POLICY BRIEFING

ENABLING CHOICE FOR RETIREMENT

The need for reform of the compulsory annuitisation rules

THE NEED FOR CHANGE

Defined contribution schemes are growing and taking an increasing share of the pensions market. Alongside this, 2012 will see the advent of personal accounts with the auto-enrolment of millions of low income consumers into yet more DC schemes. This brings with it the prospect of significant pension pots for these individuals. A median earner, for example, could end up with a pension pot of almost £100,000 (in today's money) after 28 years of saving just the 8% minimum contribution proposed under the current reforms.

Despite this change in the pensions landscape there has been little discussion about how individuals could make the most of their pension pots when they come to retire. If consumers are to get a decent income in retirement the Government needs to offer more choice, enabling greater flexibility and the potential for higher income at retirement for the increasing number of individuals being encouraged to save in these defined contribution (DC) schemes.

THE WAY FORWARD

Just as diversification is the key to investment before retirement it has an important part to play after retirement too. The current rules which require people to buy an annuity by the age of 75 act as a barrier to diversification, and prevent choice and product innovation.

IMA research demonstrates that non-annuity investment products can provide a lifetime income for retirement. The research modelled eight different drawdown strategies that could be used as alternatives to conventional annuities finding that it is possible to have a withdrawal strategy that delivers higher returns while avoiding the risk of running out of money in retirement. It concluded that the combination of lifetime income and bequest under the alternative strategies delivers up to 20 per cent more than conventional annuities. But because the strategies carry greater exposure to market risk, a combination of annuities and drawdown may be optimal for many people.

There are two potential alternatives to conventional annuities:

- **Investment-linked annuities.** Variable or hybrid annuities combine the certainty of a guaranteed long term income with the benefit of an income stream with greater links to investment performance and the better returns that can generate.

- **Income drawdown.** The accumulated pension fund, or part of it, is invested in a suitable mix of assets. Each year an income is taken from these funds.

While a number of investment-linked annuities do exist in the UK market, the IMA believes that in a flexible market there is room for a full range of products from conventional and investment-linked annuities to income drawdown.

BENEFITS OF INCOME DRAWDOWN

Income drawdown could contribute to retirement income in a number of ways.

- Access to a diversified pension pot after retirement but before annuitisation.
- Ability to draw on wider, non-pension financial wealth during retirement.
- Can be used alongside annuitisation.
- Can be used as a complete alternative to annuitisation.

The IMA has done a range of simulations to explore the potential returns of a number of income drawdown solutions. While we are not advocating a specific approach, our results demonstrate the potential advantages that income drawdown approaches could offer over a conventional annuity product. These advantages can be seen from a combination of the income stream and the bequest potential that is absent with conventional annuities.

The tale below demonstrates the difference in income receivable from an index-linked annuity, a level annuity and a drawdown strategy.

	Age 65	**Age 70**	**Age 75**	**Age 80**	**Age 85**	**Bequest**
Index-linked annuity	£4,660	£4,660	£4,660	£4,660	£4,660	Nil
Level annuity	£7,210	£6,163	£5,066	£4,164	£3,422	Nil
Drawdown						
Median	£5,130	£5,200	£5,154	£5,137	£4,858	£18,639
90th percentile	£5,130	£6,942	£8,532	£9,883	£10,533	£42,360
10th percentile	£5,130	£3,744	£2,937	£2,597	£2,351	£7,963

Assumptions:
Man aged 65 on retirement, 85 on death
"Exponentially increasing percentage" strategy
Investment strategy – 60% equities, 20% bonds, 20% cash
Tax of 55% applied to bequest
Inflation 4.0% a year

CHALLENGING COMPULSION

The arguments used in favour of compulsory annuitisation are that it:

- **Provides certainty of income** during retirement.
- **Avoids moral hazard,** preventing individuals from using tax-subsidised pension savings in the early years of retirement and having to fall back on welfare in later years.
- **Focuses on retirement,** compelling individuals to use tax-subsidised retirement savings for providing an income in retirement – rather than using it to make bequests to relatives.

These arguments can be challenged:

- **Certainty** has to be weighed against potential costs and risks.
  - varying interest rates and inflation risks may mean that an individual receives less retirement income if they are forced to purchase an annuity at a specific time.
  - the ability to make one-off capital withdrawals to pay for emergencies or unexpected health-care costs is excluded.
  - individuals purchasing conventional annuities (the majority) forego the opportunity of making additional returns from exposure to assets other than bonds.
- **Avoidance of Moral Hazard.** The risk could be minimised in a number of ways, for example, by transferring savings into an approved pension drawdown vehicle with maximum drawdown limits and minimum withdrawal levels. An individual would not be allowed simply to access their savings however they see fit.
- **Retirement Focus.** IMA accepts that bequests should not be a primary driver of retirement saving, but the evidence is that this is not generally the case. It is hard to see why someone of moderate income whose pension pot is their main financial asset should be prevented from leaving a bequest to relatives. The bequest could simply be taxed appropriately.

EDUCATION AND ADVICE

Another popular argument against creating greater flexibility in the decumulation stage is that many individuals do not possess the knowledge required to make complex financial decisions. IMA agrees that there is a need to ensure there is greater public understanding of retirement products in general, but this should not in itself act as an obstacle to regulatory reform. Furthermore, the Government is comfortable with the range of investment and contribution level choice offered by DC schemes in the accumulation stage. It is hard, therefore, to argue that the complexity of decisions in the annuities market is necessarily more difficult as to justify a more restrictive regime at the decumulation stage.

For further information please contact:
Mona Patel, Head of Communications
mpatel@investmentuk.org
Tel: 020 7831 0898