



# **The Actuarial Profession**

making financial sense of the future

## consultation response

**THE RESPONSE OF THE ACTUARIAL PROFESSION TO  
THE SECOND REPORT OF THE PENSIONS COMMISSION  
*A NEW SETTLEMENT FOR THE TWENTY-FIRST CENTURY***

**PAPER 2: The Need for Decumulation Reform – A Response to the Pensions  
Commission Report from the Actuarial Profession**

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# THE RESPONSE OF THE ACTUARIAL PROFESSION TO THE SECOND REPORT OF THE PENSIONS COMMISSION

## PAPER 2

### **The Need for Decumulation Reform – A Response to the Pensions Commission Report from the Actuarial Profession**

*Decumulation – in pension terms this is the opposite of accumulation. It refers to the conversion of pension assets accumulated during working life into a pension income to be spent during retired life. The word “decumulation” is gaining widespread acceptance throughout the pensions industry.*

#### **1. Executive Summary**

1.1 A great deal of Government time has been devoted to Pensions Reform since Labour came to power in 1997, culminating in two reports from the Pensions Commission that was established by the Department for Work and Pensions under the chairmanship of Lord Turner of Ecchinswell.

1.2 But the overwhelming majority of all thoughts about saving for retirement have been concentrated on the accumulation period. The need for decumulation reform has been largely overlooked.

1.3 Yet the two are inextricably linked. Indeed, if we are to succeed in encouraging people to save more for retirement, then we must hold out the prospect of attractive options for spending their accumulated wealth. Creating this “pull”, in a marketing sense, is an essential component of deferred gratification, the very essence of the pensions industry. You defer the enjoyment of consumption today in exchange for the prospect of enjoying it later on.

1.4 This paper therefore highlights the need to extend the range of decumulation options available to ordinary consumers beyond today’s dominant annuity market.

1.5 Many pensioners could spend their money faster. The increasing numbers falling into inheritance tax liability are a clear pointer that people’s decumulation planning is poor. It is one of today’s financial tragedies that middle income people who have scrimped and saved through their working life, to build up assets to enjoy in retirement, often end up with so much left over that on death they have sailed past the £275,000 inheritance tax exemption and into the 40% tax bracket. Often they will become higher rate taxpayers for the first time in their life, at the very moment of death.

1.6 Much of this unused wealth may be property related. This paper looks briefly at Equity Release, but the concern is a holistic planning one. We need decumulation options that help people who would like to consume their hard won assets to do so, not to leave them left over at the end.

1.7 For the high net worth and mass affluent sectors, there is a thriving independent financial adviser community who can deliver this, given the right product set to choose

from. But cost constraints will limit the extent to which middle income consumers can make use of professional advisers.

1.8 So professional advice at key lifestyle moments needs to be supplemented with a greater degree of individuals taking self control. Exercising this control – itself part of the rights and responsibilities of modern citizenship – will require a greater degree of help and education. There will be a wide spectrum of organisations that can play a part in helping consumers to adopt an efficient decumulation strategy.

1.9 Government has two roles to play. Consumer education is a key part of consumer protection, and the Financial Services Authority has taken this to heart with its own programme of generic financial information.

1.10 But more importantly, Governments sometimes need to intervene in markets where supply or demand have become constrained. Long term longevity risk is one such example, and Government could help to lubricate the decumulation market through the issue of longevity bonds. This would transfer some longevity risk to the general population, but if it stimulates new market entrants and a wider range of decumulation options for consumers then it will have rendered the population a service.

1.11 The Actuarial Profession believes that decumulation reform is an essential component of the wider pensions reform model if people are to be encouraged to save more. With this in mind, the Actuarial Profession has identified the following six key tests for measuring the Government's proposed strategy in the decumulation arena :

- **Flexibility** – decumulation must be flexible to adapt to changing circumstances as pensioners move through retirement
- **Education and Understanding** – consumers need publicly available education and generic advice, so that they can identify their needs and choose from the available solutions
- **Control** – the choices should place consumers in real charge of their destiny, with no more than the minimum of restrictions required to protect the public purse against undue benefit claimants
- **Faster decumulation** – the system should allow and encourage pensioners to decumulate and spend faster than at present. If we are to persuade people to forego consumption today, then they need to see that they will be able to spend it in their retirement, not end up with large sums un-spent and 40% lost to inheritance tax
- **Be fun and exciting to operate** – engaging consumers in the management of their own decumulation strategy, as they take personal responsibility for their finances
- **Provide safety and security** – protecting potentially vulnerable pensioners from inadvertent financial disaster

## **2.0 Responding to the Pensions Commission's Proposals**

2.1 "Save more and work longer" was the outcome of two weighty reports from the Pensions Commission. And they include some very specific proposals for the shape of extra savings, in particular.

2.2 The big new idea, the National Pensions Savings Scheme is defined contribution in pure form. We save more during our working lives, accumulating the savings in a personal account that attracts interest and investment growth as it goes along. And when we reach retirement, we spend the accumulated pot of money on an annuity or some such vehicle. This spending phase is becoming more widely referred to as “decumulation”. And it is decumulation that this paper will concentrate on, not the accumulation period.

2.3 The Pensions Commission have gone for pure defined contribution, as opposed to any form of risk sharing between employer and employee – such as final salary or average salary schemes offer – as the neglected market of un-pensioned workers belong largely to small and medium sized employers, who are least well equipped to partake in the sharing of pension risk that larger employers have historically undertaken.

2.4 A corollary of pure defined contribution in the accumulation phase is that it leaves the decumulation phase totally unconstrained. On retirement, the new pensioner has a pot of money to spend, and can do so without any reference to the wishes or involvement of his or her former employers. The Actuarial Profession notes that this offers considerable scope for innovative product ideas in the decumulation market, and hopes that providers will rise to the creative challenge.

2.5 The other big decision that the Pensions Commission made on accumulation was to stop short of full compulsion, which was the question they were set in their original remit.

2.6 Instead the Pensions Commission proposes a modest level of “soft compulsion”. All employees will be auto-enrolled into pension schemes with a combined contribution from employer and employee of 8% of earnings between upper and lower limits. But they can opt out of this if would prefer not to save.

2.7 Furthermore, the Pensions Commission opines that the 8% will not provide adequate retirement income, and that individuals should be encouraged to make further pension contributions on a voluntary basis above this level.

2.8 So our system remains voluntary, albeit with a degree of inertia selling up to about half of people’s pension needs. Workers will be much more encouraged to defer consumption and save if they believe that an attractive range of decumulation options awaits them. And that they really will be able to spend it all in the end.

### **3.0 The Three Ages of Retirement**

3.1 When the Basic State Pension was introduced by Lloyd George in 1908 at the rate of five shillings a week, its recipients were only expected to live for an average of seven years. Today, it is not uncommon for pensioners to live three times as long as that.

3.2 Yet our most widely used decumulation vehicle, the annuity, pays a pre-determined and inflexible amount of income each year throughout the pensioner’s whole retirement. Changing needs are ignored, and retirement is treated as one period of life, whereas in reality there will be a number of significant lifestyle changes during this period.

3.3 It can be helpful to look the retirement duration as consisting of three ages:

### **The first age – Part Time Retirement**

- This is a transition period between full time work and retirement. The individual will have “retired” from his or her main career employment, perhaps voluntarily or perhaps through redundancy.
- Some of the “big ticket” expense items of earlier life may have been paid off, such as the mortgage or the cost of bringing up children.
- The body is not feeling as flexible or willing as it once did (this pensioner may well be double the age at which a professional footballer is regarded as past his best), and as a potential worker the economic contribution will be more from sage and wisdom than from youthful exuberance.
- So the pensioner is likely to take one or more part time jobs, which may be of a lower level of security and permanence than earlier in their career.
- The resulting income from employment will be both lower and more variable than was the case before retirement.
- If retirement income is to fill the gap between expenditure and part-time earnings, then it needs to be highly flexible – a decumulation vehicle with a “volume knob” so that income can be turned up or down according to need.

### **The second age – Full Time Retirement**

- Here the pensioner has finished work, and is dependent entirely upon the income from the decumulation vehicle to meet all his or her expenses.
- As the pensioner progresses through this period, it becomes increasingly obvious that there is no way back into paid employment and no way to generate any additional store of wealth beyond that already possessed.
- The decumulation vehicle is going to have to provide for all the remaining years of life, however many there may be. Otherwise the pensioner will have to throw himself or herself on the mercy of fellow citizens, and apply for one or more of the various forms of means tested poverty relief that are available.
- A curious phenomenon is that the majority of annuity purchasers choose a level annuity without any provision for future increases. The purchasing power of this annuity decreases in line with retail price inflation. Consumers are voting with their feet. Faced with a choice of a level or an increasing annuity, they choose the level one most of the time as this maximises their initial income.
- There is anecdotal evidence that pensioners reduce their spending as they get older. Intuitively, as the first flush of enthusiasm for new retirement activities fades, and as the body gets older and stiffer, the likelihood is that more time will be spent watching day time television – a particularly low cost activity as over 75’s even get a free TV licence!

### **The third age – Later years and care needs**

- Recent medical advances, particularly in cardiac and respiratory fields, have extended the later years of retirement. Doctors are often able to treat successfully patients with conditions that, say, twenty years ago would have resulted in death. But whilst life is extended, these patients may have a high level of dependency on others for their care needs, the essentials of daily living.
- There is a wide spectrum of care needs that pensioners will pass through during the third age of retirement. Initial help may be quite modest, like assistance with heavy gardening tasks or a bus journey where once the pensioner would have walked. As infirmity increases, there are a wide range of services that can keep the pensioner supported in their own home, some of which may be provided by immediate family or neighbours.
- Finally, for about one in six of the population, there will be residential long term care. The average stay in a residential nursing home is about three years. However, both the timing and extent of care provision are very uncertain.
- Looking at the three stages together, income needs during the first phase will be variable, but the second and third stages exhibit the classic “U” shaped curve of pensioner income requirements – initially falling as the original enthusiasm for new retirement activities fades into a comfortable routine, and then climbing again as outside help and assistance becomes progressively more necessary.
- With such variability over so many years, this is hardly a “one size fits all” situation, so there is clear scope for product innovation in the decumulation field.

#### **4.0 Scope for Innovation: Help with Financial Planning**

4.1 In a world where flexible decumulation products put customers in control of their financial destiny, a pre-requisite is going to be help with financial planning. For the relatively wealthy this is available today, and the Independent Financial Adviser community deliver a comprehensive advice service to the mass affluent, who can choose to pay for their advice through either commission on product sales or fees.

4.2 Extending help with financial planning to a wider audience will require a break from linking advice to product sales. New options could include mentoring in the workplace for those not yet fully retired, further education colleges, the Women’s Institute and alliances with social partners such as Age Concern or the Citizens’ Advice Bureau.

4.3 In some cases these bodies, by forming a network of retired persons, can secure leverage through negotiating with product providers. In other cases, they prefer to retain the integrity and independence of their advice by taking no part in the placing of business into the market.

4.4 The Financial Services Industry recognises that it can no longer provide the breadth of personal financial advice to middle and lower income groups that it did a generation ago – times have simply moved on. However, the creation of the Resolution Foundation illustrates the recognition that this advice is still valuable to its recipients, even if it is now commercially difficult to deliver. An impartial, not for profit organisation, the Resolution Foundation aims to develop a new national finance resource for the 8 million basic rate taxpayers currently without access to financial advice. Many of these will be pensioners who would benefit from advice and help with their decumulation strategy.

4.5 Government has a role to play here too. As well as encouraging generic information programmes, such as the FSA's naked cartoon characters, Government could harness the existing professional advice channels through the issue of vouchers, redeemable against the provision of independent financial advice, at the transition point between each of the three stages of retirement.

4.5 The aim of greater financial education is to help consumers to understand and manage the risks they face in their decumulation strategy. These risks include under or over estimating future expenditure needs, running out of money too soon, losing capital spent on annuity purchase through early death and having money left over at the end which they would rather have spent.

## **5.0 Low cost Income Drawdown**

5.1 Today's income drawdown product is designed for the high net worth customer. Professional advisers will not usually recommend it for clients with less than £1/4m, or even £1/2m. This is due to the risks involved and the requirement for ongoing advice throughout the duration of the product, which would be disproportionate for those with only modest assets. Can innovative thinking extend the benefits of income drawdown to an audience that cannot support the cost of regular reviews by an independent financial adviser?

5.2 The concept of income drawdown displays a strong fit with customer needs in the first age of retirement – it is the decumulation product with an adjustable volume knob. And the limits set down by HMRC (which from 6<sup>th</sup> April 2006 will set a maximum income of 120% of a comparable annuity) reduce the risk of the pensioner eroding funds much too quickly in the early years.

5.3 From an investment point of view, income drawdown offers a well balanced solution. It enables individuals who have built up a fund during the accumulation period in a widely diversified portfolio to maintain that diversification into the decumulation period.

5.4 That investment diversification is in stark contrast to annuitisation, where implicitly the pensioner's entire assets are invested into long dated gilts on the day of retirement, an enormous concentration of "all eggs in one basket" for the next twenty five years or longer in retirement.

5.5 Both existing Stakeholder Pension Schemes and the proposed National Pension Savings Scheme suffer from even greater concentration in this respect. Anticipating the moment of retirement and annuity purchase, both of these pension types require so called "lifestyle" investments. These are nothing at all to do with the customer's lifestyle, just a crude requirement to build up a concentration of fixed interest gilt investments

during the last five to ten years of working life. The period over which the customer is locked into low yielding Government Bonds and denied the potentially lucrative returns of actively managed investments is extended to the whole of their retirement plus some of their working life.

5.6 A low cost income drawdown product would replace the need for frequent monitoring by finance professionals with a greater degree of consumer education and a system of automatic triggers that would address ongoing changes. It could be analogous to the auto-pilot on a passenger aeroplane – the customer would take the controls at key moments of their lifecycle, but leave the system on automatic while they are in mid-flight.

5.7 The automatic triggers could include a system of gradual annuitisation, so eliminating market timing risk of a single point of annuity purchase.

## **6.0 Facilitating Earlier Expenditure of Accumulated Wealth**

6.1 It is a curious phenomenon that we apparently have a “pension crisis”, yet at the same time payments of inheritance tax are going through the roof. Today only 6% of estates are liable for inheritance tax, but research published in February 2006 by Scottish Widows shows that one in three households will be liable in future to pay the 40% tax, particularly in areas where house prices have risen fastest.

6.2 The message is clear – many pensioners are not spending their wealth as fast as they could.

6.3 In some cases this is a personal choice, the pensioner wishes to leave a large inheritance to their children or other beneficiaries, which increasingly include charitable causes. And in a free society, why shouldn't they?

6.4 But in many cases, it is a reflection of inefficient decumulation. These are assets that were accumulated during the working life, and in the case of lower and middle earners, spending and enjoyment were foregone in order to save prudently for retirement. It is no wonder that it is hard to get people to save for retirement, to forego consumption today, if the likely end result is that they will only get to spend some of the savings, with a large amount left unconsumed as a gift to those left behind.

6.5 The innovative solution will again be part education and part product.

6.6 Financial education will be needed to give people the confidence to manage their finances in a way which consumes capital faster than many do at present.

6.7 And the products must facilitate this. For example, comparing a level annuity in today's low inflation world with one from twenty years ago, we see that it starts at a lower level of pension and that the rate at which it is eroded by inflation is also lower. So why shouldn't an annuitant be able to borrow against his future annuity payments, to bring forward some of that later stream of income to the early retirement years when he or she will be fitter and better able to enjoy the consumption of wealth.

6.8 Many of the strictures that prevent pensioners from decumulating their assets at anything faster than a snail's pace have been instigated by Governments over the years.

The Treasury does have a legitimate concern – the taxpayer subsidises the accumulation of pension assets with generous tax deferment, and as a quid pro quo is keen to protect the public purse against benefit claims by impoverished later stage pensioners.

6.9 But when we have reached the point that 8.2 million households are facing an inheritance tax liability, perhaps it is time to relax the rules to allow faster decumulation. The State could be protected by insisting on just a modest level of annuitisation, and allowing pensioners much greater freedom with assets held above this level.

## **7.0 Equity Release**

7.1 Much of the wealth that will give rise to inheritance tax is domestic property, and equity release clearly has an important role to play in faster decumulation. This serves to underline the importance of holistic retirement planning, that takes into account all sources of wealth and income.

7.2 The total housing wealth of people aged 65 and over now stands at around £1.1 trillion. There is a strong correlation between housing wealth and pension wealth, and the fact that much of the nation's available housing wealth lies with pensioners who are already comfortably off explains the continued slow growth of the equity release market. But the Actuarial Profession estimates that there are 4.3 million pensioners living on what they consider to be inadequate income that are also homeowners. Equity release is a financial transaction not to be entered into lightly, but these pensioners do have a real opportunity to improve their lifestyle either through this method or by downsizing to a smaller property.

7.3 This paper will not delve in any further depth to the concept of equity release, as much has already been written on this subject, both by the Actuarial Profession and others.

7.4 However, the increasingly wide spread of retired wealth that is tied up in residential property, and the growth of the view that "my house is my pension" both point to a forthcoming cultural change that will install equity release as a core component of many people's decumulation strategy.

## **8.0 Can annuities solve the decumulation problem?**

8.1 Despite alternative decumulation vehicles being available in the market, annuities today remain the most widely used form of converting pension wealth into pension income.

8.2 Their unique feature is that they promise to keep on paying an inexhaustible stream of income, no matter how long the pensioner lives for. They will therefore continue to play a valuable role in providing a baseload of income, at least sufficient to meet the essentials of daily living.

8.3 However, once a baseload of income has been secured, pensioners may find other decumulation vehicles more attractive. This is especially so in today's market, where annuity rates are at historically low levels.

8.4 The need for reform is all the more urgent as the downward trend in annuity rates shows no signs of being reversed. Stable low interest rates are Government and Bank of England policy, and these feed through into low annuity rates. The seemingly unstoppable collapse of final salary schemes has driven trustees into higher proportions of fixed interest investments, and the competition to buy gilts has pushed their rates further down, and annuity rates with them. Technical changes to the financial reporting of life offices, implemented to improve consumer security, have also had a negative impact on annuity pricing.

8.5 So while annuities will continue to play an important and core role in decumulation, there is real scope for innovative thinking.

## **9.0 The need for further State intervention**

9.1 We live in a mixed economy, with some services supplied by the private sector and others by the State. In some areas, such as National Savings, the State operates in competition with the private sector.

9.2 It is difficult to make the case politically for further State intervention in areas where there is a thriving private sector marketplace. So the Pensions Commission rejected calls for the State to provide annuities, as there is a competitive market, easily accessible through the internet, telephone or specialist direct annuity brokers, which caters for even small pension funds.

9.3 Instead the Pensions Commission has recommended a major State intervention – the National Pension Savings Scheme – in the accumulation field, having identified what it believed to be a market difficulty, with pension providers struggling commercially to provide attractively costed pensions to employees in small and medium enterprises.

9.4 This should be the model for further State intervention – to seek out areas where the private sector is having difficulty. Two such areas are :

### **Longevity Reassurance**

- Annuity providers find it difficult to reinsure their long tail mortality risk, with the virtual absence of a secondary market in longevity risk. Were such a market to exist, it would increase the number of players in the primary market, driving down prices for consumers.
- A secondary market in longevity risk would also help employers struggling with final salary pension liabilities, and help to stem the current flood of scheme closures.
- This could be achieved through the issue of longevity bonds by the Government, which could either be used by reassurers to benchmark or hedge their risk, or stripped in the capital markets into component parts.
- It would be essential for these bonds to be of long term duration. It is the long term tail of longevity risk, and its uncertainty, that causes the market the

greatest difficulties. Indeed many of the difficulties could be solved if the Government only issued some form of bond or reinsurance for just the long tail.

- Longevity bonds would represent a transfer of risk from the insurance and pensions market to the general population. But the benefits that would flow to the population from freeing up the decumulation market would provide just reason for the Government underwriting this risk on their behalf.
- Given the extent that the current generation have already suffered the pain of unanticipated longevity increases damaging their pension expectations, there is now a strong case for Government to look again at the issue of longevity bonds.

### **Long Term Care**

- Insurance based long term care is another area where the private sector has struggled.
- There are essentially two difficulties for a long term care insurer – it is difficult to predict how many people will need care, and what the cost of each claim will be. The reason why these two important factors have remained actuarially imponderable is that they will both be determined by society in the future. It will be a largely social issue whether we leave the elderly infirm at home looked after by a network of willing friends and relatives, or whether we feel such people should be in a nursing home. Moreover, for those that do go into a home, it will be tomorrow's society that defines what an acceptable standard of nursing care is, and therefore how much it costs to deliver.
- A clearer commitment from the State on the provision of long term care would help pensioners to plan financially, and to manage their decumulation over their fit and active years.

## **Contact Point**

The submission has been produced by the Actuarial Profession as a response to the Pensions Commission 2<sup>nd</sup> Report, as a contribution to the National Pensions Debate and as input to Government policy in advance of the forthcoming Pensions White Paper.

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