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Agenda

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Pension reforms in the UK: what can be learned from other countries?

Reforms in the UK pensions market announced by the Chancellor of the Exchequer, George Osborne, in the 2014 Budget are set to remove many of the restrictions on what people can do with their defined-contribution (DC) pension funds on retirement. Concerns have been raised about the likely impact of the reforms on the stability of retirement incomes for pensioners. What can comparative research from other countries tell us about the likely effects?

In March 2014, the Chancellor surprised many market participants in the UK DC pensions market by announcing that 'no one will have to buy an annuity'.[1] The market response to the Chancellor's announcement, which saw the market value of annuity providers shrink by £3bn,[2] was indicative of the predicted impact on annuity demand.

The reforms, summarised in the box, effectively relax some of the restrictions on retirement products and are set to give pensioners greater control of how they use their pension pots upon retirement. Consumer response to the reforms was swift, as sales of annuity products fell by a third.[3]

As the UK moves towards a more liberalised retirement products market, the experiences of other countries can shed light on some of the possible implications. This article looks at ten countries and offers observations on how consumers make choices at retirement and how markets have developed under different regulatory regimes.

Overview of the ten countries

On behalf of the Financial Conduct Authority (FCA), Oxera conducted an independent study of retirement income markets across ten countries:[4] Australia, Canada, Chile, Denmark, Ireland, the Netherlands, New Zealand, Singapore, Switzerland and the USA. Pension systems vary considerably across these countries, resulting in a wide range of outcomes in terms of what is accessible to pensioners at retirement. Table 1 overleaf summarises the restrictions in each country with regard to the three main categories of retirement income product: lifetime annuities, income drawdown products, and lump sums.

DC savings reforms in the 2014 Budget

Under the previous system, each person over the minimum retirement age (55) had the following restrictions.

- **Lump-sum tax**: 25% of pension savings could be withdrawn tax-free; a lump-sum withdrawal of the rest carried a 55% tax rate.
- **Trivial commutation**: the pensioner was allowed to withdraw their entire pension as a lump sum without any additional tax charge, provided the pension pot was under £18,000.
- **Capped drawdown**: if the pensioner decided to opt for an income drawdown product, there was a cap on the amount withdrawn each year, equal to 120% of an equivalent annuity.
- **Flexible drawdown**: no limit was imposed on the amount withdrawn each year, provided that the pensioner had a guaranteed retirement income of more than £20,000.

The reforms relax these restrictions in the following way.

- First, the reforms remove the restrictions on accessing private DC savings. Anyone from age 55 onwards is allowed to access their DC savings as a lump sum without facing additional taxes over the marginal rate (for income tax).
- Pensioners are allowed a tax-free allowance of 25% each time they withdraw from their pension savings (with the remainder being treated as income for taxation purposes), rather than an initial tax-free lump sum of 25%. In other words, instead of being entitled to withdraw 25% of their pension pot without paying any tax upon retirement, the tax-free amount is spread over their lifetime.

Table 1 Summary of retirement income markets by product type

Country	Lifetime annuities	Income drawdown products	Lump sums
Australia	Allowed, but very little demand	Allowed. Main options are account-based income streams	Allowed and relatively common
New Zealand	Allowed, but there are no annuity providers in New Zealand	Allowed	Allowed and relatively common
USA	Allowed, but demand is weak. 9% of retirees have significant annuity income	Allowed	Allowed
Canada	Allowed, with significant demand	Allowed, although with restrictions in some cases	Limited for DC pension schemes
Ireland	Required, unless income can be shown to be above the threshold to qualify for income drawdown	Allowed given sufficient income	Restricted to 25% or 1.5 times income as tax-free lump sum (taken by most people)
Switzerland	Default option, and subsidised	Not allowed	Allowed, but discouraged
Denmark	Unlimited deferred annuities	Restricted amounts can be allocated to term annuities	Allowed
Netherlands	Mandatory	Not allowed	Not allowed*
Singapore	Mandatory	Not allowed	Not allowed
Chile	Default option	Restricted to 'programmed withdrawals'	Not allowed
UK	Formerly primary option. Allowed	Currently restricted to 'capped drawdown' and 'flexible drawdown' products	25% tax-free, taken by most people. New policy is for whole pot to be available, taxed at marginal income tax rates after 25% tax-free allowance

Note: * Except for very small pots that would provide an annuity income of less than €417 (£330) per year (a fund of around €12,000 (£9,600), on the basis of an index-linked annuity rate of 3.5%). See Dutch Association of Industry-wide Pension Funds, 'The Dutch Pension System: an overview of the key aspects', section 6.2, available at: http://www.pensioenfederatie.nl/Document/Publicaties/English%20 publications/Nederlandse_pensioensysteem_Engelstalige_versie.pdf.

Source: Oxera.

In terms of their annuitisation rates, the countries can be grouped as follows.

- **Full annuitisation**, which is dictated by regulation mandating the take-up of annuities with some allowance for 'trivial commutation'—full annuitisation exists in Singapore and the Netherlands.
- **High annuitisation rate**, which exists in countries where there is collective bargaining of pensions (at both the accumulation and decumulation phases) and limited choice is available across products—Denmark and Switzerland are countries with high annuitisation rates (~80%).
- **Medium annuitisation rate**, whereby the regulators allow for a limited choice of products, including income drawdowns, but provide incentives for annuity products such as having a state requirement for a minimum annuitised income—countries with medium annuitisation rates are Ireland (~30%) and Chile (~60%).
- **Low annuitisation rate**, driven mostly by the taxation system, the small size of DC pension pots (mainly due to the lack of maturity of the system), as well as cultural factors (e.g. norms of self-reliance and individualism)—countries with low annuitisation rates are Australia (~1%), Canada (~30%), New Zealand (non-existent annuities market), and the USA (~9%).

The role of regulation and taxation

Regulation and taxation are arguably the most important drivers of market outcomes. Without the strong incentives that these provide, consumer demand for annuities appears to be quite low.

The availability and accessibility of products is primarily a reflection of what is allowed by regulation. In countries with high annuitisation rates, regulation allows for a small selection of tightly regulated products which provide a steady income stream at retirement (Switzerland, Denmark, Singapore and the Netherlands). Countries which offer some flexibility for income drawdown products (Ireland and Chile), but limit consumers in terms of their choices (for example, Chile allows for only four retirement products), have lower annuity demand.

The taxation structure is also an important driver of consumer choice of retirement products. In Australia and New Zealand, pension savings are taxed as regular savings. In other words, they are taxed during the accumulation phase and face no tax at withdrawal. This system allows for more freedom on what to do with retirement savings and has contributed to the reduction in demand for annuities in these countries.

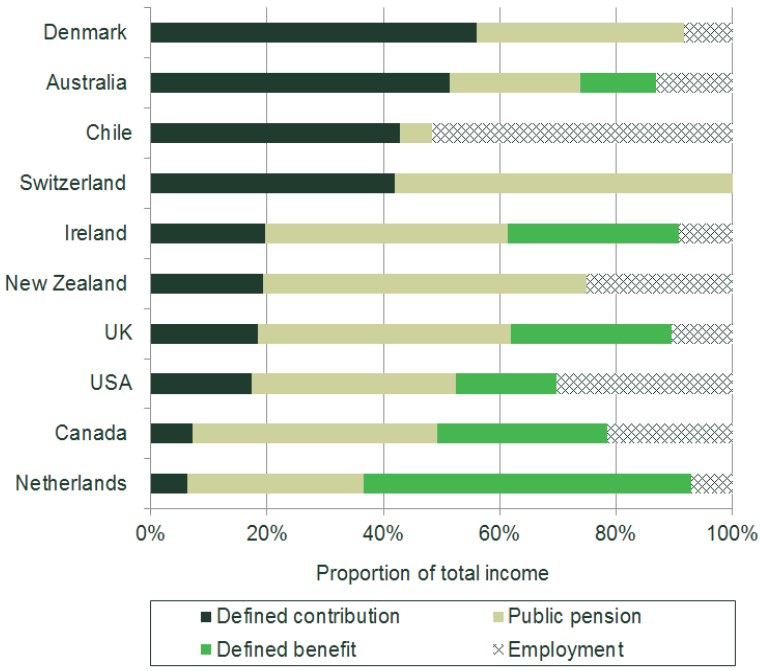
Other sources of retirement income

Consumers' decisions about retirement income products are also framed by the relative importance of their DC pension funds in providing income. This varies considerably across countries, as shown in Figure 1.

The size of a pension pot tends to affect the choice between annuity and lump sum. For smaller pots, consumers typically prefer a lump sum over an annuity or income drawdown, as the fund size would be too small to provide meaningful lifetime income. Those with larger-than-average pension pots are more likely to choose income drawdown products over annuities, as they have less need for a guaranteed lifetime income.[5]

Furthermore, the existence of a means-tested state pension may result in under-insurance from longevity risk. By providing a source of steady income and partly insuring pensioners against longevity risk, the state pension may reduce incentives to purchase an annuity. This has been a concern in Australia,[6] where the state pension is highly progressive and the consumer faces an effective marginal 'tax' rate of 50% due to the tapering of means-tested benefits.[7]

Figure 1 Estimates of income sources for pensioners (for the median of the income distribution)



Note: Data is based on estimates of the value of income sources for those in the middle of the income distribution, relative to the median average earnings. Countries are ordered by relative importance of DC pension plans to pensioner incomes.

Source: Oxera analysis of OECD Pensions Outlook data. No data on earnings from employment is available for Switzerland.

Consumer preferences for retirement products

In addition to the factors described above, demand for retirement income products such as annuities can be linked to less tangible factors such as consumer preferences, perceptions and biases. Behavioural economics provides some important insights into demand for these products.

Consumer preferences for retirement products can be shaped by several factors. First, consumers have been shown to prefer receiving more of their funds up-front, either by taking a lump sum or by purchasing an annuity product that provides higher income (in real terms) in the early years. For example, in Denmark, where consumers are not allowed to access lump-sum payments, there is a strong demand for fixed-term annuities, which enable the consumer to bring forward access to income.[8]

Furthermore, consumers value flexibility in their retirement products in order to provide for unexpected expenses. For example, one of the reasons why pensioners in the USA prefer more flexible retirement products is because they help them to cover potentially large medical costs.[9] Another driver of choice for retirement products is the desire for bequests. The importance of bequests has motivated the design of products, including annuity products, in Singapore that provide a portion of the assets as a bequest (depending on the lifespan of the member).[10]

This could imply that, in order to bolster demand for annuities, providers should increase flexibility within existing product offerings (e.g. the provision of annuities with bequest, or products that combine programmed withdrawals with life annuities).

Consumer perceptions

Consumer perceptions are also important in explaining demand for annuities. For example, in some countries, such as New Zealand, Australia and the UK, annuities are seen to be poor value-for-money products.[11] In Switzerland, on the other hand, annuities are perceived as a good deal due to a regulated minimum annuity rate ('conversion factor').[12]

Researchers have found that perceptions could be influenced by how annuities are 'framed' as a product. A field experiment in the USA found that reduced levels of annuity demand were due to the fact that people saw annuities as an investment product (with low returns) rather than as an insurance product against longevity.[13] Thus, perceptions may potentially be altered by changing the 'framing' of outcomes in terms of insuring future consumption as opposed to generating investment returns.

In Chile, the regulator has sought to address such perceptions by instituting a system of electronic quotations designed to facilitate comparison of pension products. The system provides each person with complete and comparable information about annuity and planned withdrawal offers, via a platform that connects pension funds and life insurance companies.[14] This way, consumers are able to judge for themselves the value of annuities relative to other products.

Consumer biases

As with many financial services products, consumers are subject to certain consumer 'biases' when purchasing a retirement product. One of the most notable biases identified in behavioural economics analysis in several countries is that of consumer inertia at the point of retirement, coupled with the strong impact of default options.

Default options can be expected to have a significant impact on consumer outcomes. In Switzerland, most pension schemes provide an annuity as the default option, and allow for a partial or full lump-sum payment as an alternative. Furthermore, lump sums must be requested three years in advance and, where joint life annuities are the default option, each worker also needs their spouse's signature in order to convert their money into a lump sum. Such administrative frictions make opting for lump sums more cumbersome and may serve to disincentivise them as an option.

In addition, de facto default options (which are the typical choice of most people) can affect consumer decisions. For example, regulatory debate[15] in Australia has focused on how a default option of some form of annuitisation can be introduced, as the implicit default option currently appears to be to keep the funds in the savings account used during the accumulation phase.

Recognising the existence of consumer biases when purchasing retirement products, regulators have introduced interesting initiatives aimed at influencing consumer decisions without restricting choice. Initiatives to improve shopping around perhaps have the clearest indicators of impact, such as the price-comparison tool introduced in Chile, which is believed to have strengthened price competition and helped bring down fees.

In addition, policymakers are concerned about the lack of consumer engagement and financial literacy in relation to retirement products. In the UK, the FCA's consumer research has shown that consumers find pensions 'daunting and complex'.[16] Two countries that succeeded in raising the level of financial literacy are Denmark and New Zealand. Oxera's research suggests that a number of important lessons can be drawn from the initiatives in these countries:

- information on product features and costs needs to be accessible to consumers. The presentation has to be user-friendly and the language straightforward so that it is understandable;
- disclosure and financial literacy on retirement products should start during the accumulation phase. In particular, it is helpful if members are informed of their pension entitlements during the accumulation period;
- consumers are more likely to engage with their retirement planning if the information comes in a personalised format (e.g. by telling consumers how much more they can earn at retirement if they increase their contribution level by 1%).

Conclusion: the role of behavioural economics

The experience of the ten countries examined shows that the combination of regulation, tax regime and firm behaviour can have an important impact on consumer preferences, perceptions and behaviour, thereby affecting the demand for different retirement income products. It is important to recognise that no other country has experienced policy changes directly comparable to the extensive liberalisation expected in the UK, and that, in any case, the market dynamics in the UK may be different. Decisions at retirement can be complex and can have a large impact on people's lives. This means that the new regime in the UK will create new challenges for providers and distributors in terms of designing and selling products that result in good outcomes for consumers. Firms can draw on the lessons from behavioural economics, such as those discussed above, to meet these challenges.

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[1] Osborne, G. (2014), 'Chancellor George Osborne's Budget 2014 speech', 19 March, available at: https://www.gov.uk/government/speeches/chancellor-george-osbornes-budget-2014-speech.

[2] Freming, S., Oakley, D. and Cumbo, J. (2014), 'Budget 2014: Insurers lose £3bn after pension fund shake-up', *Financial Times*, 19 March, available at: http://www.ft.com/cms/s/0/ed388eba-af6f-11e3-9cd1-00144feab7de.html?siteedition=uk#axzz3MjZa3Dav.

[3] See Association of British Insurers (2014), 'ABI statistics Q2 2014: The UK retirement income market post-Budget', available at: https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Pensions/ABI%20statistics%20Q2%202014%20The%20UK%20retirement%20income%20market%20post%20Budget.pdf.

[4] See Oxera (2014), 'The retirement income market: comparative international research', prepared for the Financial Conduct Authority, September, available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2014/The-retirement-income-market-Comparative-internati.aspx. The independent study and this *Agenda* article are the work of Oxera alone, and do not represent the views of the FCA.

[5] For evidence of this inverted U-shaped relationship between pension pot size and demand for annuities in Switzerland, see Bütler, M. and Teppa, F. (2007), 'The choice between an annuity and a lump sum: results from Swiss pension funds', *Journal of Public Economics*, **91**:10, pp. 1944–66.

[6] The Financial System Inquiry (2014), 'The financial system inquiry interim report', 15 July, available at: http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf.

[7] For 2014/15, the maximum rate of the Age Pension is AU$843 (£470) per fortnight for a single person, or AU$1,271 (£700) per fortnight for a couple. The pension is reduced by 50c per AU$1 (£0.56) (a marginal rate of 50%) for those with incomes from other sources above AU$160/AU$284 (£89/£160) (single/couple) per fortnight, which is a relatively low amount. This means that those with incomes above AU$1,846/AU$2,825 (£1,000/£1,600) will receive no Age Pension. In practice, this means that most people with additional pension income will face a marginal 'tax' rate of 50%. Source: Australian Government Department of Human Services, 'Income test for pensions', available at: http://www.humanservices.gov.au/customer/enablers/income-test-pensions.

[8] The key difference between fixed-term and conventional annuities is that fixed-term annuities give out payments for a fixed term (e.g. ten years). At the end of that term, the plans return a guaranteed capital sum, which can then be used to buy another retirement product (fixed-term annuity or a conventional annuity, or a drawdown).

[9] See Oxera (2014), 'The retirement income market: comparative international research', prepared for the Financial Conduct Authority, September, available at: http://www.oxera.com/Latest-Thinking/Publications/Reports/2014/The-retirement-income-market-Comparative-internati.aspx.

[10] CPF Life, the main annuity provider in Singapore, originally provided four products, which differed in the trade-off made between bequests and monthly payments. Following feedback from its clients, CPF Life dropped the plan that consisted of the highest monthly payouts coupled with zero bequests. This had been unpopular, chosen by only 3% of members, reflecting the strong bequest culture.

[11] Financial Conduct Authority (2014), 'The value for money of annuities and other retirement income strategies in the UK', Occasional paper 5, December.

[12] In Switzerland, there is a minimum conversion factor for lower retirement incomes, which is currently set at 6.8% of accumulated balances, fixed in nominal terms. However, the average in the market is approximately 6.0% to 6.1%, and many pension funds are moving towards rates of 5.5%. At present in the UK, a broadly equivalent joint life pension annuity for a person aged 65 on the open market has a conversion rate of about 5.7% (based on the Annuity Rates Table provided by the *Financial Times* on 28 July 2014, available at: http://www.ft.com/personal-finance/annuity-table).

[13] Brown, J., Kling J., Mullainathan, S. and Wrobel, M. (2008), 'Why don't people insure late-life consumption? A framing explanation of the under-annuitization puzzle', *American Economic Review*, **98**:2, pp. 304–9.

[14] Information from SCOMP website, available at: http://www.scomp.cl/que-es.

[15] The Financial System Inquiry (2014), 'The financial system inquiry interim report', 15 July, available at: http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf.

[16] Ignition House (2014), 'Post-budget at retirement market – qualitative consumer research', available at: http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Post-Budget-At-Retirement-Market-Qualitative-Consumer-Research,PDF.pdf.