Cass Business School
CITY UNIVERSITY LONDON

Pensions Institute

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Leading Academics Set to Quantify Consequences of Annuity Reform in Major Two-Part Study

Pensions Institute report highlights some of the consequences of the Government's proposal, setting out the issues that need further examination to ensure policy reform goes in the right direction.

The Coalition Government's proposal to end the requirement for pension scheme members to purchase annuities by the age of 75 represents a watershed for retirement income savings in the UK and an opportunity to introduce greater flexibility into the system. Such radical reform is not without potential risks and could have serious consequences for the security of pensioners' retirement incomes and the public finances, according to a new study from three of the UK's leading academic on the subject

The preliminary research from the Pensions Institute at Cass Business School, London, and sponsored by Prudential, looks at the likely effects and consequences of this policy change on both individuals and the taxpayer. The authors of the report - Professor David Blake, Director of the Pensions Institute, Dr Edmund Canon and Professor Ian Tonks – are widely recognised as the UK's foremost authorities on the subject of annuitisation. They intend to spend the summer months carrying out in-depth quantitative analysis of the proposed reform of the UK's Annuity system, the results of which will be published in an analytical report in September 2010.

This study will produce a detailed analysis of the all the options for policy reform and provide the evidence base to support change.

The preliminary findings of this two-part study, published today, agree with the need to change the current rules but highlight two areas of risk arising from significantly more flexibility in the use pension funds. First, individuals with low levels of financial literacy and understanding of longevity risk may make poor investment decisions and find their retirement assets being run down too quickly, thus making them entitled to means-tested benefits. The consequences of this for the taxpayer would be an increase in claims for means-tested benefits, demands from public sector defined benefit scheme members for lump sum (rather than income) payments, the creation of tax loopholes and a reduction in the demand for long-term government bonds.

The authors argue that annuities have an important role to play in pension provision, and the advantages of compulsory annuitisation, which far outweigh the disadvantages, must be incorporated into any reforms that emerge, not least as they protect individuals against depleting their resources during their lifetime. The major advantages are:

- It avoids selection effects
- It has lower administrative costs than in voluntary annuity markets
- It avoids moral hazard problems
- It is the *quid pro quo* for tax relief on pension saving
- It prevents the pension system being used for tax avoidance

Professor David Blake comments: "The financial strains on the public purse are likely to occur at a time when the UK government is trying to shrink the deficit. The government's proposal of a minimum annuity purchase will only succeed if certain factors are tackled soon, such as determining what the minimum income requirement is, taking into account the wide differences in individual circumstances, and creating the right annuity products to minimise means-tested benefit claims."

The authors of the report believe that this proposal could lead to major changes in the UK's savings decisions and tax payments, also encouraging members of occupational pension plans to access their funds as a lump sum.

Professsor Blake commented: “This would turn the current steady decline in defined-benefit plans into a rout, as pension fund sponsors would have to find the cash immediately rather than in much smaller amounts over a long period of time in the future.”

Barry O’ Dwyer, Deputy Chief Executive, Prudential UK said: "We welcome the new Government’s intention to update the rules on retirement income and believe reform can be a win-win for consumers and the Government, but it's fraught with risk. The new report from the Pensions Institute sets out the issues that need further examination to ensure policy reform goes in the right direction. Over the summer, while many of us are enjoying our holidays, the team of leading academics assembled by the Pensions Institute will be hard at work on the detailed analysis of policy options to ensure the debate is a well-informed one."

The report which is entitled ‘Ending compulsory annuitisation: What are the consequences?’ is available at http://pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences.pdf

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Notes to editors

‘Ending compulsory annuitisation: What are the consequences?’ is designed to stimulate the debate about the proposal to end the mandatory requirement to purchase annuities in pension schemes as formally announced in the Budget Statement on 22 June 2010 and subsequently expanded upon in the HM Treasury consultation document ‘Removing the requirement to annuitise by age 75’ released on 15 July 2010.

A second report ‘Ending compulsory annuitisation: Quantifying the consequences?’ to be published in late August will provide quantitative assessments of the following: (i) the size of the minimum income requirement (MIR) and the feasibility of annuities which are index-linked or have a wage-growth linkage; (ii) the likely effects of the MIR on the range of pensioners who will be affected by the proposal; (iii) the impact of the proposal on defined benefit schemes and long-term government bond markets; and (iv) the cognitive problems that elderly people can face when dealing with investments.

The Pensions Institute’s mission is to undertake high quality research in all fields related to pensions, to communicate the results of that research to both the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert advice to the pensions industry and to government.

Established in 1996, the Pensions Institute was one of the world’s first academic research centres to focus entirely on pensions. It is also one of the first to take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance and actuarial science, through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions. The Pensions Institute unites some of the world’s leading experts in these fields with a view to resolving many of the problems caused by the disparate elements making up the pensions mix.

The Pensions Institute has been at Cass Business School since 2004.

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