NAPF
Securing the future of pensions

Removing the requirement to annuitise by age 75

The NAPF response to HM Treasury's consultation, September 2010

Executive Summary

- The NAPF recognises the need to find more innovative and flexible ways to encourage saving. We believe that the Government's primary concern should be on reforming the annuities market so that it can meet the needs of the majority of savers and annuitants.
- We support the retention of the 25% tax free lump sum and the EET principle of pensions taxation. These act as important incentives for individuals to save in pensions.
- The Government's proposal to introduce a blanket 55% tax recovery charge is welcome in principle. Individuals should be encouraged to use their pension income in retirement but the Government must acknowledge that the majority of people receive only basic rate tax relief on pension contributions.
- The Government should consider lowering the limit for capped drawdown to 100% of the value of an equivalent annuity, taking into account the needs of individuals with impaired life expectancies.
- The Minimum Income Requirement (MIR) should be set around £16,000, as individuals with capital above this level are usually ineligible for benefits such as Housing Benefit and Council Tax benefit.
- The Government must recognise the challenge these proposals pose for the provision of information and advice. Many people often turn to their employers for information on pensions. The Government should provide guidance for employers regarding the changes around annuitisation and give employers assurance that won't be held liable for providing information.

Introduction

1. **The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential serves to the pensions sector.**

2. The NAPF and its members recognise the changing face of pension provision in the UK and the need to find more innovative and flexible ways to encourage individuals to save for their own retirement. The debate around the need for compulsory annuitisation has spanned many years and we welcome the opportunity to respond to this consultation. However, we believe that the

Government should focus its attention on introducing more flexibility into the annuities market so that it meets the needs of savers. Retirement income products need to be able to respond to the needs of savers in light of recent trends in working longer, increasing longevity and changing work patterns, but this could be addressed through more innovative and flexible annuity products. There may also be a case for increasing the age at which an annuity must be purchased to 80, considering increases in longevity and the rising State Pension Age.

3. The need to encourage individuals to save for their own retirement stems from the fact that many people simply are not saving enough, or at all. Earlier this year, the NAPF proposed a series of reforms to the UK pension system to encourage individuals to save for their retirement in the report *Fit for the Future: NAPF's Vision for Pensions*. The introduction of a single Foundation Pension set at £8,000 a year along with innovations in workplace pensions would significantly increase the size of individuals' pension pots and would provide a powerful incentive to individuals by ensuring that it pays to save for their own retirement.

4. For the vast majority of individuals, purchasing an annuity will still be the best option. According to a 2009 DWP report, over 76% of all annuities were purchased with funds of less than £20,000 and 67% were purchased by individuals under the age of 65.[1] In contrast, the average pension fund moved into income drawdown last year was £52,000.[2] The same DWP report found that people do not have a reasonable understanding of pensions, especially when it comes to investments and decumulation. Research conducted by the NAPF suggests that individuals actually prefer regular, guaranteed income retirement. Instead of removing the requirement to annuitise at age 75, the Government should focus its attention on achieving more flexibility within the annuity market to suit the needs and spending habits of individuals. Products like stepped or variable annuities, temporary annuities and flexible lifetime annuities are already developing and should be encouraged.

5. We are pleased that the Government has committed to retaining the Exempt-Exempt-Taxed ("EET") principle for pensions taxation, as well as the Pension Commencement Lump Sum, a move the NAPF called for in *Fit for the Future: NAPF's Vision for Pensions.* A large percentage of individuals use their 25% tax free lump sums to achieve financial security in later life. According to a 2008 Scottish Widows survey, 41% of current pensioners use their lump sums to pay off mortgages or clear other debt, which acts as an important incentive to save in a pension.

6. The Government must consider carefully the impact the removal of the requirement to annuitise at age 75 will have on the provision of financial

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[1] DWP, "DC Pensions", 2009

[2] According to Hargreaves Landsdown.

information and advice. Bodies such as the newly formed Consumer Finance Education Body (CFEB) have a role to play, but the Government must also recognise that people often turn to their employers and pension schemes for financial information. It is imperative that the Government publish clear and easy-to-understand guidance for employers on how to communicate with their employees following the abolition of compulsory annuitisation. The Government should also provide assurance to employers and trustees that they will not be subject to litigation if they provide this information.

Answers to specific questions

The Government has asked for views on the following topics:

<u>Developing a new tax framework for retirement</u>

1. **The level of an appropriate annual drawdown limit for capped drawdown**.

   Under the new system, individuals will have the ability to use drawdown past age 75 and will therefore be exposed to risk for a longer period of time compared to the current system. Reducing the annual capped drawdown limit (currently 120% of the value of an equivalent annuity) would have some advantages. Primarily, it would reduce the risk of individuals running out of money in the later stages of retirement and eventually falling back on means tested benefits.

   Special consideration should be given to individuals with impaired life expectancies. Individuals who would have been eligible to purchase an impaired life annuity should be able to draw 100% of the value of an equivalent impaired life annuity.

2. **Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75**.

   The UK pensions tax system has been designed to encourage individuals to lock their savings away until retirement. The principle of Exempt-Exempt-Tax ("EET") is more easily understood by savers than alternative systems and incentivises savings at the front end. The Pension Commencement Lump Sum also acts as a powerful incentive and the NAPF is pleased that that the Government has confirmed that it will continue. Many people use their Pension Commencement Lump Sum to achieve financial security in later life. According to the 2010 NAPF Workplace Pensions Survey, a third of respondents said its removal would discourage them from saving in pensions.

   The Government's proposal to simplify the tax treatment of pension benefits is also welcome. The NAPF supports the overall principle that the taxation of pension benefits should be designed only to recover past tax relief on pension contributions. This includes the taxation of pension income at marginal income tax rates. The Government should not incur a positive gain from the taxation of pension benefits.

The Government has proposed that the recovery charge on all death benefits will be 55% (except for those who die before age 75 without having accessed their pension pot, which will remain tax-free). This consistency is a welcome change from the current system where different types of payments and benefits each incur different tax charges. The NAPF is of the view that the recovery charge should be used to encourage individuals to use their pension pots in retirement, but the Government must also recognise that the majority of people will receive basic rate tax relief on their pension contributions during accumulation. It should be noted that the suggested recovery charge of 55% is consistent with the current tax charge of 55% levied on unauthorised payments and therefore could be viewed as punitive in the same way that unauthorised payments are designed to be punitive.

Minimum Income Requirement

3. **What income should be considered "secure" for the purposed of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.**

According to the Office of National Statistics, pension income[3] constitutes almost 60% of total income for pensioner couples and 80% for single pensioners. Investment income comprises approximately 10% of total income. Earnings also makes up almost 25% of income for pensioner couples, while for single women pensioners it is only about 8% of income.

However, income from investments and from earnings is volatile and can fluctuate according to market pressures. The NAPF therefore agrees with the Government that only pension income, including income derived from defined contribution (DC) pensions through the purchase of an annuity, should be considered for the purposes of the MIR. It will be crucial to specify in guidance what kinds of occupational pension scheme payments meet the MIR criteria. For example, spouses' benefits should be included in the definition.

The Government has also proposed that only pension income and annuity income which is uprated by at least Limited Prices Indexation (LPI) can be considered secure for MIR purposes. This requirement will have implications for current annuity policyholders. Almost 90% of individuals purchase a conventional

[3] Pension income includes both state and private or occupational pensions.

level (non-escalating) annuity[4] so the vast majority of individuals who have already purchased an annuity will be unable to use flexible drawdown arrangements. The Government should consider allowing level annuities above a certain amount, perhaps at least 25% above the MIR to mitigate inflation risk, to qualify for the MIR.

It has also recently announced that occupational pension schemes will be able to uprate annual increases using Consumer Prices Index (CPI) instead of Retail Prices Index (RPI). It is unclear what effect this CPI/RPI shift will have on occupational scheme payments and the Government must first clarify the situation before setting this requirement in legislation.

4. **What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.**

As the Pensions Commission itself acknowledged, it is extremely difficult to define "adequacy" when it comes to individuals' income needs in retirement. Adequacy depends on a number of factors including level of income but also including the age at which income is taken. The Pensions Commission also pointed out that people often define adequacy based on their own standards of living but in many cases, even this benchmark is flawed because inflation can erode individuals' income.[5]

What this demonstrates is that there isn't a one-size-fits all approach to setting the level for the MIR. We must therefore look to the purpose of the MIR, which is to balance increase flexibility around retirement income with the reduced risk of individuals falling back on means tested benefits.

Benefit income makes up the largest source of income for the majority of pensioners in the UK. According to the ONS, a single pensioner under the age of 75 receives on average £7,332 a year in benefit income, which includes the State Pension, Pension Credit, Housing Benefit and Council Tax Benefit. Past age 75, the average amount of benefit income received by single pensioners increases to £7,852.[6]

The MIR must therefore be set well above the current Pension Credit level of £6,760 to account for the fact most pensioners receive extra income from other benefit sources. An appropriate MIR level seems to be around £16,000 as individuals with capital above this level are usually ineligible for Housing Benefit or

4 Association of British Insurers, "Pension Annuities and the Open Market Option," 2008.
5 Pensions Commission First Report, "Pensions: Challenges and Choices", 2004.
6 ONS, Pensions Trends, Chapter 11.

Council Tax Benefit.[7] This level could be expressed in a variety of ways, but the MIR must be able to reflect increases in the cost of living or means tested benefits thresholds.

One way to express this level is as a percentage of average earnings. Average earnings are currently £26,000.[8] The MIR could be set at 60% of average earnings, which would equate to £15,600. As average earnings increase, the MIR would increase as well.

It is important to remember that only a small percentage of individuals would be able to qualify for an MIR of £16,000. According to the MoneyMadeClear annuity calculator, an individual would need a pot of around £225,000 in order to reach the MIR, in addition to the State Pension.[9] A 2009 DWP report states that the average pot size used to purchase an annuity in 2008 was £26,000.[10] It might be possible to reduce the MIR so that more individuals are able to qualify, but this increases the risk that individuals may fall back on means tested benefits. The NAPF believes this risk must be avoided.

Adjusting the MIR for different ages add too much complexity to the new system and as a result is unnecessary. Income needs often fluctuate throughout retirement and it is difficult to predict spending patterns as they vary between individuals and households. According to the Pensions Policy Institute, pensioners tend to spend a larger percentage of their income in the early years of retirement, spend a smaller percentage in the middle, and then increase spending once again at the end of their life to account for the costs of health care[11]. The MIR should be set at level high enough to cover any fluctuations in an individual's income needs over the course of retirement.

5. **Whether a different MIR should be set for individuals and couples.**

The MIR should be set at a single rate based on individual income. This would be consistent with the Government's commitment to ensure that everyone can build up a pension in their own right. Recent reforms to the State Pension system will make it easier for people, especially women and carers, to accrue a full Basic State Pension in their own right. The NAPF's proposal for a Foundation Pension would further alleviate the discrepancies. Additionally, the introduction of automatic enrolment and mandatory employer contributions will give every person access to a pension that comes with their job. Changes in annuity policy should reflect this welcome development.

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[7] In the case of an individual who has already purchased a level annuity prior to the abolition of compulsory annuitisation, the MIR should be set at £20,000 to mitigate against inflation risk.
[8] ONS, Annual Survey of House and Earnings, 2009.
[9] A non-smoking female taking an RPI-linked annuity at age 70 would receive £10,500 a year. Calculated on 10 September 2010.
[10] DWP, "DC Pensions", 2009
[11] Pensions Policy Institute, "Retirement Income and Assets: Do pensioners have sufficient income to meet their needs?" 2009.

6. **How often the MIR level should be reviewed.**

   If the MIR were linked to a percentage of average earnings, it would increase automatically as average earnings increase. As a result, there would be no need for the MIR to be reviewed regularly. However, the MIR should be reviewed in conjunction with any fundamental changes to or review of the benefits system.

7. **How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.**

   One way to minimise the burdens on individuals and the industry would be to base the assessment process on the information already provided on income tax receipts, self-assessment forms, PAYE slips, etc. Individuals will be familiar with these mediums and will be able to find the required information quickly.

<u>The UK Annuity Market</u>

8. **Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.**

   The UK annuity market is one of the most sophisticated in the world and already a number of providers have developed innovative annuity products such as fixed-term or temporary annuities and flexible lifetime annuities. However, many people could benefit from products which combine a baseline guaranteed income with investment options or income drawdown. Such products would provide both the security of a steady, lifetime income while at the same time allowing part of the pot to remain invested. The Government should work with the industry to identify barriers to product development in this area specifically.

   To help alleviate the "small pots" issue (where individuals accumulate multiple small pension pots over their working lives), the Government could consider allowing spouses to combine their pots to purchase one joint-life annuity, as the NAPF and other organisations have proposed. Although couples should not qualify for the MIR on joint income, this development would help couples who fall well below the MIR criteria either jointly or individually to secure a better income in retirement.

9. **How the industry, Government, and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.**

A 2009 report by the DWP stated that only 10-15% of DC scheme members understand the investment risks they face.[12] A separate report by the FSA suggests that understanding of decumulation products like annuities, income drawdown and equity release remains poor. [13] Research suggests that more than 75% of individuals in the UK do not have a financial adviser.[14] For these individuals, having access to easy-to-understand advice and information will be crucial to the success of their retirement decisions in the absence of the requirement to purchase an annuity by age 75.

Research also suggests that employees trust information provided by employers (or independent third-parties through the workplace) more than information provided by the Government or the financial services industry. According to the DWP's 2007 survey "Trust and confidence in Pensions and Pensions Providers", employees trust their employers the most when it comes to pensions, followed by not-for-profit organisations.

The Government must recognise this and provide support for employers. The workplace is an efficient and effective communication channel. Information can be passed on using face-to-face seminars and group sessions and/or interactive online training and education.

The NAPF has developed considerable expertise in pension education through our PENSIONFORCE service, which is delivered through the workplace and backed by the DWP. The Government should provide further support to initiatives such as PENSIONFORCE to ensure that individuals make appropriate choices following the end of the requirement to annuitise by age 75.

10. **Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.**

The ability of the market to supply annuities at attractive rates is dependent upon a number of factors, such as interest rates, gilt yields, and solvency requirements. While the requirement to annuitise at age 75 will no longer exist, the NAPF anticipates that the large majority of individuals will continue to do so anyway and therefore the impact on the demand for annuities will be minimal.

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[12] DWP, *DC pensions,* 2009.

[13] FSA, *Finance in and at retirement – results of our review,* 2007.

[14] Sun Life Financial of Canada's Unretirement Index 2010.

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