

Ending compulsory annuitisation: Quantifying the consequences

David Blake
Edmund Cannon
Ian Tonks

29 September 2010

pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences2.pdf

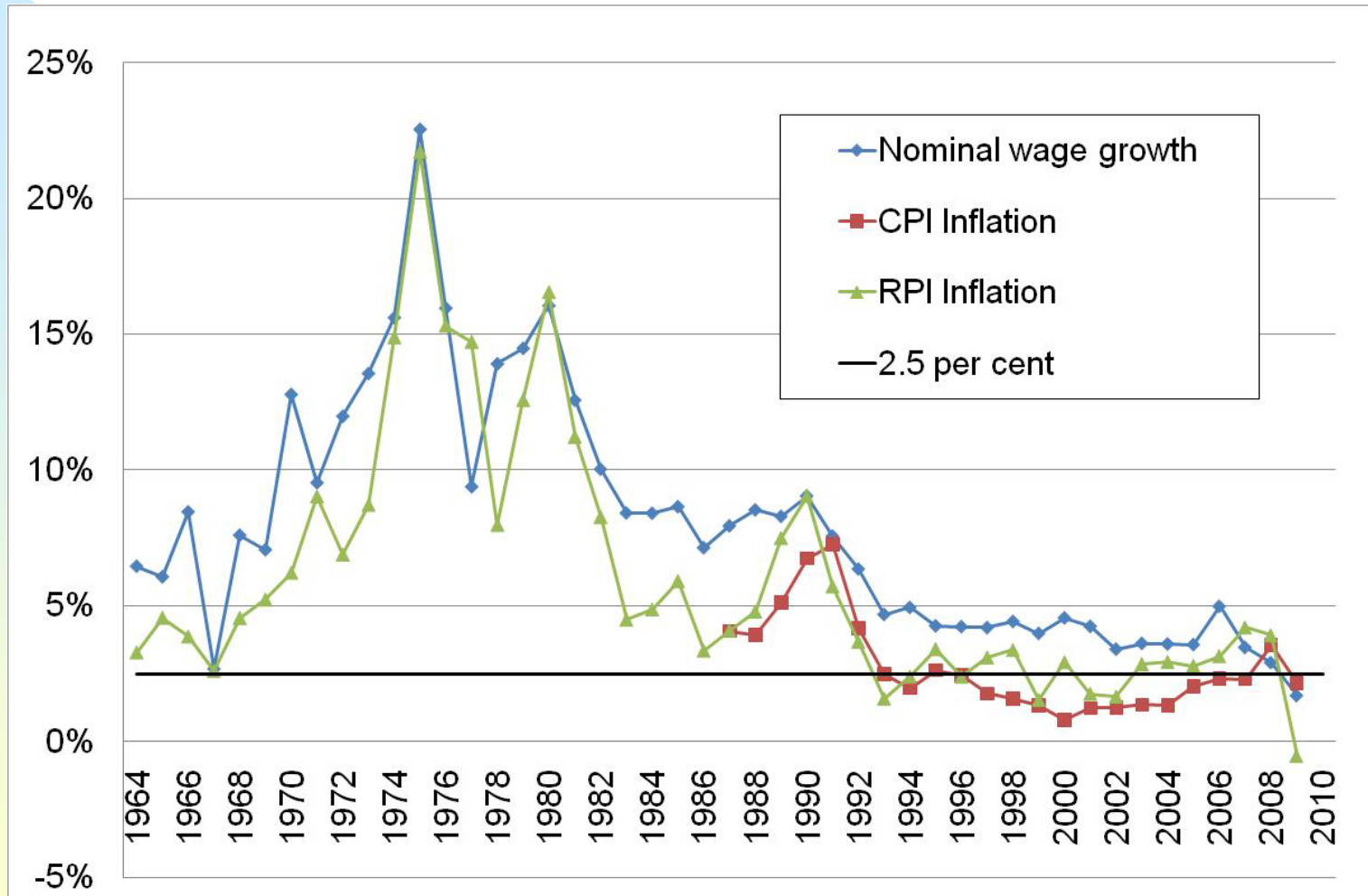
Agenda

- Calculating the Minimum Income Requirement
- Numbers of pensioners expected to satisfy the MIR
- Inheritance and savings decisions
- Impact of the proposal on the UK annuity market
- Impact of the proposal on defined benefit schemes
- Impact of the proposal on long-term government bond markets
- The optimal decumulation investment strategy and the cognitive problems that elderly people can face when dealing with investments
- Conclusions

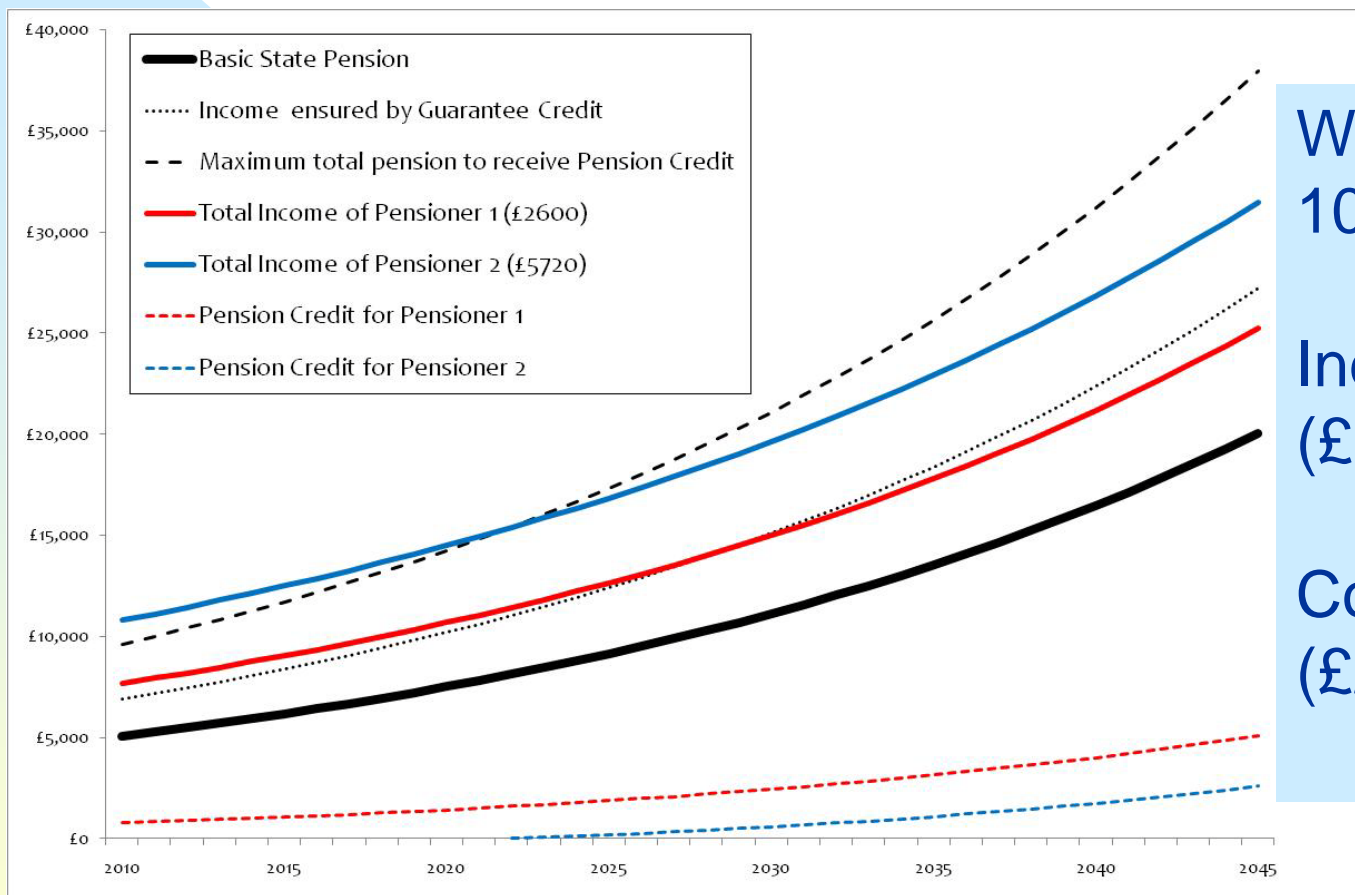
Calculating the Minimum Income Requirement (MIR)

- Government's requirement is that there is a minimal burden on the state through (means-tested) benefits.
- Need to consider rules for updating the Basic State Pension and Pension Credit.
- Complicated by existence of other benefits (and their interactions).
- Considerable uncertainty in forecasting the future.

Calculating the MIR: inflation and earnings



Calculating the MIR: inflation and earnings

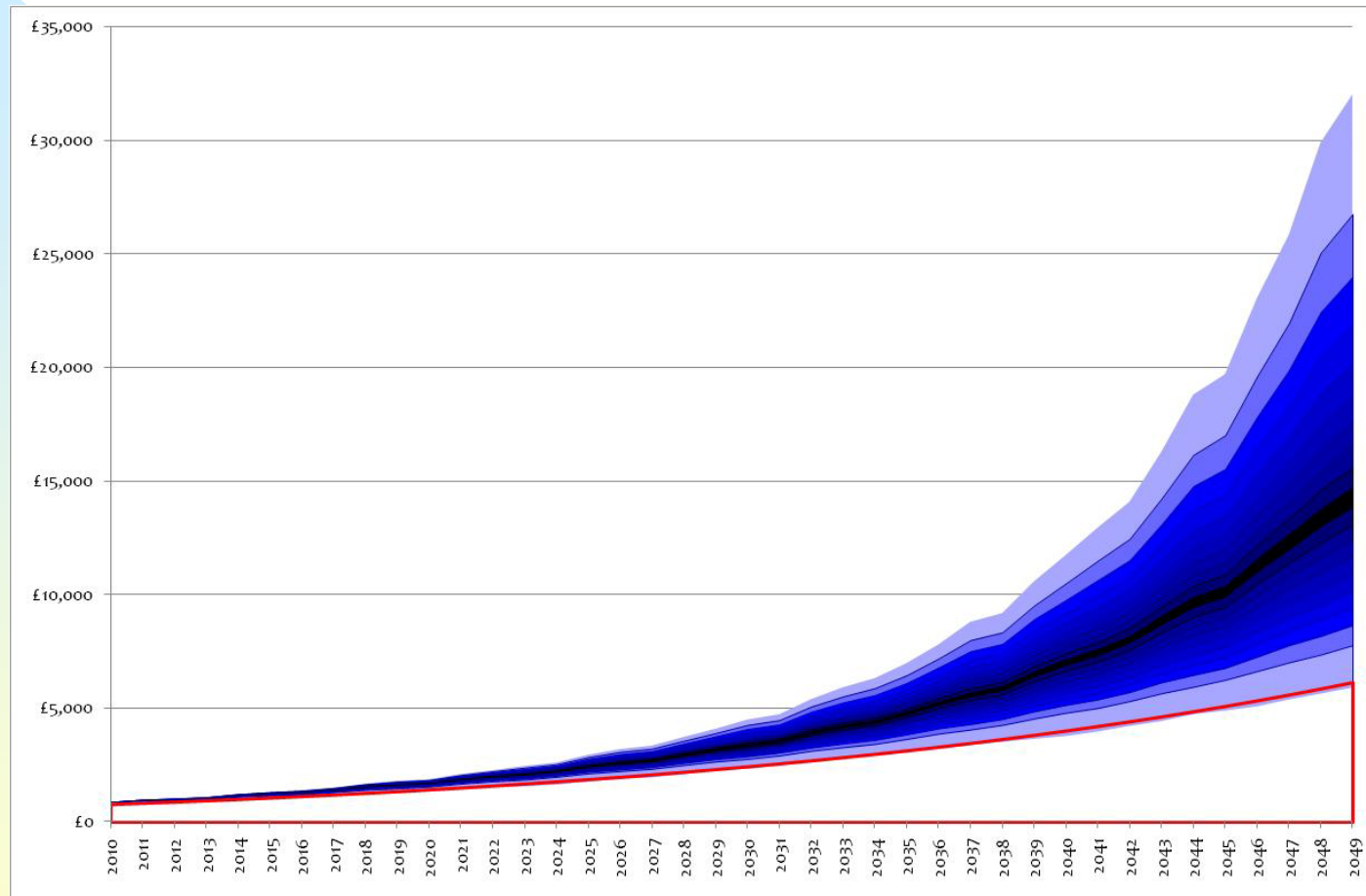


Work back from age 100 to get MIR:

Individuals: £9,000
(£14,100 with BSP)

Couples: £11,900
(£20,000 with BSP)

Calculating the MIR: uncertainty



How many pensioners will have assets above the MIR?

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

Inheritance and savings decisions

“The Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance ... The Government will monitor this closely and will take further action if there is evidence of such activity.”

- 55% withdrawal charge merely balances earlier tax benefits for *higher rate taxpayers*
- 55% is a penal rate for *basic rate taxpayers*
 - who should pay only 41%
- So it will not encourage more saving
- May be perceived as unfair

Impact of the proposal on the UK annuity market

- Annual value of annuity market: £11 billion in 2009
- Examine impact on this market of retiring-cohort accessing capped or flexible drawdown above MIR

Annuity Value = No. pensioners x Annuity Income x Capitalisation factor

- Data on number (and types) of pensioners and personal pension income from population estimates and DWP Pensioner's Income Series
- Capitalisation factors from Institute of Actuaries CMI data

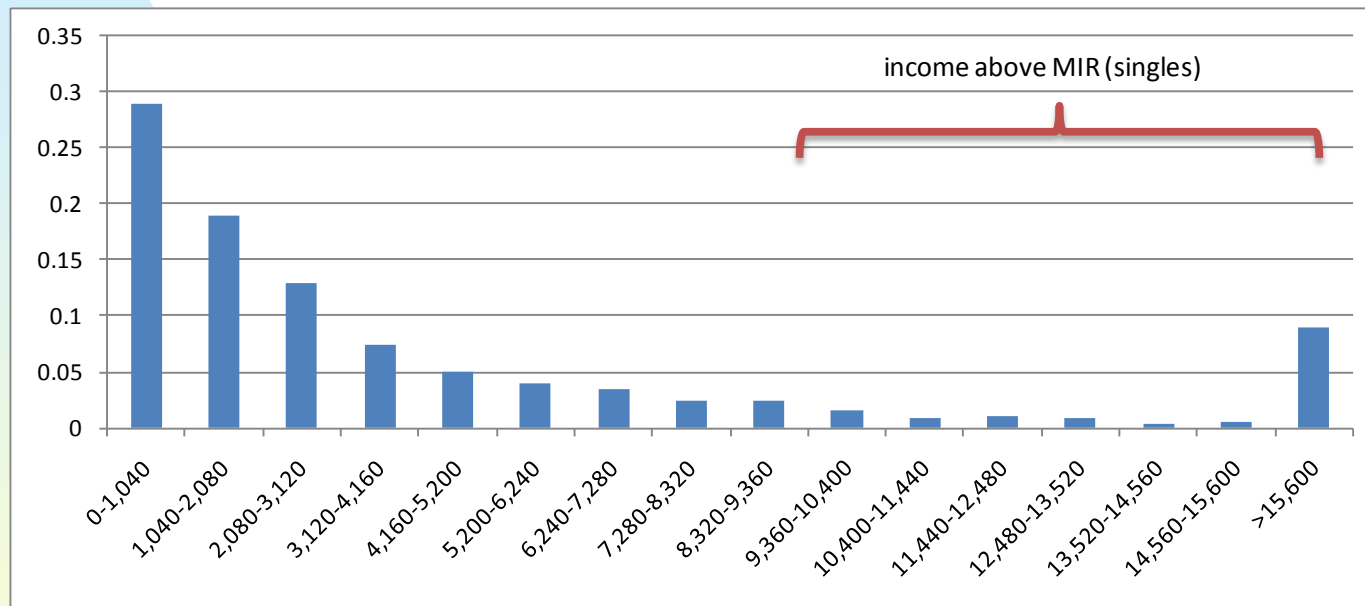
Impact of the proposal on the UK annuity market

	Retiring cohort: Numbers	Numbers receiving personal pension	Mean PP per year	Median PP per year
Married couples	248,000	62,134	5,668	2,496
Single males	68,000	8,775	7,549	3,605
Single females	120,000	15,581	2,323	1,109
Total # retiring units in 2010	436,000	86,490		

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

Impact of the proposal on the UK annuity market

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



- *Data on personal pension income from DWP Pensioners' Income Series*

Impact of the proposal on the UK annuity market

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

	Numbers receiving PPs above MIR	Mean PP income above MIR (£ per annum)	Total present value for PPs above MIR (£ million)	Total present value for personal pensions above MIR (£ million)
Data source			Pensioners' Income Series	ABI Annuity fund size
Capitalisation factor assumption			level/short	level/short
Married couples	7,767	13,200	1,078	493
Single males	2,325	14,711	266	207
Single females	1,402	2,909	11	302
Total value			1,354	1,001
Total Value after scaling adjustment			2,155	

Impact of the proposal on defined benefit schemes

- Proposal is intended for DC schemes; however
 - Potential impact on funded & unfunded DB schemes,
 - HMRC life-time allowance converts pension income into an explicit fund value
- Lobbying
 - through equality of treatment of DC with DB pensions
- Transfers from DB to DC schemes prior to retirement
- To estimate effect, as before:

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

Impact of the proposal on defined benefit schemes

Number of members of occupational pension schemes in 2008

Type of member	Numbers (millions)
Active members	9.0
Private sector DB	2.6
Private sector DC	1.0
Public sector DB	5.4
Pensions in payment	8.8
Private sector	5.0
Public sector	3.9
Deferred pension entitlements	9.9
Private sector	6.7
Public sector	3.2
Total	27.7

Impact of the proposal on defined benefit schemes

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

	Numbers receiving occupational pension above MIR	Mean pension above MIR (£ per annum)	Total present value of pension funds (£ million)	
Married couples	60,558	14,892	13,888	22,636
Single males	11,136	10,212	1,547	2,400
Single females	12,337	7,344	1,477	2,455
Total value			16,911	27,490
Value of occupational DB			10,316	16,769

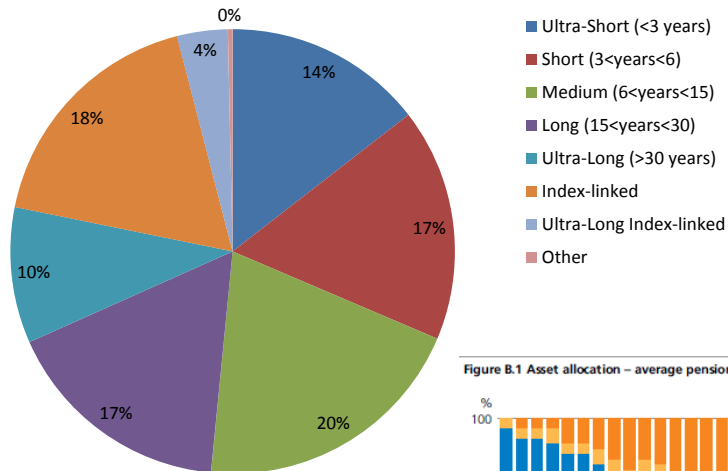
Impact of the proposal on defined benefit schemes

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

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

Impact of the proposal on long-term government bond markets

Composition of Gilts in Issue in 2010 = £913 bn



Type of Debt Instrument held by Life Insurance Companies

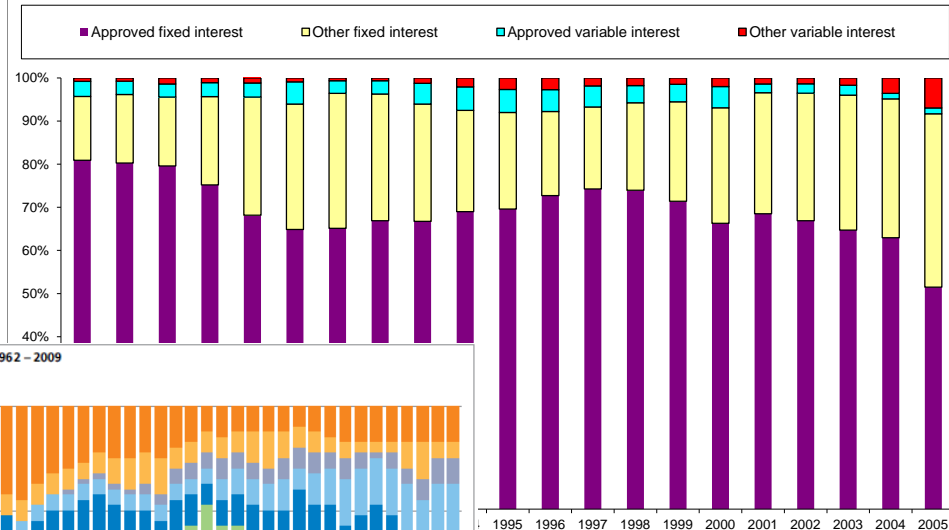
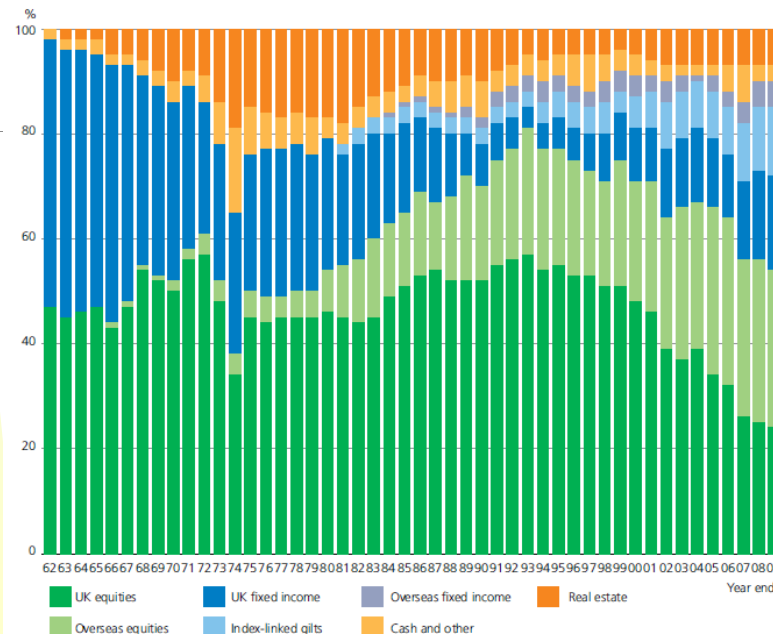


Figure B.1 Asset allocation – average pension fund 1962 – 2009



Source: National Statistics (until 1995), WM (1996 onwards).

Impact of the proposal on long-term government bond markets

- We have predicted that the existing annuity market will shrink by £1 - £2 billion.
 - ◆ Half of these funds are held in govt bonds
 - ◆ So insurance companies will sell off £0.5 - £1 billion of long-term gilts annually
 - ◆ Around 0.5% of the outstanding stock of ultra-long conventional and index-linked gilts
- We predict that if change applied to DB schemes, £10.2 - £16.7 billion could be accessed annually.
 - ◆ 31% of pension fund assets were held in UK fixed interest securities
 - ◆ pension funds will annually liquidate £3.2 - £5.2 billion of long-term government debt

The optimal decumulation investment strategy

- Highly complex, depends on anticipated investment returns, attitude to risk, life expectancy, health status and the desire to make bequests
- Optimal strategy could involve drawdown if risk aversion is low or desire to make bequest is high
- But there comes a time when the implicit return on an annuity exceeds the return on equities and then it becomes optimal to annuitise remaining wealth:
 - ◆ typically occurs around the age of 80 for males

Cognitive problems that elderly people can face when dealing with investments

- FSA (2006) survey of financial capability found that in a financial literacy quiz, the over-70s performed worst of all age groups
- US studies have found:
 - ◆ susceptibility to dementia doubles every five years after age 60
 - ◆ around 50% of people in their 80s experienced significant cognitive impairment (including dementia)
 - ☞ prevented them from making sensible financial decisions

Cognitive problems that elderly people can face when dealing with investments

- Could lead to another potential mis-selling scandal involving vulnerable people, cf:
 - ◆ pensions mis-selling between 1988-1994
 - ◆ endowment mortgage mis-selling
- Problem is compounded when it involves elderly people who are unable to return to work in order to rectify the financial consequences of any mistakes they make

Conclusions

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

Conclusions

- Government's proposals will change the frame through which pensions are viewed.
- Pensions have traditionally been viewed through a “consumption frame”
 - ◆ which is how everyone views the Basic State Pension
- Now they will be viewed through an “investment frame”:
 - ◆ people will begin to see not a stream of future pension payments
 - ◆ but instead will see a “pension pot”
 - ☞ the present value of this stream of future pension payments.

Conclusions

- And, given human nature as well as their general poor understanding of longevity risk, people would rather like to be able to invest and spend their pension pot as they see fit:
 - ◆ Government's proposals encourage this attitude.
- Government's proposals also encourage the view that it will be acceptable to live just above the breadline in retirement:
 - ◆ having secured the MIR, it won't really matter how poorly the remaining pension pot is invested.

Conclusions

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

Conclusions

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

Next event

- Wednesday 27 October 2010, 18:00 - 20:30
- Spending Optimally Throughout Retirement:
Using Behavioural Economics to Improve
Retirement Expenditure Decisions
- In this Inaugural Lecture, Prof Tom Boardman will examine how behavioural economics can be used to improve the expenditure decisions of retirees.

Thank you!

Reception in basement after Q &A

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