



Institute for  
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## Your flexible friend? DC pensions post Budget 2014

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Presentation at Strategic Society Centre event “The Future of DC Incomes: Annuities, drawdown and the default path”, London, 15 May 2014

# Outline

- How many will receive greater flexibility from the Budget changes? What are their characteristics? How wealthy are they?
  - draw on new analysis by Soumaya Keynes, Gemma Tetlow and myself published this afternoon (<http://www.ifs.org.uk/publications/7206>).
- Why might compulsory annuitisation be a good idea
  - moral hazard, myopia and adverse selection
- Should new flexibility lead to reform of how DC pensions are taxed?
- Conclusions

# How many will get greater flexibility?

- Many will receive greater flexibility as a result of Budget 2014
  - but many have no DC pension, could use “trivial commutation”, just have “small pots” or had a secure income from state and DB pensions of over £20k a year
- Use microdata on 55 to 59 year olds in England to look at who will get greater flexibility in the near-term
- We estimate that among this group
  - 60% do not have a DC pension
  - 9% could already use trivial commutation
  - 2% had a secure pension income (DB and state) of over £20k per year
  - remainder, 30%, would directly receive greater flexibility as a result of the Budget (this decomposes into 39% of men and 22% of women)



# Characteristics of those getting greater flexibility

- How these individuals respond to the greater flexibility will be the key to determining:
  - how markets will react
  - impact on individual incomes and welfare
- Looking at the 30% of 55 to 59 year olds estimated to receive greater flexibility as a result of the Budget, they are disproportionately
  - male (64% compared to 43% of 55 to 59 year olds not receiving greater flexibility)
  - high or middle levels of education (75% compared to 66%)
  - owner-occupiers (90% compared to 79%)
  - in excellent or very good health (58% compared to 46%) and likely to report a higher chance of surviving to ages 75 and 85

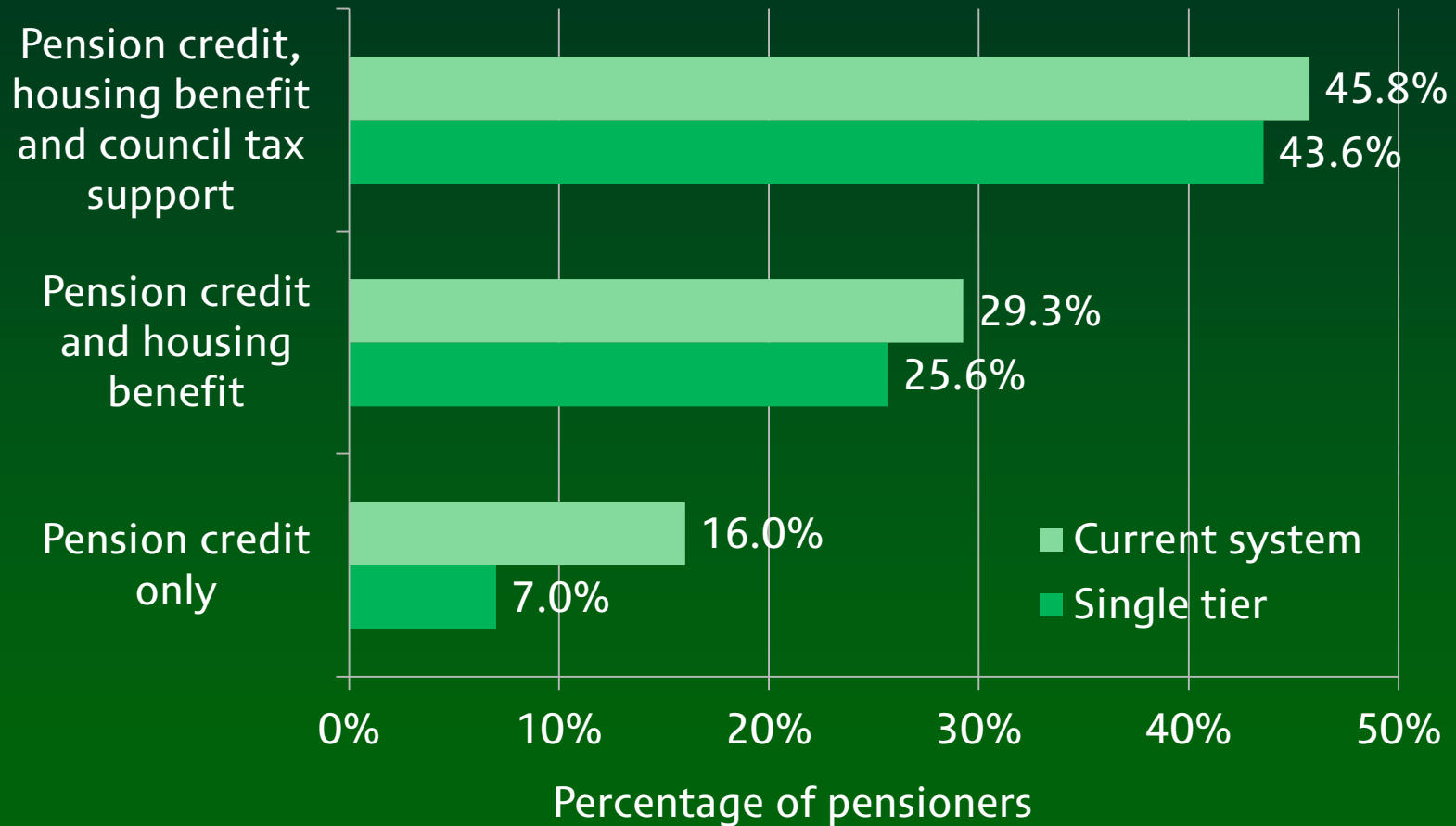
# Wealth of those getting greater flexibility

- Wide distribution of DC pension wealth
  - half have less than £55k, but 10% have more than £300k
- This wealth is only a small proportion of the average household portfolio
- Median total wealth for this group is £675k
- Mean household wealth of this group is £915k, comprising:
  - £290k in private pensions (of which £85k in DB schemes and £180k in DC schemes, £25k in pensions being drawn)
  - £80k in other financial assets
  - £240k in owner-occupied housing
  - £105k in other physical assets
  - future state pension entitlements worth £200k

# Moral hazard?

- Concern that individuals might exhaust their pension pots knowing they could receive means-tested benefits in retirement
- As Government points out those receiving a full single-tier pension not eligible for pension credit
  - but some will still have income below the full single-tier pension, or may be entitled to the disability component of pension credit
  - council tax benefit and, for renters, housing benefit also widespread

# Projected eligibility means-tested benefits in 2030



# Moral hazard?

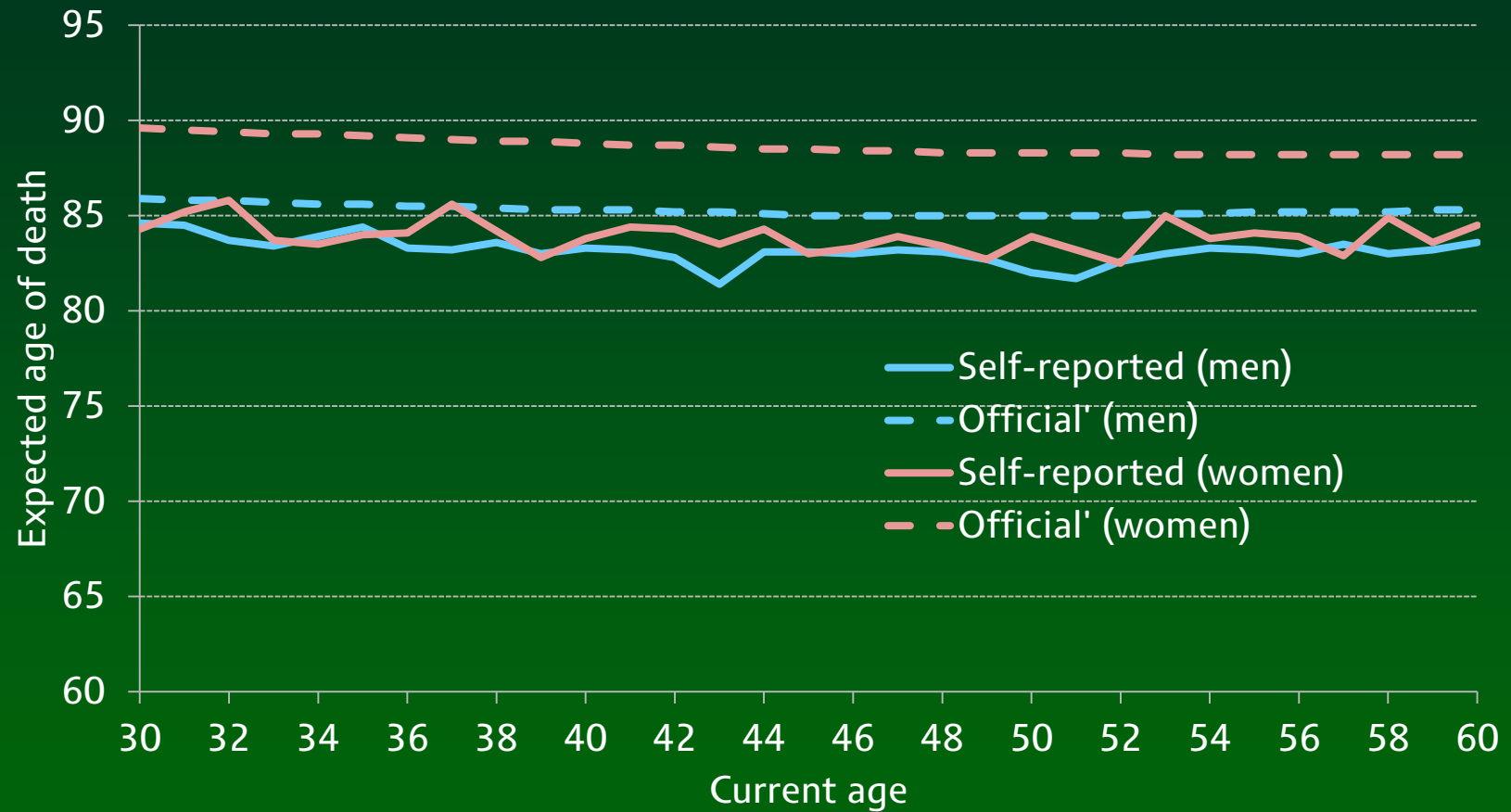
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  - but some will still have income below the full single-tier pension, or may be entitled to the disability component of pension credit
  - council tax benefit and, for renters, housing benefit also widespread
- But our estimates suggest that vast majority of those getting greater flexibility are owner-occupiers
  - so moral hazard problem might, at least in the near-term, not be too great



# Myopia?

- Possible concern that individuals might blow their pension pot
  - lack self-control?
  - men aged 50–60 on average underestimate cohort life expectancies by around 2 years, women by around 4 years

# On average life expectancy underestimated



# Myopia?

- Possible concern that individuals might blow their pension pot
  - lack self-control?
  - men aged 50–60 on average underestimate cohort life expectancies by around 2 years, women by around 4 years
- Understandable desire not to patronise people, but Government
  - is consulting on increasing minimum pension drawing age from 55
- Possible concern that some might be overly cautious in retirement
  - deposit account interest income far lower than annuity income
- Role of information, guidance and advice crucial
  - our estimates suggest that those getting greater flexibility in the near-term have higher levels of education and higher life expectancy
  - former might mean help make them appropriate decisions, but the latter makes the problem more difficult and the costs of a mistake greater

# Adverse selection?

- Those wanting to purchase a voluntary annuity might disproportionately be those who expect to live a long time
  - insurance companies respond by reducing annuity rates
  - demand falls to just those with very high expected longevity, with many priced out of annuity market
- Some getting greater flexibility are in poor health
  - these individuals could gain from not buying an annuity
  - but this would increase adverse selection pushing prices up for everyone else
- Government argues reforms will make annuities more attractive through enhancing competition and innovation
  - this might be correct, but much could have been achieved without ending compulsory annuitisation

# Should DC pension saving be tax-favoured?

- Currently private pension saving subsidised by the taxpayer
  - employer contributions escape employer and employee NICs
  - up to 25% of a pension pot (up to £312,500) can be taken entirely free of income tax
- When individuals are forced to purchase an annuity (or have restricted drawdown) a tax incentive might be needed to encourage pension saving
- Without restrictions on how DC pension saving is used why subsidise it?
  - case for subsidy certainly reduced

## Conclusions (1/3)

- **Question 1:** Will average retirement incomes of DC savers be higher or lower as a result of the Budget 2014 changes?
- Perhaps lower income, but greater wealth, is the most likely outcome
  - if individuals take on more investment risk then higher average incomes – but with greater variation in incomes – possible

## Conclusions (2/3)

- **Question 2:** ‘Default path’ – if automatic conversion of DC savings into an annuity remains the default option for retirees, will the Budget changes actually have any significant impact on individual outcomes? What should be the default path for DC retirees?
- At least in the near-term many not directly affected by the changes
- Good reasons remain for individuals to annuitise their wealth at retirement
  - bequest motives are the obvious exception
  - so annuitisation is perhaps the most appropriate default option for decumulation, and nudging individuals towards annuities could mitigate adverse selection problem

## Conclusions (3/3)

- **Question 3:** Financial capability - behind talk of ‘responsibility’ and ‘trusting individuals’, what does research suggest about the financial capability of the older population to optimise their retirement incomes? Do savers hold consistent attitudes toward annuities? Will optional, free financial ‘guidance’ for DC savers be adequate?
- Many individuals good at managing their finances
  - evidence suggests those likely to receive greater flexibility in the near-term are typically quite wealthy and highly educated
  - but also evidence that, on average, individuals underestimate their longevity and there is an explained drop in spending at retirement
- Challenge to help ensure appropriate decisions made at retirement
  - perhaps bigger challenge for those without annuities will be to make appropriate decisions once cognitive decline sets in

