Re-framing 'The Annuity Problem': Can we afford retirement?

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Abstract This paper seeks to widen the debate about the annuity problem, arguing that whether or not annuities offer a bad deal is not the crucial issue. No adequate solution for the gilt supply crisis (a key factor in determining annuity rates) is in sight, but nor is any present alternative means of drawing income in retirement likely to solve the problem, except for a few. As the trend towards DC pensions continues, a compulsory purchase annuity (CPA) purchased with the average DC fund comes nowhere near matching even the miserly basic state pension. Urging individuals alone to save more, when the vast majority have no hope of attaining anywhere near a 'full' pension, is often at best whistling in the wind. Substantial employer contributions are also required.

Keywords: *DC; annuity; gilts; drawdown; income; retirement*

Introduction

Much has been written over the past year on the so-called 'annuity problem'. In a nutshell, this generally refers to the halving of compulsory purchase annuity (CPA) rates since 1990, and the perception that CPAs are therefore a bad deal. This is arguable, but as this paper seeks to show, focusing too narrowly on the annuity problem and various proposed solutions has left a much wider and more serious problem largely unaddressed. A radical review of the long-standing obsessive insistence of successive governments on annuity purchase at retirement is necessary but not sufficient to avoid the coming crisis for retirement. We need to ask ourselves as a society, in all seriousness, can we afford to retire?

Early retirement

Annuity rates have fallen to the point where a DC fund of £30,000 (the average size of fund used to buy a CPA in 1999) buys a 65-year-old male a level, single life pension of around £2,600 pa (significantly less than the full basic state pension); a woman of the same age will get only £2,400. Of course, very few remain in work to age 65 these days. Only a generation ago 90 per cent of males between 55 and 65 were still in full-time employment. Rising expectations (by both employees and employers) of early retirement, fuelled by big DB scheme surpluses in the 1980s and 1990s, have left fewer than half the over-55s still in the workforce today.

Yet this period might well come to be seen as some kind of golden age for

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retirement. Voluntary early retirement, especially if on ill health terms as has been notoriously common in the (unfunded) police and fire service schemes, is simply no longer affordable on the same scale. Teachers, for example, are now expected to work on to their NPA (60). A typical 60-year-old male today has a life expectancy of 84. The Office of National Statistics expects that by 2030 the number of over-60s will have risen from 12m to 18m (30 per cent of the population). Years in work and years of retirement are approaching an equivalent number. For the increasing proportion of those leaving the workforce who are emerging from DC schemes (occupational and personal), retirement is a prospect to be feared.

Before considering this further, however, there are two questions to be answered. First, to what extent is it true that annuities at present are poor value for money? Secondly, to what extent would proposed alternatives meet future needs?

Annuities

Value for money?

There is a significant perceived cost in purchasing an annuity. Murthi, Orszag and Orszag¹ have shown that half to two-thirds of this — amounting to around 7 pence in the pound — is due to the higher-than-average longevity of the annuitant population, ie, adverse selection bias. (Life offices base their annuity rates on this rather than mortality of the general public, ie, they assume — correctly — that a 65-year-old purchaser of an annuity will live longer, and therefore cost more, than the average 65-year-old.) It is worth noting here that if DC (or DB) scheme membership was made obligatory, the annuitant population

would much more closely resemble the general population. Insurers would then be able to slash this cost in line with the reduction in adverse selection bias.² A further 3 to 5 pence in the pound covers administrative expenses, company profits and a contribution to reserves against future contingencies.

For a personal pension, relative to charges during the accumulation phase, these costs are low — between a third and a quarter. In general, Murthi *et al.* found that value for money declines with age (from this point of view, one widely advocated solution, viz. raising the compulsory annuitisation age from 75 to 80, generally might not be wise). They also found that indexed annuities are significantly poorer value for money than level annuities, costing a further 10 pence in the pound for an average 65-year-old man (ie, one facing general mortality risks, not the risk of the average annuitant). This is probably not the main reason why 90 per cent of annuitants choose a level annuity, though; most cannot afford to take the lower initial starting level of an indexed (or escalating) annuity. Finally, however, Murthi *et al.* were unable to discern any trend in the value for money of annuities since 1994.

The gilt supply problem

It is very hard to say, then, that the annuity providers are largely responsible for the precipitous fall in annuity rates over the past decade. Falling inflation means real rates are probably at least as good as a few years ago. Although as Murthi *et al.* observe, providers are not overly quick to adjust annuity rates as interest rates change, there is a close correlation (and hence also with inflation). Interest rates in turn are linked to long-term gilt yields, which have fallen to a 30-year low (below 5 per

cent nominal) as a result of high demand for gilts.

This is unlikely to diminish in the foreseeable future, so long as the present MFR basis remains unchanged. Set down in legislation, this includes 100 per cent investment in UK equities for all members more than ten years away from NRD and a straight-line movement to gilts thereafter (90 per cent in UK 15-year fixed interest stocks 1 year before NRD). Introduction of the MFR has significantly increased demand for long-dated gilts. Application of the MFR has been particularly ironic, both as a measure for protection of pensions which has indirectly lowered them, and for the effect it has on DC scheme members who do not even benefit from the limited protection it confers on DB scheme pensions.

Pressure on the gilts supply also stems from the requirement for all occupational pension benefits accrued in respect of service post-5.4.97 (and all annuities purchased with post-5.4.97 protected rights personal pension funds) to carry Limited Price Indexation (LPI). Annuity providers need index-linked gilts to back the LPI annuities. The Government has now recognised the problem and, after consultation with the industry in February 2000, decided to allow non-protected rights funds subject to the LPI requirement to be used to purchase with-profits or unit-linked annuities instead. In common with other partial solutions suggested for the 'annuity problem' (see below), however, this option is likely to be practicable only for members with larger-than-average funds, because of the need for advice and the additional risks involved. It might be more sensible to abandon the LPI requirement altogether, at least for non-protected rights under DC occupational schemes (non-protected rights under personal pensions already

have this freedom).

The gilt supply problem will get worse with the arrival of the State Second Pension. Since all those earning over £9,500 will be expected to contract out sooner or later, there will be a surge in demand for index-linked gilts to match the LPI requirement. This will further depress gilt yields and therefore annuity rates will fall again.

The prospect for future pensioners might not be quite so depressing if the Government could respond appropriately to the increasing demand for gilts.

Instead, the Chancellor's plan to run budget surpluses effectively eliminates the need for new gilt issues (as there will be no public sector borrowing requirement). Already, in 1999, the estimated £6.5bn purchase price of annuities exceeded medium/long-term gilt issues.

Government attempts to increase the supply have been described by one industry spokesman as 'rearranging deckchairs on the Titanic' (David Hart, NAPF economics adviser).³ This is the nub of the problem.

In any case, the Government's scope for action is constrained by the Maastricht Treaty, under which the PSBR must not exceed 3 per cent of GDP and the National Debt cannot be more than 60 per cent of GDP. On the other hand, under EU legislation, UK insurers must hold reserves of at least 104 per cent of expected liabilities, as well as satisfying other solvency and resiliency tests. To match their annuity liabilities, insurers are competing for a diminishing supply of gilts, forcing yields down. Thus the otherwise laudable goal of a balanced budget is detrimental to annuity rates. Corporate bonds are a (slightly riskier) alternative, but the supply is still small and accounts for only about 1 per cent of pension fund assets. Long-term gilt yields remain the benchmark, but the need for alternatives is urgent.

Alternatives to conventional annuities

Investment-linked annuities

What about the alternatives? The annuity market has developed dramatically in the past year, with many new providers of unit-linked and more especially with-profits annuities entering. With one or two exceptions, these require the purchaser to nominate an anticipated bonus rate (ABR) or growth level between 0 and 5 or 6 per cent. The higher the rate chosen, the higher the initial income — but the greater the risk that the next year's income will be less because the actual bonus/growth level has failed to match the level anticipated. The ABR cannot be changed once chosen — the purchaser is locked in for life, as with a conventional annuity.

As usual, there is a link between risk and reward: these investment-linked annuities are inherently riskier than conventional annuities, but because they offer exposure to the stock market they have the potential to increase. Generally considered inappropriate for people with funds of less than about £50,000 (some say £100,000), because of the volatility and increased advice and administration costs, they are thus by definition not a solution for the average retiree who at present has only £30,000. With-profit and unit-linked annuities cannot, because of their nature, be used for funds carrying an LPI requirement (a small but inexorably growing market).

Income drawdown

For most people, income drawdown⁴ is even less appropriate; few competent advisers would be prepared to recommend it for funds below £100,000 (some suggest as much as £250–300,000 should be the minimum); the average drawdown fund in 1999 was £120,000,

four times the average fund used to buy a CPA.² If — as in most cases — the maximum drawdown amount is chosen and we assume a starting age of 65, an investment return of 9.5 per cent net of inflation and charges will be needed just to give a 75 per cent probability of breaking even at the latest date of annuitisation permitted (age 75)² — quite a daunting target, especially considering the average inflation rate over the past 100 years has been 6 per cent.

The reason for this is 'mortality drag'. Conventional annuities benefit from cross-subsidisation — in a given age cohort, those who live longer benefit from the early deaths of others — whereas the drawdown client is on his or her own. It is for this reason that the most propitious date for annuitisation is sometimes put at 68. It also shows why raising the latest annuitisation date, for example to age 80 as some industry voices have strongly advocated, would benefit only individuals wealthy enough to take a considerable risk. In fact, the average age for annuity purchase in 1999 was 63 for males and 61.6 for females.²

Others advocate redefining the drawdown limits, which are presently set at 35 and 100 per cent of the maximum conventional annuity. A more useful idea in terms of broadening the market would be to base the maximum on life expectancy, not annuity rates, thus removing the link with current interest rates.

The Irish innovation

Much interest has centred on new arrangements introduced last year in the Republic of Ireland for individual (not occupational) pensions. These confer much more flexibility, with the option either to take 25 per cent cash and invest the balance in an 'approved minimum retirement fund' (AMRF) or

in an 'approved retirement fund' (ARF); or to withdraw all the capital; or to take 25 per cent cash and buy an annuity with the balance. Under either of the first two options, however, unless the individual already has a guaranteed pension or annuity of at least £10,000, or is over 75, the balance of the fund up to at least £50,000 must be invested in an AMRF, with the capital inaccessible until age 75. For UK DC pension fund members, whose fund is typically much less than £50,000, in general this approach does not seem to have much new to offer.

Minimum Retirement Income (MRI)

However, a similar idea recently proposed by the Retirement Income Working Party² would have broader appeal. The obligation to purchase an annuity, it said, should be limited to the extent needed to maintain total income above state support for the rest of the individual's life. The proposed 'minimum retirement income' (£140 pw, to start with) would be equivalent to a full basic state pension (BSP) and maximum SERPS entitlement for an individual on National Average Earnings. Inability to meet this target — after deduction of 25 per cent tax-free cash — from BSP, SERPS and other pensions, would require the individual to purchase an index-linked annuity to make up the shortfall. As an example, a 65-year-old man with a full basic pension but no SERPS would need a fund of about £55,000 to buy the necessary annuity. A woman of the same age, as ever, fares worse, needing £62,000. The Working Party proposes that there should be much greater freedom in the application of any fund remaining. The MRI proposal would offer more flexibility in retirement for a larger proportion of retirees than drawdown, but still only for about a

quarter. The problem remains for most of those with an average fund of only £30,000.

Other proposals

More radical suggestions have included allowing fixed-term annuities as opposed to life annuities; capital-protected annuities (which would, on death, return the excess of the purchase price over payments received by the annuitant); permitting switches (eg, from level to index-linked annuity, during retirement); abolishing the requirement that annuities must be non-commutable; and abolishing the requirement to buy an annuity altogether. These proposals all tend to fall foul of the oft-repeated insistence of government that any alternative must provide a guaranteed income for life (and not be designed to bequeath capital), and as with the argument for raising the latest vesting date to age 80, tend to come from the wealthier end of the market. On the other hand, they are founded on the justifiable belief that inflation and interest rates, although at the moment historically very low, are almost certain to rise and could easily double (or more) over the next 20–25 years: the buyers of annuities today will thus be locked in when inflation takes off again.

The market is evidently capable of satisfying both the Revenue and individuals with a fund of (say) £100,000 plus who wish to retire. However, the failure of the two sides to reach a mutual accommodation so far is not the real problem facing today's working population. A rapidly growing proportion are each year arriving at the point where their income from employment (or self-employment) ceases more or less abruptly. The question is not so much how should the replacement income be provided, as whether it can be provided at all.

The Minimum Income Guarantee (MRG)

Introduction of the Minimum Income Guarantee (MIG) ironically has compounded the problem. For 2000/01, the MIG for a single pensioner is £78.45 pw (£121.95 for a couple), with full entitlement if savings are below £3,000 and tapering to zero when capital reaches £8,000 (from 6th April, 2001, these limits are to be raised to £6,000 and £12,000). The MIG is delivered via Income Support on top of the Basic State Pension (BSP) and as with BSP prior to 1983, the Government is committed to raising it in line with earnings rather than prices. A pensioner couple today where the man is aged 65 and the woman 62 (and entitled to a full BSP) would require a DC fund of at least £12,500 to buy a joint life annuity to top up their BSP just to match the MIG — and that annuity would only be indexed to prices. This disincentive to save — a major threat to the success of the Government's flagship Stakeholder initiative with its target population — has very recently been acknowledged with a low-key Government mention of forthcoming consultation on a 'Pensioners' Credit' to reward work and saving.⁵ It remains to be seen whether this circle can be squared.

Contributions to DC schemes

Employee

It is abundantly clear that reliance on a DC pension fund of £30,000 to supplement state pensions for perhaps 30 years of retirement is a prescription for poverty. Everyone in the industry knows this, of course. Urging the individual to increase contributions, however, is often at best whistling in the wind. The Faculty and Institute of Actuaries, for example, recently noted⁶ that

30-year-olds who pay as much as 10 per cent of their salary for 30 years — enough to produce a two-thirds pension for a recent retiree — can expect to replace only 24 per cent of their salary on retirement at 60. To expect even the minority of 30-year-old DC scheme members who are aware of this somehow to find enough disposable income even to double this is hopelessly unrealistic. Blake and Hudson² show that to achieve a unisex pension of two-thirds of National Average Earnings in 2040 is likely to require a staggering £3,600 pa for 40 years: 18 per cent of NAE in 2000. Even this is based on a deterministic model (ie, fixed assumptions); on a more realistic stochastic projection, just to secure a 90 per cent chance of reaching this level might require over £8,800 pa (44 per cent of NAE in 2000). For the vast majority of individuals, the money simply is not there.

Employer

The drift to DC — certain to be enlarged by the arrival of Stakeholder and the new DC regime — is not inherently bad, though the psychological security of the final salary promise should not be underestimated. Very often, however, a switch from DB to DC is accompanied by a lessening of employer commitment to pensions. The minimum, indeed, is just 10 per cent of the total contributions, which may include those necessary to cover the cost of administering the obligatory AVC facility.⁷

Compulsion

Even this is not the real problem. One of the most-frequently advocated 'solutions' is 'compulsion'. A previous Minister for Pensions pleaded for

clarification of what proponents meant by this, with reason. It usually refers, of course, to reintroducing the right (abolished in 1988) of an employer sponsoring an occupational pension scheme to make employee membership obligatory (Government failure to make stakeholder scheme membership compulsory is often bewailed as a hole below the waterline). What is almost invariably not meant is making it obligatory for employers to contribute to a pension fund for every employee.

Conclusion

Politically incorrect it may be, but this is, in this author's opinion, essential if future generations are to have a hope of 'enjoying' retirement. The Australian Government recognised this in 1992 and require a contribution of 7 per cent of salary from employers (rising to 9 per cent by 2002/3). Already by 1995, 95 per cent of full-time workers and 74 per cent of part-timers were covered. Various deficiencies in the Australian system might disqualify it from serious consideration as a model for other countries to copy;⁸ it is also true that these employer contributions can be at least partially at the expense of wage rises. The fact remains, however, that only if pension contributions are deducted from pay at source and supplemented by substantial employer contributions — matching on at least a

two-for-one basis — are realistic funding levels ever likely to be approached: for the vast majority of individuals, and for the foreseeable future.

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