Default Reform

Preventing low incomes with an automatic income plan

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Key Points

- The UK's compulsory 'annuities deal' did not adapt to rising longevity and exceptionally low gilt-rates. Government policy placed too much emphasis on competition at the consumer level to ensure value for money for Defined Contribution (DC) savers.
- The April 2015 shift to voluntary annuitisation aligned the UK with other voluntary annuitisation systems, which are characterised by very low take-up of annuities; for example, in Australia and South Africa, policymakers are grappling with problems of low retirement incomes, as well as poor value for money from non-annuity products, and are exploring default income options for DC retirees.
- New research from the Strategic Society Centre – "Defined Capability: Pensions, financial capability and decision-making by UK retirees" – found: use of more sophisticated investment and products is low among DC pension savers and declines steadily with age; wide variations in the influence of different sources of information and advice on financial decision-making; for key aspects of financial engagement (monitoring inflation, stock-market changes and financial best-buy tables) engagement is low among DC savers and declines with age; and, strong evidence of 'over-saving' among DC retirees.
- This report therefore argues: there is a high risk that that over time, the April 2015 changes to rules on DC pension saving will result in lower average retirement incomes for DC pension savers in the UK as other countries have experienced; the government's 'guidance guarantee' is unlikely to be successful in preventing lower incomes or poor decisions. In time, pensioner poverty may increase.
- Against this context, policymakers have three choices: do nothing; re-impose restrictions on DC pension pots; or, implement a new default option for DC retirees, while leaving the April 2015 freedoms in place. Although any 'default' option in pensions policy will inevitably result in sub-optimal outcomes for some, the 'counter-factual' to a new default retirement income option in the UK is not optimal outcomes for all, but rather, large numbers of DC retirees experiencing lower retirement incomes and increased insecurity.
- The government should therefore define, implement in regulation and promote a default 'automatic income plan' for DC retirees in the UK, which provides a predictable, secure (guaranteed) and good-value income for DC retirees.
- Key principles for developing an automatic income plan include: maximise average retirement incomes, balance consumer preferences, ensure value for money, as well as adaptability and flexibility to changes in a person's circumstances and the macro-economy.
- Regulation for a new, default automatic income plan will likely require an outcomes-based approach. To ensure value-for-money from a default income option, policymakers will have to consider: kite-marking; an expanded trustee role; expanded governance boards; enhanced regulation; statutory provision; or, mandated brokerage or a 'clearing-process'.
- For pension providers, key design choices – which may require protocols laid down by policymakers to balance policy objectives – relate to income drawdown; longevity insurance; use of individual data; adaptation processes; the role of choice; and, 'hard defaults' and small pots.
- Given risks posed by the April 2015 changes to rules on DC pension saving, a new, default automatic income plan for DC retirees poses negligible downsides for policymakers: it is unclear why government would choose <u>not</u> to implement such an approach.

Executive Summary

Introduction

For nearly a century, UK pension policy was built around the so-called '**annuities deal**' embodied in the Finance Act of 1921, which introduced the "mandatory annuitisation of pension funds". Under this framework, in return for tax incentivised pension contributions, individuals were required to turn their pension savings into **a secure retirement income that would last until the end of their life**.

Policy context

In recent years several factors contributed to growing disquiet and hostility toward the compulsory annuitisation framework for Defined Contribution (DC) pension savers:

- **Declining 'gilt' rates** pushed down the income paid by annuities;
- **Increasing longevity** rose faster than average retirement ages, increasing risks for annuity providers and further pushing down annuity rates;
- **Value for money and competition** – relatively few individuals 'shopped around' among providers to secure the best annuity income available;
- **Value for money and mortality risk** – many DC savers with lower life expectancy owing to chronic health conditions nevertheless bought standard life annuities.

Budget 2014 and the end of the DC 'annuities deal'

The 2014 Budget saw the UK government announce the annuities deal for DC pension savers would end in April 2015, with the tax-rate on withdrawals of pension savings reduced from the punitive rate of 55% to a person's marginal income tax rate. In this way, all DC savers were released from the effective obligation to turn their pension savings into a secure retirement income that protected them from longevity risk (uncertainty over how long they will live for).

Voluntary Annuitisation: International experience

By moving the UK from broadly mandatory to voluntary annuitisation for DC pension savers, Budget 2014 aligned the UK's DC pension system with multiple other countries in which turning DC pension savings into a secure retirement income is entirely voluntary. International experience of voluntary annuitisation frameworks has consistently shown very low take-up of annuities. An extensive international academic research literature exists analysing this phenomenon – referred to as the 'annuity puzzle' - reflecting the fact that economic modelling suggests a rational, 'utility-maximising' individual with uncertain life expectancy would in fact annuitise all of their wealth.

Two countries that are grappling with the policy consequences of voluntary annuitisation are Australia and South Africa.

Australia's pension system combines mandatory private pension contributions during working life with near-total flexibility for the use of such savings in retirement. Consumer research found one-fifth of Australian pension lump sums at retirement were used to purchase a vehicle, while around one-third were spent on people's homes. Against this backdrop, the 2014 'Murray Inquiry' concluded:

> "[Superannuation] assets are not being efficiently converted into retirement incomes due to a lack of risk pooling and an over-reliance on account-based pensions. This contributes to a lower standard of living for Australians in retirement and, for some, during working life..."

In response to these issues, the Murray Inquiry argued for fundamental decumulation phase reform in Australia built around greater longevity risk pooling:

> "Greater use of risk pooling could significantly increase retirement incomes generated from accumulated balances. This could allow individuals to allocate consumption throughout their lives better... by reducing the savings required to achieve a target level of income in retirement."

To do this, the Murray Inquiry argued for the application of a default option for retirees, which could:

> "... significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement, while still allowing them to retain some flexibility to meet unexpected expenses."

South Africa's pension system is characterised by mandatory workplace pension contributions, with a form of 'mandated choice' at retirement between either a life annuity or an income drawdown product. However, there has been an historic decline in the number of individuals choosing to buy conventional life annuities, and the market for 'drawdown' products was characterised by high charges, apparently 'heuristic' decision-making around investment allocations, and short-term decision-making.

To address these problems, the South African Treasury settled on the following annuitisation reforms:

- [Pension] Trustees will be required to guide members through the retirement process, to identify a default retirement product in accordance with a prescribed set of principles, and to automatically shift members into that product when they retire, unless members request otherwise. The fund itself may provide the default product, or it may use an externally provided product.

Defined Capability: Financial capability and DC savers in the UK

How likely is it is that similar outcomes and problems – such as lower incomes - will be observable in the UK in the years following April 2015? The outcomes that result from the April 2015 changes to DC pension taxation rules will ultimately depend on the financial decisions and choices of millions of UK workers.

To address a gap in evidence on financial capability among DC pension savers and retirees, the Strategic Society Centre published **Defined Capability: Pensions, financial capability and decision-making by UK retirees**. The research drew a number of key conclusions.

First, **use of more sophisticated investment and products is low among DC pension savers, and use of such products declines steadily in later life**. Around one quarter (23%) of **DC savers aged 55 to 64 have neither a savings account nor an ISA**.

Although Budget 2014 prioritised a 'guidance guarantee' as the principal policy lever to help individuals make decisions around how to use their DC pension pots, Defined Capability found:

- **Wide variation in the reported influence of different sources of information and advice on financial decision-making**;
- **Use of 'informed sources' – such as best buy tables or financial advisers – declines with age**;
- **Individuals appear to withdraw from 'informed decision-making' as they age**, with the reported influence of friends and family increasing as people age, as well as the prevalence of individuals who make decisions without recourse to information and advice.

Individuals who opt to cash-in their DC pension savings after April 2015 will have to manage their retirement income through to the end of their life. However, Defined Capability found that for **key aspects of financial engagement – such as monitoring inflation, stock-market changes and financial best-buy tables – engagement is low among DC savers and retirees, and declines overall with age**.

After April 2015, some DC savers may cash-in their DC pension savings and place this money in a savings account, and - in their 'mental accounting' – regard this wealth as **simply cash savings indistinguishable from other forms of savings**. Defined Capability found **strong evidence of 'over-saving' among DC retirees** in the UK:

- Retirees **maintain relatively high levels of cash savings that could be annuitized, including DC retirees on a low income**;
- Retirees **deliberately and purposefully save money to boost their savings levels (principally against 'unforeseen expenditure'), despite being in the 'decumulation phase'** of the life-cycle when they should – in theory – be running down their savings to fund consumption (spending);
- Retirees **adjust their regular expenditure to below their income, with the result that they engage in 'accidental saving'**, with money frequently left in their current account.

Defined Capability also found a strong 'liquidity bias'; for example, despite total financial wealth declining as people age, the amount that individuals have in their current account actually increases. The research also found low tolerance for risk, with preferences for investment risk declining markedly with age.

The case for default reform

The findings of Defined Capability and other evidence on financial capability in the UK suggest the Budget 2014 changes to the UK's 'annuities deal' reflect an over-optimistic view of DC retirees in the UK as highly informed, engaged and active financial services consumers. As such, this discussion paper argues:

- There is a **high risk that that over time, the April 2015 changes to rules on DC pension saving will result in lower average retirement incomes for DC pension savers in the UK** as other countries have experienced, notably Australia;
- The government's **'guidance guarantee' is unlikely to be successful in preventing lower incomes** or poor decisions.

More widely, **there is a significant risk that the April 2015 changes to DC pension taxation will result in an increase in pensioner poverty**.

Against this context, this report says policymakers have three basic choices:

- **Do nothing;**
- **Re-impose restrictions on the use of DC pension saving;**
- **Implement a new default decumulation pathway for DC savers at retirement, while leaving the April 2015 freedoms in place.**

There appears to be compelling argument for UK pension policymakers to explore how 'default' retirement options for DC savers could be used to address these issues and risks associated with the April 2015. Although any 'default' option in pensions policy will inevitably result in sub-optimal outcomes for some individuals, the 'counter-factual' for implementing a default option is not optimal outcomes for every individual, but rather, large numbers of DC retirees experiencing unnecessarily low retirement incomes, as well as increased insecurity.

There are also multiple compelling potential benefits to UK policymakers designing, implementing and promoting a new, default decumulation pathway – what might be referred to as an 'automatic income plan' - for DC retirees in the UK, based on achieving a secure, predictable, good-value retirement income:

- **Inertia – deployed through a default option - is the most powerful tool available to policymakers to influence behaviour**. Indeed, financial 'guidance', information websites and the promotion of choice via the 'open market option' proved wholly inadequate to achieve acceptable consumer outcomes for DC retirees under the pre-April 2015 regime, given the power of inertia among consumers;
- **A default option, and regulatory 'nudges' from the government, are inevitable so should be exploited by policymakers**;
- **Promoting the idea of a secure income will influence behaviour and improve peace of mind**;

As such, the analysis suggests the government should:

- **Define, implement in regulation and promote a default, 'automatic income plan' for DC retirees in the UK, while retaining the right for individuals to withdraw their savings from the age of 55 subject to their marginal income tax rate**;
- **The default automatic income plan should provide a predictable, secure (guaranteed) and good-value income for DC retirees**.

Defining 'Good': Principles for an automatic income plan

In developing a new default, automatic income plan, it is important to set out what policymakers should be trying to achieve. A number of target outcomes and guiding principles can be proposed:

- **Maximise average retirement incomes**;
- **Balance consumer preferences** for cash vs. guaranteed income;
- **Ensure consumers obtain good value for money**;
- **Design a default option for real people**, rather than assumed types of behaviour and levels of financial capability;
- **Ensure a default automatic income plan is pot-neutral** and does not exclude small pots from good-value, secure retirement income;
- **Guarantee transparency** throughout the process of a default automatic income plan;
- **Ensure a default automatic income plan is adaptable and flexible** to changes in a person's circumstances and the macro-economy.

Delivering an Automatic Income Plan: Options for policymakers

For DC pension policy to be effective in maximising average retirement incomes, it must make provision for a new, default automatic income plan that provides several things:

- A mechanism for converting a person's DC pension savings into a **regular income**;
- Protection from **longevity risk**, i.e. the risk individuals will live longer than expected;
- Protection of a person's income from the effects of **inflation**, by securing investment growth.

UK governments have traditionally avoided directly providing financial services to the public, preferring instead market-based solutions, which:

- Access skills and expertise in the private sector, for example, in asset-management;
- Promote value for money and efficiency through market-based competition;
- Create space for innovation.

How should the government regulate for market-based non-governmental provision of a default automatic income plan for DC retirees? For the government to specify to providers how DC pension savings should be invested, or longevity risk pooled, would likely result in poor regulatory choices on the part of policymakers, as well as making the government liable for poor performance, and therefore, the possible target of litigation.

Instead, regulation for a new, default, automatic income plan for DC pension savers will likely require an 'outcomes-based' approach, i.e. the government would require providers to default DC retirees into an automatic income plan that would reasonably and credibly be expected to achieve certain outcomes, including:

- Providing a regular, predictable, secure income;
- Representing good value-for-money, based on the income achieved relative to a person's savings.

Nevertheless, several factors suggest that a new, default income plan for DC retirees, set down through outcomes-based regulation will be inadequate to achieve good outcomes for consumers.

First, experience has shown that **consumer-level competition at the point of decumulation (annuitisation) among both trustee and contract-based DC pension schemes proved inadequate to ensure good value-for-money for retirees**. Second, the choices confronting DC retirees following April 2015 will be **significantly more complex**. Third, unlike the one-off, purchase of an annuity, a new, automatic income plan for DC retirees is likely to involve several stages (for example, drawdown followed by staged, partial annuitisation), i.e. **a process, rather than a single decision point**. This potentially means that to be a lever to achieve good outcomes for individuals, consumer competition would have to extend beyond the point of retirement into late old age. Fourth, deploying a new, default automatic income plan for DC retirees in the UK is incompatible with high levels of consumer competition and could result in **conflicting messages**.

Both the government and the financial services industry have a strong interest in the post-April 2015 regime delivering good outcomes for consumers, and for the implementation of a new, default automatic income plan not resulting in a perception that consumers are being failed, short-changed or exploited.

In this context, the government and the financial services industry face several options:

- **Kite-marking of good automatic income plans** - although this relies on engagement and activity among individual DC retirees to switch providers;
- **Expanded trustee role** within trustee-based DC schemes, although attempts by government to extend the duties of scheme trustees to former employees, potentially decades after they left an organisation, is likely to meet resistance;
- **Expanded governance boards** that ensure providers offer good value automatic income plans to DC retirees, although such a model would be entirely new, and there could be little certainty as to how it would operate in practice;
- **Enhanced regulation** such as prescriptive regulation (e.g. ‘charge caps’), ‘naming and shaming’, promoting transfers to individual retirees experiencing poor value, and automatic transfers via a statutory body or network of independent brokers to transfer individual DC retirees away from underperforming providers;
- **Statutory provision** of automatic income plans for DC retirees by an independent, statutory body to provide an alternative to both DC savers and company scheme trustees, which would compete for business and provide a performance benchmark;
- **Mandated brokerage or clearing-process** whereby customers are placed with the provider offering the best secure income, although such an ‘auction’ approach would be less suitable in relation to an automatic income plan delivered in different ways by different providers (e.g. in relation to longevity insurance), and incorporating different consumer choices (e.g. percentage of pot to keep as cash).

Ultimately, no market is effective if businesses do not confront both the risk of losing their customers; and, the opportunity to acquire new customers. As such, it is likely that ensuring value for money through outcomes-based regulation and market-based private provision will

require a **hybrid approach**, incorporating independent governance boards with responsibility for automatic income plans, enhanced regulation and a statutory provider to offer benchmark performance levels.

A New Default Automatic Income Plan: Design choices

In the context of an outcomes-based regulatory approach, pension scheme providers would confront an important and complex set of interdependent design choices for a new, default automatic income plan. In order to balance public policy priorities, regulators may need to set out protocols for providers, for example, relating to the pooling of longevity risk and mortality cross-subsidy, and to ensure consistency across different providers in the features of an automatic income plan.

A new, default automatic income plan for DC retirees will mostly likely need to:

- Default individuals into an income drawdown vehicle;
- Default individuals into longevity insurance, whether via an annuity or some other form of risk pooling or adjustment.

For pension scheme providers delivering a new, default automatic income plan in the context of outcomes-based regulation will therefore require confronting a set of choices principally relating to:

- **Income drawdown** – how much capital is earmarked for drawdown vs. longevity insurance, level of income drawn relative to investment performance, etc.;
- **Longevity insurance** – deferred annuitisation, income-based deferred annuities, institutional annuitisation, etc.;
- **Use of individual data** – i.e. to what extent the decumulation pathway is personalised to a person's characteristics and circumstances, and if so, how is that data obtained;
- **Adaptation processes** - i.e. how a decumulation pathway responds to changes in individual and economic circumstances;
- **Role of choice** – what level of choice and options can be included without risking participation;
- **Small pots and 'hard defaults'** – what protocols should apply to those who never seek out their DC savings, and those with the smallest pots.

The Customer Journey: Messaging and nudges

What should characterise the 'customer journey' of DC pension savers under a default automatic income plan? This will be important in determining:

- **Participation** – how many individuals opt for the default, automatic income plan, as opposed to putting their DC pension savings in property or low-yield savings accounts;
- **Policy benefits** – for example, whether DC retirees experience peace of mind, fear and uncertainty.

In addition to the application of a strong default option at retirement, additional 'nudge' interventions that could be deployed, include:

- **Messenger** - in implementing a default automatic income plan, the government should consider carefully how the 'agent' that communicates relevant information to DC savers about an automatic income plan influences their perceptions and participation;
- **Incentives** – given tendencies toward 'loss aversion', communications with DC savers that provides information on the option to take some or all of their savings as cash could be presented to individuals in terms of lost annual income they would forgo. In addition, individuals who wish to cash-in their DC pension pot could be required to receive at least of six months of regular income, in order to utilise loss aversion toward this income;
- **Norms** - if the government succeeds in steering a significant proportion of retirees into an automatic income plan, the government could promote this behaviour as a 'norm' regarding other people's choices to encourage participation;
- **Salience** - since a challenge for DC pension policymakers has always been the salience of a person's pension 'pot' as a sum of money over which individuals feel ownership and control, policymakers should revisit previous debate around combining State Pension and private pension forecasts and payments, to reverse the 'mental accounting' observable in relation to DC – as opposed to DB – pension savings;
- **Ego** – since research has found individuals act in ways that make them feel better about themselves, policymakers should ensure messaging around a default automatic income plan positively affirms participation.

The politics of retirement income security and good value

In the face of the risks posed by the April 2015 changes to rules on DC pension saving, the development and implementation of a default automatic income plan for DC retirees poses negligible downsides for policymakers: it is unclear why government would choose not to implement such an approach.

A default automatic income plan of the kind set out in this report would ultimately give individuals what they want and, through the application of 'liberal paternalism', allows politicians to resolve apparently contradictory consumer preferences for flexibility and certainty.

Indeed, following the April 2015 changes to DC pension rules, significant political capital will be available to the political party that guarantees access for all DC pension savers to a secure, guaranteed, predictable, good-value retirement income - delivered through a default automatic income plan.

As such, it appears that a default automatic income plan for DC retirees in the UK after April 2015 does not just appear inevitable as a policy development; in time, politicians will compete to promote it.

Part 1: The case for default reform

1.Introduction

1.1. Background

For nearly a century, UK pension policy was built around the so-called '**annuities deal**' embodied in the Finance Act of 1921, which introduced the "mandatory annuitisation of pension funds".[1] Under this framework, in return for tax incentivised pension contributions, individuals were required to turn their pension savings into a secure retirement income that would last until the end of their life, whenever that occurred.

For workers with a Defined Benefit (DB) scheme, mandatory anuitisation was achieved by the employer's provision of a pension income.

For Defined Contribution (DC) pension savers, the 'annuities deal' was policed by **deliberately punitive tax-rates on withdrawals** from pension savings at retirement for everyone, except those with the smallest pension pots.

However, in recent years, the 'annuities deal' applied to DC pension savings has suffered rising political and consumer disquiet. This has reflected a number of issues, such as declines in the incomes paid to new annuitants, and a lack of shopping around in the UK annuity market.

After a gradual loosening of the rules on the use of DC pension pots in recent years, Budget 2014 moved to scrap the 'annuities deal' completely, downgrading the tax rate applied to withdrawals from DC pension savings at retirement from 55% to a person's marginal income tax rate. The Chancellor heralded this fundamental shift by declaring that in future: "no one will have to buy an annuity".[2]

1.2. Voluntary annuitisation and retirement incomes

The reforms announced at Budget 2014, with implementation just 13 months later, switched the UK from a system of near-mandatory conversion of DC pension savings into a secure retirement income, to a system of voluntary annuitisation.

However, the experience of countries with purely voluntary annuitisation systems overseas – such as Australia and the USA – suggest a number of problematic outcomes associated with pension systems that do not require individuals to obtain a secure retirement income. These issues include: **lower retirement incomes**; poor value-for-money retirement products; and, higher levels of insecurity and fear among pensioners.

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[1] Finance Act (1921), quoted in HM Treasury (2014) *Freedom and choice in pensions*, London
[2] Osborne G (2014) Budget 2014 Speech, Hansard

Indeed, in several countries with voluntary annuitisation systems, there is actually growing policy interest in promoting annuitisation and the pooling of longevity risk among DC retirees.[3]

1.3. Financial capability and decision-making

The changes announced at Budget 2014, and detailed in the accompanying policy statement 'Freedom and Choice', significantly increased personal responsibility for using a DC pension pot to fund retirement.

To ensure that future retirees do no suffer lower retirement incomes as a result of the Freedom and Choice changes, policymakers need a strong social science evidence base that can inform policy development around older people's financial capability and behaviour.

For this reason, the Strategic Society Centre undertook quantitative research, which this discussion paper accompanies, entitled: **Defined Capability: Pensions, financial capability and decision-making by UK retirees**.

The statistical analysis for this research was carried out by NatCen Social Research, and the project was made possible by the support of the Joseph Rowntree Foundation (JRF).

Defined Capability analysed data from a large-sample representative survey of thousands of people in the UK, and drew two central conclusions:

- Across multiple measures, **typical levels of financial capability among DC savers is low**, and declines beyond the age of 65;
- **DC savers display financial behaviour and characteristics that contradict the government's Freedom and Choice agenda**, notably: declining financial engagement in later life; a growing aversion to investment risk; and, perhaps most importantly, a tendency toward '**over-saving**' during retirement.

These research findings, and other evidence reviewed in this report, suggest there are significant risks for UK pensions policy – particularly of lower retirement incomes – as a result the UK's April 2015 shift to a voluntary annuitisation system.

To address such risks, this discussion paper develops recommendations for a **default 'automatic income plan' for DC pension savers**, built around a secure retirement income, value for money and providing individuals with peace of mind.

1.4. Default Reform: Defining a new default income plan for DC retirees

In the rest of Part 1 of this report, the case for a new default automatic income plan for DC retirees is set out.

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[3] Murray D et al. (2014) Financial System Inquiry: Final Report, The Australian Government the Treasury; National Treasury (2012) *Enabling a better income in retirement*, South Africa

Chapter 2 of this report considers the context for the government's decision to scrap the UK 'annuities deal', explores the motivations of policymakers, and examines the problems of the pre-April 2015 'default' option for retirees with DC pension saving.

Chapter 3 sets out the detail of the 'Freedom and Choice' changes to the taxation of DC pension savings, which ensure that nobody with DC savings will be compelled to obtain a secure pension income.

Chapter 4 explores the experience of other countries with voluntary annuitisation systems, evidence on the so-called 'annuity puzzle', and how policymakers have sought to address problems identified, such as lower incomes.

Chapter 5 considers the findings of **Defined Capability**, which explores key aspects of financial capability and decision-making among DC savers in the context of the Freedom and Choice changes.

Chapter 6 concludes Part 1 of the report, by setting out the principal choice for policymakers, and the multiple policy rationales for the UK government to actively define, implement and promote a new default 'automatic income plan' for DC pension savers at retirement in the UK.

In **Part 2** of this report, recommendations for the design and delivery of a new, automatic income plan for DC retirees are set out.

Chapter 7 sets out what 'good' looks like, and some principles to guide policymakers in implementing a default, automatic income plan for DC retirees.

Chapter 8 examines the options facing policymakers for delivery of an automatic income plan with the private sector, and how to ensure good outcomes for consumers.

Chapter 9 considers the design choices for a default automatic income plan, in particular, around the role of drawdown and longevity insurance.

In **Chapter 10**, the 'customer journey' is considered in the context of some additional 'behavioural nudges' that policymakers could deploy to maximise participation and the policy benefits of a default automatic income plan.

Chapter 11 concludes the report by considering the politics of retirement income security and a default automatic income plan.

The **Appendix** briefly considers distinct measures to ensure a default automatic income plan works for low-income retirees.

2.Policy Context: The 'annuities deal' and issues with the default option for DC pension savers

2.1. Background: The 'annuities deal' and UK pension policy

To ensure that pension savings are used to fund a pension income – i.e. an income guaranteed until the end of a person's life – successive UK governments coupled voluntary participation in private pension saving with compulsory conversion of these savings into a secure pension income at retirement.

The so-called 'annuities deal' had its origins in the Finance Act of 1921, which introduced the "mandatory annuitisation of pension funds".[4] Under the annuities deal, UK private pension savings benefitted from exceptional levels of tax-relief compared to other types of saving product. However, in return, individuals were expected to convert their pension savings into a secure pension income that protects them from longevity risk, i.e. uncertainty over how long they will live for and the risk of running out of money.

For workers with Defined Benefit (DB) pension schemes, the 'annuities deal' was effectively enforced through the provision of a pension income by their employer.

Under the annuities deal, most UK workers with defined contribution (DC) pension savings converted these savings into a secure pension income by purchasing an **annuity**, which is an insurance product that pays out a guaranteed income for life in return for an upfront lump sum payment from a worker's pension pot. Unless DC savers opted for the 'open market option' to 'shop around' for a potentially better income ('annuity rate'), they usually defaulted to the standard life annuity offered by their pension scheme provider.

For many years, the annuities deal was policed in relation to DC pension savings by punitive tax charges: although in theory individuals could take their pension pot at retirement wholly as cash, beyond the first 25% of its value (the 'tax-free lump sum'), individuals were charged punitive tax-rates of 55% of the money withdrawn. As a result, very few individuals exercised this option.

2.2. Flexibility in securing a pension income

Although the 'annuities deal' provided the bedrock of UK pensions policy from 1921 to 2015, successive governments introduced greater flexibility into the framework.

Rules on 'trivial commutation' enabled those aged 60 or over with a pot worth less than £18,000 to take this as a cash lump sum without incurring a tax-charge. Two further 'small pots' could be taken as lump sums if they were worth less than £2,000 each.

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[4] Finance Act (1921), quoted in HM Treasury (2014) *Freedom and choice in pensions*, London

At the other end of the scale, wealthy DC savers were given greater freedom to use their pension savings to obtain a retirement income in a way that did not involve purchasing an annuity, provided they could prove that their income would not fall below a certain level and their income would therefore be 'secure', i.e. functionally equivalent to a pension income obtained via an annuity.

From 1995, individuals opting for 'capped drawdown' were able to draw an income directly from their pension fund as an alternative to purchasing an annuity. The maximum amount a person could withdraw each year was about the same as a level annuity, although no income had to be taken at all if people wished. The upper income limit was reassessed every three years for those under 75, based on age and fund size. In the event of death, the remaining fund could be used by a dependent to continue to draw income or buy an annuity.

In 2011, the requirement to annuitise by age 75 was scrapped, and so-called 'flexible drawdown' was introduced, which enabled individuals to withdraw from their DC pension savings however much they wished (subject to their marginal tax rate), as long as they could demonstrate that they had a guaranteed minimum income in retirement totalling at least £20,000 from all sources. Individuals who could not demonstrate this income level were limited to 'capped drawdown'.

By 2014, the maximum withdrawal of income that an individual could take from a capped drawdown arrangement was 120% of the equivalent annuity that could have been bought with the fund value.

2.3. Issues with compulsory annuitisation for DC pension savers

Although a foundation stone of UK pensions policy for nearly a century, in recent years several factors contributed to growing disquiet and hostility toward the compulsory annuitisation framework for DC pension savers. At a general level, this disquiet reflected lack of flexibility in the annuities deal applied to DC pension savings, particularly given competing motivations for retirees, such as the desire to pass on savings as inheritance ('bequest motive').

However, there were specific factors particular to the operation of the annuities market that affected support for the DC 'annuities deal'. These factors include:

- Declining 'gilt' rates;
- Increasing longevity;
- Value for money and competition;
- Value for money and mortality risk.

2.4. Declining 'gilt' rates

The average income paid by annuities ('annuity rates') has fallen in recent years, reflecting changes in the underlying capital market instruments that insurance companies invest in,

especially long-term governments bonds ('gilts'). Indeed, 15-year gilt rates were 5.11% in June 2008, but had dropped as low as 1.68% by January 2015.[5]

To a significant extent, falling gilt rates represent a direct result of the policy of 'quantitative easing' (QE) pursued by central banks in the wake of the 2008 financial crisis and subsequent global economic downturn, and more widely, an exceptional period of below-average interest rates.

2.5. Increasing longevity

Increasing longevity has resulted in some DC retirees purchasing annuities at a young age relative to their life expectancy, reducing the income they receive.

Although UK life expectancy has steadily increased in recent years, the average age of retirement has not kept pace. As a result, the life expectancy of individuals compelled by the 'annuities deal' to purchase an annuity grew, thereby extending the number of years during which annuities were expected to pay an income. This in turn increased the inflation, interest and investment risk facing annuity providers, who responded by cutting annuity rates in order to hedge against this increased uncertainty.

2.6. Value for money and competition

The different annuity rates offered by insurance companies to DC retirees reflect different estimates of that person's life expectancy, as well as different predictions as to future changes in interest rates, inflation and bond prices several decades into the future.

Despite efforts to encourage workers retiring with DC pension savings to shop around for an annuity via the 'open market option' in order to secure the best income available, many individuals continued to default to the annuity offered by their pension saving provider, which sometimes represented poor value. For example, an FCA market study found that 60% of DC annuitants were not switching providers when they bought an annuity, despite the fact that around 80% of these consumers could have received a higher income on the open market, many significantly so.[6]

2.7. Value for money and mortality risk

DC pension savers with serious health conditions, such as heart disease or dementia, have a lower life expectancy. However, unless these individuals sought out an individually underwritten annuity via the 'open market option', reflecting an actuarial assessment of their individual life expectancy, they were liable to be defaulted into a standard life annuity, which assumed their longevity would be similar to the average for their cohort. In this way, their annuity rate (pension income) would be significantly below an actuarially fair level for someone with their health conditions.

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[5] Source: sharingpensions.co.uk
[6] FCA (2014) *Retirement Income Market Study: Interim Report*, FCA, London

In recent years, the prevalence of individual under-writing for retirees with health conditions has increased, lifting the incomes received by these individuals. However, commensurately, this has reduced the 'mortality cross-subsidy' available in the UK annuity market, putting downward pressure on the annuity rates paid by standard life annuities.

2.8. Analysis: What went wrong with compulsory annuitisation and the UK annuities market?

The pre-April 2015 UK 'annuities deal' regime ultimately experienced two critical flaws. First, it **did not adapt to rising longevity and exceptionally low gilt-rates** and forced DC retirees to annuitise too early in the life course, and at the wrong point in the economic cycle. Indeed, this resulted in some individuals being defaulted into purchasing an annuity, even though they could have secured a higher income from a drawdown product, before potentially annuitizing at a later age.

Second, the government's policy placed **too much emphasis on competition at the consumer level to ensure value for money and efficiency** among providers. Policymakers relied on individual DC retirees using their buying power to achieve the best annuity rate available. However, many retirees were wholly ill-prepared for the new, one-off experience of purchasing an annuity, did not understand their options, and were overwhelmed in the face of the 'search' and 'transaction' costs associated with seeking out the best retirement income possible. Having spent years developing a relationship with their pension scheme provider, many also preferred to remain with a brand they trusted. For many individuals, the result was inertia.

In short, the 'annuities deal' pushed many DC savers into a default option, but a default option that was no longer adequate to sustain the 'annuities deal' framework. As the role of DC provision in funding retirement has grown – in line with the decline of DB provision – these problems became more acute.

In a 'thematic review' of the UK annuities market, the UK's Financial Conduct Authority (FCA) identified the following concerns:

- The majority of consumers (60%) do not switch providers when they buy an annuity, despite the fact that 80% of these consumers could get a better deal on the open market, many significantly so
- The aggregate benefits consumers miss out on by not shopping around and switching is the equivalent of between £115 million and £230 million of additional pension savings
- In part consumers miss out on the benefits available from shopping around and switching due to their lack of engagement in pensions and annuities, the confusing trade-offs they face and the impact of behavioural biases that makes it difficult for consumers to make the right choices
- There is an incentive for providers to focus on retaining their existing pension customers, as overall the estimated levels of expected profitability of standard annuity business sold to existing pension customers is more than the expected profitability of annuity business sold on the open market
- The difference in retention rates (i.e. proportion of customers annuitising with their pension provider rather than switching) between firms varies widely. Some firms have relatively high retention rates and have active retention strategies that may increase customer loyalty and reduce the propensity to shop around
- There are particular groups of consumers where it appears that the market is not working well. There is an apparent lack of choice and ability to switch for those with small pension funds and lower annuity rates available to these consumers generally, which is likely in part to be due to the fixed costs of providing an annuity representing a larger proportion of the customer's funds

Source: FCA (2014) *Thematic Review of Annuities*, London, summarised in HM Treasury (2014) *Freedom and Choice*, London

2.9. Policy debate and compulsory annuitisation for DC retirees

In response to these challenges for the UK's compulsory annuitisation rules for DC savers, policy debate on pensions had featured growing interest in a number of potential solutions:

- **Improved consumer information** – more information provision to DC retirees to encourage them to shop around and help them to secure value for money, and annuitise at the optimal time;
- **Improved consumer signposting** to the 'open market option' – more triggers and 'alerts' for DC retirees to encourage them to shop around;
- **Improved consumer competition** through mandatory advice – DC retirees would be required to receive details on annuity rates available to them from the open market, before they could access their savings;
- **Compulsory consumer competition** through mandatory brokerage – DC retirees would have to be offered the best market rate by an independent broker, before being able to make a final decision regarding whom to purchase their annuity from.

Although each of these options presented different advantages and disadvantages, such debate largely became irrelevant in the context of the 'Freedom and Choices' changes to rules on taxation of DC pension pots announced at Budget 2014, which are set out in the next chapter.

3. Budget 2014 and the end of the DC 'annuities deal'

3.1. Budget 2014: The end of the 'annuities deal'

Budget 2014 announced that from April 2015, individuals over the age of 55 would be able to withdraw as much of their pension savings as they wish, 25% of which would remain tax-free, and the remainder taxed at the person's marginal income tax rates for that year, whether 0%, 20%, 40% or 45% – i.e. treated as income, and subject to a person's income tax allowances.[7]

In this way, the government ensured that from April 2015, no one would be compelled by punitive tax charges to convert their DC pension savings into a secure pension income - whether in the form of an annuity or 'capped drawdown' - breaking with the 'annuities deal' that had been the foundation stone of UK pension policy since 1921.

In recognition of this significant increase in personal responsibility for financial welfare in old age, the government simultaneously announced a 'guidance guarantee' – subsequently branded 'Pension Wise' - semi-personalised information and advice for retirees with DC savings about their choices. However, in the absence of evidence from piloting, the government was unable to set out how many individuals would be likely to use Pension Wise, nor the influence this guidance would actually have on the decisions of individuals, leading some commentators to question its potential effectiveness.[8]

3.2. Budget 2014: Stepping-stone changes to 'small pots'

Ahead of the April 2015 changes, Budget 2014 announced a set of changes to 'drawdown' rules that were applied almost immediately. The government committed to:

- Reduce the amount of guaranteed pension income people need in retirement to access their savings flexibly, from £20,000 to £12,000;
- Increase the capped drawdown limit from 120% to 150% to allow more flexibility to those who would otherwise buy an annuity.

Budget 2014 also announced changes to rules applicable to so-called 'small pots' that would apply almost immediately:

- Increase the size of a single pension pot that can be taken as a lump sum, from £2,000 to £10,000;
- Increase the number of pension pots of below £10,000 that can be taken as a lump sum, from 2 to 3;

[7] HM Treasury (2014) *Budget 2014*, London
[8] For example, see Eley J (2014) *Guidance will be offered, but will savers take it?*, Financial Times, London

- Increase the overall size of pension savings that can be taken as a lump sum, from £18,000 to £30,000.

3.3. April 2015: Options for retirees

The April 2015 changes gave DC pension savers with pension savings above the maximum 'lump sum' threshold of £30,000 several options:

- **Annuity** - purchase an annuity with some or all of their fund, whether from their pension scheme provider or via the 'open market option';
- **Drawdown** – transfer the pension pot to a drawdown product where it remains invested, but can be drawn down in stages or as a regular income;
- **Cash** - full or partial crystallisation of the pension pot as cash, with receipt of the cash value of the pot after the tax-free lump-sum subject to a person's marginal income tax rate for the year it is received.

Up to 25% of a person's DC savings can be taken tax free if individuals opt to crystallise their entire pension pot as cash or buy and annuity. Alternatively, individuals in drawdown taking regular income or sums in stages can receive the first 25% of these amounts tax-free.

If individuals do opt to draw on their pension savings as cash or drawdown, via full or partial withdrawal, individuals then face several options:

- **Invest** their savings, for example in property, equities or other investments;
- **Save** their DC pension savings in an accessible, 'liquid' form, such as a current account, savings account or tax-incentivised ISA;
- **Spend** their savings, whether on everyday outgoings, holidays, leisure activities or home adaptations or debt repayment;
- **Bequest** their pension savings to a child or other family member.

3.4. April 2015: The effect of marginal income tax rates

Although removing the punitive tax-rate on withdrawals of 55%, from April 2015, withdrawals from DC pension funds – whether cashing in or drawdown - remain subject to a person's marginal rate of income tax (after the tax-free lump-sum).

Income tax is levied at different rates, for different levels of income and for different age groups. However, before income tax is calculated, all age groups have an annual 'personal allowance' of income they can receive completely tax-free. For the tax-year 2015-16, the Personal Allowance is:[9]

- £10,600 for people born after 5 April 1948;
- £10,600 for those born between 6 April 1938 and 5 April 1948;
- £10,660 for individuals born before 6 April 1938.

During 2015-16, income people receive in excess of the value of their personal allowance is

[9] Source: HM Revenue and Customs

taxed at different rates:

- Basic rate - income of £0 - £31,785 is taxed at 20%;
- Higher rate - income between £31,785 - £150,000 is taxed at 40%;
- Additional rate - income over £150,000 is taxed at 45%.

Given only a small proportion of pensioners (around 5%) pay higher-rate (40%) income tax, from 2015, individuals in retirement with DC savings wishing to take this money as cash are unlikely to pay more than basic rate (20%) tax on withdrawals, depending on their other (DB) pension provision.

In fact, through phased withdrawals of DC pension pots and use of spare annual 'Personal Allowance' (tax-free income) entitlements, some individuals will be able to withdraw their entire DC pension 'pot' as cash paying no tax at all.

For example, on its introduction in April 2016, the New State Pension will be worth around £151.20 per person each week,[10] or £7,862.4 per year.[11]

Assuming the 2015-2016 Personal Allowance thresholds for the 65+ remained the same in the following year, someone retiring with the New State Pension and no other income would have £2,737.60 of spare Personal Allowance, and would be able to drawdown this amount of their pension savings tax-free, in addition to their 25% tax-free amount, representing £3,422 in total.

In this way, if someone retired in 2016 with just the New State Pension and a single DC pension pot of £30,001 just above the maximum small pots threshold, they would potentially be able to draw down the entirety of their entire DC pension pot tax-free in around 9 years; in effect, a form of tax-free 'Personal Allowance drawdown'.

Many DC pension savers aged 55 and over after April 2015 have other types of pension savings, notably 'Defined Benefit' (DB) pension entitlements. However, with the closure of the vast majority of DB workplace pension schemes to new members, it is widely expected that over coming decades, the majority of private pension provision among those retiring will be DC only.

3.5. April 2015: Implications for annuity choices and incomes

By moving the UK from broadly mandatory to voluntary annuitisation for DC pension savers, Budget 2014 aligned the UK's DC pension system with multiple other countries in which turning DC pension savings into a secure retirement income is entirely voluntary.

The next chapter therefore explores the experience of countries with voluntary annuitisation frameworks.

[10] This is the level of Pension Credit for 2015-16.
[11] The Department for Work and Pensions has indicated that the actual amount will be set in Autumn 2015.

4.Voluntary Annuitisation: International experience

4.1. Introduction

In April 2015, the UK moved from broadly mandatory conversion of DC pension savings into a secure retirement income through purchasing an annuity, to a system in which purchasing an annuity is voluntary.

What outcomes are observable in countries with voluntary annuitisation systems? Answering this question is made more difficult by the range of different systems observable, including countries that offer limited or conditional choice at retirement (e.g. Canada).

In addition, country specific factors are observable, notably incentives such as subsidies (Switzerland), the effect of taxation systems, and the impact of limited choices. For example, low demand and a small population have resulted in a complete collapse of the New Zealand annuity market, removing this option for retirees.[12]

Around the world, the most consistent outcome from voluntary annuitisation frameworks is very low rates of annuity purchase. In response, academic research has for several decades sought to explain the so-called 'annuity puzzle', i.e. why are voluntary annuitisation rates so low?

This chapter therefore summarises research on the annuity puzzle, and some of the explanations that have been posited for why individuals so rarely voluntarily choose to buy annuities.

The chapter then reviews the experience of two countries in which policymakers are currently exploring the problems associated with voluntary annuitisation and potential policy responses.

4.2. The 'annuity puzzle'

International experience with voluntary DC annuitisation frameworks for retirees has consistently shown very low take-up of annuities. An extensive international academic research literature exists analysing this phenomenon – referred to as the '**annuity puzzle**', reflecting the fact that economic modelling suggests a rational, 'utility-maximising' individual with uncertain life expectancy would in fact annuitise all of their wealth.

A 2014 review of this literature by the Strategic Society Centre identified three broad sets of factors explored in academic research to explain the low voluntary take-up of annuities experienced by different countries.[13] **Supply-side factors** that may explain the annuity puzzle include:

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[12] Oxera (2014) *The retirement income market: Comparative international research – Prepared for Financial Conduct Authority*, FCA, London
[13] Lloyd J (2014) *New Annuity Era*, Strategic Society Centre, London

- Poor value for money – the life annuities on offer to consumers do not offer good value-for-money;
- Selection effects – various factors may result in annuities being bought by more healthy individuals, pushing down annuity rates;
- Incomplete markets – annuity providers fail to offer annuity products that reflect the preferences of consumers sufficiently closely.

'Rational' demand-side factors for explaining the annuity puzzle are those that assume individuals are logical, rational and informed. They include:

- Bequest motives – individuals want to preserve their wealth in order to leave it as an inheritance;
- Consumption preferences around housing – since owner-occupied homes represent a good that is also a form of 'annuitised consumption', individuals prefer to allocate their wealth to housing as a guaranteed 'consumption stream', rather than an annuity as a guaranteed 'income stream';
- 'Pre-annuitisation' through state pension and other sources – some individuals, particularly with low levels of overall saving, may feel they have sufficient annuitized income from other sources, such as the state pension or other (DB) pension provision;
- Risk-pooling via families – individuals see other family members and relations as alternative sources of income and security in retirement;
- Insurance/precautionary saving against spikes in income needs – individuals may opt to keep their pension savings in liquid, accessible cash savings as 'insurance' against potential 'spikes' in income needs such as future healthcare costs or 'fixing the roof'.

Reflecting growing interest in behavioural economics across multiple academic disciplines, researchers have investigated **'behavioural' demand-side factors** that may explain the annuity puzzle, which emphasize psychological responses and various types of non-rational behaviour. These include:

- Framing – presented with the option of an annuity in an 'investment frame' – rather than a 'consumption frame' – individuals judge it a poor or risky investment compared to alternatives;
- Hyperbolic discounting – individuals excessively discount the value of receiving income in the future, as opposed to the present;
- Loss aversion – individuals over-emphasise the risk of 'losing' from an annuity (dying early), rather than living a long time and being a 'winner';
- Regret aversion – individuals fear subsequently feeling that they made the wrong choice, so opt against the 'once-and-for-all' option of buying an annuity.

Overall, the wide range of hypotheses examined in research on the annuity puzzle suggest that it may be 'over-determined', i.e. it results from multiple factors, various combinations of which may inhibit voluntary demand for annuities.

Nevertheless, in two countries, policymakers have identified low rates of annuitisation as a problem, and have sought to develop policy responses.

4.3. Australia

Australia's pension system is unusual for combining mandatory private pension contributions during working life with near-total flexibility in the use of such savings at retirement.

Legislation requires employers to pay a proportion of an employee's wages (9.25%, rising to 12% by 2021) into an authorized 'MySuper', superannuation product. Among Australians with private pension saving, median pot size among those aged 65 and over was around 120,000A$ in 2010.[14]

Given the voluntary annuity framework in Australia, industry research in 2012 sought to establish what retirees used their DC pension pots for:[15]

Use of lump sum payments for those who retired at age 65 and over

Rolled it over/invested it in an approved deposit fund/deferred annuity or other super scheme	21%
Purchased an immediate annuity	4%
Invested the money elsewhere/personal savings/bank	27%
Paid off home/paid for home improvements/bought new home	32%
Bought or paid off car/vehicle	19%
Cleared other outstanding debts	12%
Paid for a holiday	14%
Assisted family members	5%
Undecided/Did not know	4%
Other	6%

Source: Challenger Retirement Income Research (2012)

As this table shows, one-fifth of Australian pension lump sums were used to purchase a vehicle, while around one-third were spent on people's homes.

Unfortunately, no research has been undertaken into whether Australian workers opt to take out larger mortgages precisely because they can repay their mortgage with their pension fund, i.e. into the behavioural changes prompted by full flexibility in use of DC pension pots.

Although popular with the public, the lack of restrictions on how individuals use their private DC pension funds during retirement in Australia has caused concern among commentators. Deloitte Australia identified what they believe to be the key weakness in the Australian pension system arising from people behaviour at retirement:[16]

> "1. Some draw directly on their super to pay off debts and/or to maximise their ability to draw on social security
> 2. Some die before their super is exhausted but on their death any remaining balance is moved out of the system
> 3. Some outlive their superannuation and ultimately are forced to rely on social security"

The authors go on to note that if Australia moved to a system of genuine lifetime annuities:

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[14] Challenger Retirement Income Research (2012) *How much super do Australians really have?*, Challenger Limited, Sydney
[15] Challenger Retirement Income Research (2012) *How much super do Australians really have?*, Challenger Limited, Sydney
[16] Deloitte (2013) *Dynamics of the Australian Superannuation System*, Deloitte Australia

> "...then, other things being equal, we would reduce the amount of assets needed to fund adequate retirement benefits by about 15%. Let us be clear. The fixation on maintaining lump sums in retirement means that one dollar in six is effectively wasted even if we accumulated precisely enough to provide an adequate income over average life expectancy for each individual Australian. This is a substantial amount in a system that is already $1.6 trillion. It is an enormous amount in a system that is expected to grow to well over $7 trillion in the next 20 years."

Subsequently, the 2014 'Murray Inquiry' into the functioning of the Australian financial system also argued that:[17]

> "[Superannuation] assets are not being efficiently converted into retirement incomes due to a lack of risk pooling and an over-reliance on account-based pensions. This contributes to a lower standard of living for Australians in retirement and, for some, during working life — meaning people may have to save more than they did previously to reach the same level of retirement income."

In short, flexibility around use of DC pension pots at retirement contributes to lower incomes in the decumulation and – for some – accumulation phases. The Murray Inquiry also noted evidence that a major worry among retirees and pre-retirees in Australia is exhausting their assets in retirement, i.e. low levels of annuitisation results in reduced peace of mind.[18]

4.4. Australia: Policy responses

In response to these issues, the Murray Inquiry argued for fundamental decumulation phase reform in Australia built around greater longevity risk pooling. The Inquiry noted:

> "Greater use of risk pooling could significantly increase retirement incomes generated from accumulated balances. This could allow individuals to allocate consumption throughout their lives better (greater *dynamic efficiency*) by reducing the savings required to achieve a target level of income in retirement."

To achieve this end, the Murray Inquiry argued for the application of default options, which could:

> "... significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement, while still allowing them to retain some flexibility to meet unexpected expenses. An enduring income stream would give retirees the confidence to spend in retirement, which would help to sustain economic growth as the population ages and reduce the extent to which longevity risk falls on the taxpayer."

The Murray Inquiry set out specific recommendations for the design of a default option:

- Government should require superannuation fund trustees to pre-select an option for members to receive their superannuation benefits in retirement.
- Details of the pre-selected option would be communicated to the member during their working life. At

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[17] Murray D et al. (2014) *Financial System Inquiry: Final Report*, The Australian Government: The Treasury

[18] According to the evidence cited by the Murray Review, more than half of the respondents to a survey were either worried or extremely worried about outliving their savings. When asked to identify the single most important feature in a retirement income product, twice as many members identified "income that lasts a lifetime" as the second most popular response. (Source: Investment Trends 2013, *December 2013 Retirement Income Report,* Investment Trends, Sydney; Based on a survey of 5,730 Australians aged 40 and older). The Murray Review also notes results from another survey suggest that more than 90% of Australians over the age of 50 believe that "money that lasts my lifetime" is somewhat important or very important. (Source: National Seniors Australia and Challenger 2013, *Retirees' needs and their (in)tolerance for risk*, National Seniors Australia, Brisbane)

retirement, the member would either give their authority to commence the pre-selected option or elect to take their benefits in another way. This approach would simplify decisions at retirement and deliver better outcomes for retirees. No income stream would commence without the member's instruction.

- The pre-selected option should be a comprehensive income product for retirement (CIPR) that has minimum features determined by Government. These features should include a regular and stable income stream, longevity risk management and flexibility. CIPRs would be low-cost and include a 'cooling off' period. Their design could vary with the member's known characteristics, such as the size of their superannuation benefits, and take account of the possibility of cognitive impairment at older ages.
- A combination of underlying products would likely be required to provide these features; for example, an account-based pension paired with a pooled product that provides longevity risk protection. To offer these products, funds may need to partner with another provider, such as a life insurance company.

The Murray Inquiry noted that one of the primary reasons why incomes are significantly higher in products that pool longevity risk is that they reduce bequests from superannuation. However, the Review concluded that although a reformed system should accommodate bequests, it should not do so to the detriment of retirement incomes.

Overall, the Australian experience shows how voluntary annuitisation and total flexibility in how pension pots are used can actually result in lower retirement incomes for individuals and a deeply inefficient pension system at a macroeconomic level. In order to preserve choice, but improve outcomes, the Murray Inquiry argued for the application of strong default option for DC retirees, that includes longevity risk pooling.

4.5. South Africa

South Africa's pension system is characterised by mandatory workplace pension contributions where pension schemes are available, with a form of 'mandated choice' for savers at retirement in relation to two-thirds of the value of a person's pension pot. The South African Treasury describes the system as follows:[19]

- Employees are compelled to join a [pension] fund if their employer provides one. Contributions are deducted from salaries before they are paid. Investment choices are often made by trustees. Individuals can only access their funds under limited circumstances. Individuals receive substantial tax benefits when they contribute and investment returns in funds are free of tax.
- The Income Tax Act... compels members of pension funds and holders of retirement annuities to use at least two-thirds of their accumulated balances to buy products that qualify legally as annuities.
- Two main types of product qualify as annuities: a conventional life annuity and a phased-withdrawal product ['living annuity']. Retail annuities of both types can only be sold by registered life insurance companies.

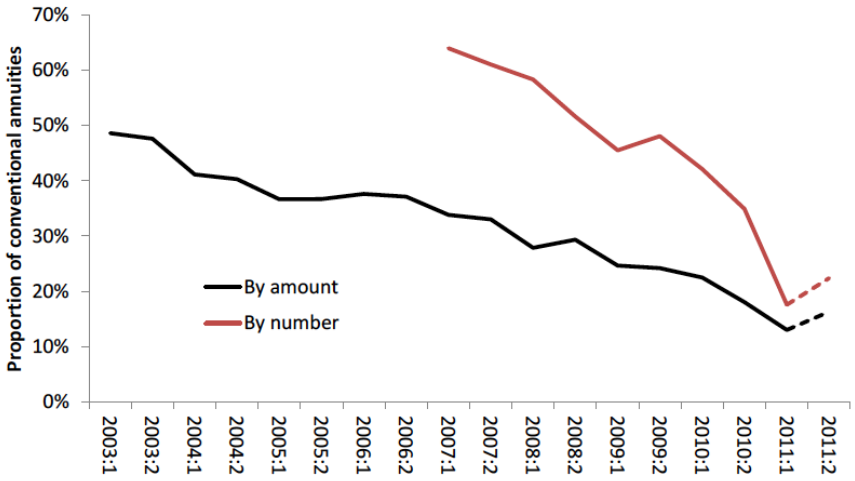
In short, DC retirees in South Africa can choose to voluntarily annuitise their savings through purchasing a life annuity, or instead go into income drawdown.

According to the South African Treasury, the value of the annuities market (living and life annuities) grew from around R8 billion in 2003 to R31 billion in 2011, reflecting growth in contributions.

However, there has been an historic decline in the number of individuals choosing to buy conventional life annuities that, unlike drawdown, provide a secure income that protects from longevity risk. In 2003, 50% of single premiums were used to buy conventional annuities, but by 2011 this had fallen to 14%.

[19] National Treasury (2012) *Enabling a better income in retirement*, South Africa

Proportion of compulsory purchase annuities that are conventional life annuities



Source: South African National Treasury (2012)

In a 2012 consultation paper, 'Enabling a better income in retirement' (2012), the South African Treasury provided an overview of the challenges confronting the DC decumulation framework, particularly in relation to the dominant 'living annuity' product, which are effectively 'regulated drawdown' products that do not provide longevity protection, but split the 'investment' and 'returns' components in separate accounts:[20]

- Living annuities are tax-protected phased-withdrawal products, i.e. essentially investment accounts provided by life insurance companies. Each purchaser has a separate account, to which asset holdings and returns are allocated and out of which benefits are paid.
- Purchasers must choose a drawdown rate between 2.5 per cent and 17.5 per cent of the total assets, which is paid to them as an income each year. When individuals die, any remaining capital reverts to their beneficiaries.
- Individuals have a wide range of choices for the underlying asset portfolio, and there are no individual or portfolio-level investment restrictions on the assets that may be held inside living annuities.

The Treasury paper notes the principal difficulties with so-called 'living annuities':[21]

- From the point of view of purchasers, however, [living annuities] are complex products. Individuals who buy them must make and continually review decisions that involve difficult trade-offs, including how much income to draw down, what underlying assets to invest in and which provider to choose. Getting any of these decisions wrong can have serious consequences that only become apparent many years later.
- Charges on living annuities appear to be very high. Holders of these policies are subject to a complex, layered set of charges covering sales, financial advice, administration and asset management. There are no restrictions on the size or type of charges that may be levied, although brokers may be subject to maximum commission scales. A portion of these charges represents the implicit and explicit costs of providing investment choice, which few purchasers appear to use after their initial asset selection.
- Despite the wide range of investment choices on offer, individuals appear to be investing their living annuity policies in broadly similar portfolios. Drawdown rates appear to be high, exposing the longer-lived to substantial risks of poverty. The median policy has a drawdown rate of 7.5 per cent per year before charges. After charges, this may be closer to 10 per cent. Drawdown rates at this level expose purchasers to substantial risks of declining real income.
- Annuity purchase behaviour appears to be driven strongly by short-term considerations and sales incentives. In particular, the commission earned by brokers for selling a living annuity may be up to 10 times larger over

[20] National Treasury (2012) *Enabling a better income in retirement*, South Africa
[21] National Treasury (2012) *Enabling a better income in retirement*, South Africa

the life of the product than the commission for selling a conventional annuity. Only about 10 per cent of policies sold by brokers are now conventional annuities.

In short, although living annuities give retirees choice and flexibility, with only limited rules on drawdown limits, the market is characterised by high charges, apparently 'heuristic' decision-making around investment allocations and short-term decision making.

Given the option of conventional life vs. living annuities, the South African Treasury notes:[22]

- Most members of pension funds who retire choose the products on offer without much advice, and often end up choosing an inappropriate product that leaves them even more vulnerable as they age, and are no longer as able to earn their own income.
- Many retirees are left to the retail market, where they must bear the risks of retirement on their own – including the risks of poor or commercially biased financial advice, and high charges.

4.6. South Africa: Policy responses

Having issued its discussion papers across different aspects of pensions saving and decumulation, the South African Treasury settled on the following annuitisation reforms:[23]

- Trustees will be required to guide members through the retirement process, to identify a default retirement product in accordance with a prescribed set of principles, and to automatically shift members into that product when they retire, unless members request otherwise. The fund itself may provide the default product, or it may use an externally provided product.
- Living annuities will be eligible for selection as the default product, provided certain design tests, including on charges, defaults, investment choice and drawdown rates, are met.
- Trustees that make commission-free financial advice available to members on retirement, paid for out of the fund on a salaried basis, will be given some legal protections in respect of the choice of the default. To increase competition, providers other than registered life offices will be allowed to sell living annuities.

Overall, the South African experience shows that even in a situation of 'mandated choice', the limitations of consumer behaviour may still result in poor value for money and lower incomes.

In response, policymakers have opted to emphasise the use of defaults and the role of pension scheme trustees in guiding individuals in relation to exposure to investment risk, value for money and how quickly to spend down funds.

4.7. Conclusion

No two countries have identical private pension systems, and it is important not to assume that the outcomes and trends observed in one country will be replicated elsewhere.

However, evidence on the 'annuity puzzle' reviewed in this chapter suggests the low rate of voluntary annuitisation observable in multiple countries potentially reflects many different demand and supply-side drivers.

In Australia, the consequences of voluntary annuitisation, freedom and choice for DC retirees have been widely recognised as problematic, given unnecessarily low incomes that result, and the wider macroeconomic inefficiencies it creates. The case studies of both Australia and

[22] National Treasury (2012) *Enabling a better income in retirement*, South Africa
[23] National Treasury (2013) *Retirement reform proposals for further consultation*, South Africa

South Africa show policymakers grappling with the consequences of voluntary annuitisation at retirement for DC retirees, with both advocating the use of default options to guide individuals.

To explore how likely it is that similar outcomes and problems will be observable in the UK in the years following April 2015, the next chapter reviews relevant literature, in particular, research on the financial capability of DC retirees in the UK.

5. Defined Capability: Financial capability and DC savers in the UK

5.1. Introduction

The outcomes that result from the April 2015 changes to DC pension taxation rules will ultimately depend on the financial decisions and choices of millions of UK workers. In putting forward the April 2015 changes, HM Treasury argued:

> "With the right consumer guidance, advice and support, people should be able to make their own choices about how to finance their retirement. Everybody's circumstances are unique and it should not be for the State to dictate how someone should have to spend their savings."
>
> HM Treasury (2014) *Freedom and choice in pensions*, London

However, in making this statement, the government did not reference evidence to show that with guidance, advice and support, DC retirees would make good decisions about their retirement income.

Indeed, it is important to underscore that decisions about retirement income, expenditure and decumulation of assets are highly complex, reflecting uncertainty around interest rates, economic growth, inflation, life expectancy and changing income needs. As a result, many individuals may have inadequate information and financial capability to make good retirement income decisions.

For example, research by the Institute for Fiscal Studies (IFS) found **individuals typically underestimate their life expectancy**.[24] In particular, men aged 50 to 60 underestimated on average by two years, and women in this age group by four years. The research also noted that individuals particularly underestimate the probability of living until the age of 90: only 9% of men and 10% of women aged 30 to 60 expect to live until at least age 90, despite the relevant official estimates being 18% of men and 29% of women.

In addition, cognitive capacity and functioning declines with age. Analysing data from the English Longitudinal Study of Ageing (ELSA), Huppert F et al. (2004) were able to identify age-related reductions in a range of cognitive performance tests relating to memory (e.g. word recall) and executive functioning (e.g. numerical ability, visual search, mental speed).[25] A complementary study using ELSA undertaken by the IFS examined in detail declines in numeracy among the older population in England by 'numeracy score':[26]

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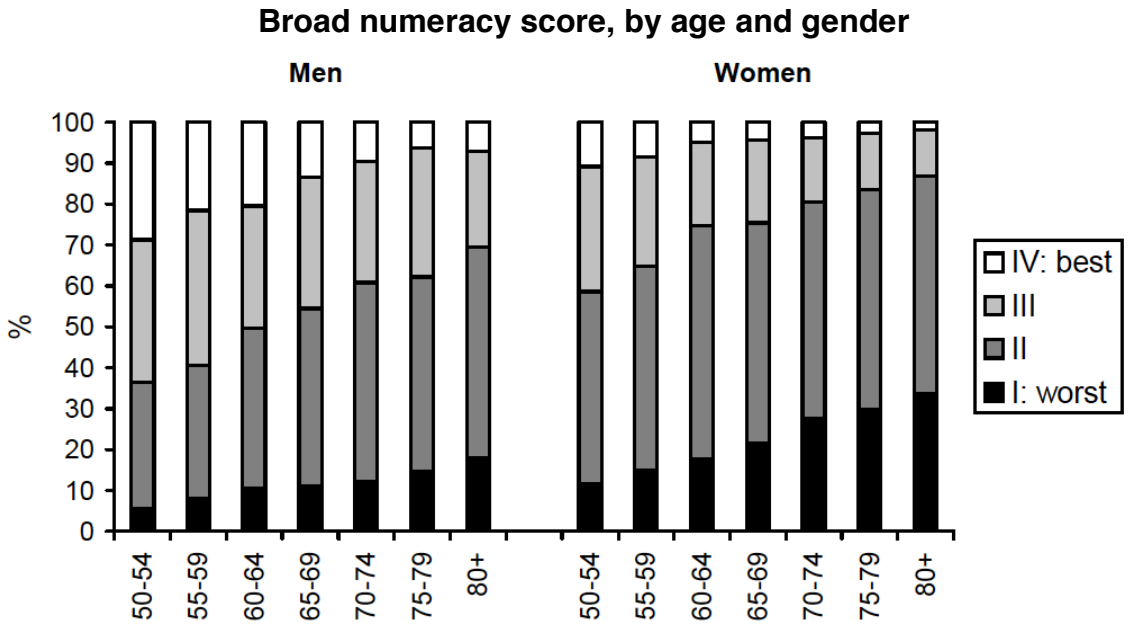
[24] Crawford R and Tetlow G (2012) *Expectations and experience of retirement in Defined Contribution pensions: a study of older people in England*, IFS, London

[25] Huppert F et al. (2004) "Cognitive Ability" in Banks J et al. (2004) *Retirement, health and relationships of the older population in England: The 2004 English Longitudinal Study of Ageing (Wave 2)*, Institute for Fiscal Studies, London

[26] Banks J and Oldfield Z (2006) *Understanding Pensions: Cognitive Function, Numerical Ability and Retirement Saving*, IFS, London



Source: Banks J and Oldfield Z (2006)

A more recent review by Age UK noted that normal brain ageing results in an average decline in some cognitive functions (speed of thinking, working memory) across the population, whereas other functions (e.g. verbal ability) are maintained. Mild cognitive impairment (MCI) affects between 5 and 20% of the population aged 65 or over.[27]

5.2. Financial capability

The outcomes that result from the April 2015 changes to taxation of DC pension savings will ultimately be determined by the financial capability and decisions of millions of individual savers.

Quantitative social research in the UK has established variations in 'financial capability' among different age groups. A 2006 study funded by the Financial Services Authority (FSA) deployed a multi-dimensional measure of financial capability.[28] The study found that levels of financial capability appear to increase steadily with age, peaking in the 60 to 70 age group, before declining among individuals aged 70 and over. This has typically been interpreted as a 'life-cycle' effect: individuals accumulate financial knowledge and experience over their lifetime, but the impact of declining cognitive ability in old age reduces financial capability.

As the inverse of financial capability, one US study looked at the incidence of financial 'mistakes' - suboptimal use of credit card balance transfer offers, mis-estimation of the value of one's house, and excess interest rate and fee payments – and how this varies among different age groups. The study suggested that middle-aged adults make fewer financial mistakes than younger and older adults, again suggesting that the benefits of experience that accumulate with age are ultimately subverted by declining cognitive ability.[29]

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[27] Ray S and Davidson S (2014) *Dementia and Cognitive Decline: A review of the evidence*, Age UK, London
[28] Atkinson A et al. (2006) *Levels of Financial Capability in the UK: Results of a baseline Survey*, FSA, London
[29] Agarwal S et al. (2009) *The Age of Reason: Financial Decisions over the Life-Cycle with Implications for Regulation*, Brookings Papers on Economic Activity

More recently, a US study evaluated financial sophistication in the American population over the age of 50, finding that many older respondents were not financially sophisticated: they failed to grasp essential aspects of risk diversification, asset valuation, portfolio choice and investment fees. Subgroups with notable deficits include women, the least educated, BME groups, and those aged 75 and over.[30]

5.3. Defined Capability

In its consultation on the changes to taxation of DC pension saving announced at Budget 2014, the government did not include a review of relevant social science evidence on financial capability and behaviour among DC pension savers or retirees.

The rest of this chapter therefore reviews key findings from **Defined Capability: Pensions, financial capability and decision-making by UK retirees**, published in 2015 by the Strategic Society Centre, in order to explore how financial behaviour and capability of existing DC savers and retirees can inform expectations for behaviour over the long-term in response to the Freedom and Choice changes.

Defined Capability comprised analysis of Wave 3 of the Wealth and Assets Survey (WAS) to build a picture of three groups of key interest to policymakers:

- **DC pre-retirees** - individuals aged 55 to 64 with some amount of DC pension savings;
- **DC retirees** - individuals aged 65+ with some amount of DC pension saving or a DC pension income;
- **Low-income DC retirees** - individuals aged 65+ with some amount of DC pension saving or a DC pension income and total equivalised household income below the median for their age group.

The analysis also explored characteristics by ten-year age band for the whole population in order to examine how individuals change over the life course, particularly in later life. Such findings are important given the expectation by UK policymakers that some individuals will continue to make active financial choices regarding their cashed-in or drawdown DC pension savings into late old age.

5.4. Defined Capability: Use of financial products

A key driver of financial capability is experience of using different financial products. The preparedness of DC pension savers in the UK for making complex financial decisions around how to use their DC pot is therefore likely to be significantly determined by their previous experience of using financial products of varying degrees of sophistication and complexity.

However, Defined Capability found that **use of more sophisticated investment and products was low among DC pension savers, and use of such products declines steadily in later life**. This suggests that for many DC pension savers in future considering

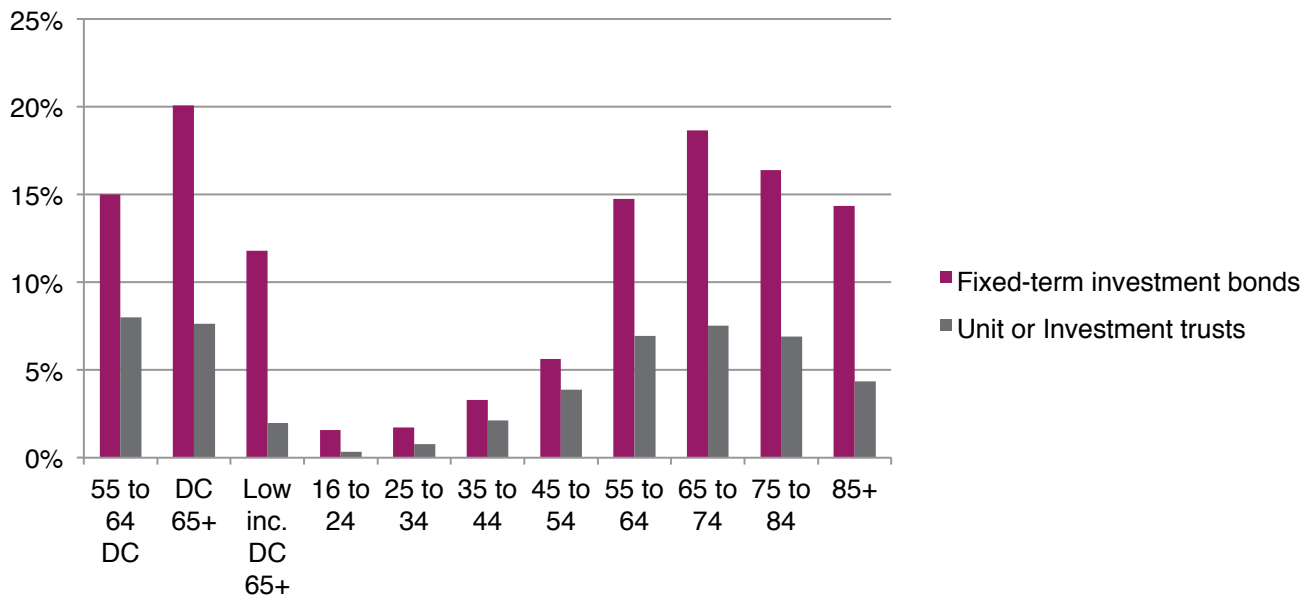
[30] Lusardi A et al. (2014) "Financial literacy and financial sophistication in the older population" in *Journal of Pension Economics and Finance*, available on CJO2014. doi:10.1017/S147474721400003

using investment products, utilising their pension savings in this way will be their first experience of such products, or the first use of such products for many years.

The most common type of products are savings accounts and ISA. Around 60% of DC pre-retirees and DC retirees had a savings account or ISA; however, **23% of DC pre-retirees had neither a savings account nor an ISA**.

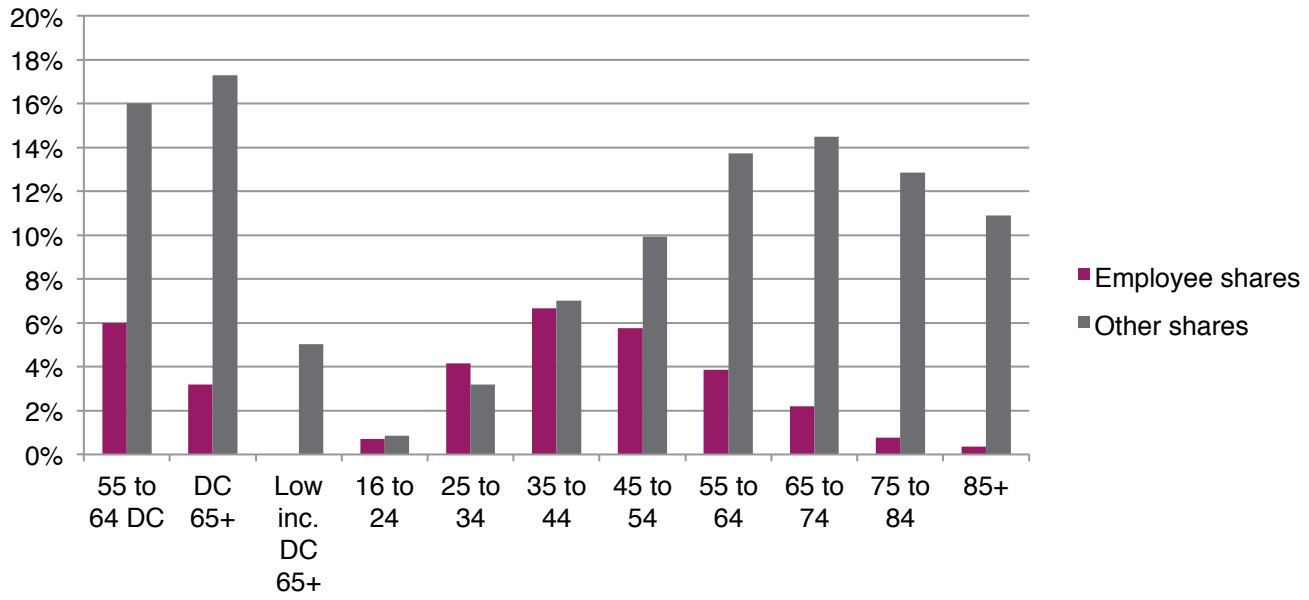
Around one in five DC pre-retirees use more sophisticated fixed-term investment bonds, and unit or investment trusts, while 8% use unit or investment trusts. However, the relevant prevalence among low-income DC retirees was 12% and 2%, and overall, usage declines during later life.

Has fixed-term investment bonds, or unit or investment trusts including jointly or overseas, 2010-2012 (WAS, Wave 3)



In addition to investment products, individuals may hold shares directly. Although possession of employee shares is relatively low, possession of other shares rises with age, and is nearly one in five among the DC retiree group.

Has employee shares or other shares including jointly or overseas, 2010-2012 (WAS, Wave 3)



5.5. Defined Capability: Sources of influence in financial decision-making

The Freedom and Choice agenda has prioritised the offer of free, impartial financial guidance – branded as 'Pension Wise' - as the principal policy lever deployed by government to help individuals make decisions around how to use their DC pension pots.

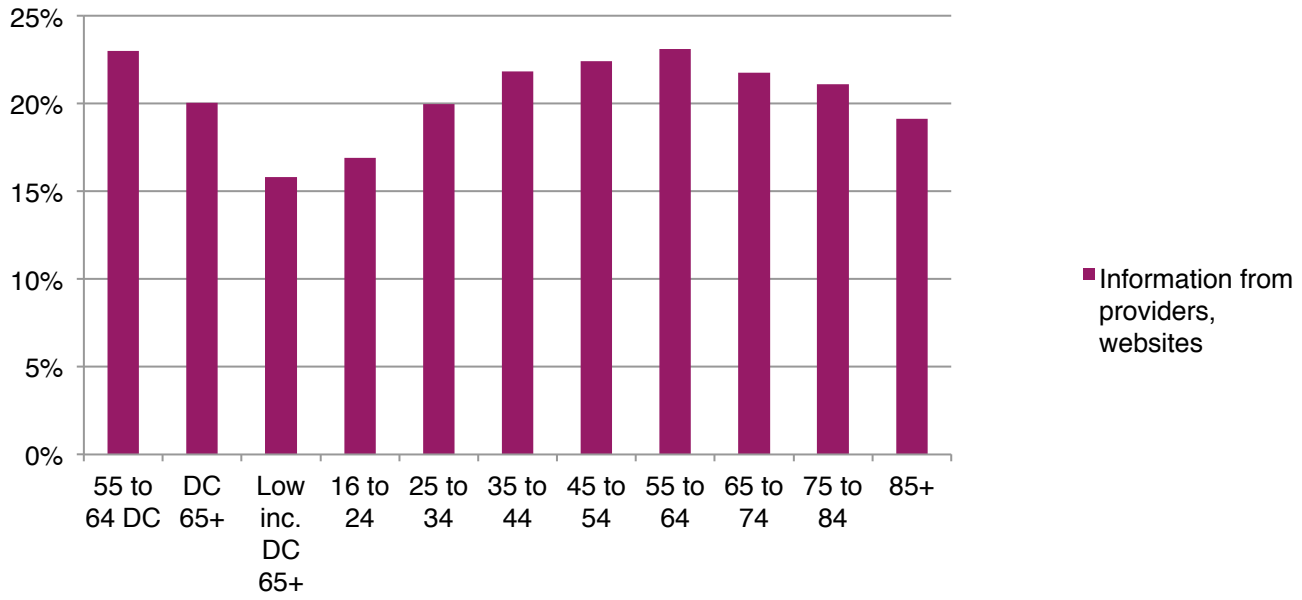
However, in exploring the financial decisions of DC pension savers who had obtained new financial products during the preceding two years, Defined Capability found:

- **Wide variation in the reported influence of different sources of information and advice**;
- **Use of 'informed sources' – such as best buy tables or financial advisers – declines with age**;
- **Individuals appear to withdraw from 'informed decision-making' as they age**, with the reported influence of friends and family increasing as people age, as well as the prevalence of individuals who make decisions without recourse to information and advice.

These findings raise questions around both the effectiveness of the government's 'guidance guarantee' introduced in the wake of the Budget 2014 announcement, and the efficacy of active financial decision-making in later life if the April 2015 changes result in DC pension savers attempting to remain 'active investors' into late old-age.

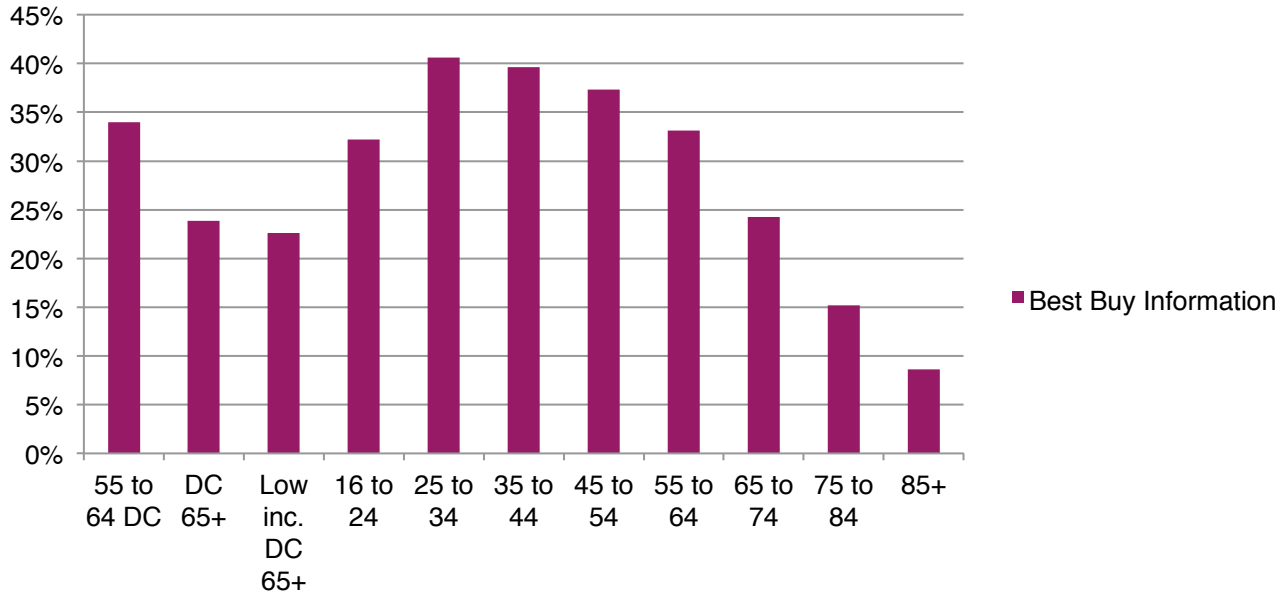
Overall, the most influential source of information and advice among retirees – cited by 21% of the 65 and over - was information from product providers including websites (i.e. both print and online):

Product decision influenced by information from providers, websites, 2010-2012, (WAS Wave 3)



The most influential source of information and advice across all age groups was 'best buy information' cited by 33% of respondents. However, despite being cited by over 40% of the 25 to 34 age group, the usage and influence of best buy information appears to decline steadily with age, to less than a quarter of those aged 65 to 74, and being cited by 24% of DC retirees.

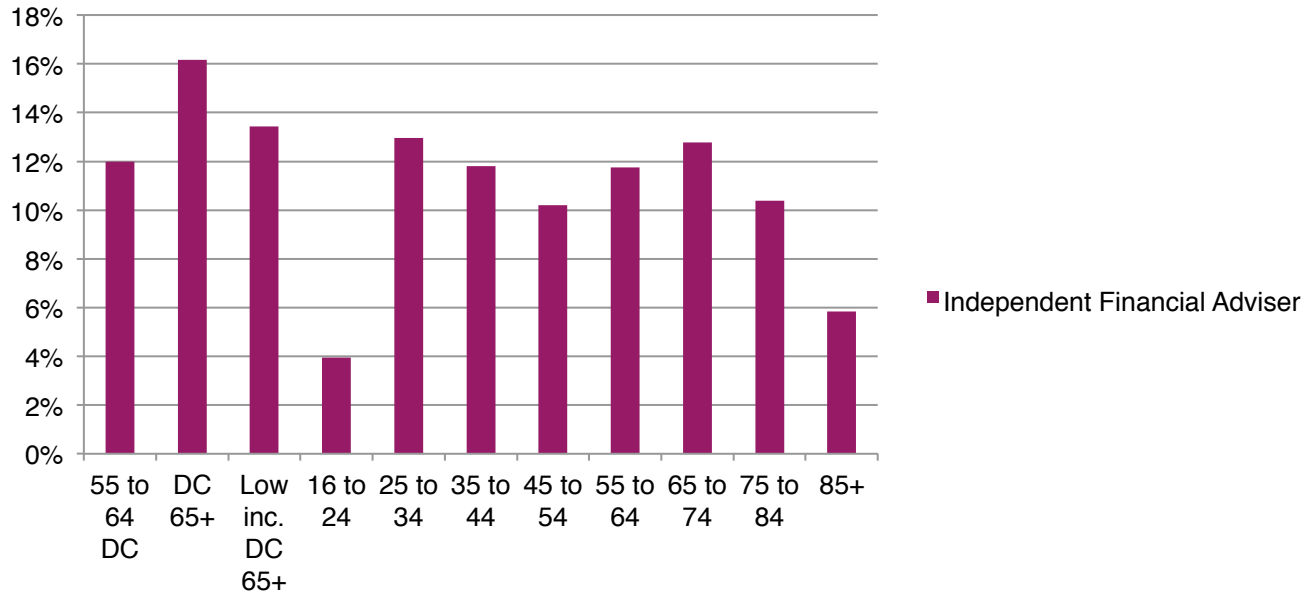
Product decision influenced by best buy information, 2010-2012, (WAS Wave 3)



Although best buy tables can be found in newspapers, these results may partly reflect lower Internet usage among older age groups.

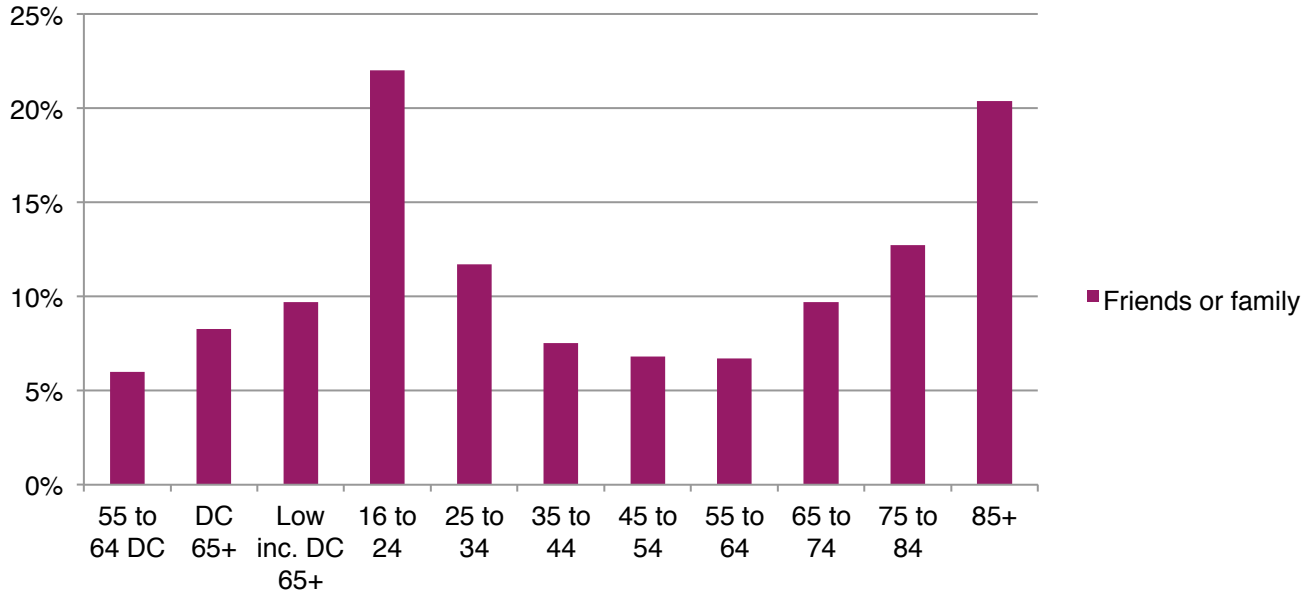
Among all age groups, only 11% cited an independent financial adviser (IFA) as being the most influential in their decision. However, at 16%, the influence of IFAs was highest among DC retirees, and low-income DC retirees, at 13%.

Product decision influenced by Independent Financial Adviser, 2010-2012 (WAS, Wave 3)



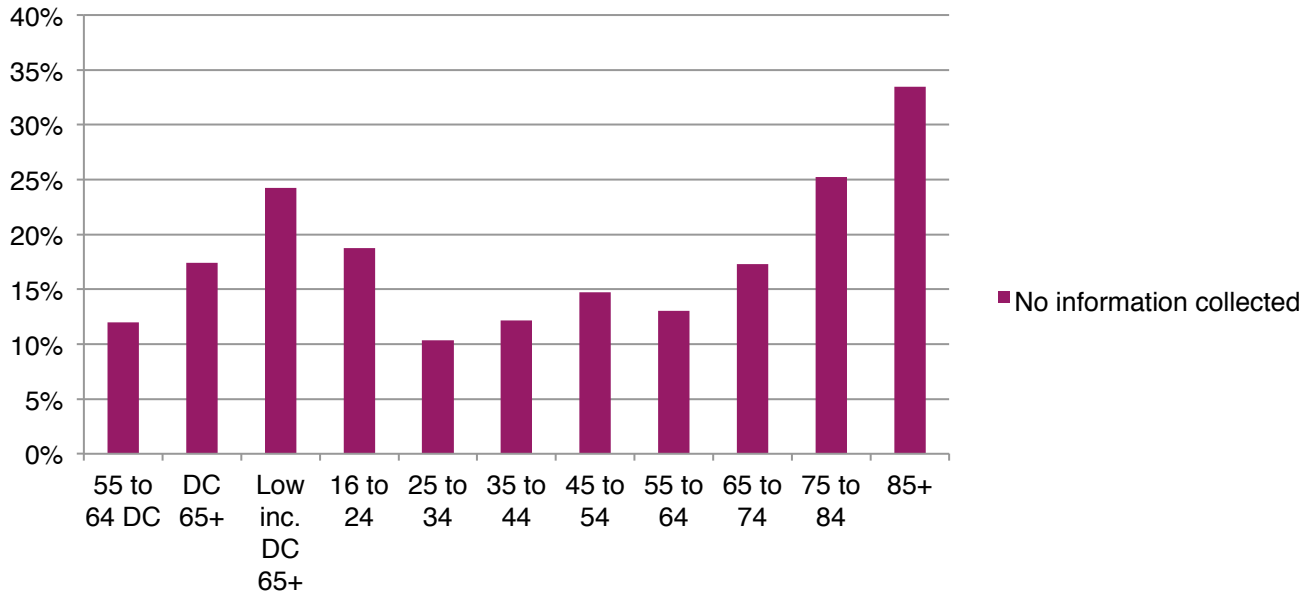
Interestingly, in contrast to other information sources, the influence of friends or family across age groups is U-shaped, i.e. high among those aged 16 to 24 (22%) before dropping to 7% of 45 to 64, then rising again to 20% of those aged 85%.

Product decision influenced by friends or family, 2010-2012 (WAS, Wave 3)



Finally, the research found that as individuals age, among those that have purchased a product during the preceding two years, they are more likely to report they were not influenced by any information or advice source in choosing their financial product.

Product decision influenced by no one, 2010-2012 (WAS, Wave 3)



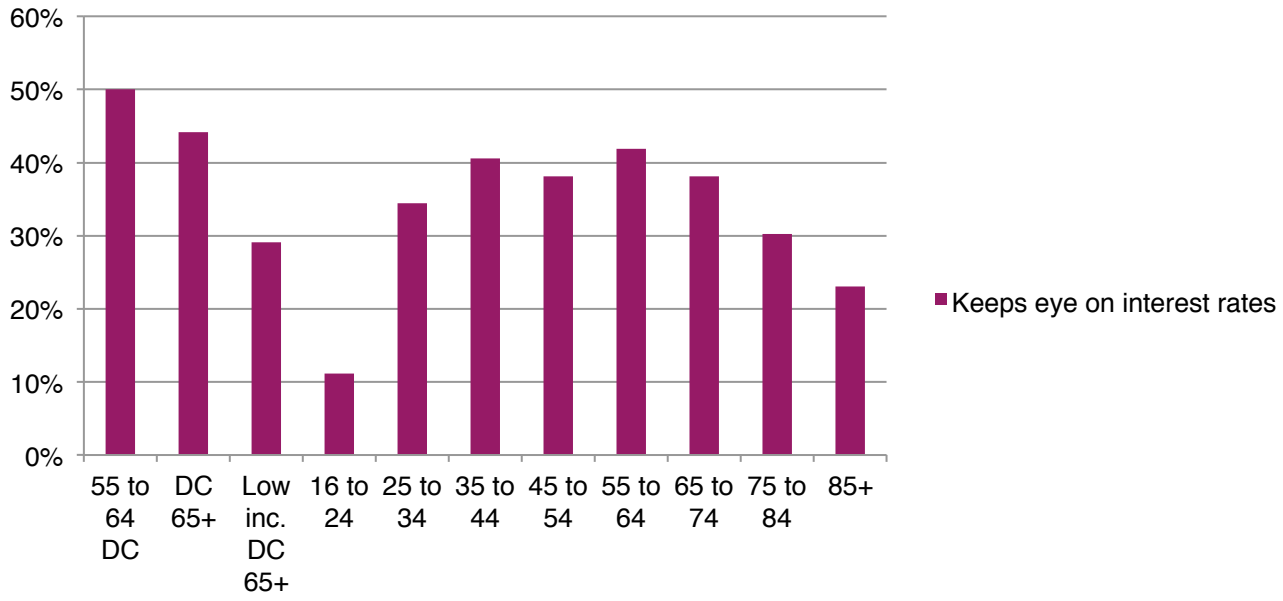
5.6. Defined Capability: Financial engagement

By seeking to increase personal responsibility for financial outcomes in retirement among DC savers, the Freedom and Choice changes to the 'annuities deal' imply that these individuals will remain financially engaged with their investment and income choices, both before and throughout retirement.

However, Defined Capability found that **for key aspects of financial engagement – such as monitoring inflation, stock-market changes and financial best-buy tables – financial engagement is low among DC retirees, and declines overall with age**. Again, this raises important questions around the potential efficacy of financial decision-making – such as securing optimal value for money from financial products – of DC pension savers, as they manage their pension savings during retirement.

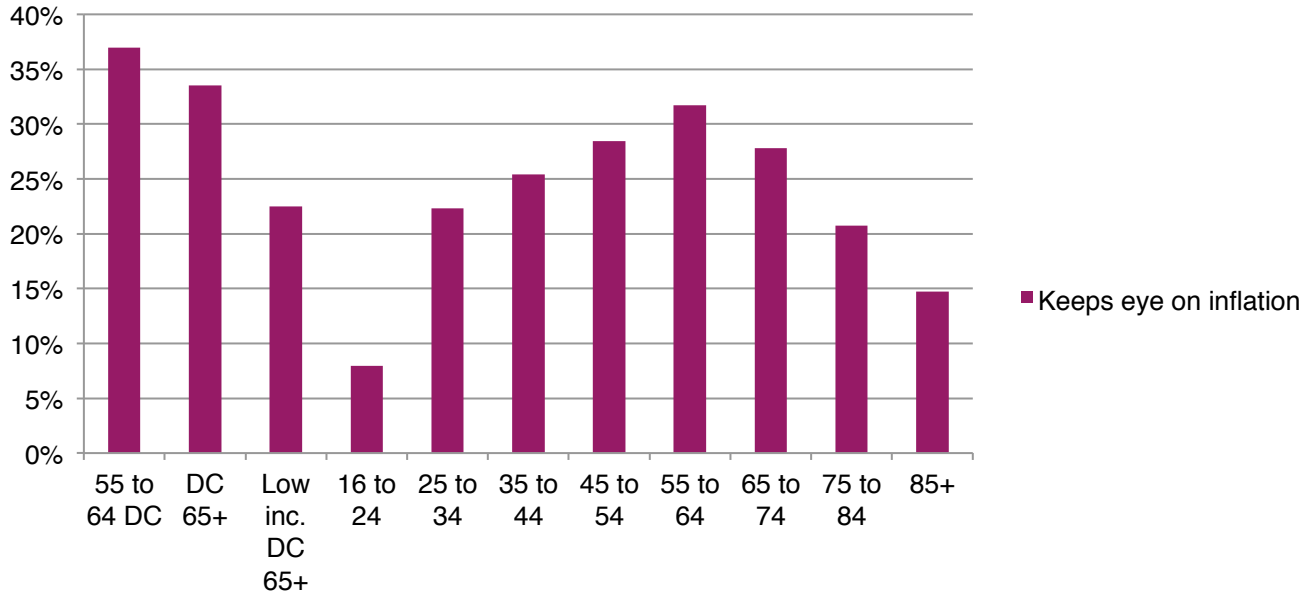
Around half of DC pre-retirees keep an eye on changes in interest rates, potentially reflecting the proportion in this group with liquid and mortgage debts to repay.

Whether keeps eye on changes in interest rates, 2010-2012 (WAS, Wave 3)



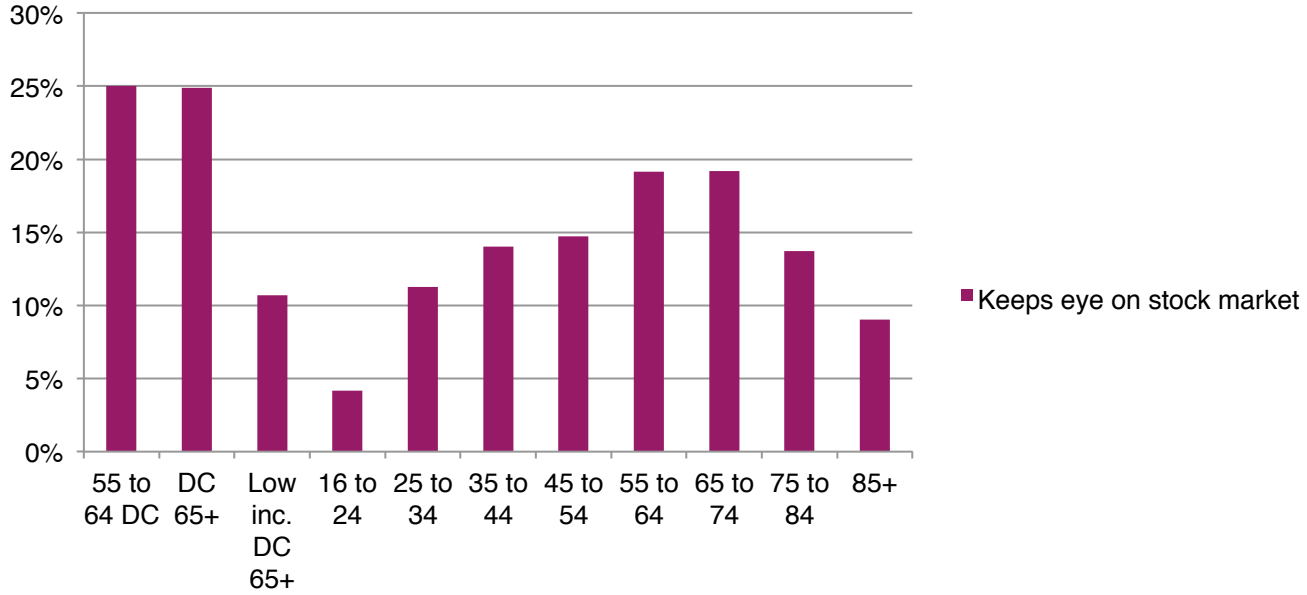
Around one in three DC retirees keep an eye on changes in inflation, although again, overall propensity declines with age.

Whether keeps eye on changes in inflation, 2010-2012 (WAS, Wave 3)



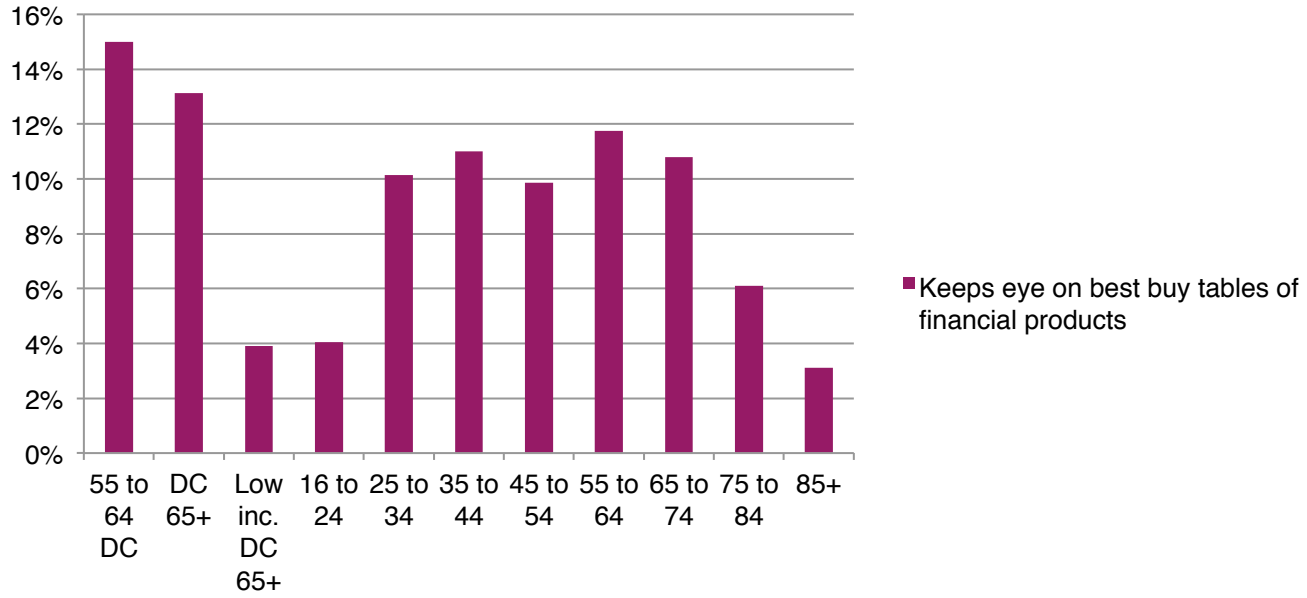
Just 16% of the 65+ age group keeps an eye on changes in the stock market. Although propensity again declines with age, it is higher (25%) among DC pre-retirees and DC retirees.

Whether keeps eye on changes in stock market, 2010-2012 (WAS, Wave 3)



Just 8% of the 65+ population keeps an eye on financial product best buy tables. Once more, propensity declines with age, but is higher (13%) among the DC retiree group.

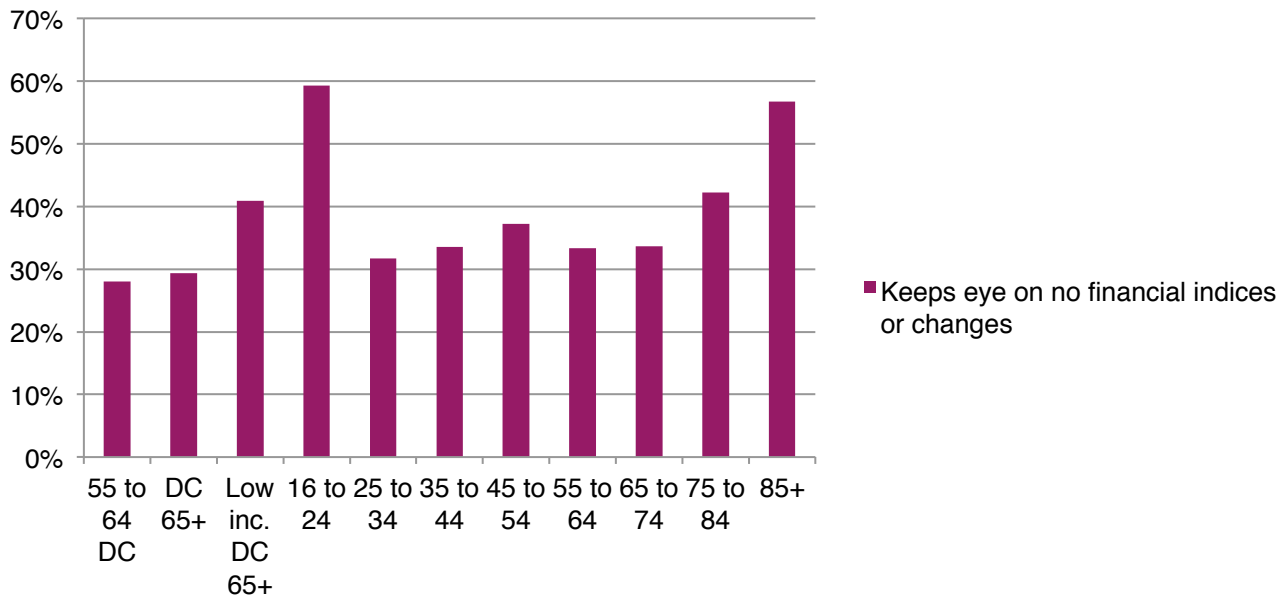
Whether keeps eye on changes in best buy tables of financial products, 2010-2012 (WAS, Wave 3)



Finally, Defined Capability found that nearly 30% of DC pre-retirees and DC-retirees do not keep an eye on changes in any financial trends or indices, rising to 39% of all individuals aged 65+ and 41% of low-income DC retirees.[31] More widely, the propensity to not monitor any economic or financial changes rises with age to 57% of the 85+ age group.

[31] The full list comprises: Changes in interest rates; Changes in housing market; Changes in state pension, benefits; Changes in inflation; Changes in taxation; Changes in job market; Changes in stock market; Best buys in financial products

Whether keeps eye on no financial indices or changes, 2010-2012 (WAS, Wave 3)



5.7. Defined Capability: Over-saving

In the context of the Freedom and Choice changes to rules on DC pension saving, there is a possibility that some individuals will cash-in their DC pension savings and place this money in a savings account, or leave their DC savings in a drawdown account, but with no plan to take a regular income.

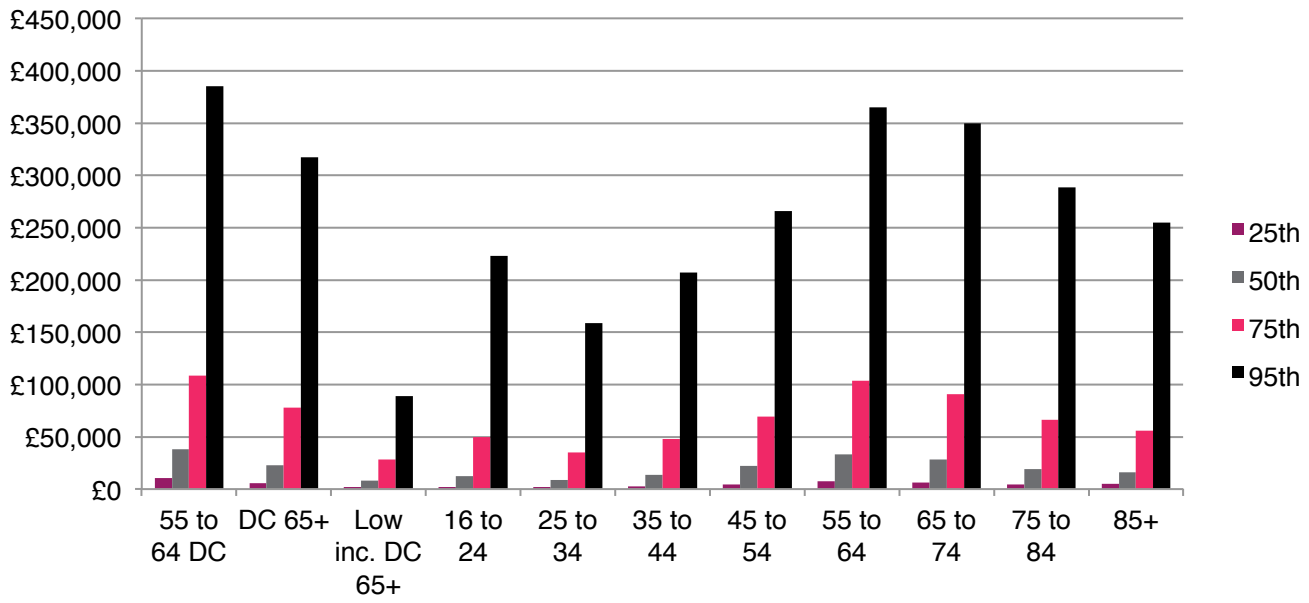
Indeed, once DC savings have been cashed-in, in the 'mental accounting' of retirees, **many may then regard this wealth as simply cash savings indistinguishable from other forms of savings** they possess. Important clues as to how individuals may behave can therefore be found in the existing savings behaviour observable among DC retirees.

Defined Capability found **strong evidence of 'over-saving' among DC retirees** in the UK. This tendency has several aspects:

- Retirees **maintain relatively high levels of cash savings that could be annuitized, including retirees on a low income**;
- Retirees **deliberately and purposefully save money to boost their savings levels, despite being in the 'decumulation phase'** of the life-cycle when they should – in theory – be running down their savings to fund consumption (spending);
- Retirees **adjust their regular expenditure to below their income, with the result that they engage in 'accidental saving'**, with money frequently left in their current account.

The median amount of liquid financial wealth among DC retirees is around £23,000; however, one quarter had at least £78,000 of financial assets suggesting some in this group could annuitise this wealth to boost their income but choose not to. Interestingly, among low-income DC retirees, 5% had financial assets of around £90,000 or more.

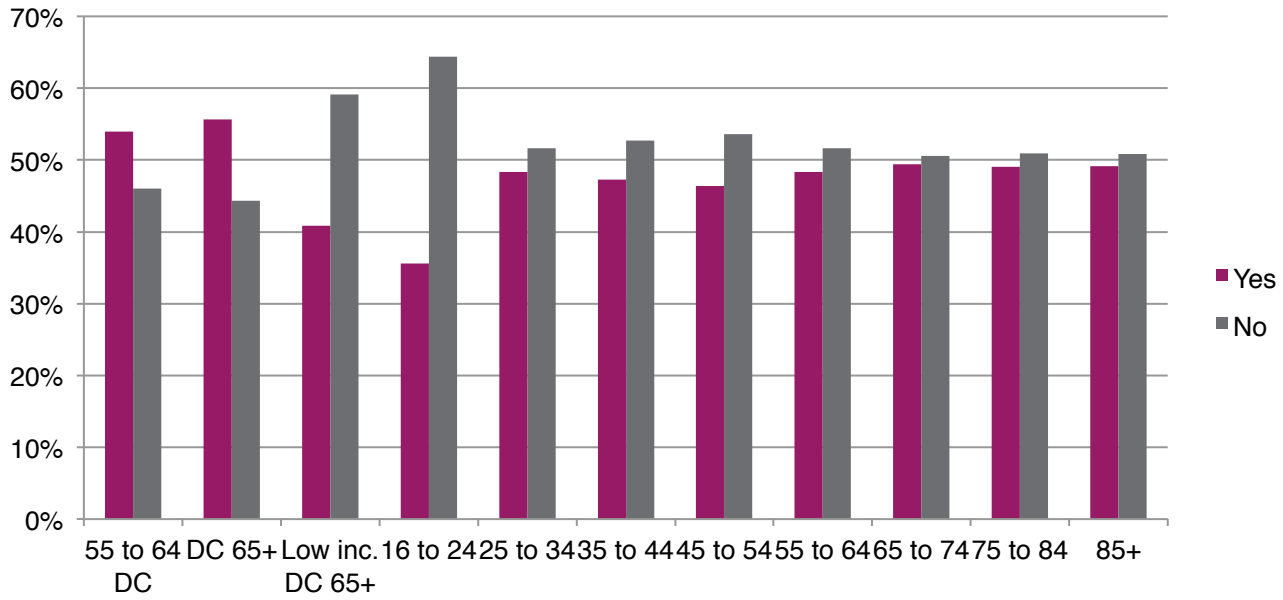
Net financial assets, 2010-2012 (WAS, Wave 3)



These findings suggest that many DC retirees – particularly low-income DC retirees - are in a position to supplement their income through annuitisation of savings, but have not taken this decision, perhaps reflecting factors explored in academic research on the 'annuity puzzle'.

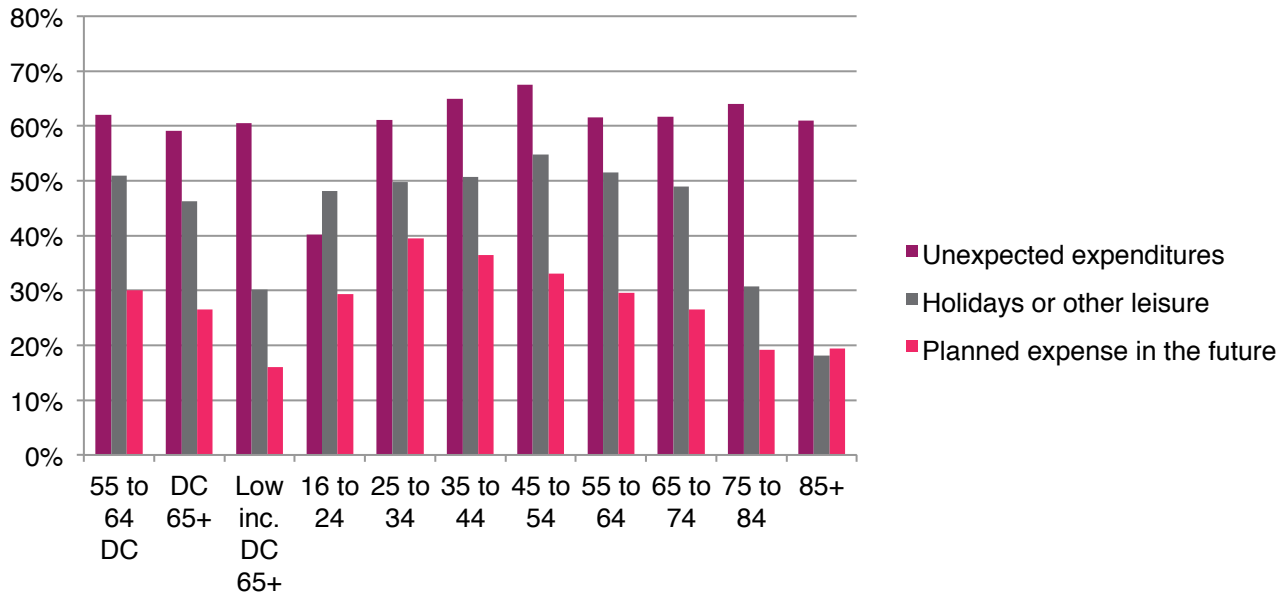
Turning to savings behaviour in retirement, despite being above retirement age, fully 49% of the 65+ population report saving income during the preceding two years. Among DC retirees, the relevant figure is 56%.

Any income saved during last two years, excluding pensions, 2010-2012 (WAS, Wave 3)



Individuals may save for multiple reasons. However, the most frequently cited motivation for saving was for unexpected expenditure, i.e. 'precautionary saving'.

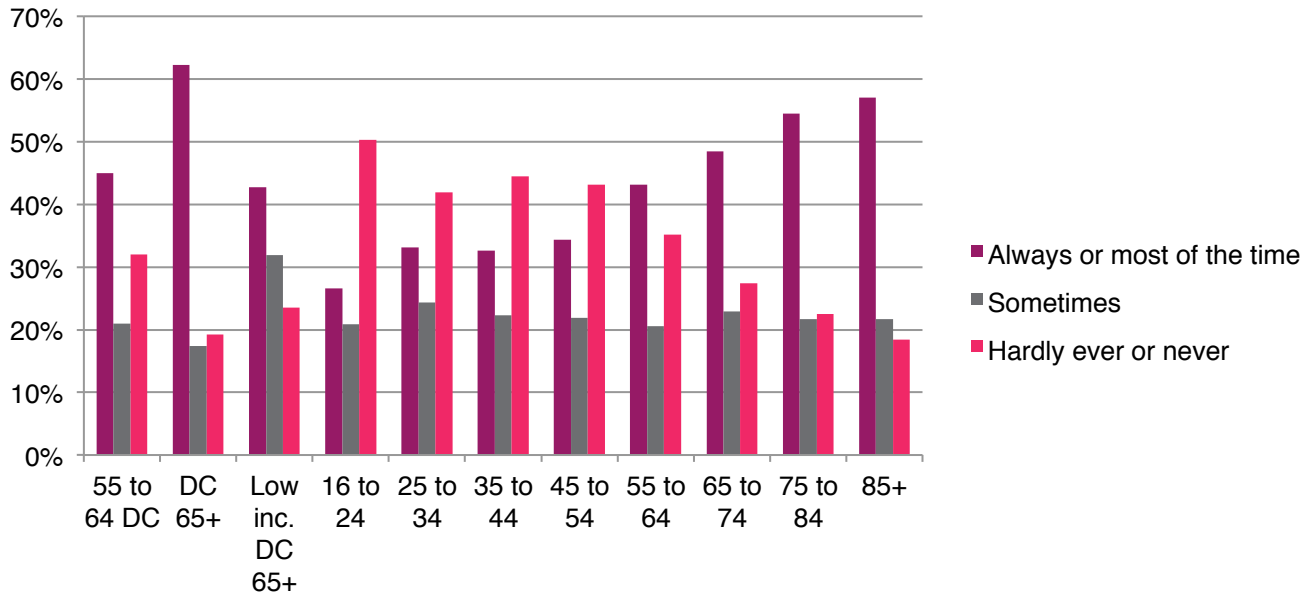
Reason for saving money during last two years, 2010-2012 (WAS, Wave 3)



In addition to deliberate, purposeful saving, Defined Capability found strong evidence of unplanned 'accidental saving', as individuals adjust their expenditure to below their income.

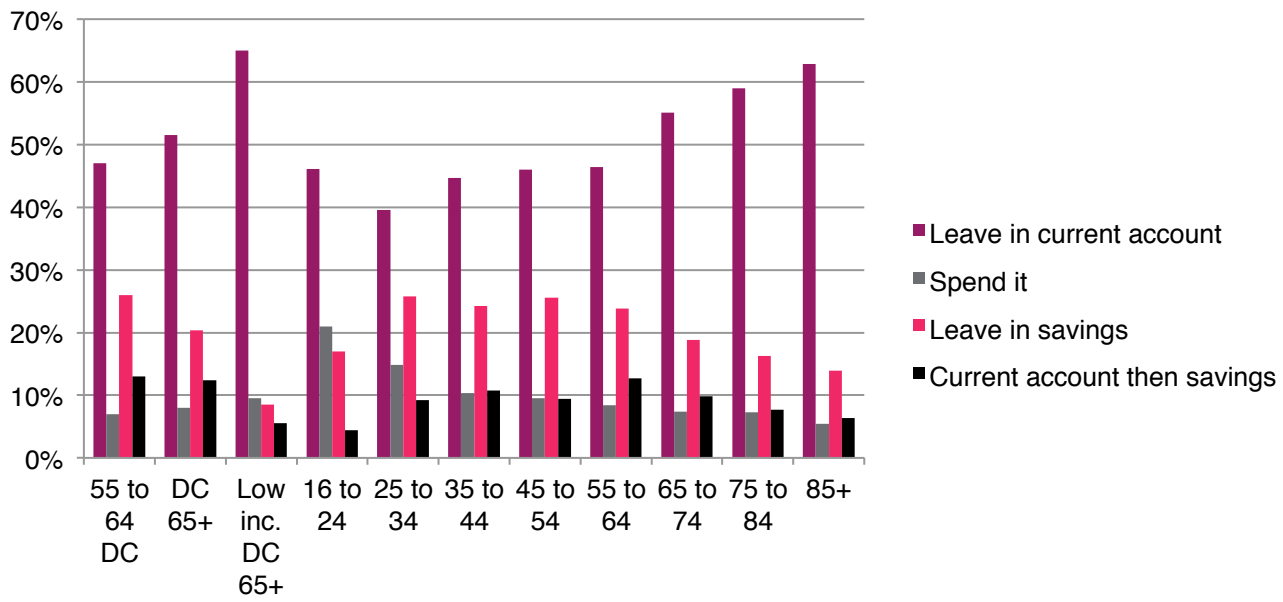
The following chart shows that most individuals have money leftover in their account at the end of the month, and the propensity to always/mostly have money left over is highest among DC retirees (62%), and increases overall with age. This could reflect reduced expenditure with ageing, accumulated financial capability, or changing expenditure patterns as individuals become more cautious in their spending in retirement.

How often had money left over at end of week/month during last year, 2010-2012 (WAS, Wave 3)



Importantly, over half of retirees report that they leave money left over at the end of the month in their current account, with very few opting to spend it or move it into a savings account, including only 12% of DC retirees.

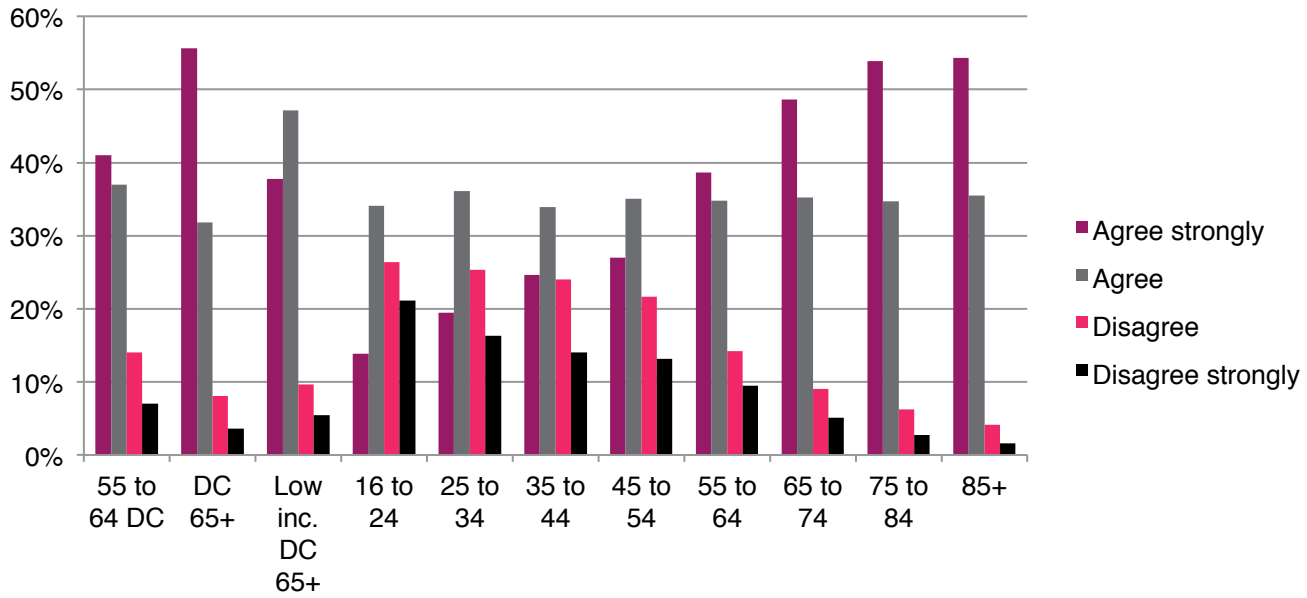
What does with money left over, 2010-2012 (WAS, Wave 3)



This suggests that the proceeds of such 'accidental saving' are not efficiently invested to achieve maximum investment returns, but are instead left in low-yield savings or current accounts.

More widely, as individuals age, they are more likely to report they always have money saved for a rainy day.

"I always make sure that I have money saved for a rainy day", 2010-2012 (WAS, Wave 3)

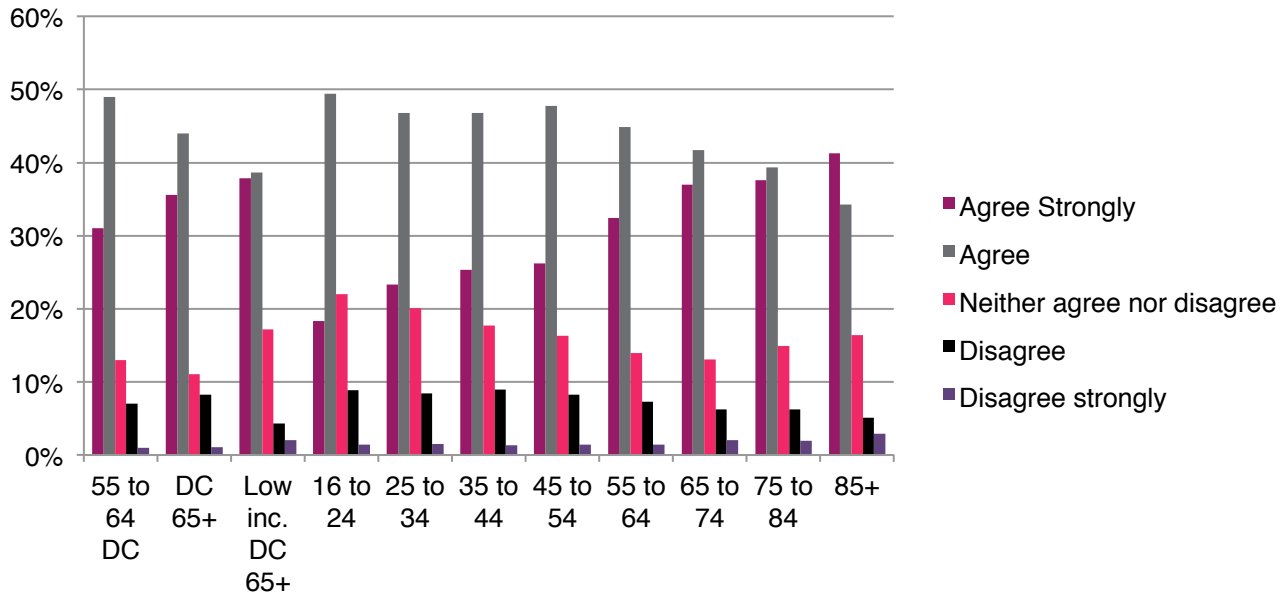


This suggests an increasing focus on precautionary saving and putting money aside for general purposes, as individuals age. In this context, retirees who withdraw their DC pension savings as cash following April 2015 may be likely to convert such wealth from 'retirement income' to 'precautionary saving' in their mental accounting, with the result that instead of using such savings to fund spending, they will instead seek to add to their stock of savings.

5.8. Defined Capability: Liquidity bias

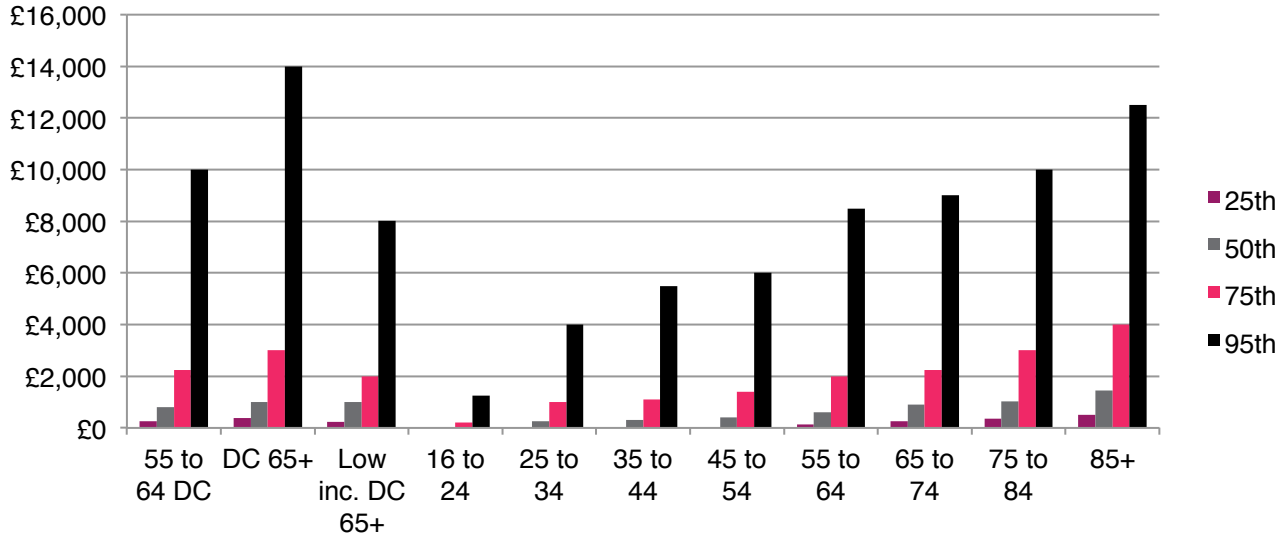
For DC pension savers to secure a good investment return on their DC pension savings after these have been cashed in, and to deal with the effect of inflation on income, DC retirees will have to be open to taking on investment risk. However, Defined Capability found a strong 'liquidity bias' and low tolerance for risk. Indeed, preference for investment risk declines markedly with age:

"It is better to play it safe with your savings even if investing in higher risk investments could make you more money", 2010-2012 (WAS, Wave 3)



However, the liquidity bias is highlighted even more keenly by the amount that individuals keep in their current account. Despite the fact that total financial wealth declines in older age groups, the amount that individuals have in their current account actually increases as people age.

Amount in current account, 2010-2012 (WAS, Wave 3)



5.9. Defined Capability: Financial incentives

In addition to financial capability and behaviour, Defined Capability was able to explore some potential financial incentives confronting particular groups of DC savers in the wake of the April 2015 changes. In particular, the research found that:

- **15% of DC pension savers aged 55 to 64 rent**, and these individuals may be incentivized to spend/bequest their pension savings in order not to lose entitlement to means tested housing support from the state during retirement;
- **31% of DC pension savers aged 55 to 64 have outstanding mortgage debt, dropping to 11% of all DC retirees aged 65+**. These individuals may be incentivized to **cash in their DC pension savings to pay off their mortgages**, even before retirement. Indeed, subsequent cohorts may be incentivised to take on larger mortgage debt in the knowledge they will be able to pay off this debt with their DC pension savings;
- **5% of DC pre-retirees aged 55 to 64 have a buy-to-let property**, and 6% have a second home. Again, these individuals may be incentivized to use their pension saving to pay off any mortgage debt associated with such property.

5.10. Conclusion

The Freedom and Choice changes to the 'annuities deal' were motivated in part by a belief that individuals, not the state, are best placed to decide how to use their pension savings to fund their retirement.

However, this suggest an optimistic view of DC retirees in the UK as highly informed, engaged and active financial services consumers, and directly conflicts with detailed, quantitative evidence on financial capability in this group set out in the Defined Capability research.

Importantly, previous literature on financial capability suggests that variations in financial capability are explained by demographic, age, education and socioeconomic characteristics – in addition to experience of using financial products.

As such, policymakers cannot reasonably assume that the financial capability of DC pre-retirees and DC retirees will improve simply in response to the additional choices and responsibility they confront as a result of the April 2015 changes to DC pension rules.

The next chapter therefore explores what the evidence reviewed in this chapter on the financial capability of DC savers means for the future direction of UK private pensions policy.

6.Conclusion: The case for default reform

6.1. Introduction

The first part of this report has highlighted a number of conclusions:

- The April 2015 changes to rules on taxation of DC pension savings moved the UK to a system of voluntary annuitisation, fundamentally breaking with the preceding 'annuities deal' that required individuals to turn pension savings into a secure retirement income;
- Low rates of annuity purchase are observable across multiple countries with voluntary annuitisation regimes, and have given rise to a longstanding field of academic research into the so-called 'annuity puzzle';
- International evidence suggests that countries with voluntary annuitisation experience low retirement incomes and increased personal insecurity;
- Academic research suggests that cognitive capacity and the efficacy of financial decision-making declines with age;
- Research also suggests that among DC savers and retirees in the UK, financial capability is low and declines with age. Among current DC retirees, high levels of over-saving – both planned and 'accidental' - are already observable, in addition to a liquidity bias, and growing disengagement with 'informed' sources of information and advice, such as best buy tables and financial advisers;
- Among low-income DC retirees, for whom the marginal impact of poor financial decision-making will be greater, financial capability is even lower than for the wider group of all retirees with DC savings or income.

Upon the announcement of the Freedom and Choice changes to DC pension saving in 2014, HM Treasury argued:

> "With the right consumer guidance, advice and support, people should be able to make their own choices about how to finance their retirement."
>
> HM Treasury (2014) *Freedom and choice in pensions*, London

However, the evidence reviewed in preceding chapters suggests very different conclusions:

- There is a very high risk that that over time, the April 2015 changes to rules on DC pension saving will result in lower average retirement incomes for DC pension savers in the UK, as other countries have experienced, notably Australia;
- The government's Pension Wise 'guidance guarantee' is unlikely to be successful in preventing lower incomes or poor decisions.

Indeed, although the prevalence of pensioner poverty has declined significantly over recent decades, **there is a significant risk that the Freedom and Choice changes to DC pension taxation will result in an increase in pensioner poverty**, in particular, as individuals fail to obtain a good-value, secure retirement income, and instead engage in the kind of over-saving that is **already observable** in the UK pensioner population.

6.2. The choice for policymakers

In light of these conclusions and evidence, policymakers face three choices:

A) Do nothing

Future governments could wait to observe evolutions in retirement choices and consumer attitudes among DC retirees in the UK in the years following April 2015, before considering further changes.

However, to the extent that the April 2015 changes lead to changes in attitudes and expectations – for example, against using DC pension savings for obtaining any kind of income – these changes may become progressively harder to counter through policy intervention.

B) Impose restrictions on the use of DC pension saving

Given the risks identified above, policymakers could fully or partially reverse the Freedom and Choice changes to DC pension saving, using punitive tax rates or other measures to limit the options for DC retirees, compelling individuals to use their pension savings in specific ways to improve levels of secure income; for example, limiting people's options to income drawdown or an annuity (as found in South Africa).

However, although re-imposing restrictions on the use of DC pension savings could reduce the risk of the UK experiencing the problems of other countries with voluntary annuitisation systems, such a reversal would likely prove deeply unpopular with the public. In addition, various commentators have noted that repeated changes in pension rules may ultimately lead to consumer disengagement with pension saving if the 'rules of the game' keep changing.

C) Implement a new default decumulation pathway for DC savers at retirement, while leaving the April 2015 freedoms in place

The government could implement a new, default decumulation pathway at retirement for DC retirees, with an emphasis on predictable, good value, secure retirement income. DC retirees would retain the full rights to flexibility and choice over their DC pension savings implemented in April 2015; however, the risk of lower retirement incomes – observed in countries such as Australia - would be significantly reduced.

Given the risks and problems associated with both doing nothing (A) and re-imposing restrictions on the use of DC pension saving (B), there appears to be compelling argument for UK pension policymakers to explore how 'default' retirement options for DC savers could be used to address the issues and risks identified with the Freedom and Choice changes implemented in April 2015.

The rest of this chapter therefore explores the pros and cons of private pension policy using default options to influence behaviour and choices.

6.3. Evaluating the use of Default Options in Private Pensions Policy

What are the pros and cons of policymakers using default options in private pension policy?

The principal downside for policymakers is that any 'default' option in pensions policy will inevitably result in sub-optimal outcomes for some individuals: what is good for some people is unlikely to be the best for everyone.

For example, the 'auto-enrolment' reforms to workplace pension saving in the UK see many workers automatically enrolled into making private pension contributions when they would be better off using their pension contributions to pay off their short-term debts (credit cards, etc.) or build up 'buffer savings' (against the risk of redundancy, long-term sickness, etc.). Many younger workers who rent would also arguably be better advised to save toward a deposit to purchase their first home, to ensure their pension savings in retirement are not simply used to pay rental costs.

The application of default options for DC savers at retirement in the 'decumulation phase' may also result in sub-optimal outcomes for some individuals.

However, for UK policymakers confronting the risk of lower retirement incomes resulting from the Freedom and Choice changes implemented in April 2015, the 'counter-factual' for implementing a default option is not optimal outcomes for every individual, but rather, large numbers of DC retirees experiencing unnecessarily low retirement incomes, as well as increased insecurity - for example, because individuals treat their DC pension pot as they already treat their liquid savings in retirement, and place their pension savings in a low-interest current account.

As such, just as UK pensions policy nudges workers into making sub-optimal savings decisions through the application of 'auto-enrolment' for the sake of achieving wider policy goals, similar arguments apply in the decumulation phase of private pensions policy.

More widely, given the complexity of risks, preferences and options confronting individuals at retirement, there are likely to be declining marginal benefits from attempts in policy design to achieve 'optimal' retirement income and wealth decisions for individuals - in addition to issues of basic feasibility. For example, what is optimal for an individual at one point in time may cease to be optimal just six weeks later if people's circumstances change rapidly, given the death of a partner or the diagnosis of a serious health condition.

However, these limitations to applying default options at retirement in the decumulation phase of private pension policy must be evaluated against the multiple compelling potential benefits to UK policymakers designing, implementing and promoting a new, default decumulation pathway – what might be referred to as an 'automatic income plan' - for DC retirees in the UK, based on achieving a secure, predictable, good-value retirement income.

These benefits are explored below.

6.4. Inertia – deployed through a default option - is the most powerful tool available to policymakers to influence behaviour

As the evidence cited in previous chapters noted, financial capability and cognitive capacity decline as individuals age. This has arguably contributed to both lower retirement incomes in countries with voluntary annuitisation frameworks, and to problems with the UK's pre-2015 system of near mandatory annuitisation, which saw some DC retirees fail to shop around to secure the best income available.

Declining financial capability and cognitive capacity during later life mean that for policymakers, the usefulness of consumer competition and choice decline as people age.

In this context, inertia - just as it is in the accumulation phase - is likely to be the most powerful policy tool available to achieve good outcomes for the majority of individuals.

Indeed, **financial 'guidance', information websites and the promotion of choice via the 'open market option' proved wholly inadequate to achieve acceptable consumer outcomes for DC retirees under the pre-April 2015 regime, given the power of inertia among consumers**, even when this meant defaulting to poor value annuities.

Conversely, in the decumulation phase it is likely that inertia, rather than a one-off 'guidance guarantee' and consumer information, will be the most powerful tool available to policymakers to prevent lower incomes resulting from the Freedom and Choice changes, and to ensure good outcomes for DC savers.

6.5. Aligning and 'completing the story' across the accumulation and decumulation phases in the context of auto-enrolment

Following the recommendations of the Pension Commission, the UK government has implemented 'auto-enrolment' into workplace pension saving for qualifying workers. Upon completion of these reforms in 2018, millions of UK workers will have begun saving into a workplace private pension for the first time, despite never having given permission for money to be taken from their salary in this way.

Implementing and promoting a default, automatic income plan for DC retirees will align the 'choice framework' for workplace pension saving and retirement in the UK, as well as 'completing the story' for workers considering whether to participate following auto-enrolment.

Indeed, by presenting the prospect of a secure retirement income at retirement as merely being an optional choice that individuals will have, alongside the choice to use pension savings for other activities, some workers may query why they should lock their money away for several decades before taking it as cash, when they could put this money into more liquid, savings vehicles – such as tax-incentivised ISAs - and have recourse to the money before retirement if they need it. Presenting this choice risks potentially disrupting the 'mental accounting' characteristic of many people's decision to engage in pension saving, i.e. "I am setting this money aside from my salary, which will pay me a steady income during retirement when I can no longer work."

More widely, in the absence of a clear, default, automatic income plan for DC retirees, applying auto-enrolment in the context of the April 2015 changes forces workers at retirement to make a choice they have not asked to make, and to take responsibility that they have not sought out, if they are to access their own money.

As such, if the government is to continue to take money from workers' salaries without their permission, some may argue the government has a moral responsibility to define and implement a clear, default automatic income plan for them at the point of retirement, rather than imposing decisions on them that they have not asked for.

6.6. A default option, and regulatory 'nudges' from the government, are inevitable so should be exploited by policymakers

Within any 'trustee' or 'contract'-based DC pension scheme, there will always be some individuals who retire, stop making contributions, and:

- Never make any attempt to access their pension savings;
- Request to receive something from their pension savings, but do not specify any other preferences.

As such, there will inevitably be a default pathway of least resistance for DC savers at retirement: some form of 'default' option is inevitable, even if this just sees pension schemes leave people's savings in a 'default retirement fund'.

In this context, the final responsibility for specifying the default option for DC savers at retirement rests with the government.

Recognising that it has final responsibility for specifying the 'default' option for DC retirees, the government should also recognise that even if it declares it is neutral as to how individuals use their DC pension savings, government decisions relating to the default option - and more widely toward product regulation, the 'guidance guarantee' etc. - will inevitably nudge individuals toward certain choices around whether or not to convert their DC pension savings into a secure retirement income.

Indeed, research undertaken into the 'annuity puzzle' has highlighted that a person's preferences as to whether or not to obtain a secure pension income are deeply influenced by how the choice is presented.

Two different types of 'frame' have been identified in research on how individuals view annuities. Under a 'consumption frame', potential annuitants focus on the end result of what can be spent over time through the purchase of an annuity. In contrast, under an 'investment frame', potential annuitants focus on the intermediate results of return and risk features of an annuity, in comparison to other potential investment options.

Experimental US survey research has provided evidence to support the hypothesis that 'framing' may influence the outcome of the choice to annuitise. Researchers found that whereas 72% of survey respondents prefer a life annuity to a savings account when the

choice is framed in terms of consumption, only 21% of respondents prefer it when the choice is framed in terms of investment features.[32]

The UK's Financial Conduct Authority (FCA) subsequently undertook similar research in relation to UK pension savers. It concluded that:[33]

> "presenting annuities and other drawdown strategies in different frames can significantly alter an individual's relative preferences for these retirement income products.
>
> Faced with a choice between the annuity and alternative strategies, consumers, on average, preferred the annuity under the consumption frame but preferred the alternative to the annuity under the investment frame.
>
> For example, consumers were asked to choose between an annuity and a savings account from which they can draw the same income as the annuity, or alternatively they could only spend the interest on the account (therefore keeping their capital intact). In the consumption frame, 66% of consumers chose the annuity. In contrast, under the investment frame, only 17% of consumers chose the annuity."
>
> Source: FCA (2014)

Such research has very important implications for the Freedom and Choice agenda: annuitisation preferences are not intrinsic, but reflect external factors such as how annuities are presented.

However, the crucial agent that will determine how the choice regarding whether to annuitise is presented to DC retirees is the government. This is because it is the government that ultimately has responsibility for the regulation of the choices people have, including default options, and how those choices are presented and promoted by pension providers and employers.

In this context, rather than deny the inevitable influence and 'nudge' that it will have in relation to the retirement decisions of DC pension savers, it is arguably better for government to acknowledge and recognise its inevitable influence, define a default automatic income plan, and nudge individuals in its direction.

6.7. Promoting the idea of a secure income will influence behaviour and improve peace of mind

A key risk for voluntary annuitisation systems is that DC savers do not associate the use of their DC pension pot with obtaining a retirement income, as the case study of Australia shows. Instead, some individuals may disregard their future retirement income needs and instead purposefully make pension contributions with the intention of accessing this money around retirement to fund, for example, holidays, gifts to their children and extensions to their home.

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[32] Brown J et al. (2008) *Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle: NBER Working Paper No. 13748*, NBER

[33] FCA (2014) *Does the framing of retirement income options matter? A behavioural experiment*, London

However, if the government and employers promote a default, automatic income plan based on providing a smooth, secure retirement income to DC savers in the UK before they reach the age of 55, workers may become more emotionally attached to the prospect of receiving this secure income in retirement, and more averse to incurring the 'loss' of this income if they choose to withdraw their DC savings and give their pension pot to their children.

In addition, various studies have noted that although DC savers may be hostile to the term 'annuity', they frequently report that they would like to obtain all the benefits of an annuity, i.e.: a smooth, predictable, regular income that will last until the end of their life.

As such, if the government implements and promotes a default automatic income plan that provides for a smooth, predictable, regular, secure income, this is likely to improve peace of mind among DC pension savers.

6.8. Preserving the 'tripartite agreement' and the foundations of UK pensions policy

Following the recommendation of the Pension Commission, workers who are automatically enrolled into a workplace scheme will be guaranteed an employer contribution. From October 2018, individuals with qualifying earning levels will make a minimum contribution of 8% of their gross salary, which must include a minimum of 3% employer contribution. In addition, DC pension savings will retain their exceptional levels of tax-relief, i.e. employer and employee contributions are made in relation to gross, 'before-tax' salary, and all investment gains that accrue to DC pension savings are free of tax.

In this way, pension savings accumulated in the wake of the auto-enrolment reforms to workplace pensions reflect a 'tripartite agreement' promoted by the Pension Commission between workers, employers and the state.

However, the entire basis of this 'tripartite agreement' was that pension savings were used to fund a secure pension income. Indeed, it is very important to note that the DC pension pot of a worker at retirement comprises contributions (money) from the individual, their employer(s) and the state.

In this context, if the Freedom and Choice changes to rules on the use of DC pension savings see many, or the majority of, workers with DC pension savings use this money for other purposes besides a secure pension income – such as holidays, debt-repayment bequests or a 'nest-egg' they never touch – the consensus underpinning the 'tripartite agreement' could break apart in several ways.

First, employers and their representative groups may lobby future governments for a reduction in the mandated level of employer contributions and/or lobby against any increase required to lift benchmark contribution rates to a level deemed likely by policymakers to achieve a sufficient income 'replacement rate' in retirement. More widely, employers have an interest in workers receiving pension income and therefore not continuing to work if they don't want to, and such a motivation was also reflected in employer support for the tripartite agreement, but would be undermined if workers do not opt to take an income from their DC savings.

Second, subsequent governments may question the policy value of the pensions tax-relief for the UK Exchequer, if public 'expenditure' on such tax-relief is simply being used to fund holidays and gifts for retirees with DC pension savings.

The result of any reduction in pension tax-relief, or reduction in employer contributions, will be smaller pension pots on average for DC pension savers – and by extension, lower volumes of personal wealth for the financial industry to manage and invest.

However, if a large proportion of DC savers in future do convert their pension savings into a secure retirement income, particularly following implementation of a default, automatic income plan that achieves this outcome, it is much more likely that the 'tripartite agreement' will be preserved into the future.

6.9. Conclusion: The case for a new default, automatic income plan

This chapter has set out the potential benefits of the UK government implementing a new, default automatic income plan for DC retirees following the April 2015 changes to rules on DC pension taxation. The range of potential benefits identified suggests the limited regulatory costs for the government of implementing a default decumulation option are far exceeded by the benefits, including those identified in subsequent chapters, such as ensuring value for money through scale and competition.

As such, the analysis suggests the government should:

- **Define, implement in regulation and promote a default, automatic income plan for DC retirees in the UK, while retaining the right for individuals to withdraw their savings from the age of 55 subject to their marginal income tax rate;**
- **The default automatic income plan should provide a predictable, secure (guaranteed) and good-value income for DC retirees.**

In fact, the analysis set out in this chapter and the advantages associated with a default, automatic income plan suggest it will be inevitable that a default decumulation option for DC retirees will ultimately be adopted by a future UK government.

The second part of this report therefore develops recommendations for the design of a new, default automatic income plan for DC retirees.

Part 2: Toward a default automatic income plan

7. Defining 'Good': Principles for an automatic income plan

7.1. Introduction

The previous chapter set out the arguments for policymakers to define and implement a default automatic income plan for DC retirees, both in terms of avoiding risks (e.g. lower retirement incomes, poor financial decisions) and opportunities (e.g. providing a benchmark for DC retirees who choose to make their own provision).

However, in developing a new default, automatic income plan, it is important to set out what policymakers should be trying to achieve, i.e. what outcomes are desirable?

This chapter therefore proposes a number of target outcomes and guiding principles.

7.2. Maximise average retirement incomes

Preceding chapters have noted how voluntary annuitisation systems can result in low incomes for DC retirees, particularly when retirement savings are simply treated as 'nest-egg' savings or spent on cars or housing. This outcome is likely to be inefficient for the majority of individuals (who unnecessarily reduce consumption during their working life), and for the wider economy (which experiences lower consumer demand as individuals set aside pension contributions from their earnings).

A core design principle for a default, automatic income plan would therefore be to maximise average retirement incomes for DC savers. In particular, this means at the time of their death, individuals should have allocated all or most of their pension savings to fund an income in retirement. If a large portion of people's pension savings are leftover at death, this means they have suffered an unnecessarily low retirement income, which in many cases may not be the result of active choice, but instead, inertia and excessive precautionary saving (i.e. fear).

7.3. Balance consumer preferences

Various studies have noted that DC savers often express contradictory preferences for their decumulation, wanting a secure, smooth, predictable retirement income on the one hand (typical of an annuity), as well as the flexibility and control to draw on their pension funds as they wish (typical of a savings or drawdown account).

A key principle for designing a new default, automatic income plan for DC retirees is therefore that it balances consumer preferences.

7.4. Guarantee value for money

A default, automatic income plan for DC retirees should guarantee good value for money for DC savers: individuals should not be defaulted into poor-value, financial vehicles.

As previous chapters noted, the breakdown of the UK's compulsory annuitisation framework in part resulted from individuals being defaulted into products that represented poor value for money, for a number of reasons. If a new, default income plan for DC retirees in the UK once again saw individuals experiencing poor value for money, another wave of public discontent with the financial services industry and reform would likely follow, with severe consequences for industry, government and the long-term future of private pensions.

7.5. Design a default option for real people

Any decumulation pathway for DC retirees will be more successful if it is built around people's actual financial capability and behaviour, rather than optimistic assumptions around levels of financial acumen and engagement.

Indeed, as previous chapters noted, a key reason for the failure of support for the UK's compulsory annuitisation regime was that it over-relied on individuals 'shopping around' to obtain the best annuity rate, and it was based on unrealistic assumptions around consumer behaviour and the competition that would result.

The April 2015 changes to rules on DC pension taxation impose more complex choices on DC savers than the preceding regime; very few will have experience of making a similar decision. There is no logical reason to expect DC savers to suddenly acquire the necessary additional financial skills and abilities to achieve optimal decisions.

A key principle for designing a new, default automatic income plan for DC retirees in the UK is therefore that it is built around people's actual, observed financial behaviour and capability.

7.6. Ensure a default option is pot-neutral

A new, default automatic income plan for DC retirees in the UK should treat all savers equally, and not make assumptions that people with small pots do not want a secure retirement income. Nor should those with smaller pots be expected to suffer poorer value for money as a result of the value of their savings.

7.7. Guarantee transparency

Throughout the process of accumulating and decumulating a DC pension fund, individuals should be able to access full information about the default, automatic income plan, i.e. what will happen when, management charges, and their choices and options at different points. Indeed, given the use of a default option, policymakers should ensure that long before the age of 55, individuals are regularly told what will happen and when in relation to an 'automatic income plan', and its core characteristics, i.e. a secure, regular, predictable good-value income. Such transparency and information is vital when policymakers apply default options

in pensions policy, and has been a characteristic of the government's 'auto-enrolment' reforms to workplace pension saving.

7.8. Ensure the default option is adaptable and flexible

A default, automatic income plan should be flexible and adaptable to people's changing circumstances and retirement plans, without forcing people to make wholly separate provision.

For example, a default, automatic income plan might see individuals defaulted into a pre-set level of income drawdown when they begin receiving the state pension, but also offer a lower level of drawdown if individuals wish to carry on working part-time into their 70s, and therefore want to defer receipt of some income.

In addition, a default automatic income plan should be flexible and adaptable to macro-economic trends and changes, i.e. 'annuity rate risks' such as changes in inflation, interest rates and investment returns, which may influence when individuals would best annuitise. As subsequent chapters explore, there will not necessarily be one single way of delivering an automatic income plan, and the optimal form of delivery may change significantly at different points in the economic cycle.

These considerations point to the multiple design options for providers, which are explored in subsequent chapters.

8. Delivering an Automatic Income Plan: Options for policymakers

8.1. Introduction

For DC pension policy to be effective in maximising average retirement incomes, it must make provision for a new, default automatic income plan that provides several things:

- A mechanism for converting a person's DC pension savings into a **regular income**;
- Protection from **longevity risk**, i.e. the risk individuals will live longer than expected;
- Protection of a person's income from the effects of **inflation**, by securing investment growth.

To achieve such provision, the government could simply provide a new, default automatic income plan itself. However - with the partial exception of National Savings and Investment (NS&I) - UK governments have traditionally avoided directly providing financial services to the public, preferring instead market-based solutions, which:

- Access skills and expertise in the private sector, for example, in asset-management;
- Promote value for money and efficiency through market-based competition;
- Create space for innovation.

As such, in the context of the UK private pension system, the government would likely wish to use market-based non-governmental provision. In practice, this is likely to mean regulation to ensure that pension scheme providers default DC retirees into a defined automatic income plan.

8.2. Delivering a default income plan through outcomes-based regulation

How should the government regulate for market-based non-governmental provision of a default automatic income plan for DC retirees?

It would be conceivable for the government to specify to providers how DC pension savings should be invested, how much investment-risk should be incorporated, etc. In short, the government could focus on 'inputs': what is being done to people's DC pension savings in order to provide an income.

However such an approach would likely result in poor regulatory choices on the part of policymakers, as well as making the government liable for poor performance and, therefore, the possible target of litigation.

In addition, it would also limit the scope for innovation and competition, i.e. for providers to explore alternative options and financial instruments that provide a secure, regular income, protect from longevity risk and protect from inflation. For example, if the government were to

specify rules on using individual life annuities in relation to a default, automatic income plan, this may prevent alternative, innovation options for providing longevity protection based on aggregation and bulk annuities.

Instead, regulation for a new, default, automatic income plan for DC pension savers will likely require an outcomes-based approach, i.e. the government would require providers to default DC retirees into an automatic income plan that would reasonably and credibly be expected to achieve certain outcomes, including:

- Providing a regular, predictable, secure income;
- Representing good value-for-money, based on the income achieved relative to a person's savings.

In short, rather than specify the detailed characteristics of a product, the government would specify what outcomes should be achieved, and subsequently, would review whether they were achieved. In part, a precedent for such an approach can be found in guidance relating to investment and fund-performance for trust-based schemes for auto-enrolment default funds.[34]

8.3. Competition, value for money and defaults

Nevertheless, several factors suggest that a new, default income plan for DC retirees, set down through outcomes-based regulation will be inadequate to achieve good outcomes for consumers.

First – as described in previous chapters – **consumer-level competition at the point of decumulation (annuitisation) among both trustee and contract-based DC pension schemes has proved inadequate to ensure good value-for-money for retirees**. Indeed, over-reliance by policymakers on consumer competition was to a significant extent responsible for a crisis of legitimacy for annuities and UK insurance companies, in the face of consumer inertia.

Second, the choices confronting DC retirees following the Freedom and Choice changes to DC pension taxation have resulted in **significantly more complex choices and decisions for individuals**. The inherent complexity of these choices is likely to make it even harder for consumer competition to be effective in promoting consumer interests.

Third, these problems are compounded by the fact that unlike the one-off, product purchase represented by buying an annuity, a new, automatic retirement income plan for DC retirees is likely to involve several stages (such as drawdown followed by staged, partial annuitisation), i.e. a **process, rather than a single decision point**. This potentially means that to be a lever to achieve good outcomes for individuals, consumer competition would have to extend beyond the point of retirement into late old age. However, as previous chapters explored, **financial capability declines with age**. As such, relying on consumer competition - for example, on individuals to transferring their DC savings to a better value drawdown provider - is unlikely to result in good outcomes for consumers.

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[34] For example, see DWP (2011) *Guidance for offering a default option for defined contribution automatic enrolment pension schemes*, London

Fourth, deploying a new, default automatic income plan for DC retirees in the UK is incompatible with high levels of consumer competition and could result in **conflicting messages**: the government would on the one hand be stating that retirees can be relaxed about remaining 'hands off' as their pension pot automatically converts into a secure retirement income; but, on the other, would be telling individuals to be engaged and shop around.

Both the government and the financial services industry therefore have a strong interest in the post-April 2015 regime delivering good outcomes for consumers, and for the application of a new, default income plan not resulting in a perception that consumers are being failed, short-changed or exploited

In this context, the government and the financial services industry face several options:

8.4. Kite-marking

This option would see regulatory or other bodies award 'kite-marks' to providers of regulated automatic income plans that meet certain criteria – for example, in relation to management charges and investment performance, income levels or annuity rates - with the intention that the absence or withdrawal of a kite-mark would encourage individuals to move providers.

The limitation of such an approach is that it relies on engagement and activity among individual DC retirees to switch providers. However, as research described in previous chapters noted, financial engagement declines as individuals age.

8.5. Expanded trustee role

For members retiring within trustee-based DC schemes, the government could expand the fiduciary duty of scheme trustees to oversee the default, automatic income plan for retirees into their 70s and 80s; for example, switching individuals away from drawdown providers providing poor investment returns. Expanding the duties of trustees could also enable them to steer their retirees to a default, automatic income plan that adapted to their characteristics and circumstances over time.

In effect, this sort of role for trustees was envisioned by the Australian Murray Inquiry, which recommended that DC retirees should be defaulted into a 'comprehensive income product for retirement' (CIPR) that has minimum features determined by government, with trustees pre-selecting the specific provider and product.

However, attempts by government to extend the duties of scheme trustees to former employees, potentially decades after they left an organisation, is likely to meet resistance among trustee-based schemes, not least amid concerns regarding future, potential mis-selling liabilities.

8.6. Regulation from Within: Expanded governance boards

Rather than expanded duties for trustee boards, this approach would see pension scheme providers operate governance boards that ensure they offer value for money to individual DC retirees. For example, this could see pension companies required, at the prompting of governance boards, to transfer customers to other providers if their investment performance consistently underperforms the market average, or individuals can obtain better annuity rates from other providers.

The nearest precedent for such an approach are rules from the UK's Financial Conduct Authority (FCA) requiring providers of workplace personal pension schemes to set up and maintain independent governance committees (IGCs).[35] Under these rules, IGCs have a duty to act in the interests of scheme members and will operate independently of the firm. They are to assess and, where necessary, raise concerns about the value for money of workplace personal pension schemes.

However, a model of provider-level competition through IGCs with decumulation phase duties would be entirely new, and there could be little certainty as to how it would operate in practice. Indeed, it is unclear that any governance board operating from within a pension scheme provider would be effective in overcoming countervailing incentives within the organisation.

8.7. Enhanced regulation

The government could deploy new, novel regulatory techniques to the private pension sector to ensure good outcomes for consumers, such as:

- Prescriptive regulation about how pension scheme providers operate automatic income plans, such as 'charge caps' in relation to investment management charges on drawdown products;
- 'Naming and shaming' – using the risk of adverse publicity and reputational damage to incentivise behaviour among providers;
- Promoting transfers – monitoring pension scheme performance, and writing to individual retirees encouraging them to move when a provider is under-performing, as well providing 'click-through' online information on how to move;
- Automatic transfers – a statutory body, or network of independent brokers, could automatically transfer individual DC retirees away from underperforming schemes to alternative providers, throughout the decumulation stage.

8.8. Statutory provision

To provide an alternative to both DC savers and company scheme trustees, the government could create an independent, not-for-profit provider of default income plans, which would compete for business for trustee-based schemes, as well as providing a benchmark for performance and consumer outcomes.

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[35] FCA (2015) *Final rules for independent governance committees, including feedback on CP14/16*, London

8.9. Mandated brokerage or clearing-process

On this approach, the DC pension savings of individuals entering into a default, automatic income plan would be transferred to a national brokerage or 'clearing process', and placed with the provider offering the best secure income. In addition to enforcing high levels of competition, such a mechanism may also increase scope for aggregating pension pots to ensure economies of scale and improved value.

However, although such a process may be effective in relation to a single 'product' with a single fixed point of purchase – such as a life annuity - it would be less suitable in relation to an automatic income plan delivered in different ways by different providers (e.g. in relation to longevity insurance), and incorporating different consumer choices (e.g. percentage of pot to keep as cash). In short, for any 'auction' of this nature, the organiser has to specify the 'basis of competition' (the services being auctioned), which would potentially drive out valuable variation, flexibility and adaptability.

8.10. Conclusion

This chapter has briefly sketched some potential options for delivering a new, default automatic income plan through outcomes-based regulation and market-based private provision, and the regulatory challenges of ensuring good consumer outcomes.

Ultimately, no market is effective if businesses do not confront both the risk of losing their customers; and, the opportunity to acquire new customers.

As such, for both policymakers and the pension industry, the key challenges to delivering a new, default, automatic income plan for DC retirees in the UK are acute and distinctive, relating to:

- Consumer competition ultimately proved inadequate under the pre-April 2015 compulsory annuitisation regime, and is even less likely to ensure good consumer outcomes in the context of a default, decumulation pathway;
- Employers and scheme-trustees are likely to resist an extension to their fiduciary duties that extends right to the end of the life of former employees;
- A default, decumulation pathway will comprise a process, not a single purchase point, such that monitoring and competitive pressures need to operate throughout this process into a person's late old-age, rather than at a single point in time.

As such, it is likely that ensuring value for money through outcomes-based regulation and market-based private provision is likely to require a hybrid approach, incorporating independent governance boards with responsibility for automatic income plans, enhanced regulation and a statutory provider to benchmark performance levels.

Such an outcomes-based approach would enable individual providers flexibility in how to deliver an automatic income plan. It would also allow regulators to specify protocols in relation to how longevity and other risks are pooled. These fundamental design choices are explored in more detail in the next chapter.

9. Providing an Automatic Income Plan: Design choices

9.1. Introduction

The previous chapter set out the rationale for policymakers to use outcomes-based regulation relating to private pension scheme providers to deliver a new, default automatic income plan for DC retirees in the UK after April 2015. The chapter also explored the difficult challenges for the government of ensuring good value for money for consumers.

However, in the context of an outcomes-based regulatory approach, pension scheme providers would confront an important and complex set of interdependent design choices for a new, default automatic income plan, which this chapter explores.

As Blake and Boardman (2014) note, retirement expenditure planning is ultimately about trade-offs:[36]

- "Higher income and expenditure today versus higher income and expenditure later;
- Higher income and expenditure versus higher inheritance;
- Protecting against future inflation versus higher immediate income;
- More investment risk versus more certainty in retirement income;
- Buying longevity insurance versus assuming longevity risk.

Personal circumstances will influence the appropriate decisions for an individual. Nevertheless, these trade-offs are hard even for professional financial planners, economists, and actuaries to make, let alone members of the general public."

Source: Blake D and Boardman T (2014)

For pension scheme providers to design a default, automatic income plan will involve judgements about each of these trade-offs. To some extent, in order to balance public policy priorities, regulators may need to set out protocols for providers, for example, relating to the pooling of longevity risk and mortality cross-subsidy, and to ensure consistency across different providers in the provision of automatic income plans.

Given the difficulties experienced by the pre-April 2015, compulsory annuitisation framework – notably the effect of low gilt-rates and increasing longevity on annuity rates – it is unlikely that an annuity would on its own in many cases represent the best option for a default, automatic income plan. Instead, there is likely to be greater use of the alternative income vehicle to an annuity for DC retirees - income drawdown - whereby individuals receive as income some or all of the investment return on their DC savings. Use of income drawdown does not preclude subsequent full or partial annuitisation.

[36] Blake D and Boardman T (2014) "Spend More Today Safely: Using Behavioral Economics to Improve Retirement Expenditure Decisions with SPEEDOMETER Plans" in *Risk Management and Insurance Review*, Vol. 17, Issue 1, p83-112

This means that a new, default automatic income plan for DC retirees who reach retirement and request access to their money will mostly likely need to:

- Default individuals into an income drawdown vehicle;
- Default individuals into longevity insurance, whether via an annuity or some other form of risk pooling or adjustment.

For pension scheme providers delivering a new, default automatic income plan in the context of outcomes-based regulation will therefore require confronting a set of choices principally relating to:

- Income drawdown;
- Longevity insurance;
- Use of individual data – i.e. to what extent the decumulation pathway is personalised to a person's characteristics and circumstances, and if so, how is that data obtained;
- Adaptation processes, i.e. how a decumulation pathway responds to changes in individual and economic circumstances;
- Role of choice;
- Small pots and 'hard defaults'.

Each of these topics would require extensive regulatory consultation for policymakers, and research by providers, in order for providers to settle on an approach. Such work would echo previous consultations on the design of default options for the UK's 'auto-enrolment' reforms to workplace pension saving, and the creation of the National Employment Savings Trust (NEST).

Given such complexity, the rest of this chapter therefore attempts to summarise the key choices in the design of a new, automatic income plan for illustrative purposes only.

9.2. Drawdown

In defaulting individuals into an automatic income plan, providers would need to decide:

- How much capital is earmarked for drawdown vs. longevity insurance;
- Level of income drawn relative to investment performance;
- Level of investment risk that the underlying capital is invested in;
- How long individuals remain in drawdown relative to life expectancy;
- Whether drawdown income should include some spend-down of the capital principal, if income has been already earmarked for longevity insurance that will provide a replacement income (i.e. an annuity). However, it should be noted such withdrawals run the risk of so-called 'pound-cost ravaging' whereby the impact of withdrawals during a market downturn can be severe, given there are no additional contributions to make up the loss, depleting the fund prematurely.[37]

[37] Cazalet Consulting (2014) *When I'm sixty-four*, Cazalet Consulting

9.3. Longevity insurance

To include protection from longevity risk in the context of a default automatic income plan, providers may incorporate some annuitisation of a DC pension pot. The annuity purchase could comprise a standard life annuity, or individually underwritten 'enhanced' annuity, if providers were able to identify and monitor changes in individual health conditions – which is explored below. More widely, providers would face options around how much of a pot to annuitise, when and how.

- Delayed annuitisation

This would see a DC retiree moved into income drawdown on retirement, followed by full or partial annuitisation of their fund at a later stage, for example, at the point that the potential annuity rate they could receive exceeds the average drawdown income available.

- Lump-sum deferred annuity

On this approach, a portion of a DC retiree's fund – e.g. 25% - is used at retirement to purchase a deferred annuity that will only begin paying an income at a pre-determined age, e.g. 80. Those who survive past this age benefit from a mortality cross-subsidy from those who do not.

- Income-based deferred annuity

A portion of person's drawdown income is automatically used to pay multiple small premiums toward a deferred annuity, which will only begin paying an income at a pre-determined age.[38]

There are two key advantages to this model over a lump-sum deferred annuity. First, individuals may be more willing to accept longevity risk pooling (and loss of capital) if multiple small premiums are paid. Second, if individuals die several years before the age that the annuity begins payment, their net capital loss will be lower.

- Phased annuitisation

On this approach, a portion of a person's remaining DC pot is used to buy an annuity that begins paying an income immediately. Harrison and Blake (2014) note:[39]

> The perceived advantage of this strategy is that it hedges annuity rate risk, because the single point of purchase is converted in a series of purchases over a period of years so that the purchaser develops a portfolio of annuities of different commencement dates that relate to differences in age and health and different prevailing interest rates. The disadvantages include... interest-rate risk, and the cost of making multiple purchases.
>
> Source: Harrison D and Blake D (2014)

[38] For example, this approach was proposed by Boulding A (2015) *What would a good quality decumulation solution look like?*, Presentation to the NAPF, London
[39] Harrison D and Blake D (2014) *The Future of Retirement Income*, Which?, London

- Alternative longevity insurance vehicles

For large groups within a cohort, longevity insurance could be provided through other mechanisms besides individual life annuities. For example, Harrison and Blake (2014) set out the potential of 'institutional annuitisation', which may be achievable in the context of a default, automatic income plan, and be particularly beneficial during a period of low gilt and annuity rates:[40]

> "The idea is for an insurance company to underwrite the longevity risks, relative to a guaranteed lifetime income, presented by a cohort of retirees. There would be a requirement for underwriting, but it is possible that this could be simplified if there were common characteristics in the cohort, for example, in relation to the industry in which they worked (occupational health risk) and/or in the area in which they lived ('postcode' socio-economic underwriting).
>
> If this model could be developed for the DC auto-enrolment market, it could deliver better value for money for retirees, and it might be implemented via a national clearing house, for example, to ensure universal access. It might also be offered directly by the large-scale DC schemes, once they have achieved the necessary critical mass, and as a natural extension of scheme drawdown."
>
> Source: Harrison and Blake D (2014)

9.4. Adaptation mechanisms

To improve the income individuals receive, a default, automatic income plan would need to adapt to changes in:

- Individual circumstances, e.g. death of a partner;
- Economic circumstance, e.g. actual and projected changes in inflation, interest rates and economic growth.

Designing a default automatic income plan would also therefore require building in processes that respond and adapt to changes in circumstance. In particular, this may involve policymakers setting protocols for when and to what extent a default income plan is modified in response to different changes, which do not depend on active choices by the individual.

Although providers can adapt the financial instruments used to provide a default, automatic income plan to different points in the economic cycle – low/high inflation, low/high gilt rates, etc. – perhaps the most important decisions around how a default, automatic income plan adapts will relate to the extent of individual-level underwriting and changes in life expectancy.

9.5. Use of individual data

In the context of a default, automatic income plan, pension scheme providers would have to operate with the minimal information available to them on DC savers such as postcode, gender, age and pot size.

However, as part of the decumulation journey, providers would have the opportunity to seek out additional information on characteristics, circumstances and preferences.

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[40] Harrison D and Blake D (2014) *The Future of Retirement Income*, Which?, London

This poses a trade-off for policymakers and scheme providers. On the one hand, seeking such information could introduce 'friction' into the default, decumulation process, increasing the risk that individuals instead opt to withdraw their pension pot and leave the decumulation pathway. Nevertheless, even limited information can help scheme providers route individuals on to an improved default pathway, better suited to their characteristics and situation. Postcode data can be used to predict socioeconomic characteristics, and lifestyle underwriting could involve obtaining data about smoking, eating and drinking habits.

Alternatively, at the point of retirement or an annual basis, individuals could be asked for some basic medical data to enable 'light' underwriting. Harrison and Blake (2014) set out what could be used in a questionnaire for light underwriting:

Example of an 'underwriting light' questionnaire
1. What is your height?
2. What is your weight?
3. Have you smoked 10 or more manufactured cigarettes per day for the past 10 years?
4. Have you smoked 3oz/85g or more of rolling tobacco per week for the past 10 years?
5. Have you been diagnosed with high blood pressure, requiring ongoing medication?
6. Have you had a heart attack requiring hospital admission?
7. Have you been diagnosed with diabetes requiring insulin or tablet treatment?
8. Have you suffered a stroke (CVA), excluding mini-strokes (TIAs)?
9. Have you been diagnosed with angina requiring ongoing medication?
10. Have you been diagnosed with cancer (excluding skin cancer and benign tumours) requiring surgery, chemotherapy or radiotherapy?

Source: Harrison D and Blake D (2014)

For example, if someone in income drawdown aged 71 is diagnosed as having three years to live, it may be desirable to move them into an individually underwritten annuity, or even to cash-in their pension fund.

To some extent, protocols may need to be set down in regulation by policymakers. This is because the application of individual underwriting in longevity risk-pooling reduces the mortality cross-subsidy available to those with longer life expectancies. Although individuals with reduced life expectancy may benefit, the income available to those who survive for longer will drop.

9.6. Role of choice

Default pathways are predicated on pre-set options and not requiring individuals to make choices. For example, the UK's auto-enrolment reforms default individuals into contributing to their workplace pension: individuals do not have to choose their level of contribution, the fund or investment risk they are contributing to. All of these choices are made for them without any active participation or engagement.

However, the design and implementation of a default automatic income plan does not preclude giving individuals options and choices at different stages; rather, it simply means that in the absence of a choice by the individual, a pre-set choice will be made for them.

Giving individuals choices in a default, decumulation pathway for DC retirees can be useful for policymakers by:

- Revealing preferences that steer the default income plan toward being better suited to a person's individual circumstances;
- Providing individuals with a feeling of control.

Indeed, even in the context of providing choices, policymakers can deliberately seek to use choices to steer individuals to particular options. The Murray Inquiry notes that the design of default pathways can therefore also guide "more engaged members by providing a framework for decision-making."[41] The Inquiry note that such an approach can be effective for three main reasons:[42]

- Effort - real or psychological costs of moving from the pre-selected option;
- Implied endorsement - products are perceived to be recommended
- Loss aversion and reference dependence - decisions are affected by the starting point.

For a new, default, automatic income plan, individuals could be given choices around:

- When to begin receiving an income;
- How much of a fund to receive as a lump-sum payment at retirement;
- Choices following diagnosis of a terminal illness;
- When – if appropriate – to 'fix' their income via annuitisation;
- Investment risk (low, medium, high, etc.) applied to a drawdown path;
- What percentage of a fund they may wish to pass on as inheritance, including to a partner.

For example, Boulding (2015) has proposed that several basic choices could be given to DC retirees, beginning in relation to the drawdown stage:[43]

- Low risk, lots of cash and bonds, modest but safe returns - We suggest you draw 4% a year
- Moderate risk, wide balance of investments but they may go down - We suggest you draw 5% a year
- Higher risk, more exciting investments, hopefully will provide a better return but sizeable losses are possible - We suggest you draw 6% a year

And for longevity protection:

- Single payment of £5000 to insurance company, who guarantee to pay you £200 a month starting at age 85
- Regular payments of £25 a month to insurance company, who guarantee to pay you £200 a month starting at age 85
- Do nothing, and rely on other sources of income if you outlive your pension pot

Adapted from Boulding A (2015)

[41] Murray D et al. (2014) *Financial System Inquiry: Final Report*, The Australian Government: The Treasury
[42] Johnson E and Goldstein D (2013) "Decisions by default" in Shafir E (ed.) *The Behavioral Foundations of Public Policy*, Princeton University Press, Princeton, pages 417–427, cited by Murray D et al. (2014) *Financial System Inquiry: Final Report*, The Australian Government: The Treasury
[43] Boulding A (2015) *What would a good quality decumulation solution look like?*, Presentation to the NAPF, London

For both these sets of choices, relating to drawdown income and annuitisation, the ‘middle option’ could be set as the default.

This would exploit the tendency, noted in studies of behavioural economics, for retirees to apply ‘rules of thumb’.

9.7. Small pots and ‘hard defaults’

Policymakers and pension scheme providers will need to make design choices, and potentially develop protocols, in relation to two particular groups.

First, whether or not to implement ‘hard defaults’ in relation to individuals who do not seek to access their DC pension savings at all, i.e. place people into an automatic income plan when they reach retirement age, even if they have not requested their DC savings.

On the one hand, various scenarios can be conceived in which individuals may not wish to draw on their pension savings at this point, e.g. they are deliberately delaying not seeking receipt of their savings. Alternatively, they may simply be characterized by very high levels of inertia.

In this situation, policymakers may see some advantages to defaulting individuals into an automatic income plan even those individuals who never seek to access their savings. Although such a measure may have consequences for someone’s tax situation, if such a measure was extensively trailed, and undertaken in a fully transparent manner, policymakers could be justified in implementing such a hard default, particularly if individuals are placed in a form of drawdown rather than their money being committed to a – largely irreversible - annuity.

Second, notwithstanding the principle set out in previous chapters that policymakers should be pot-neutral, including in relation to pot size, providers and policymakers may wish to set an effective trivial commutation level, for example, £3,000, below which DC pots will be excluded being defaulted into an income plan at retirement.

9.8. Conclusion: Flexibility, adaptation and protocol

This chapter has briefly summarised some of the design choices for providers of an automatic income plan for DC retirees in the UK, in the context of outcome-based market regulation. The analysis reveals the complexity and interdependence of different factors. Providers can use flexibility in how to deliver an automatic income plan to benefit consumers, while being adaptable to changing individual and economic circumstances, and abiding by protocols set down by regulators with an eye on coordinating key policy goals, such as fairness between different groups and consistency of user experience across schemes.

Nevertheless, the benefits of a default, automatic income plan for pensions policy will not be fully realised without paying similarly close attention to the ‘user journey’, and this is now explored in the next chapter.

10. The Customer Journey: Messaging and nudges

10.1. Introduction

What should characterise the 'customer journey' of DC pension savers under a default automatic income plan? Achieving the right customer journey will be important in determining:

- **Participation** – how many individuals opt for the default, automatic income plan, as opposed to putting their DC pension savings in property or low-yield savings accounts;
- **Policy benefits** – for example, whether DC retirees experience peace of mind, fear and uncertainty.

As noted in the previous chapter, just as for 'auto-enrolment' into workplace pension saving, it will be important for policymakers to prioritise transparency and communication in implementing a default 'automatic income plan', informing savers what will happen, when and why.

Although the application of a default option for DC retirees reflects the use of a behavioural economics 'nudge' in policy design, it does not preclude the use of other behavioural insights, particularly in designing the 'user journey'.

This chapter therefore explores additional 'nudge' interventions that could be deployed, drawing on guides to behavioural economics for policymakers,[44] in order to improve participation in a default automatic income plan and maximise policy benefits.

10.2. Messenger

Behavioural economics shows that individuals are heavily influenced by who communicates information. In implementing a default automatic income plan, the government should consider carefully how the 'agent' that communicates relevant information to DC savers about an automatic income plan influences their perceptions and participation. For example, information from employers and consumer charities about an automatic income plan may be more trusted than from the government.

10.3. Incentives

People's responses to incentives tend to be reflect predictable mental 'shortcuts', such as loss aversion. As such, communications with DC savers that provides information on the option to take some or all of their savings as cash could be presented to individuals in terms of lost annual income they would forgo.

Loss aversion could also be deployed in a second way: individuals who wish to cash-in their DC pension pot could be required to receive at least of six months of regular income before a

[44] In particular, Dolan P et al. (2010) MINDSPACE, Institute for Government, London

final confirmation that they wish to crystallise their pots. In this way, individuals would be encouraged to grow accustomed to the security of a predictable, regular income, and more averse to its loss, before making a final decision to cash in their DC pension savings.

10.4. Norms

Individuals are strongly influenced by what others do. As such, if the government succeeds in steering a significant proportion of retirees into an automatic income plan, the government could promote this behaviour as a 'norm' regarding other people's choices, to encourage participation in an automatic income plan.

10.5. Salience

Research in psychology and behavioural economics shows that people's attention is drawn to what is novel and seems relevant to them.

In this context, a challenge for DC pension policymakers has always been the salience of a person's pension 'pot' as a sum of money over which individuals feel ownership and control, and potentially draw a sense of security from, separate to their entitlement to a state pension. To some extent, resistance to compulsory annuitisation of DC pots can be attributed to such consumer attitudes, in stark contrast to consumer attitudes toward DB entitlements, which are rarely presented in terms of the value of a single 'pot'.

The implementation of a default, automatic income plan would therefore provide an opportunity to revisit previous policy debate around combining State Pension and private pension forecasts and payments.

The aim of such ideas is to help reverse the 'mental accounting' observable in relation to DC – as opposed to DB – pension savings, whereby individuals view their DC savings as a pot of money – often a 'bonus' on top of their state pension - as opposed to a future income stream.

On this approach, pension providers, the Department for Work and Pensions and HM Revenue and Customs would directly coordinate information and projections to enable:

- Single pension statements, showing total forecast income for State Pension and private pension combined, with details on pot-value afforded a less prominent role;
- Paying both the State Pension and private pension as a single payment.

10.6. Ego

Behavioural economics has found that individuals act in ways that make them feel better about themselves.

As such, policymakers should explore the extent to which a default automatic income plan, and participation in it, could be the subject of positive affirmation as a good decision by government and other stakeholders, akin to messaging around participation in workplace pension saving following auto-enrolment.

11. Conclusion: The politics of retirement income security and good value

11.1. The inevitability of a default automatic income plan

This discussion paper has set out the risks associated with the April 2015 changes to rules on DC pension savings, based on the experience of other countries and detailed evidence on financial capability and behaviour among DC retirees.

In the face of such risks, the development and implementation of a default automatic income plan for DC retirees poses negligible downsides for policymakers: it is unclear why policymakers would choose not to implement such an approach.

The implementation of a default automatic income plan would pose complex policy choices and trade-offs, which the second part of this report has reviewed; in particular, around design and regulation. However, through a careful process of policy development and consensus building, none of the questions set out in previous chapters are unanswerable.

11.2. The politics of a default automatic income plan

Research with DC pension savers has repeatedly found that individuals place great emphasis on wanting a secure, guaranteed retirement income (i.e. pension), as well as avoiding being 'ripped off' in the context of choices that many find baffling – in addition to choice and control.

In this regard, a default automatic income plan of the kind set out in this report would ultimately give individuals what they want and, through the application of 'liberal paternalism', allow politicians to resolve apparently contradictory consumer preferences for flexibility and certainty.

Indeed, it suggests that following the April 2015 changes to DC pension rules, significant political capital will be available to the political party that guarantees access for all DC pension savers to a secure, guaranteed, predictable, good-value retirement income - delivered through a default automatic income plan.

As such, it appears that a default automatic income plan for DC retirees in the UK after April 2015 does not just appear inevitable as a policy development; in time, politicians will compete to promote it.

Appendix: Making a default automatic income plan work for low-income retirees

Introduction

This report has explored the arguments for UK policymakers to implement a default, automatic income plan for DC retirees following the April 2015 changes to taxation of DC pension withdrawals from the age of 55.

However, are there specific, additional policy measures required of individuals with very low levels of DC pension savings, i.e. those who retire after April 2016 with just the New State Pension and a small amount of DC pension savings, e.g. £20,000?

In particular, given evidence that low-income DC retirees are much more likely to rent in retirement, how should policymakers resolve tensions between enhanced rights to take pension savings as cash and means tested Housing Benefit?

This Appendix sets out three sets of recommendations focused on this group:

- Targeted, personalised financial advice for low-income DC retirees;
- Guarantee value-for-money regardless of pot size;
- Disregard DC pension savings from means tested Housing Benefit.

Targeted, personalised financial advice

As set out in previous chapters, 'Defined Capability found lower levels of financial capability among the low-income DC retiree group, compared to the wider group of DC retirees. Such findings were observable across multiple characteristics, including use of financial information and financial engagement.

The marginal impact of poor financial decision-making will be greatest for DC retirees with the smallest pots.

Given this marginal impact, and the lower financial capability observable among low-income DC retirees, policymakers should make additional provision, beyond the 'guidance guarantee' and 'Pension Wise', for this group. Such provision could take the form of **targeted, personalised, face-to-face, simple financial advice for low-income DC savers and retirees**.

Ensure value for money regardless of pot size

Historically, the pension industry has sometimes struggled to provide services that are sustainable to low-income groups. For example, the decision by policymakers to create the National Employment Savings Trust (Nest) with a public service obligation to accept any

workplace scheme, no matter the number of participants or size of contributions, was in response to such potential customers being unviable for the private companies pension industry to service.

In the context a default automatic income plan, similar dilemmas are likely to be encountered. As set out in preceding chapters, it is important that a default automatic income plan for DC savers at retirement is pot neutral: if individuals with less than £10,000 wish to enter into an automatic income plan, they should be able to, and this income plan should represent good value for them. However, such an outcome may prove acutely challenging for commercial providers if fixed-costs associated with providing such a plan make it difficult for providers to offer good value-for-money.

As such, in the context of potentially very low margins available for small pots, the government should **consider the creation of a statutory provider of automatic income plans operating with a public service obligation to accept all customers, no matter their pot size.**

Disregard small pots from Housing Benefit means tested benefits

As previous chapters explored, the Defined Capability research found that **15% of DC pension savers aged 55 to 64 rent**. Beyond retirement, 32% of the low-income DC retiree group rent.

The existence of DC retirees who rent poses a challenge for policymakers. In the context of means tested state support for rental costs (Housing Benefit), DC savers who rent and opt to cash-in their DC pension pots after April 2015 may be incentivized to spend/bequest their pension savings in order not to lose entitlement to means tested housing support. More widely, individuals who expect to rent in retirement will be directly dis-incentivised from pension saving if they believe it may be 'means tested away'.

Given the principal alternative is for individuals to take their DC pension pot as cash and spend or bequest it, the **government should disregard earmarked DC pension pots of £30,000 or less – the previous trivial commutation limit - from means testing for housing benefit, thereby giving individuals the option to place such money in ring-fenced financial products**. Although such a policy measure would put some DC pension savings beyond the means test for Housing Benefit, in the absence of such a measure, many DC savers are likely to do this anyway.

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