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Leading academics quantify impact of the Government's proposal to end compulsory annuitisation in major two-part study

Pensions Institute report sets out the key consequences of annuity reform to ensure best policy reform for the UK economy

- Minimum Income Requirement identified at £14,100 though significant means-tested benefit may still exist
- Over 70 percent of retiring pensioners with private pensions savings would have insufficient wealth to secure a MIR at the levels identified by the study
- Risk to taxpayers remains significant
- Lack of secure pension may leave vulnerable elderly exposed to managing retirement wealth to generate income

If the Coalition Government is to increase flexibility in retirement by ending the requirement for pension scheme members to purchase annuities by the age of 75, it must recognise the consequences for the public finances of setting a Minimum Income Requirement (MIR) which is too low - before this greater flexibility kicks in. At the same time, the Government's proposals are likely to result in an increase in choice for pensioners which will lead to a risk of increased poverty for those who make poor investment decisions with their wealth and, hence, political pressure for more state support for the retired population. These are the conclusions of a new study from three of the UK's leading pensions academics, Professor David Blake, Director of the Pensions Institute, Dr Edmund Cannon and Professor Ian Tonks.

This report, 'Ending compulsory annuitisation: Quantifying the consequences', published today and sponsored by Prudential, is intended to provide a quantitative assessment of the issues raised in an earlier report which stimulated the debate about the proposal to end the mandatory requirement to purchase annuities in pension schemes.¹ The report has these key findings:

1. Minimum income of £14,100 a year

The level at which the MIR would need to be set to have a minimal effect on demand for Pension Credit would be £14,100 for an individual and around £20,000 for a couple (both including Basic State Pension). However, these estimates are very conservative and ignore the uncertainty attached to future wage and price inflation. When this uncertainty is taken into account, people who satisfy the MIR could still be entitled to significant means-tested benefits in future years.

2. Avoid risk of cost to public purse

Around 28% of retiring pensioners with private pension savings would have sufficient wealth to secure a MIR at these levels.

3. Maintain healthy annuity market

Annuities will continue to be the main way in which retirement income is secured for those with defined contribution funds. If the MIR is set at the levels suggested, then the annual compulsory purchase annuity market would remain strong and still be worth around £9 billion, down from £11 billion currently.

¹'Ending compulsory annuitisation: What are the consequences?' is designed to stimulate the debate about the proposal to end the mandatory requirement to purchase annuities in pension schemes as formally announced in the Budget Statement on 22 June 2010 and subsequently expanded upon in the HM Treasury consultation document 'Removing the requirement to annuitise by age 75' released on 15 July 2010. The report is available here: <http://pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences.pdf>.

4. Government proposal distorts pension perception

A key problem with the Government's proposal is that it changes the frame through which a pension scheme will be viewed and assessed. The appropriate frame for viewing a pension scheme is the 'consumption' frame but after the implementation of the Government's proposal, a pension scheme is likely to be viewed through an 'investment' frame. This will make the purchase of an annuity not only appear risky, but also very unfair to the pensioner's family who will now be denied their 'right' to inherit the pension fund when the pensioner dies.

Annuities transfer risk from the pensioner to the insurance company. Optimising a "do-it-yourself" decumulation investment strategy can be highly complex and needs to take into account anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests. Further, the optimal strategies are not static and involve complex choices about the timing of annuity purchases. However, these strategies typically fail to take into account the cognitive problems that very elderly people can face when dealing with investments.

Professor David Blake comments: "The reforms could leave many older people managing their retirement wealth, whereas previously they had a secure pension income. We report that, whether as a result of cognitive impairment or an inappropriate framing of choices, many older adults will find it more difficult to make the right decisions about how to invest and spend their retirement savings. The Government could soon find itself embroiled in another mis-selling scandal and this time involving vulnerable elderly people."

5. Impact on government bonds

The proposal to abolish the annuitisation requirement will have an effect on the long-term government bond market. If retiring pensioners access their DC lump sums, insurance companies will no longer need to hold as many government bonds to back their annuity products, and would become net sellers of £0.5 billion - £1.2 billion of gilts annually. Similarly, if DB pensioners access the lump sum equivalent of their pensions at retirement, DB funds will liquidate between £3.2 billion and £5.2 billion of long-term government debt annually. These sales of government debt will occur at a time when the Government is attempting to fund a vast deficit through bonds issuance.

Barry O'Dwyer, Deputy Chief Executive, Prudential UK & Europe, said:

"At their most basic level, pensions are a tax-incentivised locked-box to provide an income for people after they cease to be able to work. It's important we don't lose sight of that and recognise the potential pitfalls of changing this simple and successful formula. For most people, an annuity will remain the most suitable means of providing an income in retirement and we see consumer demand remaining healthy with maturing DC pensions driving this demand in the future. While we agree with the Government that there is a case for more flexibility we encourage it to take on board the analysis in this report and proceed carefully."

The report which is entitled 'Ending compulsory annuitisation: Quantifying the consequences' is available at <http://pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences2.pdf>

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Notes to editors

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The Pensions Institute's mission is to undertake high quality research in all fields related to pensions, to communicate the results of that research to both the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert advice to the pensions industry and to government. Established in 1996, the Pensions Institute was one of the world's first academic research centres to focus entirely on pensions. It is also one of the first to take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance and actuarial science, through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions. The Pensions Institute unites some of the world's leading experts in these fields with a view to resolving many of the problems caused by the disparate elements making up the pensions mix.

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