Pensions Policy Institute

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What can the UK learn about other countries' approaches to accessing DC savings?

Registered Company Number: 04145584. Charity Number: 1087856 (England & Wales)

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An INDEPENDENT Reasearch Report by the

This research report is kindly sponsored by:

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Published by the Pensions Policy Institute

© November 2023

ISBN 978-1-914468-13-1

www.pensionspolicyinstitute.org.uk

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Executive Summary

The problem of how best to use Defined Contribution (DC) assets in retirement is challenging

Historically, most pension arrangements in developed economies – both State and workplace - provided defined benefits with a regular income payment to retirees for life, often indexed to inflation. While this rationale for State Pensions has remained the same, the global shift of workplace schemes to DC arrangements providing benefits as capitalised pension pots, places new and complex responsibilities on individuals to make decisions at retirement about how best to use their accumulated pension and other retirement assets.

The challenge is that there are no easy answers to these decisions in retirement: knowing how to strike a balance between having enough income to meet your current needs and having enough to get through your lifetime. This has been described by the Nobel Prize-winning economist, Bill Sharpe, as the "nastiest, hardest problem in finance".[1]

This study gathers and analyses evidence from the **US, Canada, Australia, New Zealand, the Netherlands, Denmark, Chile and Singapore**, and offers some suggested lessons for the UK when thinking about the challenge of enabling good outcomes for those who will need to access benefits from DC pension arrangements. These suggested lessons are listed below.

The UK system has an opportunity to learn from its world context

While the UK had the second largest stock of pension assets in the world in 2021, it is some way behind Australia, the US and Canada in its journey towards a fully formed DC system. These systems, and also that in the Netherlands, are further into the process of drawing down DC pensions assets than the UK, using benefits paid as a percentage of Gross Domestic Product (GDP) measure. While the UK pensions system is well regarded in global comparisons[2], it would be rated stronger with the restoration of the requirement to take an income stream and a higher minimum pension. Previous global reviews have recommended that defaults to hybrid or multiple retirement income solutions are needed for DC pensions to balance flexibility with protection.

Retiree behaviour, given choice, often displays reluctance to draw down pension assets

In relation to policy on DC, the UK may need to address the issue of people not drawing down significant DC pension assets in retirement at a rate required to meet adequacy levels. Drawing down assets requires retirees to overcome a 40-year default to save. International evidence suggests that encouraging people to withdraw sufficient income from pension savings is problematic and could require advice, delivered in a consistent manner in a simple system, to support individual decision making about how much to withdraw. Retirees need financial confidence in retirement to make decisions to draw down pension assets. This finding should be seen in the context of other areas of social policy in retirement in these countries, such as social care, healthcare and housing, as well as the generally higher levels of underpin provided by their State Pensions.

[1] Max, S (2019) How to solve the 'Nastiest, Hardest Problem' in Retirement accessed at https://www.barrons.com/articles/jimmy-buffett-death-margaritaville-net-worth-9d7b825c
[2] Mercer (2022), Mercer CFA Institute Global Pension Index, accessed at https://www.mercer.com/assets/global/en/shared-assets/global/attachments/pdf-2022-mercer-cfa-global-pension-index-report.pdf

Retirement Income freedoms place reliance on the State underpin and effective guidance for individuals

The 2015 introduction of DC pension flexibilities, which allowed people to freely access pension savings from age 55 (subject to an income tax charge at their highest rate), moved UK policy from a position where there was a requirement to convert the majority of DC pension assets into a guaranteed retirement income to one where retirees had many decisions as to how and when to use their DC assets. Free guidance was made available, through the Pension Wise scheme, to help guide people to make informed decisions which are best for their individual circumstances.

Good outcomes in this "guided choices" approach place a significant reliance on a strong State Pension underpin – a point emphasised by the minister at the launch of the UK reforms[3]. A guided choice approach highlights the pivotal role of guidance in the system if retirees are to understand, make and execute the choices that secure good financial outcomes through their retirement.

In the absence of prescribed minimum or maximum rates of decumulation or default decumulation solutions in the UK policy stance, initiatives such as Australia's Retirement Income Covenant and New Zealand's Rules of Thumb framework are particularly relevant. Successful interventions of this type may be necessary if we are to attain acceptable replacement rates for those requiring significant reliance DC pension assets to generate adequate retirement income.

Complexities arising from means testing and tax incentives or penalties can make decisions for individuals more complex and choices more challenging. In these circumstances, policies designed to constrain choice, such as the required minimum drawdown provisions in the US, Canada and Australia, may unintentionally become de-facto defaults.

Workplace DC pensions must be considered as part of the wider pensions system

Workplace DC pensions sit within a wider retirement income system of State and other private pension systems, and regulations on their access and use. Both the Australian and Dutch policy and regulation have recognised the need to segment retirees with regard to their financial situation and preferences.

Australia has focused DC policy on middle-income earners as the primary target group, as they will not be able to maintain their living standard in retirement by relying in the State Pension alone, whereas lower-income earners can maintain (if not improve) their retirement living standards through the State Pension alone. Higher-income earners are more likely to accumulate sufficient wealth to meet their needs through pensions and other voluntary savings.

The regulators in Australia and the Netherlands are now requiring providers to research their members and tailor their offers to those most appropriate for the differing segments within their membership, and, in the case of the Netherlands, also to alert retirees to choices that may not be optimal.

However, outcomes in other countries may not transfer to the UK system in the same way, as each has its own unique retirement income system. Using a framework to compare other systems with the UK aids the assessment of how lessons from other countries might best apply.

The UK system has very specific features that need to be borne in mind, particularly when considering the role of workplace DC pension assets in individuals' future retirement finances, such as the 25% tax-free lump sum, the relatively low replacement levels delivered by the UK State Pension, the current importance of accrued Defined Benefit (DB) entitlements for many of those currently at or near retirement, as well as the high but declining level of homeownership of retirees.

DC provides new opportunities to address retirement income challenges within the UK

The flexibility of DC within the UK provides new opportunities to address changing retirement patterns and risks. There are a variety of approaches to mitigate inflation and longevity risk. The approach chosen in other countries is typically a factor of the wider retirement income system and society's appetite to pool or bear risk individually. Group structures, such as employers and industry schemes, have a potentially important role to play in improving value and choice for retirees.

The Regulator has an important role to play in enabling consensus on guidance and appropriate and timely consumer protections

Consultation and regulation should stay ahead of the market to ensure that frameworks are established and a consensus is formed to enable consumers to be properly informed and empowered to make good choices, and be protected against new or unexpected risks. The UK has the opportunity to learn from the different approaches of Australian and New Zealand regulators to initiating or adopting strategies and gaining consensus around how to improve consumer support and guidance at retirement, and from Denmark and the Netherlands in regulating the journey to variable income lifetime annuities.

Specific countries have other lessons from their own experience

The United States shows that policies that force decumulation, such as through tax penalties, are often unpopular, as retirees resent the loss of control over when money is taken. It also shows that markets may not support a significant retirement income solutions market through inherent demand. Even in the largest DC market, there is a demand failure for specific income generation products.

New Zealand and Australia reminds us of the potential importance of housing assets in retirement. Both have State Pension income levels built on the expectation of high levels of retirement home ownership. As an increasing number of retirees will no longer own their own home, this increases the costs and risks of housing tenure to those retirees who rent, and increases the level of an individual's retirement income needs. Both countries also show little market support for equity release products as a source of retirement funding.

Singapore evidences how retirement income can be eroded if funds saved for retirement are also made available for other purposes. Potential retirement savings are often used to purchase housing leases, and rising medical and care costs in retirement can significantly erode or even use up retirement incomes.

[3] Pension pots 'can be used to buy Lamborghinis', says minister The Guardian, 20 March 2014

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Introduction

Decumulation - the management and drawing down of retirement resources – is receiving increasing attention in many countries for three key reasons:

1. Individuals are living longer post-retirement, which increases the complexity of the decisions they need to make to manage retirement resources effectively over a longer time period and the danger that people will deplete savings too early;
2. The shift to Defined Contribution (DC) funds requires retirees to make active decisions about what to do with accumulated DC funds instead of passively receiving pension income from Defined Benefit (DB) arrangements that used to dominate post-retirement; and
3. As a result of ageing populations in many countries, there are proportionally more older individuals and they collectively hold a larger amount of the economies' wealth in retirement savings, investments and other assets, including housing wealth.

Private pension arrangements in which retirement income depends on contributions paid, investment returns, member charges and the way savings are accessed during retirement, such as in DC plans, are increasingly an integral part of most countries' overall pension system. In some countries, they are now the main component of their pension system. The focus on the drawing down of pension assets is expected to increase as larger proportions of people in many countries move into retirement, and concerns increase with regard to poverty and inequality at older ages.

The variable work and life paths people are taking creates uncertainty; there is no longer a clear cut-off between work and retirement. The UK Government's decision to allow people flexibility about how and when to take their pension savings from the age of 55 compounds this uncertainty.

This study explores:

- How have other countries dealt with the management and drawing down of retirement resources?

and

- What can the UK learn?

It gathers and analyses evidence from a research group of eight countries: the US, Canada, Australia, New Zealand, the Netherlands, Denmark, Chile and Singapore.

This research group of countries, together with the UK, covers five of the seven countries with over one trillion US dollars of pensions assets. They are at various stages on the transition to DC pension systems. The group also includes other countries with strong pension systems and significant DC assets, and with different approaches to the management and drawing down of retirement resources.

Chapter One – reviews the UK pension system in its world context

Chapter Two – summarises the findings and analysis from across the countries studied

Chapter Three – looks at the US and Canada

Chapter Four – looks at Australia and New Zealand

Chapter Five – covers the remaining countries studied – the Netherlands, Denmark, Chile and Singapore

CHAPTER ONE:

UK AND DEFINED CONTRIBUTION (DC) PENSIONS IN A WORLD CONTEXT

Summary:

- World pension assets are highly concentrated in just seven countries
- The UK stock of pensions assets was the second largest in the world in 2021, but only 19% of pension fund assets are in DC
- Participation in pensions in the UK is 57%, in line with other large systems with voluntary participation
- The US and Australian pensions systems are paying out the most in benefits
- The UK pensions system is rated as sound by the Mercer CFA Global Pensions Index study[4] but would be given a higher rating with the restoration of the requirement to take an income stream and a higher level of minimum pension
- Previous global reviews have suggested defaults to hybrid or multiple DC retirement product solutions may be necessary to provide flexibility with protectionGovernance and regulatory challenges, including complexity and challenges to transparency, obligations to report on costs and charges, permitted links regulations (which can be interpreted as not allowing investment in assets which do not allow immediate access to funds), and the availability of appropriate assets.

In 2021, there were over US$60tn in pension assets held worldwide

Pension assets in funded and private pensions plans amounted to US$ 60.6[5] trillion at the end of 2021, an increase of 7% on the previous year. In absolute terms, these assets are highly concentrated, with over 90% of assets held in just seven countries:

- North America (the United States and Canada),
- Western Europe (the United Kingdom, The Netherlands and Switzerland),
- Australia, and
- Japan.

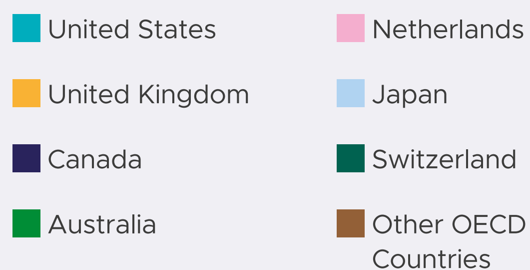
Over US$1 trillion is held in each of these countries (Figure 1.1).[6]

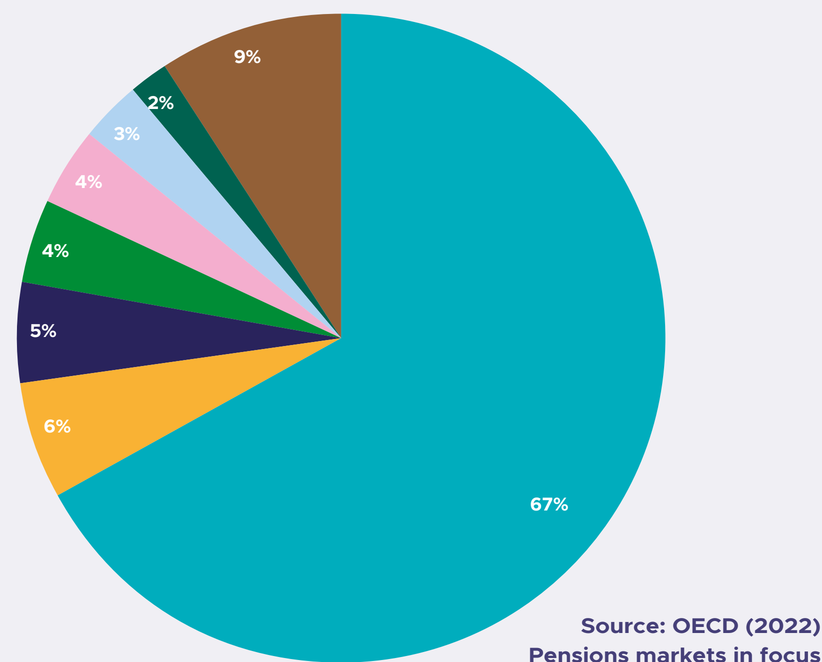
The US held over two thirds of the total assets with the UK the second largest asset holder with 6% of the total[7]

Figure 1.1

Over two thirds of pension assets are in the United States

Geographical distribution of pension assets in the OECD area (2021) as a percentage of total pension assets





Source: OECD (2022) Pensions markets in focus

Just under two thirds of Organisation for Economic Co-operation and Development (OECD) pension assets (64%) or US$38.5tn are held in pension funds, the rest being held in other pension arrangements, such as provisions in employers' books (Germany and Sweden), pension insurance contracts sold by insurance companies (Denmark and France) or products offered and managed by banks and investment companies (such as IRAs[8] in the United States).

DC assets are now half of overall pension fund assets in the largest pension markets worldwide, but just 19% of UK funds

Over the last 20 years, DC fund assets have grown from just over one third (38%) to just over a half (54%) of total assets under management (AUM) for these countries.

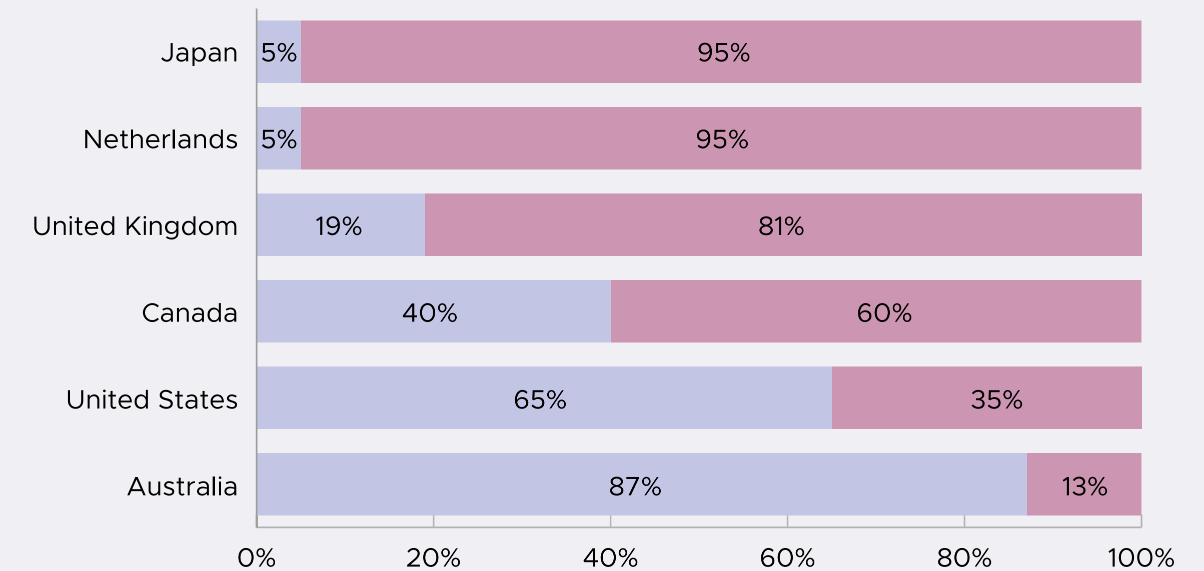
DC assets dominate AUM in Australia at 87% and are the majority in the United States at 65% in 2020. Canada, historically only Defined Benefit (DB), is now showing an increasing allocation towards DC at 40% of assets.

The UK still has only a minority (19%) of assets in DC, with the Netherlands[9] and Japan having just 5% each (Figure 1.2).[10]

Figure 1.2: The split of DB and DC pension assets for the seven countries with pension assets in excess of US$1tn

Most of the pension assets in Australia and the United States are DC

The split of Defined Benefits and Defined Contribution pension assets in OECD countries (2020)



These DC/DB splits are reflected in fund asset allocations by country: the US and Australia have higher fund allocations to equities and Japan, Netherlands and the UK higher allocations to bonds.[11]

[4] Mercer (2022), Mercer CFA Institute Global Pension Index, accessed at https://www.mercer.com/assets/global/en/shared-assets/global/attachments/pdf-2022-mercer-cfa-global-pension-index-report.pdf
[5] This figure is US$58.9tn for OECD countries, 97% of the total.
[6] OECD (2022) Pensions Markets in Focus accessed at https://www.oecd.org/daf/fin/private-pensions/Pension-Markets-in-Focus-2022-FINAL.pdf
[7] Given the significant diminution of DB assets following the LDI crisis of Sept/Oct 2022, according to the TAI Global Pension Assets Study 2023, the UK has fallen to third place in the funded pension assets league table after the US and Japan.
[8] An IRA is an individual retirement account, a retail pensions vehicle mainly used to invest accrued funds from workplace DC after that employment is left
[9] It is worth noting that in the Netherlands will convert its CDC funds to various forms of DC over the next 5 years and so this figure will rise significantly.
[10] The majority of pension fund assets in Switzerland are DC and take the form of cash balance plans, whereby the plan sponsor shares the investment risk and the assets are pooled. Pure DC assets have only recently been introduced in Switzerland.
[11] Thinking Ahead Institute (2022) Global Pensions Assets Study accessed at https://www.thinkingaheadinstitute.org/content/uploads/2022/02/GPAS_2022.pdf

Funded pension schemes now hold assets exceeding Gross Domestic Product (GDP) in nine OECD countries

Denmark (233%) and the Netherlands (213%) hold the largest total of pensions assets relative to GDP in 2021. In total, nine OECD countries hold pensions assets equivalent to or greater than their GDP.

In the research group of eight countries in this study, Australia (147%), the UK (121%) and US (100%) are also at or above this benchmark, with Canada (91%) and Singapore (94%) just below.[12]

In excess of 75% pension participation is achieved with compulsion, but just over 50% with voluntary enrolment

Participation in pensions of the working-age population shows the impact of enrolment policies. Those in our research group where there is mandatory or quasi-mandatory enrolment show participation ranging from 100% in Denmark, 93% in the Netherlands, 84% in Chile, and 79% in Australia. Those with voluntary participation have participation in the range of 57% (US) to 53% (Canada).

This study also looked at two countries with automatic enrolment into voluntary schemes: New Zealand achieves participation of 81% in Kiwisaver, similar to that under mandatory or quasi-mandatory enrolment; whereas the UK has participation at 57%, in the same range of other voluntary enrolment systems.[13] This reflects the differences in automatic enrolment policy: In New Zealand all employees in the age range 18-65 are enrolled; in the UK, only employees in the age range 22-66 (rising with State Pension age (SPa)) and earning over £10,000 from one job are enrolled. The UK participation rate should increase significantly when the bill to lower the age threshold to 18 is enacted.[14]

The US and Australia show the largest outflow of benefit payments in the research group

Payments from pension providers to retirees or entities in charge of the pay-out phase (measured as a proportion of GDP) were largest in the US (7.0%) and Australia (6.2%) in our research group. Both have mature pension systems with large assets accumulated. The Netherlands had the next highest outflows at 4.2%. Outflows for Canada (3.2%), the UK (2.9%) and Chile (2.4%) were less than half those for the US by this measure, whilst those for Denmark were just 0.7% (Figure 1.3).

Figure 1.3 Funded pensions statistics for research group countries

	Assets (% of GDP)	Participation (% of working-age population)	Benefits paid (% of GDP)
Denmark	233%	100%	0.7%
Netherlands	213%	93%	4.2%
Australia	147%	78.5%	6.2%
UK	121%	57.0%	2.9%
US	100%	57.4%	7.0%
Singapore	94%	N/A	N/A
Canada	91%	52.2%	3.2%
Chile	60%	84.3%	2.4%
New Zealand	37%	80.8%	N/A

Source: OECD (2022) Pensions markets in focus

The US retirement income system is assessed as having major risks and/or shortcomings

The Mercer CFA Global Pensions Index[15] provides a comparison of the retirement income systems of forty four countries, calculating an overall index value across three sub-indices assessing adequacy, sustainability and integrity of the systems.

All of the researched countries' retirement income systems fall within the top grades (A, B+ and B) as assessed by the Index in 2022, with the exception of the US.

The Netherlands and Demark are two of the three countries in the Grade A category, ranked second and third with a scores of 84.6 and 82 respectively. Australia is graded B+ and ranked sixth with a score of 76.8.

The US is graded C+, ranked twentieth, with a score of 63.9. This is around the average score of 63 for the forty four countries assessed in the Index. The C+ grade is described as having major risks and/or shortcomings that should be addressed. Particular areas of concern raised in the US system are:

- the low level of the minimum pension income,
- the 'vesting' process for accessing benefits by scheme members,
- levels of leakage from the system pre-retirement, and
- the lack of requirement to take an income stream at retirement.

[12] OECD (2022) Pensions Markets in Focus accessed at https://www.oecd.org/daf/fin/private-pensions/Pension-Markets-in-Focus-2022-FINAL.pdf
[13] This is despite the relatively low levels of opt out currently at around 10% (see https://www.gov.uk/government/statistics/ten-years-of-automatic-enrolment-in-workplace-pensions/ten-years-of-automatic-enrolment-in-workplace-pensions-statistics-and-analysis)
[14] The DWP Automatic Enrolment review in 2017 estimated this change would bring a further 910,00 young people into automatic enrolment. See https://assets.publishing.service.gov.uk/media/5a81e087e5274a2e8ab564db/print-ready-automatic-enrolment-review-2017-maintaining-the-momentum.pdf
[15] Mercer (2022), Mercer CFA Institute Global Pension Index, accessed at https://www.mercer.com/assets/global/en/shared-assets/global/attachments/pdf-2022-mercer-cfa-global-pension-index-report.pdf

The UK system is rated as sound but could be improved

The UK is graded B – sound with many good features - and ranked tenth with a score of 73.7. Included in potential improvement areas are the restoration of the requirement to take an income stream and raising the minimum pension for low-income pensioners.

A summary of the 2022 rating results in set out below (Figure 1.4).[16]

Figure 1.4 Summary of 2022 Global Pension Index results

Grade	Index Value	Systems	Description
A	>80	Iceland Netherlands Denmark	A first-class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity
B+	75-80	Israel Finland Australia Norway	A system that has a sound structure, with many good features, but has some areas for improvement that differentiate it from an A-grade system
B	65-75	Sweden Singapore UK Switzerland Uruguay Canada Ireland New Zealand Chile Belgium Germany	
C+	60-65	Hong Kong SAR US Columbia France Malaysia Portugal Spain UAE	A system that has some good features, but also has major risks and/or shortcomings that should be addressed; without these improvements, its efficacy and/or long-term sustainability can be questioned
C	50-60	Saudi Arabia Poland Mexico Brazil Peru Italy Austria South Africa China Japan Taiwan Korea (South)	
D	35-50	Indonesia Turkey India Argentina Philippines Thailand	A system that has some desirable features, but also had major weaknesses and/or omissions that need to be addressed; without these improvements, its efficacy and sustainability are in doubt
E	<35	Nil	A poor system that may be in the early stages of development or non-existent

Source: Mercer (2022) Mercer CFA Institute Global Pension Index 2022

DC decumulation is "the nastiest, hardest problem in finance"

Historically, most pension arrangements in developed economies – both State and workplace - provided a regular income payment to retirees for life, often indexed to inflation. While State Pensions have remained the same, the global shift of workplace schemes to DC places new and complex responsibilities on individuals to make decisions at retirement about how best to use their pension assets.

The challenge is that there are no easy answers to these decisions in retirement, essentially knowing how to strike a balance between having enough income to meet your current needs and having enough to get through your lifetime. This has been described by the Nobel Prize-winning economist, Bill Sharpe, as the "nastiest, hardest problem in finance".[17]

Defaults to hybrid or multiple retirement income solutions may be necessary to provide flexibility with protection

The OECD has suggested that DC pension plans should provide some level of lifetime income as a default for the payout phase, unless other pension arrangements already provide for sufficient lifetime pension payouts. They also recommend that full lump sums should be discouraged in general, except for low account balances or extreme circumstances.[18]

Three national actuarial bodies in the US, UK and Australia have jointly concluded that there would be value in developing appropriate defaults that allow individuals to access their pensions through an income stream that offers flexibility in their early years of retirement. However, in the latter years, they could provide, at a minimum, a structured lifetime payment with a potential for a lifetime income guarantee to protect against their longevity risk.[19]

Workplace DC pensions sit within a wider retirement income system

In looking at DC in the retirement systems across the countries studied, a series of elements need to be analysed in order to understand the framework in which retirement income policy and outcomes are framed:

1. What is the nature of **workplace pension savings?** Is it mandated, defaulted or by active choice? Is this the same or different for the employee and the employer?
2. What is the nature and adequacy of the **State Pension underpin?** Is coverage universal? Is it flat rate or earnings related? Are benefits means tested? Is the level of benefit adequate?
3. What is **the role of workplace (and other) DC?** Is it fundamental to retirement adequacy or is it supplementary? Is this different for those on low, middle and high incomes? What is its significance in relation to other pensions assets, other savings, housing wealth? What requirements are placed, if any, around accessing DC assets and/or generating a retirement income from them?
4. What role does **pooling of risk play** in DC retirement incomes? Is there risk pooling for investment, longevity or inflation risk? What guarantees, if any, are in place and how are they paid for?
5. To what degree are **employers, industry schemes or other social partnerships** involved in the procurement, administration and governance of DC pensions on behalf of members? What influence does this have on choices available, value for money, guidance and advice for retirement benefits solutions?

Figure 1.5 sets out key data for each element for the research countries.

[16] Mercer (2022), Mercer CFA Institute Global Pension Index, accessed at https://www.mercer.com/assets/global/en/shared-assets/global/attachments/pdf-2022-mercer-cfa-global-pension-index-report.pdf
[17] Max, S (2019) How to solve the 'Nastiest, Hardest Problem' in Retirement accessed at https://www.barrons.com/articles/jimmy-buffett-death-margari-taville-net-worth-9d7b825c
[18] OECD (2022) Recommendations of the council for the good design of defined contribution pension plans accessed at https://www.oecd.org/daf/fin/private-pensions/designingfundedpensionplans.htm
[19] American Academy of Actuaries, Institute and Faculty of Actuaries and Actuaries Institute of Australia (2015) The challenge of longevity risk: Making retirement last a lifetime accessed at https://www.actuaries.asn.au/Library/Opinion/2015/InternationalLongevityRiskPaper.pdf

Figure 1.5 Elements of retirement income systems in the research countries

	Enrolment into workplace saving	Adequacy of mandatory public pension schemes (gross replacement rate)	Workplace and private pensions (additional gross replacement rate)	Role of risk pooling for DC	Involvement of employers/other social partners in DC
US	**Voluntary**	39%	42%	None	Most employees have access to employer-provided retirement plans
Canada	**Voluntary**	39%	24%	None	Some employers provide pension schemes and access to retirement income products
Australia	**Mandatory**	0% (Means-tested Age Pension underpin)	31%	None	Employers select default providers for employees. Industry schemes are key providers.
New Zealand	**Automatic enrolment**	40%	21%	None	Government appoints and regulates KiwiSaver providers and default providers
Netherlands	**Mandatory**	29%	41%	Collective schemes share investment and longevity risk	Social partners and employers facilitate all workplace savings and retirement income solutions.
Denmark	**Mandatory**	30%	50%	Longevity risk typically shared	Employers facilitate all workplace savings and retirement income solutions.
Chile	**Mandatory**	0% (Universal guaranteed pension since introduced in 2022)	31%	Compulsory annuitisation	Government regulates private providers
Singapore	**Mandatory**	N/A	N/A	Government-guaranteed investment and annuity rates	Government administers universal scheme (CFP)
UK	**Automatic enrolment**	22%	27%	None	All employers required to provide access to a pension scheme. Over 40% of active DC members are in master trusts.[20]

Source: OECD (2021) Pensions at a glance and analysis in this study

All of these elements should be considered when assessing initiatives and outcomes in other systems, and potential lessons for the UK for drawing DC assets in retirement. In particular, it is important to define and compare the role that workplace DC plays for different segments of the market in this context.

For example, Australia has focused DC policy on middle-income earners as the primary target group as they will not be able to maintain their living standard in retirement by relying on the State Pension alone, whereas lower-income earners can maintain (if not improve) their retirement living standards through the State Pension alone. Higher-income earners are more likely to accumulate sufficient wealth to meet their needs through pensions and other voluntary savings.

It is also important to look at the UK system through this framework, bearing in mind the UK's system's very specific features, such as:

- That automatic enrolment in the UK, while bringing over 10 million new savers into workplace pensions, still has working-age participation levels at 57%[21]
- The full new State Pension (nSP) just covered the Joseph Rowntree Foundation (JRF) Minimum Income Standard (MIS) for households outside London in 2021[22]
- The low relative level of gross replacement rate provided by the UK State Pension
- The 8% minimum contribution rate under automatic enrolment, together with a reformed State Pension was targeted by the UK Pensions Commission to provide the median earner retiring in 2053 with 45-48% of their earnings as a retirement income[23]
- The UK is distinctive in allowing retirees to take up to 25% of their pot as a tax-free lump sum[24]
- Only around 9% of DC plans accessed are used to buy an annuity[25]
- The continuing importance of accrued DB entitlements for many of those at or near retirement
- The high, though declining, level of home ownership of those retiring
- The absence of a requirement to take any retirement income from DC assets, lifetime or otherwise, and
- The growing importance of large master trusts in the UK DC market.

Lessons for the UK

- **While the UK had the second largest stock of pension assets in the world in 2021, it is some way behind Australia, the US and Canada in its journey towards a DC system**
- **These systems, and also that the Netherlands, are further into the process of drawing down pensions assets than the UK, using benefits paid as a percentage of GDP measure**
- **Whilst the UK pensions system is well regarded in global comparisons, it would be rated stronger with the restoration of the requirement to take an income stream and a higher level of minimum pension**
- **Previous global reviews have recommended that defaults to hybrid or multiple retirement income solutions are needed for DC pensions to balance flexibility with protection**
- **The need to focus DC policy on those at most risk of not be being able to maintain their living standard in retirement by relying on the State Pension alone**
- **The UK has very specific features, set out above, that need to be borne in mind, particularly when considering the role of workplace DC pension assets in individuals' future retirement finances**

[20] The Pensions Regulator (2022) DC Trust Return Data 2021 to 2020 accessed at https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2021-2022
[21] OECD (2022) Pensions Markets in Focus accessed at https://www.oecd.org/daf/fin/private-pensions/Pension-Markets-in-Focus-2022-FINAL.pdf
[22] Hurman, N et al (2021): What is an adequate retirement income? Pensions Policy Institute
[23] Hurman, N et al (2021): What is an adequate retirement income? Pensions Policy Institute
[24] Now capped at £268,275
[25] FCA (2022): Retirement income market data 2020-21 accessed at https://www.fca.org.uk/data/retirement-income-market-data-2021-22

CHAPTER TWO:

FINDINGS AND ANALYSIS

This chapter draws together an analysis of the key themes from the Defined Contribution (DC) systems studied and the choices available to retirees to use their pension assets to fund their retirement.

Summary:

- Many retirees, given choice, are reluctant to draw their pension assets
- Approaches to retirement income policy display a continuum of approaches from guided choices to full compulsion
- DC needs to be seen as part of the wider retirement income system
- Flexibility and risk mitigation need to be balanced to address DC retirement income challenges

2.1 Retiree behaviour

Many retirees, given choice, are reluctant to draw their pension assets

The introduction of pension flexibilities in 2015, removed the requirement in the UK for most DC pensions to be converted into a lifetime income using an annuity. At that time, the immediate concern was that retirees would use the new flexibilities to access and spend down their assets too quickly, potentially rashly.

The pensions minister, Steve Webb, explained at the time that the UK Government "can be more relaxed about how people use their own money [as] the [new] State Pension takes people above … means tests. So actually, if people do get a Lamborghini, and end up on the State Pension, the State is much less concerned about that, and that is their choice."[26] Whilst the quip was somewhat flippant, it caught neatly the terms of the public policy debate around drawing down of assets that followed in the UK.

The US, Australia and New Zealand all have systems that do not require retirees to convert their DC assets into a lifetime income. The evidence from these countries is that rather than drawing down their assets in retirement and relying on a State Pension underpin, more retirees are reluctant to draw down the majority of their capital.

In the US, on average and across all wealth levels, most current retirees still had 80% of their pre-retirement savings after almost two decades of retirement. Although his figure is likely to be weighted to those with the most wealth, even for those in the lowest wealth group, more than half had 50% or more of their assets remaining after 17-to-18 years of retirement.

In Australia, maintenance or growth of assets occurs despite policy settings designed to stimulate drawing of assets. As a result, most leave the majority of the wealth they had at retirement as a bequest. Retirees tend to consume only the income from their assets and not the assets themselves.

In New Zealand, there is a tendency for retirees to treat KiwiSaver pots as a nest egg, leaving them with their provider or withdrawn and put into a savings vehicle, as they are not confident to use their accumulated assets to fund their retirement.

These findings should be seen in the context of other areas of social policy in retirement in these countries, such as social care, health care and housing in these countries, as well as the generally higher levels of underpin provided by their State Pensions.

In the UK, 40% of overall regular withdrawals were at an annual rate of over 8% of pot value in 2022/21 (43% in 2020/21). This would suggest that the UK DC retirees are not demonstrating the same behaviour as in the US, Australia and New Zealand. However, as previously noted, only 19% of UK funded pensions are DC and 61% of pots accessed for regular withdrawals were below £100,000 in value. So, DC is not a dominant contributor to retirement incomes in the UK as yet.

Interestingly, 57% of withdrawals from the largest pots (in excess of £250,0000) were at an annual rate below 4%.[27] This may just be because those with the largest DC pots also have significant Defined Benefit (DB) benefits or other assets to draw down in retirement. However, it may also suggest that some UK retirees may also display a similar reluctance to draw down large DC assets.

Retirement assets are held as security and a contingency against financial risks in retirement

An account-based DC pension contains what is, for that individual, a sum of money which they have spent many years saving. Research in Australia finds that drawing down on a non-replenishing resource is a psychological challenge, particularly in the context of superannuation, which is primarily discussed in a savings rather than a consumption frame. Retaining a lump sum, rather than converting it into an income stream, may give people a sense of continuing financial security. It also allows ongoing choice, which is valued for its own sake.

Research with US retirees finds they hold onto assets because:

- fear of ill health and associated costs in later life/retirement compels retirees to conserve assets
- the majority of retirees favour financial security over maximising spending, and
- relatively few retirees even feel the desire to draw down their assets.

As a result, retirees take comfort in maintaining their assets. Few retirees set explicit asset level goals, but, of those that do, more seek to accumulate than draw down. It appears that the accumulation mindset is deep rooted.

Real spending tends to decline in retirement

In the US, when adjusted for inflation, spending from age 65 to advanced old age declines for single and couple households at annual rates of about 1.7% and 2.4% respectively.[28] Spending declined for all initial wealth quartiles, with some small variations, suggesting that the decline is not related to economic position.

In Australia, successive waves of the Household Expenditure Survey show that for a given cohort, real spending falls once households are aged over 70.

Drawing down pension assets means retirees need help to reverse a 40-year savings default

In New Zealand, the substantial replacement rate provided by the State superannuation scheme means that people can have choice and flexibility when it comes to accessing their KiwiSaver funds in retirement. In practice, they show reluctance to access their funds, preferring to retain and increase their balances in retirement.

A strong theme that has emerged from this research is the need for guidance on how to best draw savings in retirement, and using approaches such as "rules of thumb" to help people make decisions to draw down funds.

The New Zealand Retirement Commission has concluded that "guidance and advice delivered in a consistent manner in a simple system creates an environment that supports individual decision making."[29]

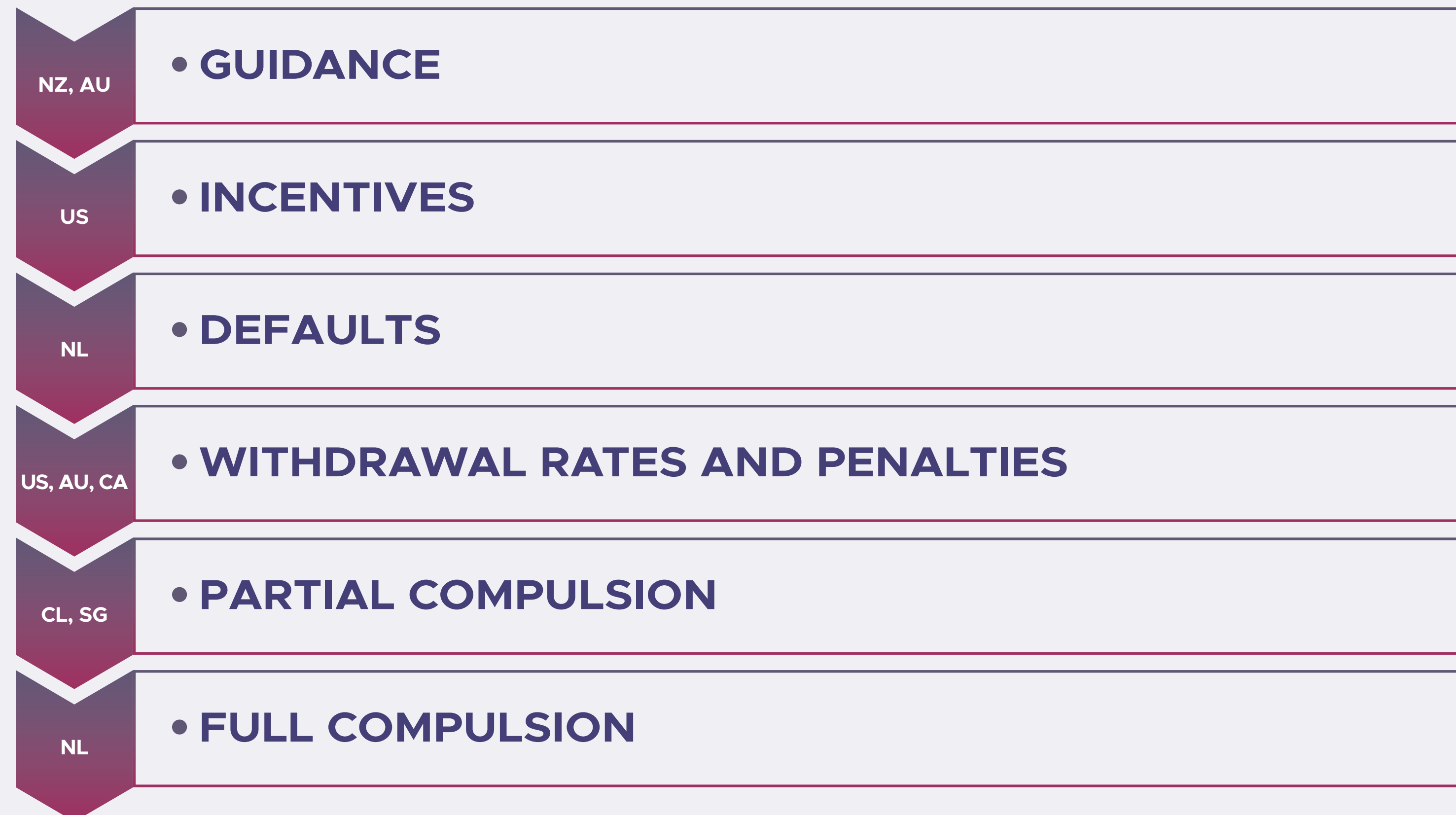
[26] Pension pots 'can be used to buy Lamborghinis', says minister The Guardian, 20 March 2014
[27] FCA (2023) Retirement Income Data 2021/22 accessed at https://www.fca.org.uk/data/retirement-income-market-data-2021-22
[28] Hurd, M and Rohwedder, S (2022) Spending Trajectories After Age 65 Rand Corporation accessed at https://www.rand.org/content/dam/rand/pubs/research_reports/RRA2300/RRA2355-1/RAND_RRA2355-1.pdf
[29] New Zealand retirement Commission (2022) Cracking open the nest egg – how to spend your savings in retirement accessed at https://retirement.govt.nz/news/latest-news/cracking-open-the-nest-egg-how-to-spend-your-savings-in-retirement/#:~:text=Te%20Ara%20Ahunga%20Ora%20Retirement%20Commission%20has%20released,series%20of%20recommendations%20to%20better%20support%20the%20process

2.2 DC retirement income policy approaches

Approaches to retirement income policy display a continuum from guided choices to full compulsion

This study shows that there are a range of policy responses deployed in the countries researched designed to guide or edit the choices available to retirees when they come to draw their pension assets in retirement. These could be seen as on a continuum although different approaches can also be combined within one system (Figure 2.1).

Figure 2.1 Continuum of retirement income policy approaches



Guidance can be via industry (Australia) or direct to consumer (New Zealand)

In Australia, the Retirement Income Covenant requires superannuation funds to develop a strategy for members who are retired or approaching retirement to help them optimise their retirement income. Funds have the discretion to determine the type of support that they provide to their members across a wide spectrum of information, education, assistance, guidance, advice and implementation. This could result in tailored retirement products, financial tools and education and personalised retirement planning and advice.

In New Zealand, the Retirement Commission is focusing on promotion of a framework and set of 'Rules of Thumb' with on-line drawdown calculators to support individual decision making and reduce the possibility for financial decision-making errors. They are also recommending that all KiwiSaver providers contact their members at milestones approaching retirement to provide them with access to this information and guidance regarding their options.

Tax incentives have been used in the US to encourage the purchase of longevity insurances

In the US, favourable tax treatment of the Qualified Longevity Annuity Contract (QLAC) was created in 2014. A QLAC is a deferred fixed annuity that can be purchased via a DC pension withdrawal with payments deferred until as late as 85, thereby guaranteeing a continuing income in later retirement. The cost of purchase is tax free and will also reduce the level of minimum withdrawal required from remaining pension assets with associated potential reduction in income taxes. Deferred fixed annuity sales totalled $112 bn in 2022, over half of the 2022 total US fixed-rate annuity sales of $208 billion.[30]

The Dutch DC system currently operates an annuity default

Since 2016, those in the Netherlands with a conventional DC pension have had a choice of a conventional annuity or variable defined contribution (VDC) lifetime income. The conventional annuity is the default and by far the most prevalent mechanism currently selected.

A number of countries have required drawdown rates

In the US, the IRS has set tax rules to ensure that assets in pension funds are drawn down during later life. As from age 73, retirees are required to take a Required Minimum Distribution (RMD) from their pots each year designed to extinguish the assets in their remaining expected life span. This is often not a popular policy with retirees as

- they don't want to be forced to take money out of their funds when they don't need it,
- they resent the loss of control over when money is taken, and
- as RMDs are treated as taxable income, it can move them into a higher tax bracket.

In Canada, if retirees do not take a cash withdrawal or purchase an annuity their pension fund will be moved into a retirement income fund (RIF). Funds are required to be drawn down from age 71 at or above a minimum rate. For funds accumulated via a workplace scheme, there are also limits on the maximum rate that funds can be withdrawn.

In Australia, minimum drawdown rates apply as soon as benefits are taken. These start a 4% up to age 64 and rise to 14% for those aged 95 or over.

While designed primarily to recover taxes deferred during the savings phase, required rates also become strong, de-facto defaults.

Chile and Singapore both operate thresholds below which action is compulsory

In Chile, the saver has the option to choose different pension products, only when sufficient funds have been accumulated, to purchase an annuity that would generate an income equal or above a defined threshold. If this threshold is not passed, then the fund will be placed by default into a programmed withdrawal. Fewer than 40% of savers are typically able to pass this threshold.

In Singapore, those with a retirement fund less the Basic Retirement Sum (BRS) threshold are required to take a level annuity accessed via the Central Providence Fund (CPF) scheme. Those with more can choose to have a higher level of annuity via the CPF or to withdraw cash in excess of the BRS as and when required.

Both of these mechanisms are designed to generate a required minimum income in systems which have limited or no State Pension support.

[30] LIMRA (2023) 2022 US Retail Annuity Sales Shatter Annual Sales Records set in 2008 accessed at https://www.limra.com/en/newsroom/news-releases/2023/limra-2022-u.s.-retail-annuity-sales-shatter-annual-sales-records-set-in-2008/

In the Netherlands a lifetime income is required

The Netherlands does not have the concept of pension freedoms implemented in the UK in 2015. The Government requires that all pension funds, bar a 10% optional taxed lump sum, are used to provide only a lifetime income.

The policy choices adopted reflect the balance struck between individual freedoms and societal expectations for pension savings

In most countries pension savings enjoy a tax-favoured status as an incentive to save. In return individuals, who are able to, are expected to finance their continuing retirement income needs from their accumulated pension assets.

This is perhaps most marked in the Netherlands where pensions must be converted into a lifetime income. This reflects the strength of Dutch society in providing a high level of social security and support and in the social partnerships which facilitate and govern workplace pensions.

In Singapore, pensions savings are part of a wider workplace funded social security system in the absence of a universal State benefits system. The purpose here is to ensure tax-incentivised savings provide a basic level of pension, beyond which choice is available. This reflects a very different society which is based on the family unit. The culture supports individual saving rather than tax-funded social services as it values low taxes to maximise rewards for enterprise.

New Zealand has a rather different balance with a strong State Pension system and no tax incentives for workplace or private pensions. This reflects a society that values simplicity and transparency in its social and tax systems and also an economy that is much smaller in scale. As a result, financial planning focuses on the fundamental issues on the best use of funds - both KiwiSaver and non-retirement designated assets - to navigate financial risks in retirement, unencumbered by complex tax planning or means-testing considerations.

The US, Canada and Australia all adopt approaches that allow for choice but bound this with requirements and penalties through the tax system to drive drawing down in later years. There are also further complexities around State entitlements through forms of means testing and, in the case of the US and Canada, earnings-related entitlements.

These make for complex decisions and trade-offs about how and when to draw pensions assets. In all of these systems, bounding requirements – such as minimum required rates of drawdown – have tended to become defaults.

Lessons for the UK

- **The change of DC retirement incomes policy in 2015 moved the UK towards the guided choices end of the policy spectrum**
- **Good outcomes in this approach place a significant reliance on a strong State Pension underpin – a point emphasised at the launch of the UK's pension flexibility reforms**
- **It also underlines the key role of guidance in the system and so focuses attention on initiatives such as Australia's Retirement Income Covenant and New Zealand's Rules of Thumb framework, and their definitions of what good looks like**
- **Complexity of means testing and tax incentives or penalties makes decisions for individuals more complex and choices more challenging. In these circumstances, policies designed to constrain choice may become de-facto defaults.**

2.3 Making the most of DC to address retirement income challenges

Flexibility is a key benefit of DC

Flexibility is inherent in DC as it creates a retirement pot as a significant asset for the individual, possibly for the first time. This gives choices about how, as well as when, it is used. It presents a wide range of options that gives the retiree strategies that DB typically does not.

This flexibility presents different opportunities to use DC to address changing retirement patterns and risks. Examples from the research include:

- bridging the gap between full employment and receipt of the State Pension (Chile, Singapore and the Netherlands),
- to purchase insurance to ensure a continuing income in late retirement (US),
- to provide buffers against later-life medical costs (Singapore) and more generally,
- to hold a specific reserve against abnormal one-off expenses in retirement (New Zealand) and
- vary the profile of your income in retirement (US, Australia, Canada, New Zealand, Netherlands)

Approaches to inherent DC risks around inflation and longevity vary

The study also shows a variety of responses to managing the risks inherent in DC that are held by the individual member.

The Dutch approach is to compel members to pool their longevity risk but to give choice over how to address inflation risk. DC members are required to purchase lifetime income but have added the option of a variable lifetime annuity to the current default conventional annuity.

Chile requires an indexed annuity to be purchased with all funds up to a minimum threshold. Singapore has a similar policy but offers indexation as an option.

Most of the researched countries mitigate inflation risk by continued investment of DC funds after retirement in programmed withdrawal funds; and longevity risk through State Pension underpins, whilst permitting annuity options. In the case of Australia and Canada there are also now examples of variable lifetime annuity products.

Group structures can play an important role for retirees

Group structures – typically through employers and industry schemes – can be important in many of the research countries. In Australia and New Zealand, the lower costs associated with superannuation and KiwiSaver schemes are continued into retirement where these are used to hold assets as they are drawn down. This is also seen in Canada for those who have access to employer schemes. The picture in the US is more complex, as many schemes will force members to transfer their funds into individual arrangements on leaving employment prior to retirement. Typically, these have higher costs.

Group structures are also potentially important in designing and facilitating retirement income solutions for members. In Australia, regulation has now formalised this role through the Retirement Income Covenant. In Canada, employers provide access to preferential group rates for annuity products and developments are seeking to increase this role by re-enabling access to variable annuity solutions.

The US also has examples of these, such as access to group annuity rates. But plan sponsors can feel constrained from facilitating options without explicit protection from litigation, requiring continued action from the US Department of Labor to provide appropriate safe harbour mechanisms. Considerable effort has been made by US product providers to develop and market specific retirement income products, including managed payout funds, as well as deferred annuities and conventional annuities with 'money back' guarantees but have not proved popular.

In the absence of enabling group structures, other devices have been tried to enable better choice and value. An example would be the SCOMP system in Chile that aggregates competitive offers for retirement income solutions for individuals from across the market, and another would be the enabling some portability at retirement for DC funds in the Netherlands, detailed in later sections in this study.

Disclosure and consumer understanding of risk is important

The different approaches to the introduction of variable lifetime income annuities in the Netherlands and Denmark highlights the importance of consultation and regulation staying ahead of the market. By letting regulation develop with the market, many DC members in Denmark were moved from guaranteed to market-based returns and variable income annuities before the regulation was in place, to ensure full disclosure of the consequences for pension holders. This appears to have stored up potential problems of consumer confidence that may have been avoided by earlier action.

The Netherlands has taken a very measured approach, fully engaging with social partners alongside the wider reform of the Dutch collective DC (CDC) schemes. Variable lifetime income arrangements have been introduced only as an option so far for DC scheme members. This is supported by requirements on providers to check and monitor those members choosing this option display appropriate risk tolerance.

Lessons for the UK

- **The flexibility of DC provides new opportunities to address changing retirement patterns and risks**
- **There are a variety of approaches to mitigate inflation and longevity risk. The approach chosen is typically a factor of the wider retirement income system and society's appetite to pool or bear risk individually**
- **Group structures have a potentially important role to play in improving value and choice for retirees**
- **Consultation and regulation may need to stay ahead of the market if the Government wishes to ensure that consumers are properly informed and protected against new or unexpected risks**

CHAPTER THREE:

NORTH AMERICA

3.1 The United States

Key Points:

- The US social security system provides a significant replacement rate for those eligible and on lower incomes
- The US holds by far the largest Defined Contribution (DC) assets, nearly twice those in Defined Benefit (DB)
- Retirees are often reluctant to decumulate, preferring to retain resources against future financial risk. This represents a growing policy challenge
- US tax policy forces retirees to decumulate from age 73 and provides incentives for deferred annuity purchase
- Despite the large potential market, specific products to secure incomes have not seen much commercial success

Social Security provides a significant underpin to retirement income for workers on low-to-median incomes

The Social Security system in the US provides a pension to those who have worked for a minimum of 10 years and have paid social security taxes. The system is earnings related, paying an indexed monthly benefit available from age 62 based on average earnings over the best 30 years of working life, revalued by an index of wage growth, subject to a cap. Whilst the system is progressive, meaning that benefits replace a larger share of earnings for lower-income workers, it does not produce the high replacement rates for those on the lowest incomes that a flat-rate system would.

Benefits replace about 40% of late-career earnings for those first claiming at age 65. Replacement rates for workers in the lowest earnings quintile are about 50%, two to three times higher, on average and across cohorts, than replacement rates for workers in the highest quintile at around 22%.

Retired-worker benefits for most long-career workers born in the 1940s exceed the official federal poverty threshold. For workers born in the 1960s, 1970s and 1980s, even more are projected to have retired-worker benefits above that threshold.[31]

As a result, the Social Security system serves as a credible annuity-style underpin for those with accrued benefits.

DB benefits are no longer a major part of the decumulation landscape

DB schemes remain an active feature in US pensions, primarily for Government workers. For non-Government workers, some DB benefits remain in the system but are no longer a major component of decumulation. Overall, DB assets represent just over a third (35%) of US pension fund assets.[32]

For the majority, despite a heritage of traditional DB-based guaranteed income pensions, a point has been reached where retirement income going forward will be based on a combination of social security and income generated from DC retirement savings. This is a new challenge for retirees and the system.

More than half of current US retirees do not draw down the majority of their pension assets

The current cohort of retirees have tended to hold onto rather than spend their wealth in retirement. On average, across all wealth levels, current retirees still had 80% of their pre-retirement savings after almost two decades of retirement, although his figure is likely to be weighted to those with the most wealth.

[31] Congress of the United States Congressional Budget Office (2019) Social Security Replacement Rates and Other Benefit Measures: An In-Depth Analysis accessed at https://www.cbo.gov/system/files/2019-04/55038-SSReplacementRates.pdf
[32] Thinking Ahead Institute (2022) Global Pensions Assets Study accessed at https://www.thinkingaheadinstitute.org/content/uploads/2022/02/GPAS_2022.pdf

Even for those in the lowest wealth levels, whilst around a third (35%) had less than 20% of their assets remaining after 17-to-18 years of retirement, more than half (53%) had 50% or more of their assets. Over a third (37%) had more assets than they started with.

Of those with medium wealth, only 16% had less than 20% of their assets whilst over two-thirds (69%) had 50% or more remaining.[33]

Research with US retirees suggests that this is because:

- fear of ill health and associated costs in later life/retirement compels retirees to “husband” assets;
- the majority of retirees favour financial security over maximising spending; and
- relatively few retirees even feel the desire to draw down their assets.

As a result, retirees take comfort in maintaining their assets. Few retirees set explicit asset level goals, but, of those that do, more seek to accumulate than draw down. It appears that the accumulation mindset is deep rooted.

Recent retirees report higher anxiety and pessimism than those retired for more than ten years. They report more healthcare cost concerns, the possibility of needing long-term care and suffering cognitive decline. They are also concerned about a major investment loss. This may help to explain why recent retirees want to keep their asset levels steady or increasing.[34]

Real spending tends to decline in retirement across all wealth groups

When adjusted for inflation, spending from age 65 to advanced old age declines for single and couple households at annual rates of about 1.7% and 2.4% respectively.

Spending declined for all initial wealth quartiles with some small variations, suggesting that the decline is not related to economic position.[35]

Decumulation is becoming a major policy issue

While the critical issue in US pensions policy is extending workplace pension coverage, with only about half of working-age population participating in workplace pension schemes[36], efficient decumulation of DC funds is a growing policy issue.

The evidence already discussed suggests that moving from saving to spending is a fundamental and little understood psychological shift. Behavioural biases are seen to be holding back current retirees from spending and retirees appear to bring an accumulation mindset with them into retirement.

But, with fewer US workers retiring each year with traditional pension income, future retirees will likely retire in an environment with multiple financial risks and face growing pressures to maximise the value of their entire savings to support desired retirement lifestyles. With the combination of declining guaranteed incomes and longer lifespans, the strong retirement asset retention seen in this last generation of retirees increasingly feels unsustainable.

Employers have also changed their views on the role of their DC plans in decumulation. In the period 2012-2016, the percentage who agreed that the sole purpose of the DC plan is to serve as a source of retirement income rose from 9% to 85%.[37]

[33] Blackrock (2023) To spend or not to spend? Accessed at https://www.blackrock.com/us/individual/literature/whitepaper/spending-retirement-assets-final-whitepaper.pdf
[34] Blackrock (2023) To spend or not to spend? Accessed at https://www.blackrock.com/us/individual/literature/whitepaper/spending-retirement-assets-final-whitepaper.pdf
[35] Hurd, M and Rohwedder, S (2022) Spending Trajectories After Age 65 Rand Corporation accessed at https://www.rand.org/content/dam/rand/pubs/research_reports/RRA2300/RRA2355-1/RAND_RRA2355-1.pdf
[36] OECD (2021) Pensions at a Glance 2021: How does the United States Compare? Accessed at https://www.oecd.org/unitedstates/PAG2021-USA.pdf
[37] Alight (2017) Distributions from Defined Contribution Plans accessed at https://www.alight.com/getmedia/7674a2a8-ab31-4c26-8ec8-b99038409aa7/distributions-from-dc-plans_1.pdf

Prev Next

Tax legislation forces minimum drawdown rate from age 73

The IRS has set rules to ensure that assets in pension funds are drawn down during later life. As from age 73, retirees[38] are required to take a Required Minimum Distribution (RMD) from their pots each year, designed to extinguish the assets in their remaining expected life span. The amount is calculated by dividing the remaining assets in DC by a life expectancy factor[39], expressed in years, published by the IRS. Thus, if the retiree holds DC assets of US$100,000 and has a life expectancy factor of 20 years, then they must withdraw US$5,000 in that year.[40]

This is often not a popular policy with retirees as:

- they don't want to be forced to take money out of their funds when they don't need it,
- they resent the loss of control over when money is taken, and
- as RMDs are treated as taxable income, it can move them into a higher tax bracket.[41]

The driver of the policy is principally one of recovering tax deferred in accumulation rather than retirement welfare. Whilst the regulations require money to be withdrawn and subject to income tax, this does not prevent withdrawals from being reinvested. This approach may be particularly relevant for couples with a large age gap.

However, the RMD has effectively become a default for retirees to take income by drawdown in later life. It also provides an incentive to start drawdown earlier to smooth income and mitigate income tax liabilities once RMD are required.

Tax policy is also used to incentivise lifetime incomes in later life

A further strategy to incentivise retirees to drawdown is the favourable treatment of the Qualified Longevity Annuity Contract (QLAC) created in 2014. This is a deferred fixed annuity that can be purchased via a DC pension withdrawal up to a maximum of US$200,000. Payments can be deferred until as late as age 85 and can be made on a single-life or joint-life basis. Inflation protection is offered by some providers at additional cost. A refund death benefit option is also available, returning any unused premium to beneficiaries.

Whilst payments from the annuity are subject to income tax, the withdrawal to purchase is tax free and also reduces the remaining DC assets by the purchase price, thereby reducing the RMD calculation from age 73.[42]

Deferred fixed annuity sales totalled $112 bn in 2022, over half of the 2022 total US fixed-rate annuity sales of $208 billion.[43]

DC plan sponsors are also encouraged to offer lifetime income options for retirees

Other policy changes have focused on improving the offer at retirement made by DC plan sponsors to members. Under the Secure Act 2019, employers who offer annuities from a selected provider as part of the DC plan are shielded from liabilities for the probity or solvency of their provider as long as they meet specific 'safe harbour' regulatory requirements.[44]

Providers are also innovating to provide new lifetime income options. BlackRock has created a new target date fund[45] that embeds group annuity contracts from age 55, providing participants with the option to use up to 30% of the DC assets to purchase a fixed individual retirement annuity at age 59½[46]

[38] Those still working can defer RMDs until they no longer work
[39] Formulae also exist for DB plans
[40] IRS (2023) Retirement Plan and IRA Required Minimum Distributions FAQs accessed at https://www.irs.gov/retirement-plans/retirement-plan-and-ira-required-minimum-distributions-faqs
[41] Waggoner, J (2020) Know the Rules for Talking RMDs from your retirement savings AARP accessed at https://www.aarp.org/money/taxes/info-2020/required-minimum-distribution-rules.html

Inflation has stimulated the market for lifetime income solutions

The US inflationary spike, and resulting monetary tightening, has prompted a sharp increase in the sale of annuities as DC savers seek to lock in increased annuity rates. Driven by record-high fixed annuity sales, total annuity sales reached $311 bn in 2022, a 22% increase from 2021 results and 17% higher than the record set in 2008.[47]

Managed Payout Funds (MPFs) provide an alternative to annuities but have not proved popular

Launched around 2008, MPFs are typically actively managed investments with an initially high allocation to equities but with a glide path towards bonds to de-risk over time, combined with some diversifying investment in property, commodities and/or derivatives.

Their aim is to produce a level income that is adjusted each year to reflect investment gains and losses. Some funds use smoothing mechanisms (such as reserves) to spread the effect of investment movements over several years.

Vanguard's MPF dominated this market with almost half of the US$3.5bn invested in MPF in 2017. Their fund sought to pay investors an annual income of about 4% of assets over the life of the investment and charged 0.34% a year on a minimum investment of US$25,000.[48]

In 2020, Vanguard repositioned its product, removing the monthly income feature from the fund in favour of annual payments, renaming it the Managed Allocation Fund. The reason given was operational complexities associated with the reporting required when distributions included a return on capital. Vanguard also realised that many of the investors in the fund did not use the monthly payout feature and instead choose to reinvest a large portion of their payouts.

Whilst other products are evolving and trying to adapt to the market, many have merged into other funds and the remainder have remained small and suffered from changes of strategy.[49]

Policy proposals have been floated to create default funds for DC plans that combine:

- An MPF,
- A cash fund for emergencies and
- A QLAC-type longevity annuity.

They are not considered likely to be progressed in the near future.[50]

[42] Ashford, K (2023) What is a Qualified Longevity Annuity Contract (QLAC)? Forbes Advisor accessed at https://www.forbes.com/advisor/retirement/qlac-qualified-longevity-annuity-contract/
[43] LIMRA (2023) 2022 US Retail Annuity Sales Shatter Annual Sales Records set in 2008 accessed at https://www.limra.com/en/newsroom/news-releases/2023/limra-2022-u.s.-retail-annuity-sales-shatter-annual-sales-records-set-in-2008/
[44] Groom Law Group (2020) Lifetime Income Provisions Under the SECURE Act accessed at https://www.groom.com/resources/lifetime-income-provisions-under-the-secure-act/
[45] Blackrock markets this under the Lifepath Paycheck brand
[46] ALM Think Advisor (2021) BlackRock Adding Annuities to 401(k) Plans accessed at https://www.thinkadvisor.com/2021/10/06/blackrock-adding-annuities-to-401k-plans/
[47] LIMRA (2023) 2022 US Retail Annuity Sales Shatter Annual Sales Records set in 2008 accessed at https://www.limra.com/en/newsroom/news-releases/2023/limra-2022-u.s.-retail-annuity-sales-shatter-annual-sales-records-set-in-2008/
[48] John, D et al (2019) From saving to spending: A proposal to convert retirement account balances into automatic and flexible income The Brookings Institute accessed at https://www.brookings.edu/wp-content/uploads/2019/07/ES_201907_JohnGaleIwryKrupkin.pdf
[49] Ashford, K and Schmidt, J (2021) What is a Managed Payout Fund? Forbes Advisor accessed at https://www.forbes.com/advisor/retirement/what-is-managed-payout-fund/#:~:text=Vanguard%27s%20Managed%20Payout%20Fund%20used,favor%20of%20an%20annual%20distribution
[50] John, D et al (2019) From saving to spending: A proposal to convert retirement account balances into automatic and flexible income The Brookings Institute accessed at https://www.brookings.edu/wp-content/uploads/2019/07/ES_201907_JohnGaleIwryKrupkin.pdf

Tontines have been proposed but face technical and legal barriers

Tontine-style products have also been proposed as an option to play a significant role in the US retirement income market by providing a higher overall lifetime income at a lower cost than a conventional annuity, but without the same guarantees of predictable income levels.

Tontines pool and invest the funds of a group of members, which creates an income. As members die, their shares of the pool – known as mortality credits - are divided amongst the survivors, increasing their income. This continues until a pre-specified small number of survivors remain who then divide the remaining funds between them.

Technical issues, such as ensuring that mortality credits are distributed fairly based on survivor life expectancy and flattening the profile of payouts through a lifetime, can be addressed with actuarial techniques, but these work more efficiently when the pool is of sufficient size to minimise statistical variances. Such techniques also bring increased complexity and less transparency in the calculation of the level of payments.

There are also legal issues: some that arise from the effective banning of Tontines in response to corrupt insurance company management in the early 1900's, and others from the application of tax, equality and discrimination laws.

Given the limited take up of conventional annuities and MPFs, the business case for providers to develop tontine-style products is far from clear, despite the attraction of a basic proposition of higher lifetime payouts at lower cost.

The US is thus seen to be lagging the rest of the world, particularly the EU, by not offering these types of arrangements.[51]

Lessons for the UK

- **Retirees will tend to conserve assets in the light of later-life financial risks, such as ill-health, valuing security over consumption**
- **Policies that force decumulation, such as through taxation, are often unpopular as retirees resent the loss of control over when money is taken**
- **Markets are unlikely to create income solutions through inherent demand. Even in the largest DC market, there is a demand failure for specific income generation products**

[51] Iwry, JM et al (2020) Retirement Tontines: A New Way to Finance Retirement Incomes The Brookings Institute accessed at https://www.brookings.edu/wp-content/uploads/2020/10/Retirement-Security-Project-Tontines-Policy-Brief-Oct-2020.pdf

3.2 Canada

Key Points:

- The Canadian pension system has a complex structure, with both a means-tested universal and a significant earnings-related State scheme, both providing lifetime incomes in retirement
- Private sector workplace schemes are now typically DC, but are only available to around two in five private sector workers. Individual pension plans are therefore important to supplement state entitlements
- Decumulation is mostly through drawdown arrangement Retirement Income Funds (RIFs) with minimum drawdown rates imposed by Government from age 71. Maximum drawdown rates also apply to workplace DC scheme assets
- Variable Payment Life Annuities (VPLAs) are being proposed, but current legislation limits their scope. The University of British Columbia scheme provides a working template for these arrangements

The Canadian pension system has considerable complexity

The Canadian pension system is composed of three pillars:

- Universal State Benefits: Old Age Security (OAS) and Guaranteed Income Supplement (GIS)
- Canada/Quebec Pension Plan (CPP/QPP)
- Voluntary Retirement Savings Plans: including workplace DB and DC and individual retirement savings plans (RSPs)

The state OAS is universal but means tested

The OAS is a universal benefit payable from age 65 and is designed to provide a 15% replacement rate of the average wage. The accrual rate is 1/40 for each year of adult residence. Benefits are uprated by the consumer price index.

OAS is means-tested with benefits reduced by a 15% recovery tax on those earning over an income threshold of just over C$80,000 (just under £48,000), around the average Canadian annual salary. Those with an income in excess of around C$130,000 (£76,000) and full accrual will have all of their OAS benefit clawed back.

GIS provides additional income for those on the lowest incomes

The GIS is an income supplement for those on low incomes, paid to around 1.6 million of the 6 million who receive OAS. GIS can add a further 75% or more to the OAS income for those on the lowest incomes. GIS benefit varies by income and marital status.

This results in a State underpin structure strongly weighted to those on the lowest household retirement incomes and with considerable complexity as to the level of entitlement.

CPP/QPP provides a significant earnings-related pension for all workers

The CPP (QPP in Quebec) is a compulsory employer- and employee-funded State DB plan. The self-employed are also included with the individual paying all of the contributions. It was initially designed to replace about 25% of the average wage, but more recent increases to contribution rates will mean it will achieve a replacement rate of around one-third (33%). Funds are managed by the Canada Pension Plan Investment Board (CPPIB).

CPP benefits are normally taken at age 65, but can be taken early at age 60 or deferred up to age 70. Benefits are uprated with the consumer prices index (CPI).

Private pensions are now mainly DC, many through individual rather than workplace plans

Voluntary occupational and individual plans therefore sit on top of a significant State provision. Accrual in DB plans are largely restricted to those in the public sector and DC plans are now the typical pillar three arrangement. DC assets represent 40% of the total funded assets, so Canada's transition to DC is significantly ahead of the UK, but well behind the US.

Only a minority (around 40%) of workers have access to a workplace pension scheme. Individual accounts (RRSPs) are therefore an important part of DC savings, with over 6.2m Canadians contributing to RRSPs. Private sector employer schemes held C$805billion of assets in 2022 compared to C$1,875billion held in individual accounts.[52]

Contributions to RRSPs are limited to 18% of income up to a maximum of just over C$30,000 per annum. Deferred benefits in DC schemes are transferred into individual accounts.[53]

Canada therefore has a complex structure of retirement provision with significant accrual in index-linked income-based benefits from the two State retirement scheme pillars.

Retirement choices for DC

Retirement benefits from a DC plan can be accessed from age 55 and must be taken by age 71. The options are:

1. Cash withdrawal,
2. Conversion into a RIF to drawdown during retirement, or
3. Purchase of an immediate annuity.

All withdrawals and income are taxed at the marginal rate of income tax.

RIFs are individual drawdown plans offered by financial service providers and insurers with investments in a range of assets. The Government sets minimum withdrawal rates from all RIFs for each year, which rise with age. Funds that originate from workplace DC are also subject to maximum withdrawal rates so as to provide a lifetime income. Cash withdrawals from workplace DC are limited to 50%.[54]

Annuities are not a popular option, so the majority choose to access DC retirement income from RIFs.

[52] Canadian Life & Health Insurance Association (2022) Canadian Life & Health Insurance Facts accessed at http://clhia.uberflip.com/i/1478447-canadian-life-and-health-insurance-facts-2022-edition/0?
[53] Omololu, E (2023) A Complete Guide to Retirement Income in Canada in 2023 Savvy New Canadians accessed at https://www.savvynewcanadians.com/a-complete-guide-to-canadas-retirement-income-system/
[54] Omololu, E (2023) LIRA, LRSP, LIF, LRIF, and PRIF: What's Their Place in Your Retirement Planning? Savvy New Canadians accessed at https://www.savvynewcanadians.com/lira-lrsp-lif-lrif-rlif-prif-meaning/

Group scheme decumulation options are uncommon but can offer better options

Some retirees have access to group options set up by their employer or group plan provider. These may be within the DC scheme or used in conjunction with it.

Most DC scheme sponsors are reluctant to offer internal scheme retirement income options due to concerns about:

- continued liability to members, especially where there is no longevity protection,
- additional oversight required in administration of retirement benefits, and
- increasing difficulties of communication with members of older age, especially without the ease of communication through the workplace.

However, where such options are offered, they are typically carried out through the plan's own administration arrangements and independent governance. This will usually deliver lower costs, guidance and convenience for members making it an efficient method of converting their savings into retirement income.

Where employers arrange retirement options outside but in conjunction with the DC scheme, they will still typically be able to obtain preferential rates for members from providers through the sponsor's additional buying power, the reduced cost for the provider of communicating with prospective members through the group scheme and the continued retention of funds for an incumbent provider into the retirement phase.

The most common offering is a variable benefit, made available from 2006, with the funds transferred into a variable benefit account remaining invested in the plan's funds and the retiree receiving periodic payments from this account. The payments are not guaranteed and are subject to the same maximum and minimum (from age 71) Government income limits as for other RIFs.

Less common, due to increasing tax and legislative restrictions, are internal annuities paid directly from DC plans. Such arrangements typically predate more recent tax and pension legislation reform.[55]

As a result, there are just a few large and mature DC schemes in Canada that have experience of delivering DC decumulation solutions to members. Those schemes show the impact of decision making of independent governance on plan design, balanced control and fiduciary standards. Examples include tools and calculators to assist members in assessing:

- their risk tolerance and best match asset mixes;
- the optimal withdrawal rate (consistent with their investment choices and expected remaining lifespan);
- the potential benefits of combining variable benefits with annuity purchase (either immediate or deferred); and
- their DC decumulation choices in the wider context of their State and other private pensions and savings, and spouse's assets and entitlements.[56]

[55] The Association of Canadian Pension Management (2017) Decumulation, The Next Critical Frontier accessed at https://www.acpm.com/ACPM/media/media/resources/7/media/AGR/Publication/Decumulation-Improvements-for-DC-and-CAP-(27-Mar-17).pdf
[56] The Association of Canadian Pension Management (2017) Decumulation, The Next Critical Frontier accessed at https://www.acpm.com/ACPM/media/media/resources/7/media/AGR/Publication/Decumulation-Improvements-for-DC-and-CAP-(27-Mar-17).pdf

VPLAs are a possible additional option

Legislative change in 2021 enabled the addition of VPLAs to DC plan scheme decumulation options. A VPLA provides retirement payments for life that vary based on the investment performance of the underlying annuity fund and the mortality experience of annuitants.[57]

Previously, only the few DC plans who already offered internal annuities in 1988 could offer this type of product. The University of British Columbia (UBC) Faculty Pension Plan, has continued to offer VPLAs since 1988 and provides a working template for new arrangements. Only around one in eight (12%) of UBC retirees in 2022 choose a VPLA income from the scheme.[58]

UBC offer two choices – the 7% and the 4% annuity – both invested in the UBC balanced fund. The fund's long-term expected return is 5.25%-5.5%. As a result, the income from a 7% annuity is expected to reduce over time and that of the 4% to increase. A 50/50 mix of the two options would result in a broadly level of expected income. This compares to the lower level of income from a conventional insured annuity - typically 20-30% less than a VPLA[59] - but which provides the certainty of fixed monthly payments.

Both the VPLA and the insured annuity provide protection against longevity risk – the insurance company takes on this risk completely, whilst the VPLA pools this risk amongst all of the VPLA participants. The insured annuity also provides protection against investment risk.[60]

The significant actual variability of income from a VPLA is shown by the table of annual investment and survivorship adjustments to UBC VPLA pensioners with 7% and 4% contracts in the period 2006-2023 (Figure 3.1):

Figure 3.1 Annual Investment and Survivorship Adjustment to VPLA Pensioners

Year	7%	4%	Year	7%	4%	Year	7%	4%
2006	3.7%	6.7%	2012	-5.1%	-2.3%	2018	0.9%	3.9%
2007	5.8%	8.9%	2013	1.8%	4.7%	2019	-8.1%	-5.4%
2008	-5.0%	-2.2%	2014	4.9%	7.9%	2020	6.3%	9.3%
2009	-19.8%	-17.5%	2015	3.1%	6.0%	2021	0.4%	3.3%
2010	2.8%	5.8%	2016	-1.6%	1.3%	2022	4.2%	7.1%
2011	1.2%	4.1%	2017	-6.9%	-4.2%	2023	-11.5%	-8.9%

Source: The University of British Columbia[61]

Given that VPLAs can currently only be provided as an in-scheme decumulation option, there is limited scope for them to develop. Insurers have lobbied for legislation to enable standalone VPLAs to be offered, arguing that the current arrangements could only assist "a few thousand" of the 500,000 Canadians that retire each year.[62]

Lessons for the UK

- **The Canadian system provides annuity-style incomes from State schemes at a similar target level to that of the new State Pension (nSP) and statutory automatic enrolment combined**
- **Canada accepts that DC funds must be decumulated, starting from age 71, using minimum and, in some cases, maximum drawdown rates to achieve this**
- **Canada is another market where annuities are little used and conventional drawdown is the typical income solution for DC**
- **The UBC is a mature example of the variable income solution which illustrates the considerable volatility of retirement incomes that can result**

[57] Mercer (2021) Canada enacts legislation to implement 2021 federal budget accessed at https://www.mercer.com/insights/law-and-policy/canada-enacts-legislation-to-implement-2021-federal-budget/
[58] The University of British Columbia (2022) Faculty Pension Plan Annual Report accessed at https://faculty.pensions.ubc.ca/files/2023/04/2022AnnualReport.pdf
[59] Ideal Canadian Pension Plan (2021) Variable Payment Life Annuity (VPLA): Delivering Lifetime Pensions accessed at https://www.idealcanadianpensionplan.ca/variable-payment-life-annuity-vpla-delivering-lifetime-pensions/
[60] The University of British Columbia (2023) The variable payment life annuity explained UBC Pension Administration Office accessed at https://faculty.pensions.ubc.ca/files/2023/02/annuities.pdf
[61] The University of British Columbia (2023) The variable payment life annuity explained UBC Pension Administration Office accessed at https://faculty.pensions.ubc.ca/files/2023/02/annuities.pdf
[62] See https://www.clhia.ca/web/CLHIA_LP4W_LND_Webstation.nsf/page/BA654658A0A4E6C385258838006A491F/$file/Standalone%20VPLA%20submision%20to%20Finance.pdf

CHAPTER FOUR:

AUSTRALASIA

4.1 Australia

Key Points:

- The Australian system provides an example of a more mature Defined Contribution (DC) system with significant funds accumulated at retirement promising rising retirement living standards
- But most retirees will still need to access the means-tested Australian Age Pension in retirement. This creates complex decisions about drawing down DC assets if living standards are to be optimised.
- This complexity triggers a search by retirees for defaults and desire to retain assets, resulting in inadequate drawdown and, potentially, unplanned bequests
- Regulatory initiatives to stimulate providers to assist members to draw an income more effectively are proving challenging and, so far, largely ineffective

Workplace DC pension provision is already an important part of personal assets

Compulsory superannuation into workplace DC schemes has been part of the Australian retirement income system for over 30 years. Currently, employers are required to contribute a minimum of 11% of salary into employees' superannuation funds.[63]

Average balances in superannuation funds have doubled in real terms in the period 2002-2018 from A$122,000 to A$240,000 as the system has matured. For over 80% of households, superannuation (together with owner-occupied housing) is the most dominant form of saving. Other assets (apart from owner-occupied property) are held by a relatively small proportion of households. It is only for a small minority, just over 20%, that other financial assets are of relevance to wealth and retirement savings.[64]

The State Pension plays an important and complex subsidiary role in retirement income support

The Australian Age Pension, now available from age 67, is subject to both an income and assets means test. Superannuation assets are counted in both tests but not the residential home.[65] Just around 40% of those aged 66-69 currently receive the Age Pension. This figure rises to almost 60% for ages 70-74 and to 85% for those aged 85-89. Overall, around two thirds (65%) of those over age 66 receive an Age pension, with around half of those (32% overall) receiving a part-rate pension.

Middle income earners, the primary target of compulsory superannuation policy, require a combination of superannuation, voluntary savings (mainly in the form of owner occupancy) and the Age Pension to maintain their living standards in retirement.[66]

Thus, the Age Pension plays an important role in supplementing the income of retirees and as a buffer for retirees whose retirement incomes and savings fall, and for those who outlive their savings. It also suggests that it has significance in enabling confidence in retirees to draw down fully on their superannuation savings by being a 'safety net' against unforeseen or unexpected outcomes.

[63] See https://www.ato.gov.au/Rates/Key-superannuation-rates-and-thresholds/?=redirected_SuperRate&anchor=Superguaranteepercentage#Superguaranteepercentage
[64] Wilkins, R et al (2020) The Household , Income and Labour Dynamics in Australia Survey: A Statistical report of the HILDA Survey Melbourne Institute: Applied Economic & Social Research accessed at https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0009/3537441/HILDA-Statistical-report-2020.pdf
[65] See https://agepensionguide.com.au/are-you-eligible-for-the-australian-age-pension/
[66] The Australian Government the Treasury (2020) Retirement Income Review: Final Report accessed at https://treasury.gov.au/publication/p2020-100554

Retirement living standards are projected to increase as superannuation balances grow

Currently, around 30% of couple and single retiree households reach or exceed a comfortable[67] living standard of around A$50,000pa for a single and A$70,000pa for a couple household. By 2050, projections indicate that around 50% will be able to afford expenditure at the comfortable level. The maturing of the superannuation system is therefore seen as a primary driver of improving outcomes for Australian retirees. This assumes that retirees draw down their savings in retirement.

However, it is worth noting that home ownership is the most important part of voluntary savings. As well as reducing housing costs for those in retirement, the pension system favours homeowners by excluding retirees' residences from the Age Pensions mean test. The implicit assumption of home ownership and its support for retirement living standards may not be sustained for the generation of younger savers, if their higher levels of renting continue into retirement. 60% of single retirees who rent their home are in poverty compared to about 10% of single homeowners.[68]

There are concerns that middle income retirees are not drawing down their retirement savings

As superannuation is projected to be a main source of income for median-income earners and above, drawing down superannuation assets efficiently is seen as critical to those groups to achieve the targeted replacement rates. Only at the 90th percentile are non-superannuation assets a large proportion of projected retirement incomes.

Australia has therefore focused DC policy on middle-income earners as the primary target group, as they will not be able to maintain their living standard in retirement by relying on the State Pension alone, whereas lower-income earners can maintain (if not improve) their retirement living standards through the State Pension alone. Higher-income earners are more likely to accumulate sufficient wealth to meet their needs through pensions and other voluntary savings.

Middle-income earners will have replacement rates below target if they draw down their superannuation at the statutory minimum rates.[69] More than half of retirees have been reported as drawing down at the legislated age-based minimum rate.[70]

More detailed analysis suggests that the drawdown rate adopted by a given member reflects both their age and account balance:

- Those whose balance falls below A$100,000 will tend to withdraw a greater proportion of their assets, reflecting the largely fixed actual minimum cost of living (rent, food, etc); and
- Those whose balance remains above A$100,000 will drawdown at higher rates as they get older reflecting the increase in the minimum drawdown rate and higher aged care costs that individuals often face.[71]

Minimum drawdown rates apply as soon as benefits are taken. These start at 4% up to age 64 and rise in 5-year steps to 14% for those aged 95 or over.[72]

Analysis of a single superannuation scheme found that just under 40% of retirees selected the minimum rate and just over 10% a rate no more than 1% above the minimum. Of the remainder selecting higher drawdown rates, more than half had smaller account balances (under A$200,000).[73]

[67] As defined by the ASFA. See https://www.superannuation.asn.au/resources/retirement-standard
[68] Coates, B and Cowgill, M (2020) 5 key takeaways from the Retirement Income Review Grattan Institute accessed at https://grattan.edu.au/news/5-key-takeaways-from-the-retirement-income-review/#:~:text=5%20key%20takeaways%20from%20the%20Retirement%20Income%20Review,...%205%205.%20Renters%20are%20in%20trouble%20
[69] This is 5% of account balance for those aged 65-74
[70] Retirement Income Review p.181 citing Rice Warner (2019) Super Insights 2019, Rice Warner Client Research Portal; Reeson, A et al (2016) Superannuation Drawdown Behaviour: An analysis of longitudinal data, CSIRO-Monash Working Paper No 2016-04
[71] Dunn, R. and Berg, M (2019), Lifecycle design – To and Through Retirement, 27th Colloquium on Pensions and Retirement
[72] See https://www.ato.gov.au/Rates/Key-superannuation-rates-and-thresholds/?anchor=Minimumannualpaymentsforsuperincomestrea#Minimumannualpaymentsforsuperincomestrea
[73] Boal, A (2020) Spending in retirement and the taper rate, Institute of Actuaries of Australia

Decisions about an efficient rate for an individual to draw down are complicated by means testing

Decisions on drawdown rate are further complicated by the taper rates applied to the Age Pension – a reduction of just under 8% in pension payment for assets held in excess of the test threshold. This should incentivise retirees to draw down their savings as fast as possible between the point where they become eligible for a part-Age Pension payment until their assets fall below the threshold entitling them to a full pension.[74] However, there is little evidence that this happens in practice.[75]

Complex decisions may trigger a search for defaults and desire to retain assets

Many retirees are struggling with the complexity of the drawdown decision and are, by default, using the minimum withdrawal rates as a guide under considerable uncertainty around longevity and future expenses. Given people are generally risk averse, it is perhaps to be expected that minimum withdrawal rates will act as an anchor for those uncertain about the best decision.

An individual's account-based pension contains what is, for that individual, a large sum of money which they have spent many years saving. Drawing down on a non-replenishing resource is a psychological challenge, particularly in the context of superannuation which is primarily discussed in a savings rather than a consumption frame. Retaining a lump sum, rather than converting it into an income stream, may give people a sense of continuing financial security. It also allows ongoing choice, which is valued for its own sake.

Managing longevity at the individual level can be seen as costly and inefficient, as it necessitates retaining a large proportion of savings, and only those who live to a particularly old age will get to draw all of their savings. It is likely that the perceived costs are substantially reduced by the fact that unspent balances can be passed on as a bequest.[76]

Some pensioners consume only the income derived from their assets, leaving wealth as a bequest

The Treasury's Retirement Income Review, published in 2020, found that maintenance or growth of superannuation assets in retirement occurs. This is despite policy settings designed to influence drawdown behaviour [such as means testing and drawdown rules]. A major misunderstanding by retirees is the view that 'retirement income' involves the return from investing superannuation balances rather than drawing down those balances to fund living standards in retirement.

As a result, when retirees die, most leave the majority of the wealth they had at retirement as a bequest. They cite one large superannuation fund that found members who died left 90% of the balance they had at retirement and another that found around 90% of the assessable assets held at retirement were left at death.[77]

Pensioners spend less as they age. Successive waves of the Household Expenditure Survey show that for a given cohort, real spending falls once households are aged over 70. Most retirees could afford to spend substantially more than they do, and choose not to do so. Not only do most retirees not draw down on their savings, many are net savers through much of their retirement. Most retirees never spend a large part of the savings that they have on the day they retire. Many retirees seem reluctant to draw down on their capital, and instead live on the income their savings generate.[78]

Around 45% of pensions were net savers in the first five years of receiving the Age Pension, while 43% drew down on their savings. In the final five years of receiving the pension, 43% of pensioners were still net savers, while just a third drew down on their savings.[79]

Bequests do not appear to be a high priority for retirement savers

'Leaving a bequest' was one of the least important retirement savings objectives for people. One study found bequests ranked 18th out of 19 possible savings motives in retirement. Similarly, bequests ranked last out of nine possible attributes for savings in a consumer group survey. They ranked among the bottom three desired retirement income product features in another survey. This suggests that underconsumption of retirement assets observed by the RIC is consequence of inefficient drawdown rather than a bequest motive for their pension wealth.

The bequest motive may be different for the principal residence. Some researchers suggested the principal residence serves a dual purpose: allowing people to fund out-of-pocket aged care and health expenses as needed and, if not needed, leaving a bequest. In a Productivity Commission survey, 71% of respondents said they saw the family home as a safety net for adverse events, and 44% said they wished to pass the family home on to their children.[80]

Retirees also tend to avoid using housing wealth to fund retirement

Despite Government initiatives, and the potential benefits of equity release products especially for retirees who are asset rich and income poor, retirees still tend to draw less on home equity than other assets. This is because they:

- Want to use their home equity to fund future expenses such as aged care services,
- View mortgage equity products as inherently risky and do not understand the nature of Government programs to encourage their use,
- Wish to 'age in place', lack suitable downsizing options or want to pass on their principal residence to heirs, or
- Are put off by transaction costs, such as stamp duty, and the difficulty of moving.[81]

Legislation introduced to require super funds to assist members drawing an income

In response to the Retirement Income Commission's findings and to enable retirees with the confidence to spend their superannuation funds appropriately, in February 2022, an obligation was placed on the superannuation industry under the Retirement Income Covenant. This requires superannuation funds to develop a strategy for members who are retired or approaching retirement to help them optimise their retirement income. A summary of the strategy must be published on the organisation's website.

The requirement is principles-based so that funds have the flexibility to respond in a way that is specific to the needs of their members with regard to their situation and preferences. It requires funds to balance three broad objectives:

- Maximise expected income
- Manage income risk (longevity, inflation, investment and other)
- Providing flexible access to funds

Challenges for providers in responding to the Covenant requirements

The objectives set out in the Covenant compete and so require complex trade-offs about future projected outcomes. These also interact with the member's broader household financial situation, including Age Pension means testing.

Funds have the discretion to determine the type of assistance that they provide to their members across a wide spectrum (Figure 4.1)

[74] The level at 1/7/23 is approximately A$300,000 for a single homeowner and A$450,000 for a couple. Part pension eligibility start at approximately A$650,000 for single and just under A$1,000,000 for a couple. See https://www.superguide.com.au/in-retirement/age-pension-rates . The income tests are not relevant if you are asset tested.
[75] Boal, A (2020) Spending in retirement and the taper rate, Institute of Actuaries of Australia
[76] Reeson, A et al (2016) Superannuation Drawdown Behaviour: An analysis of longitudinal data, CSIRO-Monash Working Paper No 2016-04
[77] Retirement Income Review p432
[78] Daley, J and Coates, B (2018) Money in retirement: More than enough Grattan Institute accessed at https://www.grattan.edu.au/wp-content/uploads/2018/11/912-Money-in-retirement.pdf
[79] Australian Government (2015) Media Release by Minister for Social Services, The Hon Scott Morrison MP: Fairer access to a more sustainable pension 7 May 2015 accessed at https://formerministers.dss.gov.au/15866/fairer-access-to-a-more-sustainable-pension/
[80] Retirement Income Review p436
[81] Retirement income Review p236-7

Figure 4.1: Range of assistance funds can provide to their members

This could result in:

- **Tailored Retirement Income Products** – to align with the member's needs and preferences and providing, for example, lifetime income streams
- **Financial Tools and Education** – such as expenditure calculators, longevity estimators, drawdown modellers; as well as factual information on, for example, Age Pensions eligibility, capital drawdown as income, and different types of income streams available
- **Personalised Retirement Planning advice** – with the necessary licences, and subject to a robust scoping process, to cover single issues, episodic and complex advice. Recent Government changes have made it easier for funds to provide more personal advice.[82]

However, in determining the type and scope of assistance to be provided, funds must also have regard for the statutory requirement to have a robust business case to demonstrate that the expenditure to deliver assistance is in the best interests of the majority of members.[83] If the initiative cannot be justified then funds might still be able to provide support by introducing members to a third-party.[84]

In trying to assess the suitability of income solutions for members, a number of technical issues arise, in part driven by lack of specificity of the objectives in the Covenant. Two important examples are:

1. Assumptions around the indexation of the Age Pension and the profile of members' spending patterns over time are crucial, and
2. Whether 'expected income' should be mortality weighted – in essence, should consumption at any age be considered equally important at all ages, regardless of the likelihood of reaching each age.

The stance taken on these issues informs the priority that needs to be placed on longevity protection within a solution – for example by adding a lifetime income stream or limiting drawdowns so the assets last.

Limited progress made in response to the Retirement Income Covenant

Given the mixed objectives in play both in designing and implementing strategies to respond to the Covenant requirements, it is perhaps not unexpected that many funds, so far, have appeared to adopt a response of minimum compliance - although there are some interesting and innovative developments, such as Q Super's Lifetime Pension.[85]

A thematic review by the regulators of progress, published in July 2023, one year after implementation of the Covenant, found that "while trustees were improving their offerings of assistance to members in retirement, there was variability in the quality of approach taken and a lack of urgency in embracing the intent of the Covenant."[86]

More focus was called for on:

- Understanding member needs
- Designing fit-for-purpose assistance and
- Overseeing strategy implementation

The review warned that trustees must get the fundamentals right – their retirement income strategies must be designed with consumer needs in mind and be evidence-based. They need to be mindful that their members' needs evolve over time and commit to continuously monitoring and improving their approach.[87]

There appears to be a risk that without the creation of a consensus between the regulator and schemes of what good looks like in practice and how it is best assessed, that the schemes and regulator may become locked in a negative spiral. This might drive increasing regulatory pressure resulting in evermore reactive responses to the Covenant requirements. So, schemes may end up focusing more on regulatory compliance than member needs.

Lessons for the UK

- **The importance of maintaining the coverage and level of the UK new State Pensions (nSP) to provide a simple, trusted and credible income safety net**
- **The need to focus DC policy on those at most risk of not be being able to maintain their living standard in retirement by relying on the State Pension alone**
- **Clear income paths, trusted guidance and accepted defaults will be needed to address the instinct to retain rather than drawdown DC assets**
- **Successful policy in pensions accumulation may not deliver the improved retirement living standards expected**
- **Pressuring providers to formulate and implement income withdrawal strategies without a clearer consensus of what 'good looks like' in practice may not produce the outcomes public policy seeks for scheme members**

[82] This is in response to the Quality of Advice review. See https://treasury.gov.au/sites/default/files/2023-01/p2023-358632.pdf
[83] These requirements are contained within the MBIFD regulations
[84] See https://www.actuaries.digital/2023/07/05/balancing-retirement-assistance-and-member-best-financial-interest-duty/?utm_medium=email&utm_campaign=2307206-MCOM-Digest-%20Sub%20Digest&utm_content=2307206-MCOM-Digest-%20Sub%20Digest+CID_e99722d85d4e5f9fbe6d74e231cf3a7d&utm_source=Campaign%20Monitor&utm_term=Balancing%20retirement%20assistance%20and%20Member%20Best%20Financial%20Interest%20Duty
[85] This is a variable annuity with mortality pooling similar to those in the Netherlands or the UBD example. One particular feature is the
[86] Australian Prudential Regulation Authority (2023) Review finds super trustees need to improve retirement outcomes planning accessed at https://www.apra.gov.au/news-and-publications/review-finds-super-trustees-need-to-improve-retirement-outcomes-planning#:~:text=The%20review%20was%20conducted%20jointly%20by%20the%20Australian,outcomes%20for%20their%20members%20in%20or%20approaching%20retirement
[87] Australian Prudential Regulation Authority (2023) Review finds super trustees need to improve retirement outcomes planning accessed at https://www.apra.gov.au/news-and-publications/review-finds-super-trustees-need-to-improve-retirement-outcomes-planning#:~:text=The%20review%20was%20conducted%20jointly%20by%20the%20Australian,outcomes%20for%20their%20members%20in%20or%20approaching%20retirement

4.2 New Zealand

Key Points:

- The smaller scale and simplicity of the DC system in New Zealand provides insights into underlying retiree behaviours
- The strong State Pension system is a critical part of maintaining retirement living standards
- Owner occupation is an implicit assumption in public pension policy
- Clear and consistent consumer education and guidance are being advanced as the key public policy tools to address retiree reluctance to decumulate DC assets

New Zealand's retirement income system is notably simpler

A striking feature of the New Zealand retirement savings and income landscape is the simplicity of the system. There are no tax incentives for long-term savings or drawdown. Contributions and savings are made from taxed income, and income or investment gains are taxed as for other income and savings.

The KiwiSaver system was introduced in 2007 to provide an incentivised system for retirement savings. The system uses automatic enrolment in the workplace and contingent compulsion on the employer to make matching contributions. The employee and employer both contribute 3% by default. The Government will add a further 1.5%, up to a cap of just over NZ$520.

Contributions towards and savings within KiwiSaver have no preferred tax status. Access to the matched contributions is only possible at retirement, although funds can be used to assist first time buyers in house purchase.[88] At retirement, benefits can be taken tax free.

As a result, financial planning focuses on the fundamental issues on the best use of funds - both KiwiSaver and non-retirement designated assets - to navigate financial risks in retirement, unencumbered by complex tax planning considerations.

The State Pension provides good protection against longevity risks

The New Zealand State Pension – NZ Super – is universal, non-contributory with price indexation and no means testing. It is available from age 65, and targeting 65% of net national average ordinary time wage for a couple household – a target referred to as '65 at 65'. Individual households receive around 40% of average wages.

This forms a strong base for retirement income, especially for those on lower incomes, and does not place such a strong emphasis on the need for lifetime income generation from other assets. Maintaining NZ Super as a stable and consistent part of policy is seen as critical as 40% of people aged 65 and over have virtually no other source of income, and a further 20% only a little more.[89]

Home ownership is a key aspect of New Zealand personal finances

Implicit within '65 at 65' is an expectation that most retirees will own their own homes. Home ownership is a principal focus for working-life savings and so housing wealth is typically the key asset at retirement, with 80% of those aged 60-70 owning their own homes in 2018.[90] In addition, investment in rental property has also been popular, although the New Zealand Government has taken some recent steps to disincentive this.

Housing wealth represented 57% of total wealth in 2013 and house prices have increased at an average of 7.2% in the last two decades. Housing represents the largest asset class for those in the 50th to 95th wealth percentile.[91] However, home ownership levels are falling in New Zealand and, whilst this hasn't had a significant impact on those in the current retiring cohorts, in the long term the balance of home ownership is expected to fall to around 60%.

'Cracking the nest egg' - a key policy challenge

KiwiSaver is still relatively new - only by the early 2050s will it have been available for a full working life – and there is no backdrop of previous significant workplace pension provision. With relatively small sums available to access from KiwiSaver and no legacy of retirement products, there is a tendency for retirees to treat KiwiSaver pots as a nest egg, leaving them with their provider or accessed and then put on deposit, as they are not confident to use their accumulated assets to fund their retirement.

The safety net of New Zealand Super means that people can have choice and flexibility when it comes to accessing their KiwiSaver funds in retirement. In light of this flexibility and choice, a strong theme that has emerged from research is the need for guidance on how to best draw savings in retirement.

The New Zealand Retirement Commission has stated that "guidance and advice delivered in a consistent manner in a simple system creates an environment that supports individual decision making. It is really important that the financial services sector work together to use consistent terminology and supply consistent information and guidance for the drawdown phase of retirement."[92]

The Commission believes that retirees need to have more information and guidance to build their confidence to drawdown their assets. They are focusing on promotion of a set of 'Rules of Thumb', and planning to develop supporting online drawdown calculators, to provide a consistent framework to support individual decision making and reduce the possibility for financial decision-making errors. They are also recommending that all KiwiSaver providers contact their members at milestones approaching retirement to provide them with information and guidance regarding their options.[93] It is planned that this would require providers to reference the Retirement Commission's rule of thumb resources so as to provide repeated prompts to a consistent guidance framework.

Creating a guidance framework

New Zealand Actuaries Retirement Income Interest Group (RIIG) have proposed a guidance framework to help savers think about how they can develop their own drawdown approach.

Recognising that the necessary choices are not easy and that guidance from KiwiSavers is limited to one standard level income strategy, they suggest that drawing down should be thought about using a "two buckets" framework:

- An **emergency bucket** reserved for spending needs which are not usually met from a regular budget, such as medical bills, eyesight needs and hearing aids, home or car maintenance and repairs - one to two years of living costs is suggested; and
- A **longer-term** drawdown bucket which supplies cash for regular budgeted spending.

The emergency bucket should be in readily accessible deposits and the drawdown bucket in medium-risk funds, such a conservative or balanced KiwiSaver fund.

The drawdown bucket should be accessed by the retiree creating a personal plan, guided by a consideration of four suggested Rules of Thumb. The Rules of Thumb are designed to give a reliable, useful steer, suitable for a range of personal drawdown priorities (Figure 4.2).

[88] See Getting my KiwiSaver savihttps://www.treasury.govt.nz/publications/an/an-21-01-htmlngs for my first home (ird.govt.nz)
[89] New Zealand Retirement Commission (2022) Review of Retirement Income Policies accessed at https://assets.retirement.govt.nz/public/Uploads/Retirement-Income-Policy-Review/2022-RRIP/RRIP_2022.pdf
[90] See https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years
[91] New Zealand Government the Treasury (2021) The Wealth Ladder: House Prices and Wealth Inequality in New Zealand accessed at https://www.treasury.govt.nz/publications/an/an-21-01#references-and-further-reading
[92] New Zealand Retirement Commission (2022) Cracking open the nest egg – how to spend your savings in retirement accessed at https://retirement.govt.nz/news/latest-news/cracking-open-the-nest-egg-how-to-spend-your-savings-in-retirement/#:~:text=Te%20Ara%20Ahunga%20Ora%20Retirement%20Commission%20has%20released,series%20of%20recommendations%20to%20better%20support%20the%20process
[93] New Zealand Retirement Commission (2022) Review of Retirement Income Policies accessed at https://assets.retirement.govt.nz/public/Uploads/Retirement-Income-Policy-Review/2022-RRIP/RRIP_2022.pdf

Figure 4.2: The four RIIG Rules of Thumb

Rule of Thumb	Most Suitable For	Pros	Cons
6% Rule: Each year, take 6% of the starting value of your retirement savings	People who want more income at the start of their retirement, to "front-load" their spending, and are not concerned with inheritance	Very simple: Known, regular income	Income will not rise with inflation. Risk of retirement savings running out within lifetime
Inflated 4% Rule: Take 4% of the starting value of your retirement savings, then increase that amount each year with inflation	People worried about running out of money in retirement or who want to leave some inheritance	Fund likely to last near to a full lifetime. Income will rise with inflation	Lower income than other options
Fixed-Date Rule: Run your retirement savings down over the period to a set date – each year take out the current value of your retirement savings divided by the number of years left to that date	People comfortable with living on other income (for example New Zealand Superannuation) after the set date. Those wanting to maximise income for most of their life and not concerned with inheritance	Income for a known selected period	Amount of income varies from year to year. Annual calculation necessary
Life Expectancy Rule: Each year take out the current value of your retirement savings, divided by the average remaining life expectancy at that time	Those wanting to maximise income throughout life and not too concerned with inheritance	Efficient use of fund to provide income for whole of life	Amount of income varies from year to year; low in later years. Annual calculation necessary and relatively more complicated

The RIIG work sets out illustrative income profiles to show how the real income patterns would play out if followed through retirement.

However, it is stressed that it is not intended that the plan be a single, 'set and forget' exercise. It should be reassessed at least every second year, the strategy chosen being checked against changing household and economic circumstances. The amounts can then be re-calculated, as necessary, to implement course corrections in their drawdown path.

The suggestion is not to answer the question 'How much income should I commit to take for the next 25 years or so?' but rather, 'How much income am I comfortable taking for the next year or two until I review?' It may be better to split the drawdown pot, so that one rule could be applied to part and another to the balance if savers feel the need to spread their risks, rather than focusing solely on just the one approach.

Previous research found that guidance proposed for drawdown, including the rules of thumb, should nudge savers to the relevant knowledge needed for the drawdown decisions, provide a reliable steer that is tested and up to date, and normalise the decision process.[94]

The expectation is that the most popular rule would be the fixed-date rule with most of the remainder largely split between the 6% and inflated 4% rule, leaving the life expectancy rule as a minority choice.

Consideration may also need to be given to putting in place a default drawdown strategy, rather than the current implicit default to no drawdown. If so, the inflated 4% rule may be the more appropriate as it closes off least options for future saver strategy reviews.

New Zealand Retirement Commission have adopted the Rules of Thumb approach

In its review of retirement income policies in 2022, the New Zealand Retirement Commission concluded that people need to have confidence to use their accumulated assets to fund their retirement, with a key element being the provision of appropriate guidance (including "rules of thumb") and advice.

This guidance and advice should be delivered in a consistent manner in a simple system that creates an environment that supports individual decision making about how much to withdraw, and reduces the possibility for financial decision-making errors. The Commission is delivering guidance and calculator tools based on the RIIP framework to deliver this and making these available for use via its consumer financial guidance website, www.sorted.nz .

In addition, it has recommended that

- the financial services sector, as part of the National Strategy for Financial Capability, should work together to use consistent terminology, and supply consistent information and guidance (including "rules of thumb") for the drawdown phase of retirement and
- Government should require that all KiwiSaver providers contact members at milestones approaching retirement (at 55, 64 and 65) to provide them with information and guidance regarding their options.[95]

Funds and market size focuses attention on KiwiSaver-based guidance

Whilst support could be sought from an advisor, the majority of savers' funds are likely to be too small to make paid-for advice a viable choice. However, the KiwiSaver infrastructure presents an opportunity to channel guidance prompts and support to retirees, whilst KiwiSaver funds provide a cost-effective and well-supervised vehicle for drawdown. It is worth noting that the small size of the New Zealand market has not supported any annuity product providers over the last 20 years.

Whilst it might be expected that the high value of housing assets would present opportunities to use equity release as a vehicle to supplement retirement funds, providers who have launched reverse mortgage products have not had sufficient support and have largely withdrawn from the market.

Lessons for the UK

- **Savers' reluctance to draw down assets in retirement is clearly evidenced even in a simple system with good state pension provision**
- **It is important to remember the importance of housing assets in retirement and that this can be a key factor in the level of individual's retirement income needs**
- **The New Zealand approach of consistent guidance and terminology and flexible, generic "Rules of Thumb" decumulation strategies suggests a promising and pragmatic line of policy intervention**
- **The important role of guidance in the run-up to retirement and at retirement.**

[94] New Zealand Society of Actuaries (2021) How to make drawdown a success accessed at https://actuaries.org.nz/content/uploads/2022/03/How-to-make-drawdown-a-success-FINAL-Nov21.pdf
[95] Reyers, M (2022) Decumulation: Policy Insights New Zealand retirement Commission

CHAPTER FIVE:

OTHER COUNTRIES

5.1 The Netherlands

Key Points:

- The State system provides a significant minimum income level
- Major reform of Collective Defined Contribution (CDC) schemes will convert these into more conventional Defined Contribution (DC) schemes
- The retirement income system in the Netherlands requires DC benefits to be taken as income
- The default decumulation method is currently an annuity
- A variable lifetime income contract, which combine programmed drawdown with longevity insurance, is set to become the dominant DC decumulation vehicle over the next five years

The requirement for a lifetime income

The Netherlands does not have the concept of pension flexibilities that was implemented in the UK in 2015. The law requires that all pension funds are used to provide a lifetime income.[96 97]

Traditionally, this was satisfied through conversion of individual DC funds into a conventional annuity at retirement. This is typically possible from five years before State Pension eligibility.[98] Annuities are either level or escalating at a fixed rate (to provide some inflation protection). Unlike in the UK, index-linked annuities are not widely available through insurers.

The State Pension provides a significant income for qualifying retirees

The flat rate universal State Pension benefit (AOW) provides a minimum income level for all qualifying retirees and a replacement rate of around 40% for a median/typical earner. The AOW accrues at a rate of 2% for each year for those who live or work in the Netherlands.[99] The standard target rate for retirees with State and workplace pensions is the AOW level plus 70% of the average income in excess of this level.

Variable lifetime income contracts are a growing part of the market

In 2016, reforms were implemented that enabled new lifetime income contracts, known as variable pensions or, colloquially, as 'Doorbeleggen' pensions.[100] This allows for investment risk to be continued after retirement. There is also some flexibility about how income is taken – for example, providers may allow for expected outperformance from the investments in the pension calculations and may also offer payment profiles which provide additional bridging pension until the State Pension is payable.

Up to now, fixed pensions have generally been the default retirement option, although reforms are now in progress which will make variable pensions the most prevalent mechanism for converting pension capital into an income after retirement.

At the point of retirement, providers may offer one or more different variable pensions with different risk profiles. A 30% equities/70% fixed interest investment strategy might be seen as typical, but there is considerable variation in the market. Higher investment risk therefore offers a higher expected level of pension income but with greater expected volatility in that income.

More investment risk also allows providers to apply, within regulatory limits, an assumption for outperformance over risk-free rates. This will offer members a higher initial income, but with the reasonable expectation that the investments will probably still meet that higher performance target and thus maintain a broadly level income.[101]

Retirees are provided with information to illustrate the expected outcomes from different investment strategies and assumed returns, as well as outcomes in 'optimistic' and 'pessimistic' scenarios. The model to calculate these scenarios is prescribed by the regulator.[102]

The level of initial income determined by the scheme is then adjusted (at least) annually depending on the investment returns achieved and changes in interest rates. Returns in excess of the assumed required return result in an increase in the next year's income. Similarly, returns below the assumed rate result in a reduction by that shortfall percentage.

Providers of variable pensions have the ability to smooth income variations over a period of up to 10 years (more typically, three to five years is used). To limit intergenerational risk-sharing, this smoothing mechanism is directly applied to the member's capital value. Thus, if they receive more/less pension income via the smoothing mechanism, this directly leads to a lower/higher pension capital value.[103] For commercial or practical reasons, some variable pension providers may choose not to apply such smoothing.

Variable pensions can be managed on a collective or individual basis: in the collective arrangement all pensioners will receive the same increases or decreases in their pension, whilst in an individual arrangement, the pension change will be based on how the investments of the individual performed. The collective basis therefore assumes that everyone is protected against interest rate movements to the same extent and are invested in the same risk asset proportions.

Mortality risk is pooled

Whilst the level of income is not guaranteed and fluctuates with investment returns, an income is guaranteed for life through a pooling of mortality risk. Any funds remaining at an individual's death (or death of a spouse, if a joint-life pension) are retained by the fund and distributed amongst the survivors' pots. This "biometric return" is included in the original actuarial assumptions of the initial income level and is added to investment returns in the income adjustment calculations.

This system relies on adequate pooling of risk to establish equity of treatment. This can be facilitated within the large schemes typical of the compulsory Dutch occupational scheme system. It can also be facilitated for commercial schemes using reassurance contracts.[104]

Portability is facilitated at point of retirement

DC scheme retirees with contracts with insurers or Premium Pension Institutions (PPIs), which are broadly equivalent to UK Master Trusts, can shop around at the point of retirement and select from the market both for conventional annuities and variable pension arrangements, and transfer their funds to their chosen provider. Once entered into, these contracts are not portable as the member has entered an insurance or longevity risk-sharing solution. Retirees from other providers generally have the right to select from other providers only if their chosen option (a fixed or variable pension) is not offered.

[96] A recent law change will allow up to 10% of the value of the fund to be taken optionally as a lump sum at retirement. This is treated as income for tax, so will be taxed at the member's marginal rate
[97] Joint life pensions can be selected and, in this case, the last survivor pension does not need to be life long
[98] If a pension is taken more than five years before State Pension age (Spa) and the retiree then needs to return to work, there are hefty tax penalties.
[99] See https://www.expatica.com/nl/finance/retirement/the-dutch-pension-system-106854/
[100] This translates broadly as 'continued investment'
[101] The investment return assumed is based upon the interest rate curve and allowable excess return for risk assets. There is a methodology prescribed for converting the asset mix into an investment return so the more risk assets held the higher the assumed investment return can be, subject to a maximum. However, pension providers can apply lower investment returns than the methodology prescribes.
[102] These are set at +/- 5% of the central income assumption
[103] The Dutch describe these different types of smoothing as "smoothing with your own pot" versus "smoothing with the collective pot".
[104] Warren, O and Irwin, M (2021) Going Dutch: What are variable DC pensions? The Actuary, November 2021 accessed at https://www.theactuary.com/2021/11/04/going-dutch-what-are-variable-dc-pensions

Reform of Dutch CDC schemes is expected to make variable pensions the dominant decumulation mechanism within five years

With the reform of Dutch CDC schemes agreed this year, members' accrued pensions will be converted into individual pension pots, either as part of a single collective investment strategy with returns distributed via a novel glidepath mechanism (the solidarity pension arrangement or SPR in Dutch) or as part of a more traditional individual DC arrangement with a choice of glidepaths or self-select funds for members (the flexible pension arrangement or FPR). This will occur during a five-year transition period to 2028.

Under both, the mechanism for variable pensions will broadly follow the form described above, with fixed pensions an additional option for FPR members. As a result, variable pensions are expected to become the dominant DC decumulation mechanism in the next three to five years.

Under the new pensions law, the provider is also obliged to establish the risk profile of the members at least once every five years and take it into account in the solution(s) they offer. Much research is being carried out to determine the best methods for determining members' risk preferences and converting these into the choice of glidepaths to progressively reduce an individual's investment risk during the retirement phase (or, in the SPR case, finding the best single glidepath to best meet the membership's preferences as a whole). Where a choice of glidepath is offered, members will be recommended one based upon their individual risk preferences, but the member will be free to choose another or a self-select option.

Lessons for the UK

- **The Netherlands illustrates a system with limited choices at retirement that is focused on generating retirement income**
- **Within this, major changes are in train to shift from traditional annuities to variable lifetime income contracts**
- **These changes have been made after extensive consultation and preparation and are being phased in over a further five-year period**

5.2 Denmark

Key Points:

- The Danish system illustrates a different journey towards variable lifetime annuities
- Schemes have already largely moved from guarantees to market-based variable returns
- Changes may not have been fully appreciated by members and debate continues around regulation and improving products offered

Denmark differs from the Netherlands as it has had DC in place of CDC

Denmark has a similar pensions system to that of the Netherlands with a universal Old Age Pension based on residence, although in Denmark there is a means-tested supplement.

Workplace systems sit on top of the State system, organised via a similar system of workplace social partnership, resulting in near universal membership. However, in Denmark, workplace pensions are entirely conventional rather than CDC schemes.

DC plans traditionally had guaranteed returns and annuity rates

DC plans, until about 15 years ago, were traditional products with guaranteed rates of return in the investment phase that converted into an annuity, again at guaranteed rates. These were of the same type – with-profit deferred annuities – as were typical in the UK for the self-employed, prior to the introduction of personal pensions.

Guaranteed returns were gradually reduced as interest rates fell[105] and life expectancy increased, ultimately putting pressure on providers as it became more difficult to generate returns sufficient to meet the guarantees. As a result, and faced with increasing stringent solvency requirements, schemes have typically switched to non-guaranteed products with market-based returns and variable-income annuities at retirement.

Changes to market-based returns and variable-income annuities may not have been fully appreciated by members

The move away from guarantees took place whilst regulation of the non-guaranteed environment was still developing. A number of issues resulting were not fully debated or disclosed to members at the time. It was only since 2014, when many customers had shifted, that clear regulatory guidelines were in place. As a result, pension holders may not have been made fully aware that once the guarantees were given up, the higher expected returns were also associated with an increase in uncertainty of retirement income.[106]

Calls have continued to increase consumer protection and to manage better the volatility in retirement incomes

The Danish Financial Supervisory Authority (DFSA) has since consulted on possible ways of increasing consumer protection, including information that can ensure customers really understand non-guaranteed products and their associated risks.[107]

[105] In pension schemes established up to 1996, the guaranteed interest rate was usually between 3.7% and 4.5%; for schemes established between 1997 and July 2005, the interest rate varied between 2% and 3%. Since then, the guaranteed interest level has varied between 1.25% and 0.00%.
[106] Balter, A et al (2018) The move towards riskier pension products in the world's best pension systems Netspar Design Paper 105 accessed at https://www.netspar.nl/assets/uploads/P20180626_DES105-WEB.pdf
[107] Danish FSA (2017) Pensions when the guarantees disappear accessed at https://www.dfsa.dk/-/media/Nyhedscenter/2017/Discussion-Paper-Pension-pdf.pdf

Criticisms continue that market volatility causes retirement income to vary too much from year to year, creating anxiety for members in retirement or about to retire. Better individual investment risk profiling and product designs to avoid excessive risk taking have been called for, designed to align with the risk tolerance and capacity of members to accept risk, especially as they get older.[108]

Ældre Sagen, the Danish Old Age Association, have stated that "The Financial Supervisory Authority should ensure that there is some form of smoothing out of the fluctuations in these products. This way, as pensioners, we automatically get a smooth development in the pension, unless we actively choose something else"[109], whilst the Danish Consumers Association (Forbrugerrådet Tænk) have observed that "It cannot be intended that people should sit by themselves and do cigar box economics or invent random Storm P[110] [meaning crazy and absurd] solutions. The pension companies should develop a cheap solution for more smooth payments, which can then apply to everyone or be an option".[111]

Greater stability in pension benefits by smoothing payments in various ways could be created using investment-based smoothed income approaches without the need for individual or collective buffer capital.[112]

Lessons for the UK

- **Market forces can drive change at a pace that challenges public policy and oversight**
- **Consultation and regulation should stay ahead of the market to ensure that consumers are properly informed by providers and protected against new or unexpected risks**

5.3 Chile

Key Points:

- Chile's 40-year-old DC system has recently been significantly underpinned by a broadly-based State Pension
- Compulsion applies both in accumulation and in decumulation
- Limited choice is only available to a minority with sufficient funds
- Programmed withdrawal has significant uncertainties over income levels

Chile's DC workplace pension system has been in place for 40 years

Since the pension reforms of the 1980s, during Chile's period of military rule, employees are required to save 10% of their earning into a DC pension plan administered by a regulated private provider (AFP). These reforms eliminated employer contributions, passing all the risk and burden of saving to the individual. The system also provides disability and survivor pensions via compulsory insurance.[113]

The normal (legal) retirement age is 65 for men and 60 for women. This is a minimum requirement; the individual can decide to retire later if they wish. To retire earlier than the normal retirement age, the employee must satisfy a self-financing test to access choice in their decumulation.

Programmed withdrawal is compulsory for those below the choice threshold

At retirement, the saver has the option to choose different pension products, only when sufficient funds have been accumulated[114], to purchase an annuity that would generate an income equal or above a defined threshold, currently at CLP$ 108,000 (approximately £100). If this threshold is not passed, then the fund will be placed by default into a programmed withdrawal. Fewer than 40% of savers are typically able to pass this threshold.

State Pension underpin has been significantly strengthened

In January 2022, the Government reformed the first pillar (solidarity pillar) by replacing the existing solidarity pension, introduced in 2008, by a Universal Guaranteed Pension (in Spanish Pensión Garantizada Universal or PGU). The PGU features a flat-amount State-financed pension, which currently equals a monthly value of approximately US$250 (slightly above the poverty line). The PGU is available to the poorest 90% of the population aged 65 and above. This social pension complements the self-financed pension provided by the DC scheme.[115]

Structured choices available at retirement for those with adequate savings

For those savers passing the threshold requirement, there are four choices available to them when accessing their funds:

1. Programmed withdrawal of funds – a drawdown of funds from investment designed to provide a variable income for an expected lifetime;
2. An indexed annuity – providing a guaranteed income with escalation linked to inflation;
3. A temporary pension[116] (for two to three years) together with a deferred annuity[117]; or
4. A split of savings between (a) programmed withdrawal and (b) an annuity.

The saver (or their adviser) will submit their details to a central system (SCOMP[118]), expressing interest in one or more of these options. The SCOMP system will then generate offers, via offer certificates, from all companies willing to quote and return these to the saver. They can then submit the offer certificate to their provider of choice to access their funds. This device was introduced to stimulate competition between providers.

[108] Linnemann, P (2022) Overcoming inefficiencies in investment-based retirement income. Actuaries Digital, 29 September 2022 at https://www.actuaries.digital/2022/09/29/overcoming-inefficiencies-in-investment-based-retirement-income/
[109] Politiken 11 June 2022
[110] Robert Storm Peterson, a Danish cartoonist known almost exclusively by his pen name Storm P, is perhaps best known for his Storm P. machines: comic drawings of machines that perform very simple tasks through an unnecessarily complex and usually humorous series of actions – similar to those of Heath Robinson in the UK
[111] Pederson, MB in Finans 15 July 2022
[112] Linnemann, P (2022) Overcoming inefficiencies in investment-based retirement income. Actuaries Digital, 29 September 2022 at https://www.actuaries.digital/2022/09/29/overcoming-inefficiencies-in-investment-based-retirement-income/
[113] Castiglioni, R (2018) Chile in McClymont, G and Tarrant, A Towards a new pensions settlement Rowman & Littlefield International
[114] Both funds in occupational (pillar 2) and any private additional pensions (pillar 3) are considered
[115] Federacion Internacional De Administradoras De Fondos De Pensiones (2022) Progress of the Pension Systems Accessed at https://www.fiapinternacional.org/wp-content/uploads/2022/03/mdp_enero_febrero_2022_ing.pdf
[116] The level of income from the temporary pension is capped at 2 times that of the subsequent annuity
[117] Since September 2022, a similar pension product is also available (a tiered annuity) in which the pensioner can get a higher and fixed amount in real terms for a period of 2 to 3 years, after which an annuity is provided. This product is provided by insurance companies.
[118] https://www.scomp.cl/scompsa/que-es-scomp.html

The typical saver will select the programmed withdrawal or the annuity. However, the temporary annuity option is gaining in popularity to help manage changes around retirement. One example would be to provide an initial supplementary income at a lower level, to support a phased retirement from employment.

Early retirement and lump sums are also subject to threshold tests

Savers may access their DC funds to take early retirement prior to SPa, provided they can demonstrate the ability to self-fund. The threshold set is that the saver can generate a 70% replacement rate of their income from their pension funds.

Similarly, a saver may choose to take a lump sum from their DC pension, but such withdrawals must still leave sufficient funds to pass the 70% replacement rate test.

Programmed withdrawal provides a defined mechanism for lifetime income, but is likely to result in significant volatility in retirement income

If the saver selects programmed withdrawal, the funds remain with their AFP[119], but with the investment restricted to the two most conservative fund options. The level of withdrawal income is calculated by a regulatory defined algorithm based on assumptions of expected longevity, interest rates, and the effective investment returns obtained on the residual savings kept in the AFP pension fund.

The level of withdrawal income is adjusted annually to reflect actual vs assumed interest rates and changes in mortality, and can increase or decrease significantly in response. Swings of 5% or 10% are considered typical. This level of volatility is creating pressure on the regulator to change the methodology to increase the level of smoothing inherent in the algorithm. It has also been used to support calls for creating a default choice of annuity at retirement.

The programmed withdrawal system also contains a mechanism to ensure a lifetime residual income, as a small premium is taken from the fund at retirement to provide a guarantee that income does not fall below a floor of 30% of the first withdrawal income. This can be seen as a mechanism to support withdrawal rates designed to make full use of funds during retirement. Any residual funds at death are passed on as bequests.

Lessons for the UK

- **Compulsion produces different kinds of drivers and challenges for public policy**
- **Note the changes to market process in the SCOMP system to try to drive better retirement choices in the absence of effective market competition**
- **Good outcomes in retirement still rely first on a good State system and then adequate funds in workplace pensions**

[119] The saver does have the option to transfer funds to another AFP. In general savers do not change provider and have not been sensitive to fees. To stimulate more competitive demand a bidding mechanism was introduced in 2010 where the AFP offering the lowest fee gets the new members for a period of 2 years.

5.4 Singapore

Key Points:

- Retirement benefits in Singapore are embedded in a much wider funded social benefits system, the Central Provident Fund (CPF)
- Savings allocated to the Retirement Account within CPF must be used to generate a retirement income once they exceed a minimum threshold
- The default is a level annuity, but for those below the threshold it is programmed drawdown with a low-level underpin
- Retirement income can be severely impacted by rising medical care and insurance costs

Pension saving is part of a much wider social benefits scheme

Retirement funding is provided within the Singaporean social security system, the CPF. The origins of the CPF date back to 1955. It was created by the colonial Government for non-Government employees, using the model of the British overseas pension scheme. The CPF has been extended many times, since its origins in retirement savings, to cover a whole range of uses including for housing purchase, education and medical care and paying the premiums of the national basic catastrophe medical insurance scheme, MediShield Life.[120]

The CPF is a funded workplace system with mandatory employer and employee contributions for citizens and permanent residents, with contribution rates for those aged under 55 currently at 17% and 20%, for employers and employees respectively. These tax-exempt contributions go to three funds:

1. **Ordinary Account** – used to buy property as well as approved financial assets and insurance funds. Balances can also be used to cover education costs.
2. **Special Account** – used for retirement funding and contingency purposes
3. **Medisave Account** – used to fund medical expenses and pay for approved medical insurance

The ordinary account attracts the bulk of savings, especially for younger people – the splitting of savings to accounts depending on age. Funds receive a guaranteed interest rate from the CPF, the Special and Medisave rates attracting a higher interest rate than the Ordinary account.[121] Citizens can choose to invest their funds in other financial products, but the returns have not generally been attractive.

Retirement Accounts are created at age 55, for access at age 65

At age 55, the special account is transformed into a Retirement Account. This is required to be up to a minimum prescribed cash sum, the Full Retirement Sum (FRS). Individuals owning a property have the option to only meet the Basic Retirement Sum (BRS), which is half the FRS balance. The other half is considered to be met by pledging a housing unit. However, this only applies if the remaining lease of the property lasts to when an individual reaches 95 years old. The level of the FRS is assessed and uprated annually.[122]

[120] MediShield Life works on an inclusion basis, that is only stated conditions qualify for coverage. What is not stated is not covered. This includes most psychiatric and psychological conditions, cancer treatment options, and many other conditions. Hence while it is universal, in that all individuals must enrol, its coverage is considered basic when compared to other systems like the NHS.

[121] Rates at 1/1/23 were 2.5% for OA and 4% for SA and Medisave (source: CPF website)

[122] The FRS is the original retirement account. This was split into its current structure in the late-90s and early-2000s as it was found that many members could not meet the FRS after housing purchases. But despite the creation of the BRS, the FRS remains the benchmark for individuals to attain.

Housing assets can be used to supplement Retirement Accounts

If insufficient funds have been accumulated in the Special Account by age 55 to meet the BRS, additional funds, if available, must be transferred from the ordinary account to secure the sum. Up to half of the FRS can also be secured against property assets held in the Ordinary Account.[123]

Up to SG$5,000 (approximately £3,000) can be withdrawn from the Retirement Account at age 55, and a further 20% of the Retirement Account can be accessed as a lump sum from age 65.[124]

As from 2015, for those born after 1958, the Retirement Account automatically enrols members into a deferred annuity, payable from age 65. Members are exempted from the annuity scheme if there is less than SG$60,000 in the Retirement Account when withdrawals begin (typically from 65), or if they are enrolled in an annuity or pension scheme that matches or exceeds the CPF annuity's payout.

Retirement income default is a level annuity with optionality for those with larger funds

At age 65, funds can be accessed from the Retirement Account to provide a tax-free income. The default for those with a cash sum up to the BRS figure is a level annuity accessed via the CPF. For those with more, then they can choose to have a higher level of annuity via the CPF or to withdraw cash in excess of the BRS as and when required. A common option is to leave any remaining balances as bequests to next of kin.

An option is available to take an annuity that escalates at 2%, where access can be deferred for up to five years in return for a higher annuity income.

A low-level income underpin is provided for those with insufficient funds

For those with less than the BRS, a regular income is paid as a programmed withdrawal, rather than an annuity, with a guaranteed floor, currently SG$350.

Retirement income can be severely impacted by healthcare costs

Whilst the separate Medisave account builds funds to pay for medical insurance and medical costs, medical insurance premiums increase with age based on the underlying costs – there is no age cross-subsidy in the system. As a result, funds can become exhausted within the Medisave account with calls made on other resources, include retirement income and, ultimately, the wider family unit.

Lessons for the UK

- **This system is very different from that in the UK and operates in a very different societal context, and so it is difficult to draw many comparisons**
- **It does illustrate how retirement income can be impacted if funds saved for retirement are also made available for other purposes, such as housing and care costs**

[123] The assumption is that each generation will form a new household in a separate housing unit such that the prevailing unit will likely become larger than necessary as only the parents will continue to live there. Hence, one line of the rhetoric is to downgrade and 'right-size' and another line is to 'unlock the remaining monetary potential' of the HDB lease. However, this only applies to HDB flats with more than 30 years remaining on their leases. Currently, no HDB flat has reached this remainder. Private property owners who 'right size' are encouraged to top-up their balances to the FRS, or more, from the sale proceeds.
[124] This figure was reduced from 50% in 2015

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Acknowledgement & Contact Details

The Pensions Policy Institute is grateful for input from many people in support of this paper, including:

Claire Altman
Keith Ambachtsheer
Marianne Assaf
Danielle Baker
Bill Catchpole
Ross Clare
Peter Cowell
Chris Curry
Madeline Forrester
Olga Fuentes
David John
Janine Harrison
Stuart Jarvis
Jamie Jenkins
Dick Kamp
Tarryn Kleinschmidt
Chang Yee Kwan
Paul Leandro
Maritha Lightbourne
Per Linnemann
Sarah Luheshi
Mark Ng
Theo Nijman
Alison O'Connell
Shantel Okello
Warren Oliver
Diana Olsburg
Jonathan Parker
Oliver Payne
Ian Perera
Laura Quinby
Ream Creative
Christopher Scicluna
Adam Sewell
Michelle Tan
Mark Upton
Chris Wagstaff
Jo Wong

Editing decisions remained with the author who takes responsibility for any remaining errors or omissions.

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ISBN 978-1-914468-11-7

Registered Company Number: 04145584. Charity Number: 1087856 (England & Wales)