ideally, but otherwise level rate;
- inheritable pension status if death occurs prior to commencement; and
- accommodations in respect of ill health.

[33] This is, effectively, a deeply deferred annuity that begins to pay out at age 90 coupled with a standard annuity which pays out until age 90.

(c) The private pension age: 55 is too early

Ideally, auto-protection should come into effect at 60 or 65, but following the 2014 Budget's liberalisations, the genie is out of the bottle. For now, we are stuck with today's private pension age of 55, an anachronism that is out of step with post-war improvements in life expectancy. The Government has recognised this, and the private pension age will rise from 55 to 57 in 2028.[34] Thereafter it is set to be linked to ten years below the State Pension age, which itself is now due to be linked to improvements in life expectancy. Even so, this is too slow: today, the private pension age should be 60, with politicians preparing people for 65 by 2030.

> **Proposal 3:** Today's private pension age of 55 (rising to 57 in 2028) should be rapidly raised to 60 in 2024, i.e. by a year every two years, commencing in 2016. In addition, politicians should be preparing people for 65 by 2030-35.

(d) Deferral: incentivise

Given that auto-protection is inextricably linked to today's premature private pension age, we should incentivise people to defer taking their default pension, not least because they go against the prevailing mood of flexibility at the private pension age. Most people close to retirement are not interested in addressing the issue of funding later life, in spite of pensions being much larger if taken later.

It is proposed that those who defer taking a default pension to at least five years after the private pension age should be rewarded with a pension exempt from Income Tax. In any event, for many people, 55 is too early to take an immediate annuity, and there can be significant pricing disadvantages in so doing, particularly in respect of lifetime guarantees.

> **Proposal 4:** Those who defer taking a default pension until at least five years after the private pension age could be rewarded with a pension exempt from Income Tax, paid for by a reduction in upfront tax relief.

It is acknowledged that industry capacity to offer deferred pensions (particularly lifetime pensions) is small, reflecting today's lack of demand for them. As a practical simplification measure, pots below a minimum size should be automatically excluded from auto-protection (perhaps only after consolidation possibilities had been exhausted).

(e) A role for Pension Wise guidance

If more than one form of tax-free pension were to be made available, today's somewhat nebulous guidance could play an important role. It could help savers select the most appropriate pension structure under auto-protection (including whether to defer taking the pension to gain tax-free status, and assessing eligibility for a health-related enhancement) or, indeed, whether to opt out altogether.

> **Proposal 5:** The guidance guarantee should form an integral part of the auto-protection process, to help savers select the most appropriate form of pension (including whether to defer for a tax-free pension, and determining eligibility for health-related enhancement) or, indeed, whether to opt out altogether.

(f) **Retirees on low incomes**

It is noted that tax-free pensions would only benefit those who pay Income Tax, i.e. with

[34] HM Treasury; *Freedom and choice in pensions: government response to the consultation*, July 2014.

incomes above the Personal Allowance (at least £10,500 for people aged 65 and over, well above the future full flat-rate State Pension[35] of £8,060).[36] However, many retirees on low incomes are unlikely to have substantial DC pension pots but, if they did, they could opt out of auto-protection and draw them down in a manner that replicated an annuity that kept their total incomes below the Personal Allowance, i.e. tax-free.

(g) Exercising the default

i. Provider choice would be essential

Savers purchasing pensions through the auto-protection process would not be tied to their existing providers. All providers, acting on behalf of customers, would be required to participate in the proposed annuity auction house process. They should be motivated by the prospect of additional volumes helping to increase the diversity (and size) of their longevity risk pools.

ii. Treasury participation

The Treasury may wish to participate in the provision of tax-free pensions by acting through agents such as the Post Office and National Savings. The resulting pensions could be accompanied by a consumer-friendly brand, for example, a Post Office Pension or a National Savings Pension. The account would bear the saver's name, i.e. the rights to it would be legally separated from the state.

Proposal 6: The state should be free to offer default private pensions, perhaps via the Post Office and National Savings (acting as agents for the Treasury).

7.3 Occupational DC and CDC pension schemes

The introduction of auto-protection should encourage DC occupational schemes (including NEST) to offer pensions tailored to the default mechanism. Members who stayed in after the age of 55 (rather than taking lump sums) could gain access to the economic benefits of being part of a collective purchase of pensions, perhaps within a Collective DC framework.

Indeed, CDC could become the decumulation vehicle of choice. Higher pensions are the likely outcome of pooled longevity risk and investment strategies that can span longer timeframes than the typical individual's retirement. The latter accommodates a larger allocation to equities which, over the smoothed long-term, produce less volatile, higher returns than bonds.

7.4 Other forms of auto-protection

For completeness, we should consider other forms that auto-protection could take.

(a) Additional State Pension?

The auto-protection default could be used to trigger the purchase of additional State Pension rights. This has the merit of simplicity, and it would be a very efficient way of hedging longevity risk, but some people may not trust the state to subsequently deliver on its promise.[37]

(b) State-provided deferred annuities

Annuity providers have long campaigned for the state (i.e. taxpayers) to write deferred annuities from the age of 80, say, thereby assuming the tail end of longevity risk. A Treasury decumulation subsidy could be focused here, freeing up the private sector to offer fixed term, less risky, annuities covering the period from retirement to

[35] £155 per week, assuming 35 years of National Insurance contributions, from April 2016.

[36] The significant recent rises in the Personal Allowance signals a clear (and sensible) intention to lift more people on low incomes out of Income Tax altogether.

[37] The State Pension is, of course, an unfunded, deferred lifetime annuity written by the Treasury, in return for NICs.

the age of 80. Theoretically, with the tail risk removed from the pool, the pricing would be more attractive to consumers (partly due to lower regulatory capital costs). In addition, fixed term annuities should be fairer, the scope for cross-subsidy (early deaths subsidising long lives) having been reduced.

(c) Self-annuitisation

The Treasury could subsidise self-annuitisation, perhaps by encouraging the purchase of retail corporate and government bonds. Coupons could be exempted from Income Tax, for example. This would cut out the cost of middle men (i.e. the industry) and the annuity providers' regulatory costs (Solvency II costs are estimated to reduce annuities by 15%), but investors would lose out on the consequences of pooling longevity risk (which may, or may not, be beneficial, depending upon how long they lived).

(d) Reintroduction of a Minimum Income Requirement (MIR)

Finally, the MIR could be reinstated, whereby a saver must have an assured annual retirement income of at least £12,000 before being eligible for flexible drawdown. Given that the MIR, and allied Minimum Income Guarantee (MIG), are set to disappear in April 2015, such a (political) U-turn is *most* unlikely.

7.5 The 25% tax-free lump sum

(a) Ineffective

The tax-free status on the first 25% of a pension pot would act as an incentive to opt out of auto-protection. Its continued existence is out of step with evidence from across the globe that the risk of running out of money in retirement is very real. Converting the whole DC pot to a pension, rather than 75% of it, would produce a pension 33% larger than otherwise. In addition, it is ludicrous to offer a tax exemption that ultimately incentivises premature departure from the labour market. Furthermore, the prospect of 25% of some distant, uncertain lump sum being tax free is unlikely to persuade Generation Y, in particular, to save within a pensions framework. As an incentive for long-term saving, it is wholly ineffective.

(b) Inequitable

The tax-free lump sum costs the Treasury at least £4 billion per year, a cost that is set to rocket with the anticipated huge increase in the total DC pension pot conversion market. In addition, as with tax relief on contributions, it is unreasonably regressive.[38] 2% of lump sums are worth £150,000 or more, yet they attract 32% of all lump sum tax relief.

(c) Politically challenging

Ideally, the 25% tax-free status on lump sums at the age of 55 should be scrapped: perfectly justifiable given that recipients of tax-free lump sums will have already received up-front tax relief on their contributions.[39] But to do so would be politically challenging, so a compromise is proposed: access to it should be delayed until the age of 60 or 65 (a nudge), perhaps as an interim measure before scrapping it at some later date (a shove). This would remove the immediate disincentive to taking the auto-protection default (but any savings to the Treasury would materialise only very slowly).

[38] Pensioners paid Income Tax of £12 billion in 2013-14. Without the 25% tax-free lump sum, this may have been £12 / 0.75% = £16 billion, i.e. £4 billion more. The 2014 Budget liberalisation is likely to encourage many people to take large lump sums sooner, increasing the cost of the 25% exemption, and therefore the potential saving to be made from scrapping it.

[39] This means that a quarter of contributions are, today, effectively subject to a very generous EEE (exempt, exempt, exempt) treatment for Income Tax purposes.

Proposal 7: Access to the 25% tax-free lump sum should be delayed until the age of 60 or 65. Alternatively, it should be scrapped, with accrued rights to it protected.

CONCLUSION

Auto-protection would ensure that savers reaching the age of 55 are not left to wallow in indecision when pondering the complexities of decumulation. To the extent that people went with the default of a pension, preferably deferred, the risk of running out of money before death would be reduced, as would the risks of exposure to pot conversion fraud and moral hazard.

Auto-protection could also be incorporated within Collective DC schemes to encourage the collective hedging of individuals' exposure to the unquantifiable risk of longevity, and the uncertain outlook for investment returns and the cost of living. Through harnessing economies of scale, and risk pooling over generations, larger pensions could result.

To be clear, everyone would be free to opt out of auto-protection to pursue alternatives, consistent with the liberalisations announced in the 2014 Budget. There is no desire to prevent people doing what they wish with their own savings.

THE AUTHOR

Michael Johnson is a Research Fellow of the Centre for Policy Studies and a highly regarded pensions analyst. He originally trained with JP Morgan in New York and, after 21 years in investment banking, joined Towers Watson, the actuarial consultants. More recently he was Secretary to the Conservative Party's Economic Competitiveness Policy Group.

He is the author of more than 10 influential pensions-related papers for the Centre for Policy Studies (all of which can be freely downloaded from www.cps.org.uk). He is occasionally consulted on pension reform by serving Ministers and shadow Ministers, the DWP Select Committee and the House of Lords Select Committee on Public Service and Demographic Change.

ISBN 978-1-910627-05-1

© Centre for Policy Studies, February 2015

57 TUFTON STREET, LONDON SW1P 3QL TEL:+44(0) 20 7222 4488 FAX:+44(0) 20 7222 4388 WWW.CPS.ORG.UK