The future of retirement income – beyond annuities

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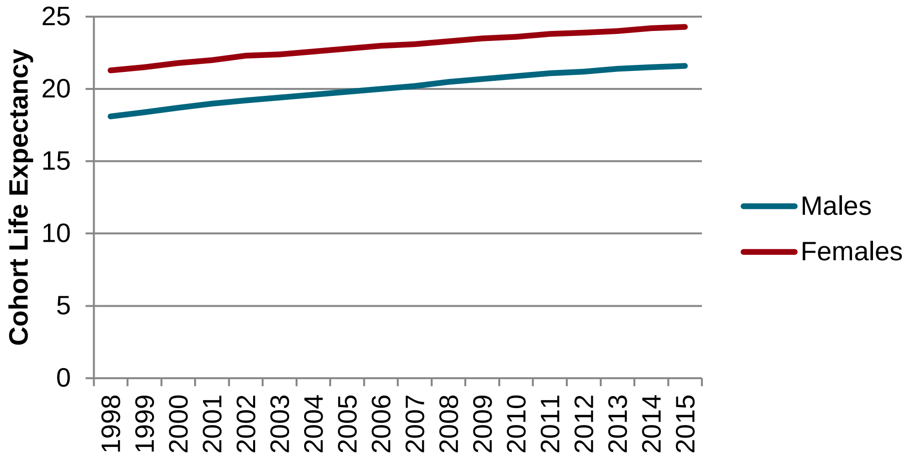
A recap: “Freedom and Choice”

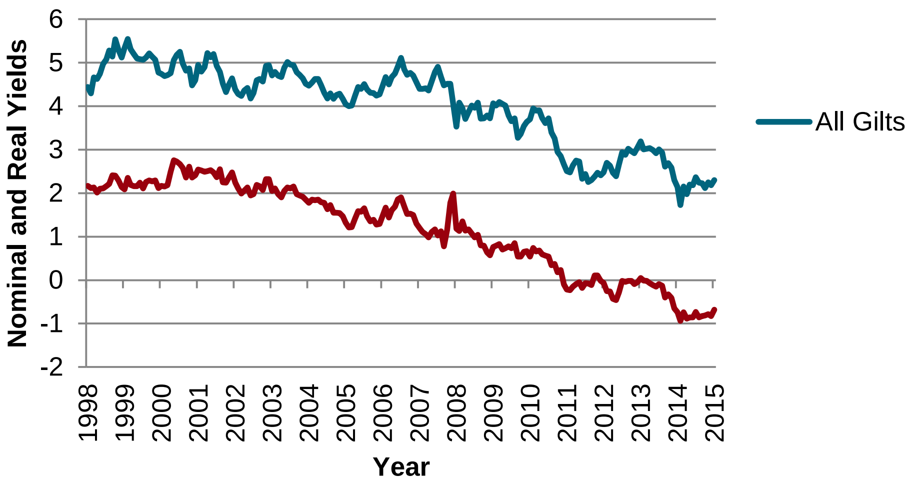
- Until 2014, almost every DC member turned their pot into an annuity
- (except for the 25% tax-free cash lump sum)
- Income drawdown was available
  - But only until age 75…
  - …unless an individual had other guaranteed income
- 2014 Budget
  - Everyone can take as their pension how they want, when they want…
  - …subject to tax at the marginal rate (for amount over tax-free 25%)
- Key implication: target date funds – as they stand – might not be the answer
- Key challenge: determining what savers might want
- Key objective: dividing savers into homogeneous investor types

A caveat: don’t expect miracles

- Annuities fell out of favour because they were too expensive
  - Longevity has increased…
  - …and yields have fallen
- But just avoiding annuities will not magically create any additional income…
- …and those drawing down will face same challenges as annuitants
- Higher expected incomes come with higher risk to that income…
- …and the “mortality credit” gets harder to beat the older you get



Source: Office for National Statistics



Source: DataStream

Beyond annuities?

- Might reports of the death of annuities be exaggerated?
- Annuities continue to exist in some countries…
- …without compulsory annuitisation…
- …whilst being absent elsewhere
- Why the difference?

Case study: United States

- Has had a “Freedom and Choice” regime for many years
- Annuities very unpopular
  - Cultural aversion to risk pooling
- In income terms, advanced life deferred annuities as popular as traditional annuities…
- …but variable annuities more popular
  - These are not really trues annuities…
  - …but mutual funds that allow an proportion of assets to be withdrawn…
  - …generally with a guarantee of no fall in income…
  - …and a lifetime guarantee
  - Often used simply as vehicle to keep DC assets tax-exempt
- This highlights the importance of culture…
- …and of the tax regime

Case study: Switzerland

- Has a compulsory DC plan for part of its second pillar (workplace) pension
- No requirement to annuitise, but annuities are popular
  - They are the default option
  - Annuities are at a favourable non-market rate
  - Home ownership is low in Switzerland – so a regular retirement income is important
- This highlights the importance of the default option…
- …and of societal factors

Case study: New Zealand

- In 1993, 9 annuity providers in New Zealand…
- …but by 2013, final provider left the market having sold only one policy
- Potential reasons
  - Bequest motive? Always existed
  - High tax rate paid by insurers on annuity assets?
  - NZ Super – around 8k-11k per annum - so why buy an additional guaranteed income
- Might UK single tier pension mean people no longer need annuity?

What does this mean for the UK?

- Many factors at play…
- …complicated by the fact that large pots exist…
- …when the rules suddenly changed
- Likely outcome is variety…
- …with the result dependent on the investor type

What defines an investor type?

- Wealth (excluding DB pensions)
  - Relevant both in absolute terms and relative to pre-retirement income
  - Consists of both DC pensions and other assets
  - Increasing wealth generally allows more flexibility…
  - …providing it is sufficiently liquid and/or income generative
- Income (in addition to that generated by wealth)
  - Defined by time horizon and certainty
- Health
  - Affects length of time for which income may be needed
  - May affect pattern of income need
- Bequest motive
  - Although this maybe a residual rather than an objective
- Risk tolerance

Wealth

- Higher wealth
  - Increases ability to take investment risk
  - Increases the ability to withstand unplanned expenditure
    - This includes health-related issued (such as long-term care)…
    - …and other issues (such as home repairs)
  - Reduces the need to plan for extreme old age
    - This means less need to consider longevity insurance
  - Increases the cost-effectiveness of and access to high-quality advice
  - However, this assumes that the wealth is income-generating…
  - …as housing wealth is more difficult to access

Income

- The impact of income is more complex
- In this context, we mean income *in addition to* anything generated by the assets
- This is defined in terms of timing and size
- Timing
  - Is the additional income due to end (e.g. from part time work)…
  - …not yet being received (e.g. state pension)…
  - or constant (e.g. final salary pension)?
- Size
  - How significant is it relative to income needs?
- These factors have a major impact on the role of DC…
- …particularly when combined with wealth

Health

- In terms of investor type, this relates to issues known at retirement
- May be existing health issue…
- …or known predisposition
- May make an enhanced annuity more attractive…
- …but may also make the need for a guaranteed income lower (for a given pot size)

Bequest motive

- Unlikely to be a motive on its own
- In other words, unlikely to restrict post-retirement consumption to fund bequest…
- …unless relates to particular asset (such as house)
- Otherwise
  - Objective will require significant assets…
  - …which will need a bespoke asset allocation

Risk tolerance

- Relates to the risk prepared to take in a number of dimensions
  - Volatility (or downside risk) to income
  - Risk of inadequate income growth
  - Risk of asset exhaustion
  - Risk of illiquidity (inability to sell assets to supplement income, to cash in an annuity)
  - Risk of regret (regarding purchase of a particular insurance policy)
- Will impact the asset allocation…
- …and the use/avoidance of insurance
- Also worth noting that behavioural approaches can be used to avoid some risk biases

DC segmentation: short-term top-up income

- May be added to part-time income before commencement of final salary pension…
- …or may replace pay in the period before the State Pension Age
- In any case, term known with reasonable certainty
- Reasonable certainty required of the income…
- …so little scope for volatility
- Most people in this position will have a low risk tolerance with regards to investments…
- …but given the increasing importance of the State Pension, this could play a part for many people

$\Rightarrow$ **Fixed term fixed income fund *or***
$\Rightarrow$ **Fixed term annuity**

DC segmentation: long-term top-up income *or* long-term main income for those with a large DC pot

- For people with a relatively large final salary pension *or*
- Significant volume of other liquid or income-producing assets
- Ability to absorb income volatility, and no need for longevity protection

- Sufficient DC assets to provide high level of income…
- …with little need for asset withdrawal

⇒ **Open term multi-asset income fund *or***
⇒ **Multi-asset fund plus robo-advice *or***
⇒ **Bespoke multi-asset portfolio plus advice**

⇒ **Possible role for annuity…**
⇒ **…especially if enhanced terms available**

DC segmentation: long-term main income – small pot

- No significant alternative income sources
- Assets must last until death…
- …with limited capacity to take losses
- Suggests that longevity insurance is needed *at some point*

⇒ **Advanced life deferred annuity *or***
⇒ **Bond fund hypothecated for annuity purchase at advanced age**

plus

⇒ **Fixed-term multi-asset decumulation fund *or***
⇒ **Multi-asset fund plus robo-advice**

⇒ **Possible role for annuities depending on risk tolerance…but unlikely to be popular**

DC segmentation: complications

- Health issues (known at retirement)
  - May make an enhanced annuity more attractive…
  - …but may also make the need for a guaranteed income lower (for a given pot size)
- Health issues (not known at retirement)
  - May lead to unexpected health- or care-related expenses
  - Could be an argument for hypothecated annuitisation pot that can then be redirected to costs
  - Expenses could also be funded by house sale/equity release…
  - …or the sale of pension assets/commutation of income streams
  - Opening for new insurance products (with morbidity-related payments)
- Unexpected property expenses
  - Unlike health-related expenses, these do not generally coincide with a reduced long-term income need…
  - …but sale of pension assets/commutation of income streams may be only option (if uninsured)

Some final thoughts

- Aggregation
  - The solutions here assume that all pensions savings are aggregated (at least within DC)…
  - …and this is unlikely to be the case for most
- It's not just pensions
  - Housing is an increasingly important proportion of people's wealth
  - Ongoing changes to pensions could increase the importance of non-pensions saving
- Many of these solutions could require a significant change in strategy…
  …posing problems with people being anchored to existing asset allocation…
  …so options will work best if linked to accumulation strategies
- Far too many people will be in the short-term top-up income category…
  …unless retirement saving increases drastically

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