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Cass Business School
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ENDING COMPULSORY ANNUITISATION

What are the consequences?

A Pensions Institute report for policymakers, financial advisers,
and pension scheme members

*David Blake
Edmund Cannon
Ian Tonks*

July 2010

Ending compulsory annuitisation: What are the consequences?

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Pensions Institute
Cass Business School
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EC1Y 8TZ

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About the Authors

David Blake

David is the Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School.

Edmund Cannon

Edmund is Reader in Economics at the University of Bristol and Fellow of the Pensions Institute. He is author of *Annuity Markets* (joint with Ian Tonks), Oxford: Oxford University Press.

Ian Tonks

Ian is Professor of Finance in the Xfi Centre for Finance and Investment in the University of Exeter Business School and Fellow of the Pensions Institute.

List of abbreviations

ASP	Alternatively Secured Pension
CFEB	Consumer Financial Education Body
CPI	Consumer Price Index
DB	Defined Benefit
DC	Defined Contribution
DMO	Debt Management Office
EET	Exempt-Exempt-Taxed
FSA	Financial Services Authority
HMRC	Her Majesty's Revenue & Customs
ISA	Individual Savings Account
LPI	Limited Price Indexation
MIR	Minimum Income Requirement
NEST	National Employment Savings Trust
NI	National Insurance
RPI	Retail Price Index
SERPS	State Earnings Related Pension Scheme
S2P	State Second Pension
USP	Unsecured Pension

Foreword

This is the seventh¹ of our series of reports that focus on pensions issues of direct relevance to policymakers, financial advisers, and pension scheme members.

The Conservative–Liberal-Democrat Coalition Government that came to power on 11 May 2010 announced that it was going to end the requirement for pension scheme members to purchase annuities by the age of 75.

We felt that would some serious unintended consequences of this proposal and wrote to The Times on 27 May 2010:

Sir, The new Government has confirmed manifesto promises to remove the requirement that individuals use their pension fund to buy an annuity at retirement. Such a policy would be popular, easy to implement and generate much-needed tax revenues. However, we have grave concerns that this will have serious consequences for the security of pensioners' retirement incomes and the public finances.

Without an annuity, retired people risk outliving their resources and also bear the responsibility of managing their financial assets. If things go wrong, they will surely turn to the taxpayer for help. The Conservatives propose a minimum annuity purchase, so pensioners never become eligible for means-tested benefits. We suspect that estimating such a minimum will be difficult, since benefits are calculated according to individual circumstances and these circumstances, together with the level of state support, are likely to change considerably over the next 30 years.

The proposal could lead to significant changes in the nation's savings decisions and tax payments. It could also encourage members of occupational pension plans - including those in the public sector - to access their entire fund as a lump sum rather than receive it as income. This would turn the current steady decline in defined-benefit pension plans into a rout, as pension fund sponsors - and that would include the Government - had to find cash immediately, instead of gradually over a long period into the future.

We suggest that the seriousness of the unintended consequences of their pension policy is fully recognised and that the policy proposal is re-examined.

Professor David Blake, Director, Pensions Institute, Cass Business School

Dr Edmund Cannon, University of Bristol

Professor Ian Tonks, University of Exeter

<http://www.timesonline.co.uk/tol/comment/letters/article7137165.ece>

Following publication of the letter, we were approached by the Prudential and invited to prepare a short report that expanded on the ideas that were contained in the letter.

The purpose of 'Ending compulsory annuitisation: What are the consequences?' is very specific: to stimulate debate about the proposal to end the mandatory

1. Previous reports are listed at the end of this document.

requirement to purchase annuities in pension schemes as formally announced in the Budget Statement on 22 June 2010.

This research was sponsored by the Prudential and we are extremely grateful for their support. The Prudential has not sought to influence the conclusions of the report and they may not share or endorse the views expressed here. Furthermore, the Prudential have not imposed any conditions or requirements on the contents of the report.

We should also stress that the views in the report are those of the authors and not necessarily those of the Pensions Institute, which itself takes no policy position.

On 15 July 2010, HM Treasury published a consultation document: 'Removing the requirement to annuitise by age 75'. We intend to respond to this consultation document in a more detailed analytical report entitled 'Ending compulsory annuitisation: Quantifying the consequences' which will be published before the consultation period ends on 10 September 2010.

David Blake, Edmund Cannon and Ian Tonks, *July 2010*

Executive Summary

1. The Government intends to end the requirement for defined contribution personal pension scheme members to annuitise their pension fund by the age of 75. This report looks at the likely effects and consequences of this policy.
2. Annuities protect individuals against outliving their resources for however long they live. Nevertheless, they are also inflexible once purchased and consumers tend to avoid buying an annuity if they can do so voluntarily. Three reasons have been put forward to explain this: consumers' low levels of financial literacy; consumers' poor understanding of longevity risk; and behavioural biases resulting in consumers making inconsistent or irrational decisions. Yet there is evidence to show that the advantages of annuitisation outweigh the disadvantages.
3. A number of reasons have been put forward to justify compulsory annuitisation: it avoids selection effects; it has lower administrative costs than in voluntary annuity markets; it avoids moral hazard problems; it is the quid pro quo for tax relief on pension saving; and prevents the pension system being used for tax avoidance.
4. If pensioners choose not to buy annuities, they face a range of risks and costs associated with running down their retirement savings, including: longevity risk, investment return risk; costs of managing pension wealth; and the risk of making mistakes. They may mis-manage their pension fund either due to a lack of understanding or because of behavioural biases. They might also be sold unsuitable investments.
5. There are a number of potential risks to the public purse from removing the annuitisation requirement for DC pensions. First, there is the impact on means-tested state benefits, since pensioners who run out of funds will fall back on taxpayers for support. Second, there may be an impact on defined benefit pensions. An unintended consequence of allowing DC pensioners to avoid annuitisation is that it may encourage DB scheme members, including public sector workers in unfunded schemes, to lobby for their pension to be received as a lump sum rather than as an income. Third, there are the consequences for tax avoidance. Fourth, there are the impacts on government and other long-term bond markets.
6. The Government proposes to deal with the impact of ending compulsory annuitisation on means-tested benefits by requiring annuitisation up to a minimum income requirement (MIR). However, there are a number of problems in calculating such a minimum annuity purchase. It is difficult to predict the environment in which the means-tested benefits system will operate a long way into the future. The state benefits system is complicated and the precise amount that needs to be annuitised will depend upon individual circumstances and will affect and be affected by means-testing. There is an issue of how to treat couples fairly. There is the difficulty in creating appropriate annuity products to avoid receipt of means-tested benefits over a lifetime. There is also the difficulty in matching pensions to inflation when a number of different definitions of inflation (RPI, CPI, LPI and increases in national average earnings) are in use.

1. Introduction

The Conservative–Liberal-Democrat Coalition Government that came to power on 11 May 2010 announced that it intended to end the requirement for defined contribution pension scheme members to purchase annuities by the age of 75. This was formally confirmed in the Budget Statement of 22 June 2010. The Finance Bill 2010 of 1 July announced that the minimum age for annuitisation would be raised to 77 years as a transitional measure to defer compulsory annuitisation while further consultation on rule changes takes place. On 15 July 2010, HM Treasury published a consultation document, ‘Removing the requirement to annuitise by age 75’, which outlined the government’s proposals. The consultation paper emphasises that the tax treatment of pension savings should continue to follow the “exempt-exempt-taxed” (EET) model, but suggests three important changes: (i) the intention to establish a minimum required annuitisation level, based on a minimum income requirement (MIR), (ii) the desire to make the annuitisation process more flexible above this amount; and (iii) the introduction of a tax relief recovery charge on capital withdrawals to recover the value of the tax relief made available during the accumulation phase of the pension scheme.

In Section 2, drawing on the arguments in Blake (1999) and Cannon and Tonks (2008), we briefly summarise the advantages and disadvantages of compulsory annuitisation. In the following two sections, we outline the potential consequences of the proposal to abolish the annuitisation requirement, first for pensioners themselves (in Section 3) and then for the public sector (in Section 4). Section 5 looks at the issues surrounding annuitisation up to a MIR, and Section 6 concludes. Our intention is to produce a second report with policy recommendations, after further analysis and quantification of the issues raised in this initial report.

2 Advantages and disadvantages of compulsory annuitisation

The most important benefit of annuitisation is that annuities protect individuals against outliving their resources. Pensioners who buy an annuity continue to receive an income however long they live. As a consequence of this insurance against longevity risk, the purchase of an annuity allows each individual to maximise the income generated from pension savings. As with all insurance products, there is a cross-subsidy from the insureds who do not make a claim to the insureds who do; in the case of annuities, this cross-subsidy – known as a mortality cross-subsidy or a survival credit – is from those individuals that die early to those individuals who live for a long time. Annuities also insure against a range of other risks and we consider these risks in more detail below.

The key disadvantage to purchasing an annuity is that it is a once-and-for-all decision which locks a pensioner into an inflexible financial asset (since it is impossible to renegotiate the terms of the annuity). Cannon and Tonks (2008) review a large body of evidence which suggests that this disadvantage is small compared with the advantages of annuitisation.

This leaves a paradox: although purchasing an annuity nearly always increases the consumer's welfare, consumers almost always avoid purchasing annuities in situations where they are allowed to do so voluntarily. There are three reasons why consumers do not purchase annuities despite it being in their long-term interests to do so:

1. **consumers' low levels of financial literacy and difficulties in valuing future income and expenditure streams**, resulting in poor decision making about financial products generally (evidenced not just in pensions but also in mortgages or credit card debt);
2. **consumers' poor understanding of longevity risk** and how annuities work: many people do not even know what an annuity is; and
3. **behavioural biases** resulting in consumers making inconsistent or irrational decisions.

A policy of compulsory annuitisation *ensures* that consumers benefit from longevity risk protection in much the same way that policies against smoking and drugs help to promote healthy lifestyles. Obliging consumers to purchase annuities is certainly paternalistic, but this may be cheaper and more effective than trying to re-educate them. Apart from any paternalistic arguments, justifications for compulsory annuitisation are that it:

1. **avoids the problems associated with selection effects;**
2. **is cheaper to administer**, and has lower administrative costs than voluntary annuity markets;
3. **avoids moral hazard problems**
4. **is the quid pro quo for tax relief on pension saving**, and ensures that the pension system is not used for tax avoidance.

Selection effects arise because annuities will be purchased disproportionately by people who believe that they will live for a long time, resulting in life insurers having to charge higher prices to cover their costs.² If this effect is strong

enough, it may result in adverse selection where annuity (or, indeed, any insurance) markets fail to function properly, since people who believe they have shorter life expectancies drop out of the market, with the result that annuity prices rise further.³

In a voluntary market, life insurers would have higher administrative and marketing costs, since life insurers will devote more resources to collecting information about annuitants (to reduce selection effects), and are likely to increase marketing budgets to attract particular types of annuitants. Compulsion ensures that everyone participates in the market which not only lowers marketing costs, but also allows life insurers to price on the basis of national average life expectancy and thus charge lower prices overall.⁴

Moral hazard arises when individuals try to game the system for their own advantage at the expense of someone else. The risk in this case is not to the life insurer but to the public purse. Obliging someone to buy an annuity eliminates the possibility that they spend their retirement savings too quickly and then fall back on the state for welfare support (a form of “double dipping”⁵). In this sense, compulsory annuitisation is a bit like compulsory motor insurance, which reduces the external consequences of bad luck. We shall discuss the consequences for public welfare provision in section 4.1.

Ever since individual pension arrangements were introduced in the UK in 1956, tax relief on pension contributions has been granted during the accumulation phase to provide an incentive for people to save for an income in retirement. The pension itself is taxed with the government’s aim being broad fiscal neutrality over the lifetime of the pension plan. Removing compulsory annuitisation provides individuals with an incentive to find ways of avoiding paying tax in the decumulation phase of a pension plan.

2. This assumes that consumers have more information about their own life expectancy than the life insurer. Since life expectancy is determined partly genetically (and hence can be inferred from the life length of blood relatives) and partly by lifestyle, this asymmetry of information will be significant in practice.

3. Finkelstein and Poterba (2002) have documented some evidence for the existence of selection effects in UK annuity markets. However, the market has changed since 2002 with more sophisticated underwriting.

4. The Pensions Commission Second Report (2005, pp.110–114, and Appendix F) devotes several pages to the issue of costs of personal pensions covering both the accumulation and decumulation phase. It concludes that compulsion is considerably cheaper than auto-enrolment and that it is essential to have a scheme which does not involve personal advice.

5. Double-dipping refers to a situation where an individual receives multiple state benefits, when the original intention of these policies was that these benefits were substitutes.

3 Consequences for pensioners

Annuities are insurance products which remove several important risks and costs for pensioners. Following the removal of the compulsory annuitisation requirement, individuals who did not voluntarily purchase annuities, would then face the following risks:

1. **longevity risk;**
2. **the costs of managing pension wealth;**
3. **investment return risk;** and
4. **the risk of making mistakes.**

Individual pensioners face uncertainty about how long they will live: this is known as longevity risk. While it is possible for couples to pool their idiosyncratic life-expectancy risks, even couples face considerable uncertainty over their joint needs for resources in retirement due to longevity risk. Longevity risk makes it very difficult for pensioners to plan how best to consume their assets over their remaining lifetimes: consume too little and they reduce their standard of living and leave a bequest which may be unintentionally too generous; consume too much and they risk running out of resources and living their final years in straitened circumstances.⁶

Not all pensioners will bear these risks equally. A relatively small proportion of pensioners are rich in absolute terms and have sufficient wealth to meet all of the “necessities” of life in retirement (such individuals may have wealth substantially in excess of the lifetime limit of £1.8 million in their pension fund). In this report, we do not address the concerns of such people because they are such a small proportion of the population and because they do not raise such important issues for annuitisation or the public purse.

Turning to more “typical” pensioners, those who do not annuitise face the problem of investment return risk and managing their assets. Annuities involve an investment return guarantee as well as a longevity guarantee. Managing assets is a time-consuming and expensive business and one advantage of an annuity is that the fund management is handled by the life insurer. In a comprehensive study of management costs, James (2000) estimated that an investor needs to put aside about £1.50 in an actively managed unit trust (or life office fund) to obtain the market rate of return of £1. One of the driving forces behind the Pensions Commission Second Report (2005, pp.110–113 and Appendix F) was the idea that having compulsory enrolment would allow these costs to be reduced. Another concern is that vulnerable old people might be pressurised into buying unsuitable (i.e., risky and/or high-charge) investments.

Many pensioners minimise investment risk as well as the costs of managing assets by placing their savings in deposit accounts with banks or building societies, but these typically yield relatively (and, indeed, absolutely) low rates of return. A further problem is that the best interest rates on such accounts can often only be achieved by regularly opening new accounts, particularly

⁶ It is true that the latter possibility is mitigated by means-tested state benefits, but many pensioners would find that these were low relative to the pension that they might obtain from an annuity. And from the perspective of the public finances, this is just what the government should be trying to avoid.

online accounts. The most elderly pensioners are those least likely to be able to manage their funds actively or willing to use e-banking. Currently, many such accounts are paying rates of return which are negative after deducting tax and allowing for inflation.

It is true that higher rates of return can be achieved by holding pension wealth in equity (or, a half-way house, corporate or government bonds). But this exposes pensioners to considerable downside risk. Although there is an equity premium, leading to higher long-run average returns for equity investments compared with safer assets, this is likely to be insufficient to encourage risk-averse pensioners to move away from deposit accounts into assets that might fall in value.

Finally, there is the risk of making mistakes. If a pensioner does not purchase an annuity, then they need to manage their pension fund and they may do so badly either due to lack of understanding or because of behavioural biases.

A lack of understanding could be due to poor financial education. The general level of financial education in the UK, as almost everywhere else, is very low.⁷ This means that many people, pensioners included, do not have the skills to make sensible investment decisions. An additional cost arising from the removal of the compulsory annuitisation rule may be increased expenditure on financial education or advice at retirement choices.⁸

Behavioural biases cause many people to make short-sighted, inconsistent or plainly irrational decisions. An important example of poor decision making which seems prevalent in savings decisions is a tendency for individuals to procrastinate: while people say that they want to change their behaviour, they never actually get around to doing so (i.e., they are subject to inertia).

Recent advances in behavioural psychology have begun to provide potential solutions to these problems. For example, one way of dealing with behavioural biases such as procrastination and inertia is to use “nudges” to encourage people to make decisions that improve their welfare. This is consistent with the principle of “libertarian paternalism”, whereby a paternalistic state introduces a default which it and its advisers believe is in the best interests of the majority of people, but individuals can exercise their libertarian right to opt out of the default (Thaler and Sunstein, 2003, 2008). This was the principle underlying auto-enrolment in NEST (the National Employment Savings Trust). But letting the default at retirement be to take the whole pension as a lump sum would be inconsistent with the principle, because of the very real risks of sub-optimal outcomes.

7. Atkinson, McKay, Kempson, and Collard (2006).

8. Financial Services Authority (2003) reports that fewer than half of people approaching the point of purchasing an annuity really understood how it worked.

4 Consequences for the public sector

There are four sources of risk to the public purse from removing the annuitisation requirement for defined contribution personal pensions:

1. **impact on means-tested state benefits and government finances;**
2. **impact on defined benefit pensions;**
3. **consequences for tax avoidance;**
4. **impact on government and other long-term bond markets.**

4.1 The impact on means-tested state benefits and government finances

Removing the compulsory annuitisation requirement may result in some pensioners' incomes being substantially lower at some point in the future for a number of reasons that have already been mentioned: individuals may be unlucky with their investments, they may make mistakes and under-estimate their life expectancy, or they may deliberately run down their savings very quickly. For whatever reason, once an individual has lost their capital, they will fall back on taxpayers for support. Governments cannot credibly commit to refuse to help very elderly individuals who have insufficient resources. Such risks could have serious effects on the welfare of substantial numbers of individuals for significant periods. And if sufficient people are affected for a long enough period, then the risk will ultimately fall back upon the public purse and it will have to change policy in response.

In common with most developed countries, the UK's pension system combines both state and private pensions: in addition to this, the social welfare system also includes measures to ensure that no individual, regardless of age, has an income below a minimally acceptable level. This means that pensioners are potentially eligible for a variety of state benefits, and the removal of the compulsory annuitisation requirement may affect the degree of eligibility.

The state benefit system is complicated and consists of a variety of types of benefit: some are unconditional (or conditional only on being above a certain age); some are conditional on other personal circumstances and some are conditional on a pensioner's income, wealth or combination of the two (i.e., means-tested benefits). This implies that any changes to the pension being received by an individual could result in changes to their entitlements from the state. In the most extreme case, an individual might access all of their accumulated pension savings, and spend it all on immediate consumption, and then become eligible for means-tested benefits (double dipping with a vengeance). Removing the compulsory annuitisation requirement would thus affect total government expenditure.

Apart from changes in government liabilities through state benefits, removing compulsory annuitisation will also affect tax receipts. To some extent, this can be neutralised through an appropriate tax relief recovery charge (i.e., exit tax) on cash withdrawn from pension funds other than by way of annuitisation. In fact, this recovery charge might be a net revenue raiser in the short term. However, this will be very unpopular: it should not be assumed that pensioners (who are also voters) will perceive revenue-neutral changes in taxation indifferently: the

very behavioural biases that affect people's annuitisation decisions may also mean that they object to the taxation of pension fund values more than the taxation of the pension income that such funds would have generated.

There are also issues relating to the timing of taxation receipts. Changing the timing of receipts would affect the dynamics of both government borrowing and the national debt. In the first instance, this might appear to have a beneficial impact: if pensioners chose not to annuitise but instead had to pay a compensating recovery charge on their pension fund, then tax receipts would be brought forward, thereby improving the UK's financial position. However, the improvement would be more apparent than real, since it would mean lower tax receipts in the future and might disguise the need for other policy changes to reduce the government's structural deficit.

The government's long-term fiscal projections in 2008 (HM Treasury, 2008) suggested a need to reduce government spending relative to taxation by between 1 and 2 per cent of GDP, perhaps about £20 billion per year. Most of these calculations were made before the current recession, but it is unlikely that the conclusions would be much affected by the recession.⁹ Some of the structural deficit arises from explicit pension and implicit health-care commitments which will fall due only in the 2020s and 2030s and which are not explicitly on the public's balance sheet. Bringing forward tax receipts would make the explicit and visible national debt smaller, while increasing the public sector net off-balance sheet (and hence less visible) liabilities. In the light of this deficit, it is essential that changes in government policy do not exacerbate government spending commitments in either the short or long term.

The Budget Statement of 22 June 2010 announced that, from April 2011, the Basic State Pension will increase by the higher of price inflation (measured by the Consumer Price Index (CPI) rather than the Retail Price Index (RPI) as previously used), increases in national average earnings, or 2.5 per cent. The Basic State Pension (which is not means-tested) interacts with Pension Credit (which is means-tested): changes in non-means-tested benefits can have significant effects on the amount of total means-tested benefits which are being paid.

4.2 The impact on defined benefit pensions

The annuitisation requirement most obviously applies to defined contribution (DC) schemes. But implicitly it also applies to occupational defined benefit (DB) pensioners who effectively receive their pension in annuity form automatically. A possible unintended consequence of allowing DC pensioners to avoid annuitisation is that it encourages DB scheme members to demand their pension as a lump sum rather than as an income. An example of how rules like this can expand across different types of pension is the gradual expansion throughout the twentieth century of the rule that up to 25 per cent of a pension can be taken as a tax-free lump sum (Hannah, 1986), which Nigel Lawson tried unsuccessfully to reverse in the administration of the 1980s. There is also the risk

⁹ Up-dated revisions in December 2009 (HM Treasury, 2009) revised the long-term projections, suggesting that the situation would be worse by about 1.5 per cent of GDP by 2050. Comparison was made difficult by the omission of any tables of numbers, so the estimate of 1.5 per cent is based upon a visual analysis of some rather small graphs. The Office for Budget Responsibility Pre-budget Forecast (June, 2010) appeared to confirm this revision, but provided very little detail, noting that "the OBR has not yet had the opportunity to study the Treasury's long-term projections in any detail". All of the projections were sensitive to debatable assumptions about the path of welfare payments and immigration.

that individuals in DB schemes may be inappropriately advised to transfer DB pension wealth into DC schemes to access the entire lump-sum rather than the 25 per cent of DB pension wealth which is currently available.

Since 1988, those who leave pensionable service have been entitled to transfer their pension wealth. This effectively allows someone to convert their accrued pension promise under a DB scheme into a cash sum under a DC arrangement. Under current rules, there has been little point in doing this, since it would still be compulsory to annuitise 75 per cent of the pension fund by age 75. Given transactions costs and the fact that the pension wealth transferred may be calculated at unfavourable actuarial rates for all except those with health problems, the benefit to following this strategy has been sufficiently small that very few pensioners have taken advantage of this possibility.

Removing the annuitisation requirement could change things dramatically. Currently, there is a puzzle as to why individuals in a DB scheme seem content to convert their implicit pension fund into a regular pension income, whereas some individuals whose savings are in a DC scheme are reluctant to annuitise. Behavioural psychology would indicate that the annual reporting of the size of the DC pension fund, rather than the amount of pension that the fund will generate, plays a role in this puzzle. With annual pension statements in DB schemes now showing the cash value of DB pensions (in order for individuals to be aware that they are within their lifetime limit), the removal of the need to annuitise when combined with the presentation of a cash value for accrued benefits may have significant behavioural consequences. Put simply, it may lead DB members to a preference for taking the fund over the pension.

Public sector workers are covered by a variety of occupational pension schemes most of which are unfunded or funded but implicitly or explicitly underwritten by the government. There is a real possibility that a large number of public service workers would also demand their pension as a lump sum transfer value and therefore dramatically bring forward payments from the government. Effectively, off-balance sheet public pension liabilities would be brought onto the balance sheet immediately, since the government would have to issue additional bonds to make these pension payments. Although in one sense, this is merely an accounting change, it could unsettle financial markets. One reason for this is that credit markets are not perfect and changing the pattern of the government's cash flows might affect interest rates and credit ratings.

A similar problem would also be felt by private sector pension funds which would be faced with either borrowing or selling financial assets to make the cash payments, putting downward pressure on the market prices of those assets. Further, a potentially political problem could arise in the case of individuals who had opted for the State Second Pension rather than contracting out: they would feel that they were being treated differently if they were eligible only for a pension rather than a lump sum.

4.3 *The consequences for tax avoidance*

As we have already discussed above, the tax privileges extended to pension schemes are designed to encourage people to save for an income in retirement, but it is difficult to distinguish pension saving from other forms of saving. This means that the current pension system is potentially a tax loophole, as it can be used to avoid paying tax.

The Second Report of the Pensions Commission (2005, p.323) explicitly notes that individuals can retain flexibility over their savings by accumulating wealth in an ISA and then putting it into a pension scheme just before retirement. The maximum contribution into a pension fund in any year is the lower of £215,000 or 100 per cent of earnings, although the June 2010 Budget Statement (¶ 1.118) indicates that this annual limit might be reduced to between £30,000 and £45,000.

At the moment, the possibility of taking 25 per cent of pension wealth as a lump sum means that some occupational schemes allow members to make Additional Voluntary Contributions, all of which can then be taken as a lump sum. For most individuals, especially those relying on personal pensions, the current annuitisation requirement means that a significant part of any additional contributions has to be annuitised.

Let us consider what would happen were the annuitisation requirement to be removed altogether. Significant numbers of people approaching retirement are likely to have sufficient non-pension wealth that they could take advantage of the high annual allowance.

Consider someone earning £50,000 who was approaching retirement with entitlement to a 50% of final-salary pension and therefore likely to fulfil any MIR. Suppose this person had savings available of £30,820 (which would not be implausible). These savings could be paid into a personal pension fund and attract relief of £7,705 (assuming tax relief were limited to the basic rate), allowing a total of £38,525 to be retained as cash in a tax-favoured environment (at the moment only 25 per cent of this, or £9,631, could be taken as a lump sum).

If significant numbers of pensioners engaged in this behaviour, it would result in substantial losses in tax receipts. The current proposals to limit the annual allowance to between £30,000 and £45,000 would have limited effect for the example just considered.¹⁰

10. Current anti-forestalling rules apply to people on much higher incomes.

4.4 *The impact on government and other long-term bond markets*

The recent public finance crisis in Europe has led many commentators to reflect on the exceptionally long term to maturity of UK government debt relative to that in other countries, which means that the UK has considerably more flexibility in dealing with its primary deficit. A major driver for the UK Debt Management Office's ability to issue long-dated bonds is the demand by life insurers and occupational pension funds for suitable assets to back their pension liabilities. This is because, notwithstanding their exposure to longevity risk, pension payments are akin to long-term, fixed-income liabilities for the provider, which can most appropriately be backed with long-dated government (as well as corporate) bonds.

Between 1985 and 2005, life insurers consistently held about 90 per cent of their assets in fixed-income assets (Cannon and Tonks, 2010). Over this period, this block of fixed-income assets was gradually switched from government bonds to corporate bonds, with total holdings of government bonds falling from 80 per cent to just over 50 per cent. This main reason for this is to benefit from the credit and liquidity premia on generally illiquid corporate bonds in a world of low interest rates.

Apart from the maturity structure of the UK public debt, the UK is also unusual among developed countries in having a deep and efficient market in inflation-linked government bonds. Again this is related to the need of pension providers to have assets which generate an income which rises in line with inflation but with low risk. While returns on equity generally match or exceed inflation over the long run, equities are not a "hedge" for pension liabilities since they are highly volatile in the short run. Although this can be partially addressed by careful portfolio management by pension funds or life insurers, it cannot be completely addressed: the recent problems at BP resulting in the dividend payment being suspended have already had major repercussions for UK pension funds.¹¹ Because of this risk, most life insurers back the majority of their pension liabilities – especially pensions in payment – with bonds.

Those wishing to remove compulsory annuitisation should also be aware of the consequences of this for the gilts market. It would be unfortunate if a fall in demand for annuities led to the gilts market becoming less efficient.

¹¹. According to the *Daily Telegraph* (9 June 2010) about one-sixth of pension funds income comes from BP alone. But this includes pensions in accrual (the accumulation phase) as well as in payment.
www.telegraph.co.uk/news/worldnews/northamerica/usa/barackobama/7815713/Barack-Obamas-attacks-on-BP-hurting-British-pensioners.html

5 The issues surrounding a minimum level of annuitisation

HM Treasury (2010) suggests that the problem of double dipping could be overcome by imposing an annuitisation requirement to satisfy a minimum income requirement (MIR), where the minimum would be set at a sufficiently high level that a pensioner could never fall back upon means-tested benefits.¹² However, with means-tested benefits now linked to earnings rather than prices, such a policy could be very difficult to implement in practice.

There are a number of problems in calculating a minimum annuity purchase:

1. predicting the future of pension and welfare policies;
2. calculating the effect of individual circumstances on means-testing;
3. deciding how to treat couples fairly;
4. the difficulty in creating appropriate annuity products to avoid receipt of means-tested benefits over a lifetime;
5. the difficulty in matching pensions to inflation when two definitions of inflation are in use.

Predicting the future is no less difficult when it comes to pensions policy than with many other areas of economic forecasting. A typical 65-year old male pension scheme member has a life expectancy of 87.8 years and an 8 per cent probability of living to 100.¹³ If we replaced the requirement that a pensioner never received means-tested benefits with one not permitting pensioners to receive means-tested benefits until they became a centenarian, we would still need to forecast the evolution of the entire benefit system for thirty five years. Casting our minds back to 1975, we believe that no one then could have predicted what would happen to the UK pension and welfare system in the period 1976–2010 and we believe that there may be similar problems in predicting the period 2011–2046. So any minimum annuity purchase requirement which is appropriate for conditions today is very unlikely to be appropriate for the whole of the pensioner's lifetime. If pensions or welfare policy changes,¹⁴ then there will need to be procedures to determine who bears the consequences: will the pensioner be made worse off or will the taxpayer bear the burden?

One possible way to deal with this uncertainty would be to set a series of rules based on what is considered "likely" to happen in the future. Aside from any disagreement about what is "likely", this creates a trade-off between setting a high minimum and a low minimum. A low minimum annuity requirement entails a high probability that a pensioner will become eligible for means-tested benefits as a result of future policy changes. A high minimum annuity requirement reduces the number of people who benefit from the policy change, possibly restricting the scope of the new policy to the very wealthy.

12. According to the Pension Commission (2005, p. 33): "The Government should consider where there is a case for a cash limit to the amount which individuals are required to annuitise at any age (with the benefits of tax relief recovered via the appropriate tax treatment of withdrawals during life or of balances remaining at time of death)". In HM Treasury (2006), the last government rejected this proposal (paragraph 3.27, p. 19).

13. Derived from the mortality table PNMA00 projected to 2010 with a 1% improvement floor.

14. There are a variety of possible changes: the level of pensions or other benefits could change; some benefits could start or cease to be means-tested; the rules for how the different benefits interact could also change. Over such a long period it is quite possible that some of the changes that will occur are currently inconceivable.

A second problem is that the existing state benefits system is complicated and the precise amount that needs to be annuitised will depend upon individual circumstances. This means that it will be difficult to calculate the minimum annuity requirement by just assuming the existing set of rules with no allowance for any changes. The minimum is likely to vary according to where one lives, leading to complaints of a “post-code lottery”, especially since some life insurers are also using personal data, such as address, to determine annuity prices.

For an individual pensioner in good health owning a house with a full set of National Insurance contributions, the calculations would be straightforward, because the only means-tested benefit that they would receive would be Pension Credit (which tops up the Basic State Pension to ensure a guaranteed level of income). This individual would receive the maximum Basic State Pension of £97.65 per week (£5,077.80 per year). The minimum income guaranteed by Pension Credit is £6,895.20, so an individual with the maximum Basic State Pension would have to annuitise sufficient wealth to receive an income of £1,817.40. Assuming an annuity rate of just over 6 per cent, this would mean an annuity purchase of about £30,000 for a 65-year old male today. An annuity linked to increases in the Retail Prices Index would cost around £45,000.

In practice, for most people the calculation would be much more complicated for a variety of reasons, including the impact of any National Insurance shortfall on their level of Basic State Pension or the existence of other pensions or savings affecting the level of Pension Credit. This problem is particularly acute for women.¹⁵ In addition, some pensioners will have made contributions to previous additional public pension schemes, SERPS or S2P,¹⁶ which will make calculation of their full state pension more complicated.

The situation would be even more complicated for someone who had to rent accommodation because they could well be entitled to Housing Benefit, which is a means-tested benefit (dependent both on income and financial wealth),¹⁷ which varies by region (because rents differ regionally). Since pensioners might move after retirement, this raises the question of what would happen if they subsequently moved to a region where rents were higher.¹⁸

Pensioners who are unable to look after themselves also receive Attendance Allowance. This is not means-tested, but it does increase the maximum income that one can receive before becoming ineligible to receive Housing Benefit and Pension Credit and thus the likelihood that a currently healthy pensioner would receive Attendance Allowance in the future would presumably raise the minimum purchased at retirement.

In a very small number of cases, pensioners might be receiving means-

¹⁵ Full time parents and carers can receive NI contributions, but these have to be claimed for and not everyone claims their full entitlement.

¹⁶ The State-Earnings Related Pensions Scheme (SERPs) was replaced by the State Second Pension (S2P) in 2002. Membership of these pension schemes was compulsory for people in work who did not “opt out” into an occupational scheme. In practice, many pensioners will have pensions from a variety of sources

¹⁷ The Budget Statement of 22 June announced that there will be a maximum limit on the amount of Housing Benefit that a family will receive, although there were no details on how this would interact with additional local government support (which is discretionary).

¹⁸ We are not sure how many pensioners are likely to fall into this situation: obviously it would only apply to people poor enough not to own a house but rich enough to have some form of personal pension that was sufficiently high not to fall under the trivial commutation requirement.

tested benefits for caring for a disabled person (Carer's Allowance) or a child (Child Tax Credit). In the case of Carer's Allowance, a pensioner who was not entitled to the allowance would still receive the Carer's Premium in calculating entitlement to Housing Benefit.¹⁹

The third issue is that most annuities, even if purchased by an individual, will need to provide an income for a couple (or possibly a family with other long-term dependants, such as a disabled relative). It is possible that both members of a couple will have their own pension arrangements which will independently remove the possibility of them receiving means-tested benefits. But in many cases, one partner, typically the female partner, may have made insufficient National Insurance contributions to receive a state pension in her own right and the couple will receive a state pension as a couple which is more than would be received by an individual. The Basic State Pension (assuming a full set of NI contributions) is £5,077.80 per year for an individual but £8,119.80 for a couple, with corresponding Pension Credit guaranteeing incomes of £6,895.20 and £10,524.80, respectively. Currently, the husband could purchase a single life annuity: if, as is likely, he dies first, then the wife might fall back upon means-tested benefits anyway. This suggests that the proposals in HM Treasury (2010) would actually strengthen the annuitisation requirement slightly depending on whether the requirement to avoid means-testing would apply to the individual or the household.

To meet the MIR over a pensioner's lifetime, annuity providers would need to offer different sorts of annuity products from those currently provided, since the conditions for receiving means-tested benefits will change, leading to another problem: the difficulty in creating appropriate annuity products to avoid receipt of means-tested benefits over a lifetime. Since the Basic State Pension from April 2011 will increase in line with national average earnings, the MIR will need to grow in line with national average earnings, and hence the required annuity purchased will need to be indexed to the growth in earnings.

Such annuity products are not available at present, and it is unclear whether annuity providers would be able to offer them, since there is no obvious matching asset for annuity providers to invest in. Currently, final salary occupational pension schemes face a similar problem and hedge against wage growth during the accumulation phase of their scheme in two ways: by investing in risky equities (which tends to be correlated with wage growth in the long term), and through cross-subsidies between age-cohorts. If annuity providers were to begin offering wage-indexed annuities, they would also probably have to invest in equities (which would increase their capital requirements under Solvency II) and they would be unable to cross-subsidise different age-cohorts (unless the annuities were of the with-profit type). Alternatively, the government might consider issuing long-term bonds with a coupon linked to wage-growth, which could then be bought by annuity providers as matching assets for their wage-indexed annuities. However, the UK Debt Management Office has shown considerable reluctance to innovate in the design of bonds that it issues, as evidenced by its refusal to issue longevity bonds which would help pension schemes and annuity providers hedge the aggregate longevity risk they face (United Kingdom Debt Management Office, 2009, p30).

¹⁹ However, a preliminary look at the data suggests that the sums of money involved in Carer's Allowance paid to the over-65s are tiny (about £6 million per year in total).

An additional problem arises purely from the treatment of inflation, because there are currently three different measures of inflation in use in the UK pension industry: the Retail Price Index (RPI); the Consumer Price Index (CPI); and Limited Price Indexation (LPI). The difference between the RPI and the CPI arises from the fact that they measure the prices of different goods and use different methods for averaging price changes. The LPI follows the RPI but is capped at 2.5 per cent. This will only be sufficient to protect pensioners if the Bank of England is consistently successful in hitting the inflation target of 2 per cent: if inflation is regularly higher then pensioners are not fully protected against inflation.

Existing pensions and benefits are typically linked to the RPI, but the government has announced that state pensions and public pensions will be linked to the CPI (which tends to be slightly lower than the RPI). On 8 July 2010, the Minister of State for Work and Pensions, Steve Webb MP, announced that the government would also introduce legislation so that defined benefit pensions could also be linked to the CPI instead of the RPI (although it is not clear how this will apply to all private pensions, since some are explicitly linked to the RPI in the trust deeds and changing to the CPI would require a more substantial piece of legislation).²⁰ Inflation-linked government bonds are tied to the RPI, suggesting a particular problem: the difficulty in matching pensions to inflation when two definitions of inflation are in use.

Regardless of whether the inflation indexing is RPI, CPI or LPI, indexing pensions to prices does not ensure that pensions rise in line with earnings and hence the value of a private pension will fall relative to state pensions and the MIR, suggesting the possibility that a pensioner whose pension is rising in line with one of the inflation indices will eventually be eligible for means-tested pension benefits. Moving from the RPI to the CPI will exacerbate this problem: the CPI and LPI are usually lower than the RPI and are expected to remain so into the medium term (the Budget Statement of 22 June explicitly mentioned that using the CPI to upgrade welfare benefits would save money).

Finally, we reiterate the point that government policy is itself partly endogenous because it is influenced by attitudes of the general public, of whom the retired population form a large part. There seems to be a psychological bias that retired people are unwilling to use their pension capital to finance retirement (Poterba, 1994). Any relaxation of the annuitisation requirement will thus result in pensioners consuming only from income rather than capital and thus having a lower standard of living. If such expectations become embedded in public debate then a likely corollary is that there will be more pressure to augment pensioners' income through state pensions or benefits, thus placing even more pressure on the public purse.

19. <http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm100708/wmstext/100708m0001.htm>

6 Conclusions

We have attempted to identify some of the issues and consequences of the government's decision to end compulsory annuitisation. These consequences fall into two categories, those that affect individuals and those that affect the wider society in terms of claims on the public purse.

If individuals, as a consequence of low levels of financial literacy, poor understanding of longevity risk, poor investment decisions or a deliberate strategy, run down their retirement assets too quickly, then their welfare in retirement will be much reduced. They will also become entitled to means-tested benefits.

The consequences for taxpayers could be equally devastating. Not only could there be a huge increase in claims for means-tested benefits. There could also be demand from defined benefit scheme members, including public sector workers in unfunded schemes, to have their pension as a lump sum rather than as an income. There will also be new opportunities to use the pension system to create tax loopholes and there is likely to be a fall in the demand for long-term government bonds which will occur at precisely the time the government is issuing debt to plug the hole in the government finances.

To mitigate these problems, the government is proposing a minimum annuitisation requirement to satisfy a minimum income requirement, such that the minimum would be set at a sufficiently high level that pensioners could never fall back upon means-tested benefits. While this goes some way to dealing with the consequences we have highlighted, we also pointed out a number of problems with determining what the minimum level should be, chief among these being the wide differences in individual circumstances and the difficulty in creating appropriate annuity products that are guaranteed to avoid the need to claim means-tested benefits ever again. These are factors that must be confronted if the government's proposal is to succeed.

This initial report has outlined some of the issues and consequences of removing the UK's compulsory annuitisation requirement at age 75. Our intention is to write a follow-up report in which we will further analyse the impacts of removing the annuitisation requirement. In the second report, we will provide quantitative assessments of the following: (i) the size of the minimum income requirement and the feasibility of annuities which are index-linked or have a wage-growth linkage; (ii) the likely effects of the MIR on the range of pensioners who will be affected by the proposal; (iii) the impact of the proposal on DB schemes and long-term government bond markets; and (iv) the cognitive problems that elderly people can face when dealing with investments. We will also provide policy recommendations in relation to this proposal.

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Appendix

Summary of HM Treasury's consultation document 'Removing the requirement to annuitise by age 75' published on 15 July 2010

- The consultation recognises that for many an annuity will always remain the best product
- However the Government wishes to introduce greater flexibility in how people can take income to reflect the changing pensions and workplace environment, to encourage more pension saving and to encourage product innovation.
- The age 75 rules on annuitisation, value protection lump sums, tax free cash and trivial commutation lump sums will be removed.
- The age 75 rules on contributions and Lifetime Allowance checks will remain.
- Pension funds will be able to remain in a USP ("capped drawdown") indefinitely. ASPs will cease to exist.
- The USP maximum withdrawal limit may be reviewed. The current 120% is probably too high at older ages and may have to be less than 100% to avoid the risk of people exhausting their funds.
- There will be no minimum withdrawal requirement.
- Any withdrawals will be taxed as income.
- A USP customer will be able to access additional flexibility (in effect the permanent removal of the upper withdrawal limit) through "flexible drawdown" provided they have secured a minimum income (the Minimum Income Requirement). This minimum income will need to be a secure pension income for life and escalate by the lower of 2.5% or inflation.
- The customer would then be able to withdraw up to 100% of the remainder of their fund. This will be taxed as income.
- The minimum income required is not set out in the consultation paper.
- However they expect it to take account of not just current means-tested benefits, but also potential health costs and future expenditure needs.
- Restrictions on value-protection annuities will be removed.
- Lump sum death benefits will be taxed at 55% to counteract tax relief given - this includes value-protection payments.
- The only exception is pension saving where no part has been used for an income when the saver dies before 75 where the pot will be tax free.

The consultation asks for responses on 10 questions:

- A.1 The level of an appropriate annual drawdown limit for capped drawdown.
- A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.
- A.3 What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.
- A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.
- A.5 Whether a different MIR should be set for individuals and couples.
- A.6 How often the MIR level should be reviewed.
- A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.
- A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.
- A.9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.
- A.10 Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

Previous Pension Institute Reports



'Delivering DC? Barriers to participation in the company-sponsored pensions market', by Debbie Harrison, Alistair Byrne, and David Blake, October 2004.

'Pyrrhic Victory? The unintended consequences of the Pensions Act 2004', by Debbie Harrison, Alistair Byrne, Bill Rhodes and David Blake, October 2005.

'Annuities and Accessibility: How the industry can empower consumers to make rational choices', by Debbie Harrison, Alistair Byrne and David Blake, March 2006.

'Dealing with the reluctant investor: Innovation and governance in DC pension investment', by Alistair Byrne, Debbie Harrison and David Blake, April 2007.

'An unreal number: How company pension accounting fosters an illusion of certainty', by David Blake, Zaki Khorasane, John Pickles and David Tyrrall, January 2008.

'And death shall have no dominion: Life settlements and the ethics of profiting from mortality', by David Blake and Debbie Harrison, July 2008.



Prudential is pleased to sponsor this report examining the potential impact of the removal of the 'age 75' annuitisation rule.

Established in 1848, Prudential remains one of the country's best known financial institutions, and one of the UK's leading providers of retirement income.

Society faces many challenges as patterns of employment, private pension provision and needs in retirement change. We believe it is right that pension rules are reviewed and updated to reflect such changing circumstances and we welcome the opportunity to contribute to the debate about the direction of those reforms.

Whatever reforms are considered, the most important objective of the retirement income market remains to provide consumers with a replacement income by the most efficient and appropriate means.

In practice, we believe that for most people the "income for life" guarantee under an annuity will continue to provide the cornerstone of retirement income. As this report demonstrates, it is important for everyone that this core message is not lost.

It is also critically important that changes are made only after the potential consequences for consumers and the public finances are understood and, where necessary, addressed.

We believe this report provides an important insight into the risks and consequences for individual consumers and for society that need to be taken into account when considering reform of the current rules.

Prudential looks forward to supporting the publication of the second research report. By quantifying the potential impact of rule changes we believe the second report will provide valuable information to policymakers when considering proposals for reform.

Prudential UK & Europe
July 2010

About the Pensions Institute

The objectives of the Pensions Institute (www.pensions-institute.org) are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.

We 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.

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The Pensions Institute undertakes research in a wide range of fields, including:

Pension Microeconomics

The economics of individual and corporate pension planning, long-term savings and retirement decisions.

Pension Fund Management and Performance

The investment management and investment performance of occupational and personal pension schemes.

Pension Funding and Valuations

The actuarial and insurance issues related to pension schemes, including risk management, asset-liability management, funding, scheme design, annuities, and guarantees.

Pension Law and Regulation

The legal aspects of pension schemes and pension fund management.

Pension Accounting, Taxation and Administration

The operational aspects of running pension schemes.

Marketing

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The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy (e.g., corporate, public and international sectors).

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