

“The UK market is unique when it comes to DC policy saving challenges” says the Pensions Policy Institute

A new report published today by The Pensions Policy Institute (PPI) has found that the UK pension system has unique characteristics which set it apart from those in other nations, and which will influence its evolution.

The report, *“How might the UK pensions landscape evolve to support more flexible retirements?”* is based on evidence from four countries - Australia, Ireland, New Zealand and the United States - and considers how the UK pensions and retirement income landscape might evolve in the context of the new Budget freedoms.

Factors present in the UK, such as tiered tax rates, mean that it may be advantageous for UK Defined Contribution (DC) savers to convert their savings to a regular income or to withdraw their pensions gradually over the course of their retirement.

The low level of the UK state pension suggests that, relative to other countries, individuals will typically require another source of income in retirement and the absence of healthcare costs in later life in the UK may remove one of the barriers to conversion of pension savings into a regular income during retirement.

The UK policy/regulatory landscape is moving in opposite directions to Australia and the US, with some significant governance gaps emerging.

The report was sponsored by The Investment Association and The People’s Pension.

Commenting on the research, PPI Director Chris Curry said

“While the behaviour of DC savers overseas, where drawdown products have frequently been popular, can provide some insight into the direction of travel of the UK, there are significant differences that may have an impact on its response to pension flexibilities. Differences between the UK and the US, in particular, mean that some of the barriers to annuitisation in the US are absent in the UK.”

“The findings from the research are encouraging in that the UK pensions industry as a whole has an understanding of various types of risk and a sophisticated market has developed here for, in particular, underwritten annuities. The challenge for the industry will be around the identification of effective default glide-paths where it can no longer be assumed that individuals purchase an annuity.

So far, the focus of regulation in the UK has been the introduction of a standards regime to ensure the quality and consistency of guidance. This contrasts with countries, such

as Australia, which are now considering the introduction of rules to ensure defaults that manage longevity risk. It is possible that further steps will be considered in the UK that 'nudge' individuals towards decisions that ensure they have a regular income stream over the course of their retirement."

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Notes for editors

1. The Pensions Policy Institute (PPI) is an educational research charity, which provides non-political, independent comment and analysis on policy on pensions and retirement income provision in the UK. Its aim is to improve the information and understanding about pensions policy and retirement income provision through research and analysis, discussion and publication. Further information on the PPI is available on our website www.pensionspolicyinstitute.org.uk.
2. The Investment Association represents UK investment managers. It has over 200 members who manage more than £5 trillion for clients around the world, helping them to achieve their financial goals. Its aim is to make investment better for clients, companies and the economy so that everyone prospers. More information can be viewed at www.theinvestmentassociation.org.
3. The People's Pension is the largest private sector mastertrust (multi-employer pension scheme) in the UK, with more than 1.2 million members and 4,700 employers signed up. Run by **B&CE**, a not for profit company, it offers a simple and low cost automatic enrolment workplace pension solution for employers of any size from any sector.
www.thepeoplespension.co.uk <http://www.bandce.co.uk/>
[@peoplespension](https://twitter.com/peoplespension)

4. “How might the UK pensions landscape evolve to support more flexible retirements?” is a report sponsored by The Investment Association and The People’s Pension, and part of the PPI’s Transitions to Retirement research series. The first major report, published in November 2014, focused on the complexity of decisions DC savers face at retirement. The first stage of the third report published in January 2015 explored effective defaults for DC savers moving into retirement (second stage is due for publication in summer 2015). The Transitions to Retirement research series should serve as a timely, invaluable and independent assessment of how well equipped the UK pensions landscape is to support good member outcomes in retirement. The series as a whole is being sponsored by a consortium: Age UK, Fidelity Worldwide Investment, The Investment Association, Partnership, The Pensions Advisory Service, The Pensions Regulator, The People’s Pension, and State Street Global Advisors.

Executive summary

How might the UK pensions landscape evolve to support more flexible retirements?, is part of the PPI's Transitions to Retirement series exploring how people access pension savings.

This report builds on the findings of previous reports and, using evidence from four countries, Australia, Ireland, New Zealand and the United States (US), considers how the UK pension and retirement income system might evolve in the context of changes in the retirement landscape. In particular, this report considers the impact of the new flexibilities introduced from April 2015.

Different pension systems include different components, such as the state pension, means-tested benefits and health or social care costs, as well as differences in the tax treatment of pensions. Direct comparisons with other countries in terms of how individuals would rationally withdraw their Defined Contribution (DC) pensions are imprecise but suggest some possibilities for the UK

- The low level of the UK State Pension suggests that, relative to other countries, individuals will typically require another source of income in retirement.
- The absence of healthcare costs in later life in the UK may remove one of the barriers to conversion of pension savings to a regular income during retirement.
- Compared to Australia and New Zealand and, in some cases, the US, withdrawals from UK DC pensions are subject to tax. In broad terms, tiered tax rates in the UK mean that it is likely to be advantageous for many individuals to withdraw their pensions gradually over a number of years in order to avoid incurring a higher marginal rate of tax.

The behaviour of DC savers overseas can provide some insight around the direction of travel in the UK

- Annuities are available in the US and Australia, but are not popular. Barriers to annuity purchase include levels of pre-annuitised wealth, regulatory frameworks and bequest motives. Lack of availability of annuities may also perpetuate their lack of popularity. There are also behavioural factors, such as loss aversion.
- Drawdown products are popular in the countries under consideration; in Ireland it has been noted that where individuals have the option of using drawdown products rather than purchasing an annuity they do so. However, the Irish system remains focused on preventing people from running out of money. As individuals have to receive guaranteed income of €12,700 from other sources in order to use drawdown products rather than annuities, annuities in Ireland are now aimed at individuals with smaller retirement funds.
- Use of drawdown products without any longevity insurance can lead to individuals drawing down their resources too slowly or too quickly, in

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Australia, 25% of people aged 55 deplete their balances by the age of 70.¹ These individuals were more likely to have lower levels of private saving and to have experienced the onset of a disability, suggesting that they may exhaust their savings partly because their costs are higher than average and their savings are lower.²

- 'Rules of thumb' such as the 4% rule around the rate of withdrawal have evolved in the US.³ However, it appears that, many retirees do not stick to a particular level of withdrawal per year, instead they monitor their portfolio and change their withdrawals in line with changes to the market and their needs.⁴
- The use of pension pots to repay debt has been observed in other countries. It has been reported that, of the 50% of individuals who opt for a lump sum in Australia, 32% use it to pay off housing costs, to purchase a home or to make home improvements and 12% used it to pay off other debts.⁵ The relatively high rates of personal debt in the UK suggest that using DC savings to pay off personal debt may be popular; however, individuals should be aware of how these withdrawals will be taxed.

However, the UK regulatory landscape is evolving. Compared to Australia, in particular, the UK appears to be moving in the opposite direction.

- Prior to April 2015, the decumulation phase was strictly regulated relative to the US and Australia, with the majority of DC savers effectively required to purchase an annuity. However, the absence of minimum withdrawals and rules around governance of and defaults during the decumulation phase from April 2015 means that the position has reversed so that the decumulation phase is regulated to a lesser extent than in both Australia and the US. Similarly, in the UK, the decumulation phase is moving in the opposite direction to the accumulation phase, which has become more regulated due to the introduction of automatic enrolment.
- In terms of the management of longevity risk, Australia and the UK appear to be moving in very different directions in the current policy/regulatory debate. The Australian Financial System Inquiry report (Murray Review) has proposed default income products for all superannuation funds. In contrast, the UK Government has argued that there should be no explicit defaults offered to retirees.
- If the proposed guidance system (Pension Wise) and second line of defence prove to be inadequate there is the risk that individuals will access unsuitable retirement products or access their pension savings rapidly and become liable for a higher rate of tax than anticipated.

¹ Murray, D. (2014)

² Social Policy Institute (2013)

³ Vanguard (2012)

⁴ Vanguard (2012)

⁵ Challenger (2012)

In some respects, the UK DC market has significant differences from overseas markets. These may impact on its response to pension flexibilities from April 2015.

- The UK pensions industry has a sophisticated understanding of the various types of risk, including longevity and market risk, and has the infrastructure to offer investment and risk pooling strategies in a more challenging environment.
- While some UK asset managers and pension providers have made alterations to their default asset mix in response to the new flexibilities, there is currently no single approach or default, although there are likely to be more changes once the pension freedoms have bedded down.
- Differences between the UK and the US, in particular, mean that some of the barriers to annuitisation are absent in the UK:
 - Annuities are widely available in the UK.
 - Individuals and organisations are used to framing retirement decisions in terms of the purchasing power of a regular income rather than investment returns or the possibility of losing their whole pension pot on death where they have annuitised it. It has been suggested that where retirement decisions are framed in this way, individuals are more likely to annuitise.
 - A sophisticated market has developed, including a market for underwritten annuities, that takes into account lifestyle and health conditions, suggesting that individuals may be more likely to find an annuity that meets their needs.
 - The UK regulatory framework does not discourage annuitisation.

The new pension flexibilities will radically change decumulation in the UK DC market. International examples suggest areas where challenges may arise and some possible remedies for the UK Government and pensions industry.

- The focus of regulation in the UK has been the introduction of a standards regime to ensure the quality and consistency of guidance. This includes Pension Wise, to provide free, face-to-face or telephone based guidance for individuals approaching retirement and the FCA's 'second line of defence' rules.
- Other liberal regimes have gone further, for example Australia is now considering rules to ensure retirement defaults for members with some provision for managing longevity risk. It is possible that further steps will be considered in the UK to 'nudge' individuals towards decisions that ensure they have a regular income stream over the course of their retirement.
- International experiences show that governments have a wide range of options to promote better outcomes. Depending on how the UK DC market evolves, the UK Government will have access to various levers, as follows:
 - Changes to the State Pension
 - Tax changes
 - Regulation (e.g. minimum drawdown amounts)
 - DC governance placing requirements on trustees, employers or providers
 - Financial product sales regulation
 - Guidance or advice