Decumulation of Assets
- The Impact of the Economic Downturn

Notes based on ILC-UK and Actuarial Profession Joint Event:

Supported by Age Concern and Help the Aged

November 2009

ILC-UK

www.ilcuk.org.uk

The International Longevity Centre - UK (ILC-UK) is an independent, non-partisan think-tank dedicated to addressing issues of longevity, ageing and population change. It develops ideas, undertakes research and creates a forum for debate. The ILC-UK is a registered charity (no. 1080496) incorporated with limited liability in England and Wales (company no. 3798902).

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Introduction and Background

Within the context of the economic downturn, the ILC-UK, in partnership with the Actuarial Profession hosted a debate on 13th October 2009 to consider the current state of play in relation to decumulation policy. Almost 200 people attended including representatives of the financial services industry, the voluntary sector and Government.

The recent historical low in interest rates has highlighted the dependence that some retirees have on their savings. And for many pensioners in the UK, perhaps especially those with relatively modest savings held in bank or building society accounts, recent economic events have created uncertainty, and for some real financial difficulty. Not only have many seen their incomes fall to unexpectedly low levels but some have faced the fear of losing their money as banks around the world face difficulties or even collapse. In maintaining levels of income, some pensioners may now be eroding their capital.

These notes are based on the presentations of

Professor David Blake, Cass Business School
Tom Boardman, Prudential
Jane Vass, Age Concern and Help the Aged
Jackie Wells, Fellow, ILC-UK
Niki Cleal, PPI

ILC-UK are extremely grateful for their contributions to the debate. We are also grateful to others for their comments from the floor.

Presentations from the debate are available from our website at:
http://bit.ly/decumulation

At the event, Age Concern and Help the Aged presented their policy briefing on annuities. This is available at: http://www.ageconcern.org.uk/AgeConcern/policy-report-annuity.asp We are very grateful to Age Concern and Help the Aged for kindly sponsoring the event.

The representation of the presentations reflect the views of ILC-UK and not necessarily the views of any individual speaker.

In addition, Jackie Wells presented the findings from her review into Purchased Life Annuities. The paper can be found at http://bit.ly/Timetoannuitise

Decumulation of Assets - The Impact of the Economic Downturn

"Decumulation strategies are very complicated. Much more so than accumulation strategies" David Blake

Expenditure in retirement

Expenditure in retirement is not even. At or soon after retirement we see an increase in expenditure (people doing what they didn't have the time to do before) which then declines before increasing again later in life (to pay for care needs). And because expenditure needs vary over the course of retirement, so does the need for income.

At the moment 80 to 90% of people who buy an annuity choose to buy a level annuity. In other words, even if the basic state pension is indexed to earnings, income in real terms is likely to decline over time. Yet as can be seen from expenditure patterns over the lifetime, this product alone is unlikely to meet the two lumps in expenditure needed.

Risk in retirement

Decumulation strategies can be very risky and complicated. Yet few people understand the risks associated with different strategies:

Interest rate risk - Uncertain interest rates could undermine a decumulation strategy. In a period of low interest rates, for example, an individual reliant on income from the interest accumulated from their assets, could see a significantly lower return on their investment than anticipated.

Inflation risk - The uncertainty of inflation can also make long term decisions difficult. High rates of inflation for example, could mean that older people require more resources than they expected?. In the case of older people, with a different spending pattern to younger people, they can be hit by high inflation even when others around them are seeing low inflation. At the moment, the relative high inflation for certain essential goods and services (some food products, energy) exemplifies this issue.

Longevity risk - For those who reach 65, life expectancy is currently 87. However one in four of these people live to over 90. People of all ages underestimate their life expectancy, men by about five years and women by about three years.

In addition to these risks, other factors also make rational decision making difficult. For example, changes to the regulatory environment can also allow products to deliver a higher or lower return than anticipated.

And individuals, when weighing up all of these factors also face complex trade-offs. They need to choose between income today and income tomorrow.

it remains unclear as to whether the generations entering retirement today are likely to have different attitudes to risk and opportunity as previous generations. The industry will need to carefully monitor this issue as it could create new demand for new products and services.

"Real life is messy"

Human behavioural traits also make things difficult for people considering decumulation products including annuities. People typically overestimate things which have a low probability of happening and underestimate the things which have a high probability of occurring. For example, we are likely to overestimate the likelihood of an aeroplane crash and underestimate the likelihood of us living longer?. In addition, as highlighted above, the needs and expectations of older people change over their retirement. Devising a decumulation strategy which can deal with this uncertainty is very difficult.

Behavioural economists seek to explain the resultant human behaviour in the context of decumulation as the 'annuity paradox'.

What is successful decumulation?

Successful decumulation will mean different things to different people. But there seem to be a number of key aims for a successful decumulation strategy:

- A stable post tax income;
- A retirement free from the stress of an uncertain income.

And if a goal of successful decumulation is a stable post tax income, it is vital at the same time that this income can cover unexpected expenditure such as care. Insurance should be the option to cover uncertain expenditure spikes (e.g. due to care needs as highlighted above).

The annuity market today

There has been a gradual increase in the number of annuities purchased over recent years due to two main factors, the decrease in number of final salary schemes and the increasing fragmentation of pension funds as people move from one job to another. Around 450,000 (mainly pension) annuities were sold in 2008.

However, of these 450,000 only a tiny number (around 800) were non compulsory Purchased Life Annuities.

Income requirements and issues in retirement - for those on low incomes

Most older people live within limited means. Their income is low and whilst most older people budget carefully, they do not have a lot of decumulation options. Half of the retired population live on under £15,000 a year.

Yet for those with limited resources, the decisions taken can be of a much higher significance than those with a large asset base. E.g. if an individual puts all their modest savings into one place and is hit badly by changes in interest rates, they can find themselves in very severe financial difficulty.

This picture of low income is exemplified by the fact that most pension purchases are for very small amounts. One third of pension annuity purchases are for less than £10,000. For these individuals a debate on compulsory annuitisation at 75 is a diversion. They can not afford investment risk and their assets are too small to spread the risk around.

But for many who can expect very low levels of income in later life, the decisions are in some ways much simpler. They are likely to have to rely on the state and possibly housing equity. Any bequests are likely to be left as a result of chance.

Yet there are a number of factors which ensure that those on low incomes cannot get the best return on their limited assets. These factors include the difficulties faced by those with small pots of money to invest.

Individuals expecting a low income in retirement can be hit hard by fragmented pension pots (due to moving employers). Not only do they risk losing track of their pension pots[1] but their pots may be too small to ensure they get a good (or indeed any) return.

The Association of British Insurers has undertaken very positive initiatives recently to make it easier for consumers to consolidate pension pots but it remains the case that there is a need to improve the situation for those faced by trivial commutation.

Some of the difficulties faced by older people on low incomes are best exemplified by the issues relating to trivial commutation. For the 2009-10 tax year, there is a £17,500 limit to trivial commutation. To take advantage of trivial commutation all pension savings have to be cashed in within 12 months. Under this rule, lost accounts which are later found may be too late to commute. In addition, the taxation of trivial commutation is complicated. The complexity is highlighted by the fact that the group 'Tax Help for Older People' have reported that they have dealt with 1200 trivial commutation clients since June 2009. People on low incomes are also hit hard by the problem of stranded pots – pension funds that are too small to annuitise but cannot be consolidated with other pension funds and cannot be trivially commuted (usually because the individual already has a small defined benefit pension that takes them over the £17,500 limit) .

[1] In Australia in 2007 it was estimated that there were 6 million unaccounted for accounts. There were also on average 2.8 accounts per member of the workforce.

The ABI have undertaken some positive work in recent times to increase the awareness of the open market option but the market is difficult to navigate. It is expensive for the insurance industry to pay out small sums and there is a wide range of prices in the market.

The issues facing the market suggest the need to review its current workings in the light of older people with very modest incomes.

Income requirements and issues in retirement - income poor, asset rich

Whilst the majority of older people live on low incomes, a significant proportion of these also have assets in the form of savings in housing. A quarter of retired people have savings of over £25,000 (and some have suggested this is an underestimate).

Three million retired people have savings and those who have kept those savings in instant access accounts over recent years will have seen a 96% fall in their income from their investment.

Jackie Wells presented case studies which highlighted that individuals who had decided to annuitise part of their income instead of leaving it in an instant access account would not[2] only be seeing a higher income at the moment, but that they would have a more stable income in the long term.

Clearly PLA's are not for everyone, however it does appear that the gap between the number of people who could potentially benefit (hundreds of thousands) and the number sold (just 800) is too large to be explained by poor value (or perceived poor value).

The majority of those with savings of under £10,000 would probably be better not considering annuitisation as they are likely to need the flexibility of their assets.

Income requirements and issues in retirement - for those on high incomes

For the affluent there are a complicated set of decisions they may need to make. Income optimisation is difficult for people in their 60s who are looking to fund a retirement of over 20 years. In early retirement individuals are likely to get relatively low returns on e.g. annuity purchases or on a decision to release equity in their home. But as individuals get older they have a greater opportunity of higher returns on their investment.

In other words the optimum solution (best decumulation strategy) early in retirement is likely to be to ensure significant flexibility alongside the provision of insurance to cover any unexpected costs.

[2] See Time to Annuitise for full description: www.iluk.org.uk/

When is it 'Time to Annuitise'?

Annuities play a unique role in providing a stable long term income for individuals. And whilst it is important that the majority have a mixed approach to decumulation of assets, there is a strong case for annuitisation to be part of this package.

Early on in retirement a decision to annuitise may produce poor returns. Yet as people get older the return on annuities increases significantly. As David Blake argued "It is not if you annuitise but when".

Over recent years there have been a number of important reviews of the annuity market but most of these have focussed on the compulsory annuity market and little if any attention has been paid to the issues around Purchased Life Annuities (PLA).

Jackie Wells quoted Pollen who argued that you should spend or allocate every penny of your wealth before death. As part of his strategy he proposed the gradual but complete investment of wealth into annuities. Whilst this is an extreme approach to decumulation, it is one worthy of consideration.

The market for PLAs has fallen in recent years and last year there were only around 800 sold. Yet for those who need a steady and reliable income in retirement, they could be a key part of a successful decumulation strategy.

There are a number of factors why the PLA market is struggling:

- Product providers have not actively sought to promote these products;
- There are limited incentives for providers to sell;
- Other alternatives to annuities can be more attractive to providers;
- The media is not convinced that annuities are good value;
- The industry has in part talked itself out of a market;
- The annuity paradox (see above and below;)
- Annuities provide an insurance against living long but most people assume they will die younger than they actually do;
- the restrictions an annuity can place on passing wealth onto future generations
- the taxation of income from annuities.

However, the greater use of annuities could actually guarantee an income for dependents in a way in which other decumulation strategies cannot do so. By annuitising part of your assets to give a regular income this could avoid you needing to eat into other capital. One speaker argued that an annuity (alongside insurance) can allow people to actually spend more today safely as they will not need to worry about saving now in order to meet possible costs tomorrow.

If the PLA market were underwritten this would also help the market develop. Because the market is currently small, actuaries assume that the only people buying the product at the moment are likely to live a long time. They then price accordingly.

A number of suggestions were given during the debate in relation to the tax efficiency of annuities including one suggestion that the money from ISA could be transferred to an annuity in a tax efficient way.

A number of people expressed major concern about the emphasis on annuitisation. There was a worry about the impact of government policy and that individuals would be served? much better to spend their assets then rely on means tested benefits.

There was also a view that many older people might take a more positive view to annuities if impaired annuities were better explained.

Access to Information and advice

More than one speaker commented on the changes in the IFA (Independent Financial Advice) sector. It seems that the sector is decreasingly likely to be providing advice for those at the lower ends of the market. At the same time it appears that many IFA's lack the confidence and qualifications necessary to sell annuities. They are also often incentives (through higher commission for example) to sell products other than annuities.

Throughout the debate many speakers emphasised the need for a huge consumer education exercise in relation to decumulation products including annuities. One speaker argued that financial capability should form part of citizenship education. Tom Boardman and Baroness Greengross respectively highlighted interesting initiatives going on across the world to tackle this problem (including a new disney attraction which encouraged learning).

During the debate one speaker commented that we should move towards a system which help people understand what sort of investment they need in order to ensure they get the return they want. In other words, when talking to people about their state pension provision they should also highlight how much people would need to save to bring in a private income at similar levels.

One thing is certain in the world of decumulation. And that is that decumulation is a terrible word for the end user to understand. The industry of decumulation is stuck with phrases which the majority don't understand, from "Annuity", to "Purchased Life Annuity" or "guaranteed annuity".

A number of speakers at the end of the debate expressed concern about the focus on financial education in:

- that it essentially puts the responsibility/blame on the end consumer
- it assumes that "at 65 we leave our brains at the door and don't use them again"
- that people are actually making rational financial decisions at the moment - it was argued that the choice to consume now is actually a very rational one in the light of means testing;
- that individuals do notactually want to be taught about decumulation or money issues generally;
- that the approach of "educate the public and they will buy annuities" is the wrong approach to have to decumulation of assets;
- that we cant do financial education well until it is clear what we are telling people/selling people.

Impact of the credit crunch

People drawing pension benefits now are likely to be suffering major aftershocks from the credit crunch . The fall in the stock market and low interest rates have had a significant impact. (in particular on those individuals who made decisions -perhaps by inertia- to rely on income from interest to support them in retirement).

The credit crunch will also have an impact on decisions made by people as to the best decumulation strategy today . It could, for example, play a role in encouraging people to reconsider the case for PLAs. It could also result in more older people finding themselves wanting to give more resources to their children and grandchildren to help them in difficult times. Many older people do continue to have a desire to make life better for the younger generation which actually has much less in the way of assets than today's older generation.

New products

There are of course new products entering the market which could suit some people as part of their decumulation strategies (Third way products e.g. variable annuities).Whilst it is important for the industry to continue to develop new products and services, many people felt that it was notthe lack of products more their branding and marketing which was an issue.

The insurers argued that they would be much more likely to come up with new products if there was certainty in terms of government policy. They argued that they would for example create products for the long term care market should the 'Big Care Debate' result in a clear direction of travel.

Other options and next steps for retirement savings

The debate on 13th October focussed mainly on the annuities market. However issues such as the use of housing wealth, equity release, and income draw down, were all mentioned in debate.

Other issues also emerged such as the challenges of making the right decision if also faced with mental capacity issues or a lack of power of attorney.

It is clear that we are only beginning the debate on the different options for different groups of the population. It is also clear that this debate has to develop if we are to ensure that today's and tomorrows older population maximizes their potential income.

And as Tom Boardman pointed out in conclusion "we need to try and ensure that we don't see a generation which runs out of money".

Recommendations:

In the context of this debate ILC-UK believes that:

- Certainty in the regulatory environment would help people make long term decisions.
- Financial education is certainly not the complete answer but is part of the jigsaw. There is much emphasis on financial education to ensure accumulation of assets but we need more financial education, information, advice and brokerage to help people have the right decumulation strategy.
- For those anticipating a low income in retirement, the introduction of personal accounts could help tackle the problems associated with fragmented pension pots. They also reduce the likelihood that people lose track of their different pension pots over their lifetime.
- Staged retirement could help people ensure that they have access to the income they need in retirement. Government should ensure that employment law supports flexible working and facilitates a longer working life.
- There is need for a major debate about the decumulation of assets as part of any financial education campaign.
- There should be reforms to the trivial commutation rules to help those with small retirement savings.
- There should be more research into the PLA market.
- Government should undertake a "Turner-esque review of decumulation which would consider amongst other things:
- the options for decumulation;the role of the family in decision making, the potential pressures put on older people and the role of Power of Attorney; (can not seem to move this sentence to be in line
- The role of the PLA market;
- Tax treatment of decumulation products;
- Consumer attitudes to annuities and other decumulation products.
- The market should ensure products manage the balance between simplicity and innovation.
- Industry needs certainty to invest in marketing and devise new products. The Government must follow the Big Care Debate by confirming the direction of travel. There is a need for political consensus if industry is to engage actively in this market.
- We should seek to move away from the phrase decumulation to something which the majority of consumers are likely to understand e.g. "Using retirement savings".

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