

# Optimising Value In Retirement

A report by the  
**Pension Income Choice Association**



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## Pensions Income Choice Association

Pensions Income Choice Association (PICA) is a membership funded group set up in July 2009, representing product providers, IFAs and EBCs in the annuities and retirement market. The Association is composed of a management group which consists of AEGON, Living Time, LV=, MGM Advantage, Partnership, and Bluefin Group. Tom McPhail, Hargreaves Lansdown, is the acting chairman.

**It is supported in its aims and objectives by an advisory board. The members of the advisory board include MetLife, Hornbuckle Mitchell, Rockingham Retirement, Pearson Jones and Which?**

PICA is dedicated to promoting the importance of reviewing pension assets at retirement to determine the most appropriate solution for the needs and circumstances of every individual.



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## Summary

Britain stands on the edge of a national tragedy. Future generations of pensioners will be significantly poorer than previous generations. The erosion of state pensions, among the lowest in Europe; significant reductions in employer pension contributions – a common feature of the move from defined benefit (DB) to defined contribution (DC) pensions; and the lowest savings ratio in almost 30 years means many people retiring in the future will face far greater financial challenges than previous generations.

Indeed, we are on the brink of a new divide: The beneficiaries of the dominance of defined benefit pensions in the 20th century giving way to a new underclass of 'have-nots' in the 21st century. A new generation of retirees who have not made sufficient provision in the belief that reasonable state pensions and generous DB pension plans would secure a comfortable retirement.

This situation is exacerbated by increases in longevity. On the one hand, it is an exciting era to retire: People can look forward to 20 or more years in retirement on average. On the other hand, it is one of the most difficult times financially. The savings and capital people have accumulated during their working life will need to last longer than ever before.

There is no silver bullet for today's retirees. Property may help ease the burden for those who have reasonable levels of equity in their home, but beyond this it will become increasingly important that people make the most of what they have accumulated for their retirement.

Against this background, it is disappointing that a great number of people who have saved for years in DC schemes might not maximise their income in retirement. For example, it is over thirty years since the introduction of the open market option and only around 1 in 3 people use it to secure a better income. What is more, retirees most likely to exercise the option are those who have access to advice (usually more affluent customers). The current system is failing the less well off members of our society who most need to maximise their pension savings if they are to avoid hardship in retirement.

The potential gain from a review of retirement options has never been greater. It's no longer about the best conventional annuity rate. The array of retirement income options available to today's pensioners means that a two step process is required: Choosing the right product is the first priority; then it's important to select the best rate. This approach can often result in significant increases in income. Even a retiree in a pension scheme that offers the highest conventional annuity rate in the UK might still improve their income significantly if they qualified for an enhanced rate.

There are legitimate reasons why people may accept the solution they're offered by their pension scheme. The size of the fund may be too small to place on the open market; guaranteed annuity rates could be available that are particularly attractive or the scheme may offer highly competitive rates. All of these are valid reasons, but it is unlikely that these examples account for the relatively low numbers of people who exercise their right to move their pension savings to another provider.

So what are the barriers to progress? Why have we failed to encourage more people to take advantage of the freedom of choice available?

The reasons are many and varied.

On the supply side, IFAs have successfully helped clients make better informed decisions about their finances at retirement, but many IFAs find it economically challenging to offer advice to retirees with funds below £50,000. In practice, this accounts for the vast majority of retirees by number.

Pension schemes have a duty to promote the open market option and many are exemplary in demonstrating best practice. However, a review of insurance company literature last year by the FSA revealed that around 40% of firms were not meeting the standards required in this area. There are also concerns about the quality of information provided by employers and trustees in trust based DC schemes.

The Pensions Regulator has recently reviewed the information provided by trustees in trust based DC schemes and found that more than half of the schemes have scope for improvement when benchmarked against good practice.

On the demand side, consumer inertia and a lack of understanding play a large part. Some consumers believe that the costs of advice would negate any potential increase in their retirement income. Others just don't know how to go about finding suitable advice or don't understand the impact that a review of their options could have on their retirement income. In some instances, consumers believe they will be treated favourably by the company they have saved with for so many years as a reward for their loyalty.

Lack of education is also an issue in this area. Many people do not understand what an annuity is, let alone have any appreciation of the different types of annuity. Yet it is precisely these people who need to squeeze as much income as possible from their retirement savings.

There are a number of current initiatives that should be encouraged and will lead to more people reviewing their options, but these are unlikely to produce an immediate impact and time is not on our side.

No one wants to struggle financially in retirement. Everyone has the option to choose the right product to provide their retirement income and on the most advantageous terms, but those who most need to do this are failing to do so.

We have the opportunity to help improve their finances during retirement. We can achieve this without any substantial direct cost to government, without any significant burden on industry and without any major sacrifice from individuals.

We must take this opportunity.



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## Recommendations

### **The Pension Income Choice Association (PICA) believe that the default option should be for everyone to review their options at retirement.**

The existing process should be reviewed. PICA recommends a three stage communication process that all product pension schemes would be required to follow:

- The first step would focus on the choices and decisions people face at retirement and the action they need to take.
- Step two would require the production of a personalised statement containing sufficient information for people to use to obtain quotations.
- The third step would be a short communication requiring the member to inform the company/trustees how the fund should be applied.

The wording of these communications would be prescribed, written in jargon-free plain English and compulsory for all companies and trustees to comply.

PICA appreciates that there are complexities to be considered in the implementation of this process (for example, the treatment of small funds and guaranteed annuity rates), but this should be the starting point for any reform of the present system.

### **PICA believes that adopting this change could lead to hundreds of thousands of people over the next ten years securing a better income in retirement.**

PICA has commissioned a macroeconomic study by Oxford Economics to financially quantify the implications of such a move. The full findings are to be published in a separate report scheduled for release in November 2009. The economic analysis reveals that had the move occurred this year it could have raised the total income of those retiring in 2009 by over £30 million. Furthermore, as pensioners would continue to receive extra income every year for the rest of their lives the benefits of the policy change will, in the long-term, amount to hundreds of millions of pounds in each year.

In addition, PICA proposes seven further recommendations.

#### **1. Support for IFAs**

Support for initiatives to help IFAs deal with smaller fund sizes through process improvements and flexible commission structures. As a minimum, all providers should sign up to the ABI/Origo 'Options' campaign.

#### **2. An IFA register**

The establishment and maintenance of a register of IFAs who are prepared to advise on funds less than £50,000 with details of any minimum fund size and charging structures

### 3. Best practice for Pension Schemes.

Guidance on best practice should be provided to help employers and trustees establish a policy on providing access to financial advice and information for retiring employees. The guidance would cover:

- Appointing an IFA or annuity broker to offer advice for all employees approaching retirement.
- Nominating a member of staff able to provide information and generic guidance and support.
- Allowing employees nearing retirement time off to attend a retirement workshop.
- Accepting transfers into the scheme from other pension arrangements to aggregate small funds.

The trustees or the employer's pension governance committee should monitor the effectiveness of the process. This would cover the timescales of the purchase process, how many employees take advice (and how many take the open market option) and the performance of the adviser.

The NAPF is also urged to add a fourth core test to its Pensions Quality Mark which would expressly review the adequacy and extent of the arrangements in place to ensure employees are supported at retirement.

### 4. Encourage direct to consumer propositions.

The promotion of direct to customer propositions to enable people to compare prices quickly and simply should be encouraged.

### 5. Expand FSA comparison tables

The expansion of the FSA comparison tables to include all providers and all annuity types.

### 6. Develop Money Guidance proposition

The Money Guidance pilot, assuming it is successful, is an obvious way to help people with small funds to better understand their options. At the earliest opportunity, consideration should be given to deepening the support that could be provided at retirement.

### 7. Review trivial commutation limits

A review of the trivial commutation limits to help people who would not otherwise be able to take advantage of these changes (because of the size of their funds) commute their benefits for cash.

## Section 1: Background and context

### *'The times they are a changing'*

The current generation of retirees may be the last generation to enjoy generous levels of income in retirement. Overall, pensioner incomes increased by 39% in real terms in the 12 year period from 1994/5 to 2006/7<sup>1</sup>, but this conceals wide variations between income groups. There are still many people struggling to make ends meet financially during retirement.

The main driver of this growth in incomes is the impact and importance of occupational pensions, but this is set to change: Defined benefit (DB) schemes\* have been closing to new members at an alarming rate for some years now, to the point where the majority of private sector DB schemes are now closed to new members or are in the process of closing down completely<sup>2</sup>. Indeed, only three FTSE100 companies still offer DB pension schemes to new employees<sup>3</sup>. What is more, some DB schemes are beginning to review whether they can afford to continue to offer benefits for future service for existing scheme members.

Most companies that have reviewed their DB arrangements have introduced a defined contribution (DC) scheme\* for new employees and/or for future service. There is nothing inherently wrong with DC as a construct, but contribution levels are generally lower. In 2007, the average employer contribution rate for DB schemes was 15.6% of salary, compared with 6.5% for DC schemes<sup>4</sup>.

That's not all. The value of state pension benefits has been gradually eroded over the years. For an average earner retiring in 2007, the UK replacement rate of 17% was the lowest in Europe: Far below the European average of 57%<sup>5</sup>.

\* DC schemes are often known as 'money purchase'; DB schemes as 'final salary'

Consumers are also saving much less. In the past 15 years, the household savings ratio has dropped from a high of 12% to just over 2% at the end of 2008<sup>6</sup>. There has been some improvement since then, but this is largely attributed to the economic downturn and the need to guard against the threat of redundancy, rather than evidence of a long term trend towards greater levels of saving.

There are some counterpoints to this rather bleak outlook: The government's intention to restore the system of linking increases in the basic state pension to earnings, rather than prices, will help stabilise the value of the basic state pension. The new proposed personal accounts should increase the coverage of private pensions (though there is the threat of 'levelling down'), and, despite the fall in house prices, many people still have significant levels of equity in their home that they can leverage to help fund their retirement.

But this should not mask the fact that future generations will find it more difficult to maintain a comfortable standard of living in retirement.

The situation is exacerbated by improvements in longevity. Retirement savings will need to last much longer than ever before. On average, a 65 year old man can look forward to 17.2 years in retirement and a woman aged 65, 19.9 years<sup>7</sup>. Of course, these figures are averages: while some may die earlier others will live even longer. In a couple, both aged 65 and in good health, there is a 1 in 4 chance one of them will still be alive at 99<sup>8</sup>.

The planned increases in retirement age will mitigate the impact of improvements in longevity. Employees working longer will spend less time in retirement and have greater opportunities to increase their savings, but these steps are unlikely to have a substantial impact.

What is more, increased longevity isn't necessarily accompanied by an equal increase in disability; recent studies

in the US conclude that 'disability rates are falling in the later decades of life, relative to the increased numbers of surviving older persons'<sup>9</sup>. In part, this is due to relentless advances in medical innovation.

Improvements in health also have significant impacts on finances in retirement. The greater the number of productive years people spend in retirement, the more income they will need.

And there is more bad news. It is widely believed that the Solvency II requirements, scheduled for implementation towards the end of 2012, will impact annuity rates negatively. Some commentators have suggested that annuity rates could fall by as much as 10%.



What makes this such a compelling and urgent problem is the scale of the issue. We have already seen the market almost double over the last 10 years to the point where nearly 500,000 people bought an annuity or an income drawdown product last year (see figure 1).

**Figure 1: The retirement market has almost doubled in size over the last 10 years**

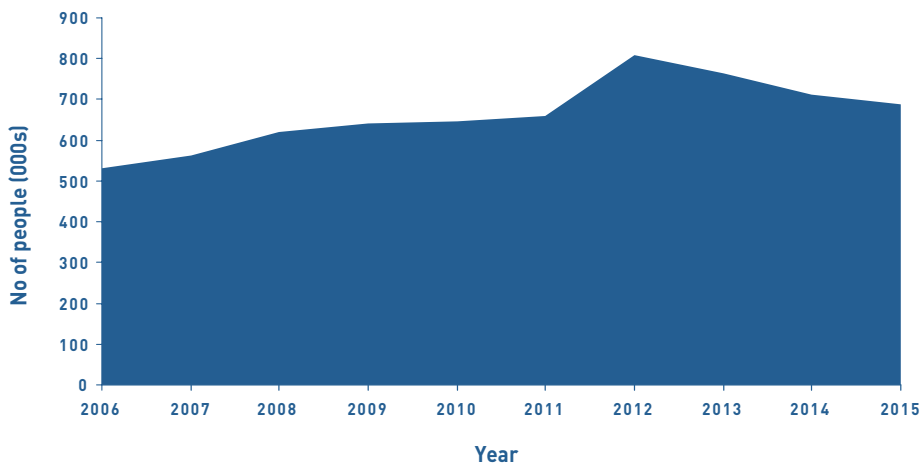
Year	Number of new annuities	Number of income drawdown policies	New premiums (£m)
2008	459868	29234	13916
2007	447603	32808	14061
2006	367369	25234	12157
2005	292185	11769	9307
2004	349362	12765	9022
2003	341162	15081	9208
2002	329903	19284	9577
2001	256611	15884	8545
2000	249821	14769	7911
1999	232000	16000	7569

Source: ABI Stats 2009

Yet there is much more to come. The numbers of people reaching 65 years of age will continue to increase as the baby boomer generation start to retire.

**Figure 2: Increasing numbers of people will turn 65 in the coming years.**

Source: Government Actuaries Department, Population projections (UK).



It is critical that those approaching retirement make the most of their assets. For many people, the majority of their wealth (with the possible exception of the equity in their home), will be the savings they have accumulated in a company or private pension plan.

promised lies with the employer or trustees, DC schemes effectively make the individual member responsible for deciding how best to deploy their pension savings at retirement.

Increasingly, these savings will be held in a DC plan. Unlike DB schemes, where the responsibility to pay the pension

Unfortunately, the evidence suggests significant numbers of people may not be making the most of their pension savings.

## Section 2: What's all the fuss about?

### 'Money for nothing'

In 1978, the government introduced the Open Market Option (OMO). This gave people the right to shop around for the highest lifetime annuity rate available in the market, rather than insist they accept the rate offered by the company they had saved with for retirement.

In September 2002, the FSA introduced new rules requiring pension providers to inform customers of their rights to shop around.

In 2003, annuities were added to the FSA's comparative tables.

Despite this, the numbers of people exercising the OMO hasn't significantly increased over time.

**Figure 3: There has been no material improvement in OMO take up rates**

Year	Percentage of people exercising OMO
2004	33
2005	32
2006	34
2007	39
2008	37

Source: ABI Stats, 2009

There are legitimate reasons why people may not exercise the option. These include:

- **Fund size**

Many annuity providers have a minimum premium. Commonly, this is at least £5000. Based on 2008 data<sup>10</sup>, this means 23% of annuitants would have had little choice of provider if they were to exercise the option. Even for funds above £5,000 but less than £10,000 choice is limited (figure 4).

- **Guaranteed annuity rates.**

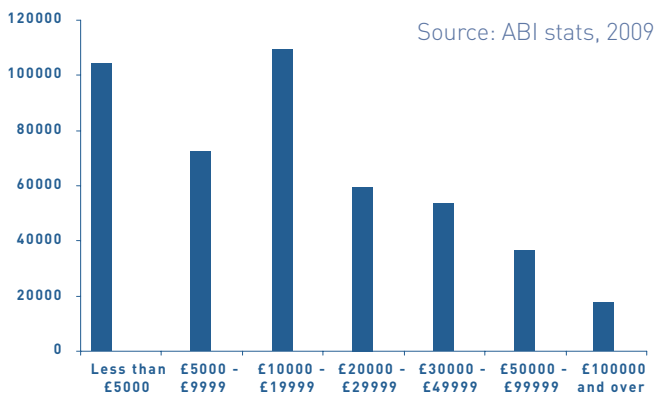
Some pension contracts, particularly those sold in the 1970s and 1980s, offer valuable guaranteed annuity rates that are more attractive than the best current annuity rates.

- **Penalties on transfer**

Some companies impose a penalty if funds aren't used to buy an internal annuity.

- **Competitive rates**

There will be people saving with companies that do offer highly competitive rates and therefore the benefits of switching may be negligible.

**Figure 4: Almost 400,000 annuities last year were for funds less than £50,000**

It is unreasonable to expect everyone to **exercise the open market option** at retirement. Nevertheless, everyone should be encouraged to **explore the possibility** of improving their retirement income. This is particularly so given that there are far more opportunities to secure a better deal these days.

The open market option was originally intended to help people choose the best lifetime annuity rate. Nowadays, people have many different products they can select at retirement and some of these are not lifetime annuities. This means that the open market option needs to be redefined. It is actually a two-step process:

- **Choosing the right product.**

The first stage is to identify the most appropriate product. Here are the main choices:

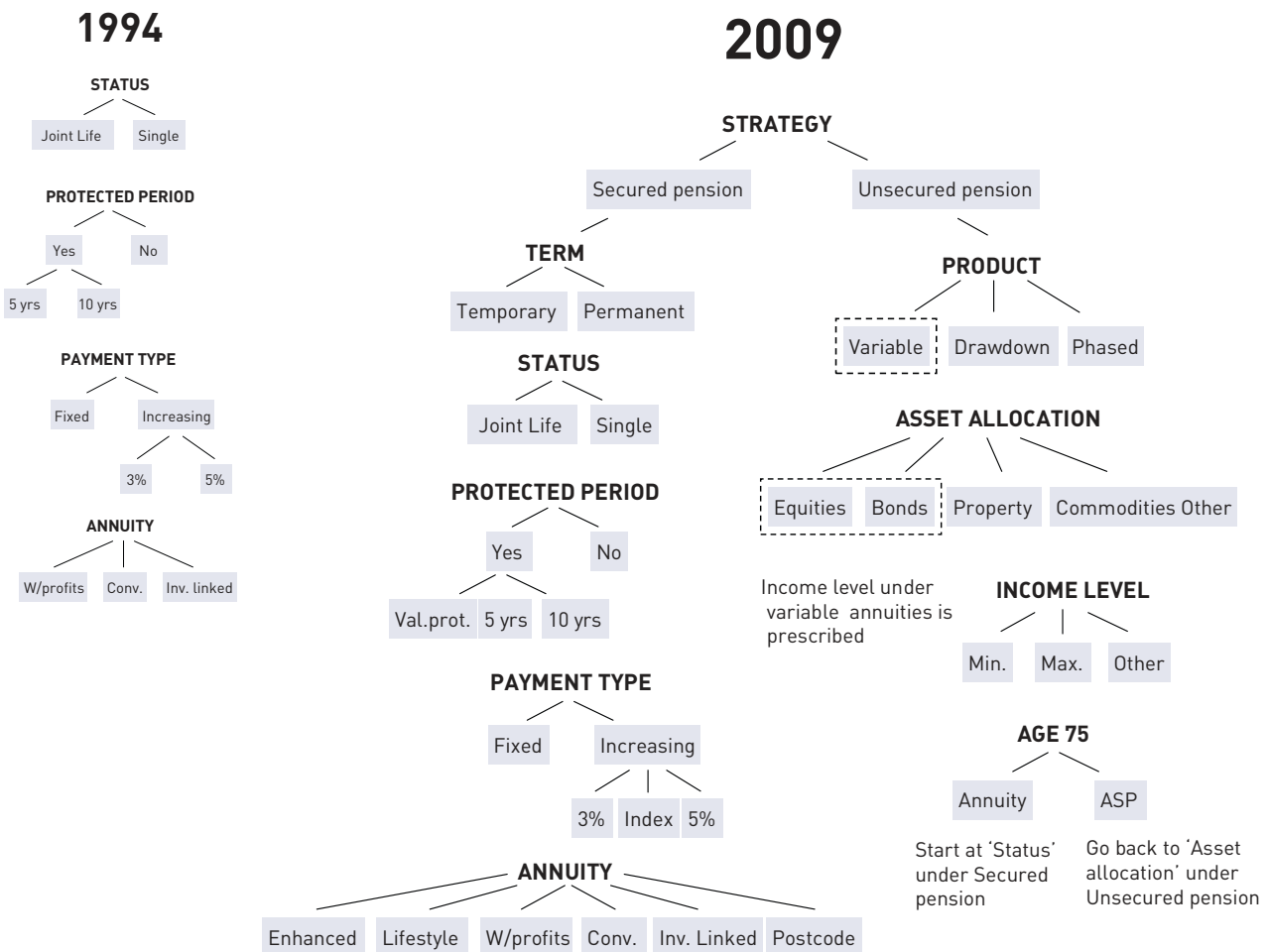
- Conventional annuities
- Income drawdown
- Phased retirement
- Variable annuities
- Fixed term temporary annuities
- With profits/unit linked annuities
- Specialist annuities: Enhanced, lifestyle, smoker, postcode\*

\*These are strictly conventional annuities priced for particular market segments. They are also available in a variety of different formats i.e. lifetime annuity, fixed term, unit linked.

- **Selecting the best rate**

Once the most appropriate product has been chosen then a comparison of rates.

Figure 5: Over the last 15 years the process has become much more complex



Source: PICA, 2009

This process can produce significant benefits. Different people will have different needs and the array of choice means there is a strong likelihood that, for many people, the optimal solution may not be a conventional annuity. For example, people looking for high levels of income may wish to consider investment linked annuities, income drawdown or phased retirement. Alternatively, many people could boost their income because of their health, lifestyle or where they live. Others may wish to keep their options open for the moment and choose a fixed term annuity.

The choice of product is a personal one: An individual's objectives, personal circumstances, other savings and investments (including equity in the home), will all have an influence on the choice of product.

It's important that people are encouraged to make the right decisions for their future. For example, it is estimated that around 40% of people could qualify for an enhanced rate. This can make a significant difference (see figure 6).

**Figure 6: The difference in outcomes can be material**

Aggregate Income (£)	1 Year	5 Years	10 Years	15 Years
Worst Conventional	1,921	9,605	19,210	28,815

Improvement (£)	1 Year	5 Years	10 Years	15 Years
Best Conventional	102	510	1020	1530
Postcode (Glasgow)	140	700	1400	2100
Impaired (Diabetes)	273	1365	2730	4095
Smoker	408	2040	4080	6120
Impaired (Cancer)*	587	2935	5870	8805

Source: Exchange except \*LV= (cancer rates aren't quoted on The Exchange) Based on 65 year old male, single life, £30k premium, level, 5 year guarantee and payable monthly in advance (October 2009).

There are companies that offer competitive products to help people accumulate savings for retirement while also offering competitive solutions at the decumulation stage, but it is not axiomatic that this is the case. The skills and capabilities required to help people save for retirement and to grow their savings (the 'accumulation' phase), are not the same skills required to provide people with a guaranteed income for all of part of their retirement (the 'decumulation' phase).

Choosing the right product at the point of retirement is a completely independent decision. The product selected to accumulate savings effectively matures and, though the company offering the savings product may be obliged to offer an annuity, there is no obligation on the individual to accept the offer

The proposals for the new Personal Accounts recognise this. It is intended to promote the open market option and to offer a focused choice of providers and annuity types for those who do not want to shop around<sup>11</sup>.

**The number of people aged 65 and over is expected to increase by 60% in the 25 year period from 2005-2031: From less than 10m in 2005 to more than 15m in 2031. Some 23 % of England's population will be aged 65 or over at this point<sup>12</sup>.**

**While there may be people who can't use (or may not benefit from using) the OMO, it is likely that there are many people who could use it to improve their income in retirement, who aren't.**

**For these people, it is a national tragedy. The need to maximise income in retirement is universal, but never has it been more important. The move from generous DB schemes to more modest DC schemes, the erosion of state benefits and the collapse of personal savings, coupled with unprecedented increases in life expectancy, will create a new underclass of retirees struggling to maintain a reasonable standard of living.**

**The open market option is not a panacea to this dilemma, but it is an important component in any solution.**



## Section 3: Why isn't the process working?

### *'I can't get no (Satisfaction)'*

There is general agreement on the barriers to progress. There are issues around both supply and demand: A lack of capacity in the market to help people make better decisions and a low level of demand from consumers.

On the supply side, IFAs struggle to provide advice economically to low value clients, employers and trustees are concerned about straying into providing advice and product providers find themselves in an invidious position insofar as they are required to promote the open market option, but often rely for part of their profitability on retaining as much of the money as they can at retirement.

On the demand side, too few people are aware of the potential to increase their retirement income. Even those who are aware, often labour under a number of misapprehensions about how the process works and whether it's a worthwhile exercise. There is also a general lack of understanding about what an annuity is, let alone an appreciation of the different types of annuity.

In this section, we investigate the reasons for the lack of supply and demand and suggest how this position could be improved.

#### **Is face to face professional advice the way forward?**

One obvious solution is for everyone to have access to face to face financial advice (preferably from an Independent Financial Adviser) and indeed many people take exactly this route and generally make better decisions as a result<sup>13</sup>. Unfortunately, while there is a will among many IFAs to help medium to low income families, the economics of running an IFA practice means that many IFAs struggle to offer advice to people with funds less than £50,000. This isolates the majority of retirees.

ABI statistics indicate that 88% of annuities bought in 2008 were with funds below £50,000. What is more, the introduction of Personal Accounts will exacerbate this situation.

Certain IFAs, often those who have invested in technology to streamline their processes or redefined their business model to reduce costs, are interested in dealing with clients with small funds, but these are few and far between. Not only is it difficult to make money on the annuity, but clients with small pension pots will not generally have significant other assets. Therefore there is little, if any, long term value created for the IFA's business.

The challenging economics are not solely a function of the level of commission. It is the interplay between the commission paid and the time involved to complete the transaction.

Annuity illustrations are often only guaranteed for a specified period of time, say 14 or 21 days, but the money could be coming from several sources and some product providers may take several weeks to release the funds. This means if annuity rates have changed in the meantime, the IFA may have to go through the whole process again. For small funds this exacerbates the challenge of making annuity business profitable.

There are a number of initiatives to try and tackle this problem from both ends: Improving the speed and ease of annuity processing and increasing the commission. For example:

- **The Options initiative.**

Driven by the ABI and Origo, it is intended to cut payment times to a maximum of 30 days initially and has produced impressive results. Unfortunately not everyone has signed up to the initiative. Notable absentees include some of the worst offenders.

- **Annuities clearing house**

There is another new initiative being tested by specialist annuity IFA, Rockingham Retirement. The IFA has established an annuity clearing service. Initially, only three companies are involved but, if successful, it is likely to attract more interest from other providers<sup>16</sup>.

- **Increasing commission**

A number of providers now pay increased commission to help and encourage IFAs to try and provide advice to people with funds of less than £50,000. The rate of commission payable is effectively deducted from the amount of the annuity, but this can still result in a significant improvement in income for the individual.

These initiatives should be encouraged, but there are still barriers that make it unlikely that IFAs will be the panacea to the supply-side issues. For example, the Retail Distribution Review (RDR), scheduled to come into effect from 2013, may hamper IFA efforts to offer advice to people with small pension funds. The RDR is likely to lead to a reduction in the number of IFAs resulting in a further contraction of capacity in the market. Estimates around the likely reduction in numbers vary from as low as 12% (FSA) to as high as 40% (Ernst & Young)<sup>17</sup>. What is more, the change to the way IFAs will be remunerated could also impact the numbers of people who are prepared to pay for advice on their retirement income options.

The RDR is also likely to increase costs which will also have a detrimental effect.

Having said this, the changes proposed by the RDR may lead to new models of distribution offering simplified advice that could make it more economic for IFAs to deal with smaller case sizes.

### **Should product providers be more proactive?**

Product providers could also provide a more proactive service to people approaching retirement, but there is a potential conflict of interest. Many companies find it very profitable to retain the proceeds of maturing pensions and therefore have little interest in promoting the open market option to their existing customers approaching retirement.

It has been compulsory since September 2002 for product providers to publicise the open market option in the literature they send to people approaching retirement.

However, an FSA survey last year found that almost 40% of the literature they reviewed did not meet the standards set<sup>18</sup>. Shortcomings included failure to explain that exercising the open market option can result in a higher pension and burying the information in the pack (preferring to give greater prominence to the company's own annuity product, for example).

The ABI published new guidelines for pension provider wake-up packs in July 2008 and have been working with providers to improve communications. While there is some evidence of success, it is still questionable whether the improvements will have a significant impact.

Quantitative research by the ABI among retirees who should have received a wake-up pack in the 4-16 week period prior to their interview with the researchers revealed that 15% claimed they had not received the pack and a further 3% could not remember. Of the remainder, 58% had either skimmed the pack, not read it or could not remember what they did<sup>19</sup>. Having said this, the research clearly demonstrates that the improvements are having an impact among those who read the packs. Awareness of the OMO increased significantly

particularly among those who did not know, prior to reading the packs, whether they could shop around.

Nevertheless, according to YouGov 61% of over-55s don't know that they can arrange their retirement income with someone other than their pension company<sup>20</sup>. This figure should reduce closer to retirement as a result in part of the wake-up packs, and the ABI initiatives should be encouraged, but there is no room for complacency. It's critical that there is continued focus on improving the quality of literature, but there remain concerns about the significant numbers of people who do not read the literature thoroughly.

Aviva recently announced its intention to voluntarily show competitors' rates when quoting for annuity business. It's not clear at this point exactly how this will work.

### **Should greater responsibility lie in the workplace with employers and trustees?**

There has been much discussion about the transfer of the investment risk from the employer to the employee when DB schemes are converted to DC, but often very little is said about the transfer of decision making at the point of retirement. In a DB scheme it is the employer's or trustee's responsibility to ensure that there is enough money to meet the scheme's commitment to pay the pensions at retirement. In a DC scheme the member must decide how to apply their fund at retirement.

The Pensions Regulator has issued a recent statement calling for trustees to recognise their responsibilities in this area and for employers to become more engaged in the issue<sup>21</sup>. It has also undertaken a review of best practice in this area and has emphasised the value that trustees can add for members at retirement, for example, facilitating access to advice<sup>22</sup>.

There are benefits for employers to take a more proactive position. A Watson Wyatt survey revealed that only around 1 in 5 employers believe they get full value from the money they spend on employee benefits<sup>23</sup>. Greater education and engagement by employers to help employees, particularly in making the right choices at retirement, would improve perception of the benefits of a good pension scheme.

It may also be financially efficient. In November 2004, employers were encouraged to provide pensions advice to employees with the introduction of a tax free benefit of £150 per employee per annum.

Many employees naturally look to their employer for help and support at the point of retirement. After all, it is a company pension scheme. The provision of an income for retirement is the ultimate purpose.

A 2007 Department for Work and Pensions research report on trust and confidence in pensions and pensions providers suggested that around twice as many people trust their employer to 'act in their best interests' than trust either the government or the financial services industry<sup>24</sup>.

Some employers and trustees already make financial advice available to employees. Others recognise they should do more at the point of retirement, but are uncertain how best to achieve this. It is not necessary for employers to stray into the vexed area of advice in order to aid employees. Much can be done by way of education.

It is critical for employers and trustees to take a far more proactive role in developing effective processes to help employees approaching retirement.

### The consumer perspective

That there is little demand from consumers should not be surprising. There are significant numbers of people who do not read the literature they are sent closely and therefore may not be aware of the OMO<sup>25</sup>. Even among those who read the pack the significance of reviewing their retirement income options may not be apparent. Here are some of the more common reasons why people do not always undertake a review of their options at retirement from a qualitative study carried out for the Department for work and Pensions in 2007<sup>26</sup>:

- A belief that the subject is just too complex, time consuming and not worth the effort.
- A sense of misguided loyalty. Some people expressed the view that the company they had saved with for many years would reward their loyalty with a competitive offer.
- Some people felt that there was no point in using an IFA as they believed that they would be asked to pay up front charges that would eliminate any benefit.
- A sense that smaller pension funds, typically with values below £40,000, allowed only a limited range of choices about annuity types, or that decisions made about annuitising smaller funds were financially inconsequential.
- Established attitudes and patterns of behaviour, including a sense of resignation to achieving a poor result from annuitising a pension coupled with a mistrust of providers and advisers.

Education is an important issue. Few people understand what an annuity is, fewer still have any appreciation of the choices and options they have at retirement. If they did it is highly unlikely that this situation would exist. Consumers are happy to spend time looking for the cheapest car insurance or the lowest mortgage, yet for many the savings they make are inconsequential when compared with the potential to increase their income in retirement.

**There is much to be done. It is important that the misconceptions that many people have are tackled. Communication needs to be improved and there are steps being taken to make the wake-up packs clearer and more engaging; IFAs need to be encouraged to reach out to people at retirement with small pension funds and the moves to increase commission and simplify the process will help; and employers and trustees must be made to recognize their responsibility to support employees more proactively than many have done to date.**

**But is this enough? Given the deep rooted nature of the misapprehensions people have, the breadth of the different perspectives and the scale and importance of this issue to future generations of retirees, is it likely to prove too little too late?**

**An incremental strategy may not produce the desired result quickly enough. Every year in the UK for many years to come, more than half a million people will reach age 65<sup>27</sup>. Most of these people will not have enough pension savings to enjoy the standard of living they had expected in retirement and many of them will struggle financially. Yet, for some of these people, their financial position could be improved by the simple expedient of reviewing their options at retirement.**

**In the next section, we will consider the implications of government action to change the existing processes and the likely consequences of such action.**

## Section 4: Where do we go from here?

### *When I'm 64*

More than 600,000 people will turn 65 in the UK next year. The majority of these people will have pension savings, but many will not properly review all of the options available to boost their income in retirement. Most of the people who do review their options will be affluent or high net worth investors; better informed with sizeable funds and supported by expert advisers. Most of the people who do not review their options will be people with smaller funds, less well informed and without access to professional advice.

Over several years, the cumulative impact of this situation could mean that hundreds of thousands of people might lose out on the opportunity to boost their income in retirement.

There are a number of initiatives that can and are being taken to avert this situation, but these are likely to take time to produce results. Time is not on our side. If more drastic action is not taken, significant numbers of people will retire on incomes that are less than they could have achieved.

**The only way to deal with this swiftly is to encourage everyone to review their options at retirement by making this the default option.** This is the most effective way to materially increase the number of people who secure a better pension at retirement.

There are a number of benefits to this approach:

- **Socially desirable.**

Potentially hundreds of thousands of people could retire on higher incomes without any direct cost to government.

- **Increased consumption.**

The majority of people who would benefit are those on small incomes; they are likely to be spenders rather than savers.

- **Higher tax revenues**

Pensions are taxed as earned income so the higher the pension the more tax paid.

- **Greater competition**

Making it more difficult for providers to seamlessly roll-over pension savings into their own annuity products will promote competition among providers.

PICA has commissioned a macroeconomic study by Oxford Economics to financially quantify the implications of such a move. The full findings are to be published in a separate report scheduled for release in November 2009. The economic analysis reveals that had the move occurred this year it could have raised the total income of those retiring in 2009 by over £30 million. Furthermore, as pensioners would continue to receive extra income every year for the rest of their lives the benefits of the policy change will, in the long-term, amount to hundreds of millions of pounds in each year.

#### **How could this work?**

In order to succeed there are a number of conditions to be met:

- People must be encouraged to review their options.
- Product providers should be prevented from exploiting consumer inertia.
- More education and information is essential.
- Help and support will be necessary for people to make decisions.
- The process must be simple to make it easy for people.
- Any solution must work effectively for the majority of retirees.

Overriding these conditions are two key challenges:

- How do we encourage people to read the materials that are sent to them?
- What should people do once they have read these materials?

### Encouraging people to read the materials they are sent

The ABI initiatives in improving the awareness of the OMO have had a significant impact on people who read the information they are sent. However, the majority of people do not read the literature they are sent thoroughly. Most merely skim the contents and many do not read it at all. In some instances there may be legitimate reasons for this, but nevertheless this is disappointing:

The likely reasons for the relatively low number of people who read the wake-up packs thoroughly are:

- The size of the pack. Many wake-up packs are formidable and intimidating to read.
- Too much irrelevant information. Packs often cover in great detail issues that are irrelevant to the majority of retirees, lifetime allowances for example; this simply serves to confuse people.
- Providers often seek to promote their own products and play down the impact of the open market option.
- Lack of plain English. Many packs contain too much jargon and use technical expressions which assume a level of understanding that doesn't exist for the most part.
- Prominence of the open market option. The information may be presented in such a way that the benefits of the open market option are not clear.

Again the ABI are attempting to tackle these issues, but PICA believes that a more radical approach is needed.

### A new approach is proposed that would encourage people to review their options at retirement by making this the default option that all pension schemes should comply with.

The new approach should replace the existing process and would comprise three stages of communication in the run up to retirement:

#### Stage 1:

This would be a relatively short communication, no more than 15-20 pages, and sent 6 – 9 months from retirement. It would focus exclusively on the options at retirement and would include the following:

- Call to action. The pack would stress the importance of taking action immediately and outline the decisions to be made.
- A list of sources of information. For example:
  - FSA's Money Made Clear
  - The Pensions Advisory Service
- Brief descriptions of the types of retirement income product available and their suitability for different clients.
- Examples of the potential benefits of exercising the open market option (range of conventional rates, enhanced and lifestyle rates)
- Next steps? The pack should explain the rest of the process and the actions employees should take.

The communication would be written in plain English, jargon-free and tested with consumers to check its effectiveness.

This process would help employees identify what type of retirement product is likely to be most suitable and motivate them to act.

The Pensions Regulator recently revised its guide 'Making your retirement choices: think before you choose'. This is a good example of how this subject can be presented in a compelling and engaging manner.

### Stage 2:

Three months before retirement each client would receive a pre retirement statement that would contain personalized details such as:

- Name and address
- Date of birth
- Sex and marital status
- Estimated fund size
- Protected rights
- Tax free cash

The form would also include boxes for the employee to tick that should highlight whether certain types of product may be suitable. For example:

- Do you smoke?
- Height and weight
- Do you suffer from any of the following conditions?

This could be used by the employee to obtain quotations and rate comparison. It should contain most/all of the information required.

### Stage 3

The third and final stage would be a brief communication six weeks before retirement, that requires the employee to inform the provider what should be done with the fund.

It is our view that this process would have a material impact on the numbers of people who would be better off in retirement. There are a number of challenges that arise from these proposals, but we do not believe that these are insurmountable.

### What should people do once they've read the materials?

The second key challenge is to make sure people have access to the information, guidance and advice that they need to make decisions. Clients with funds over £50,000 should have no problem seeking an IFA to advise on the most suitable solution. The issue generally lies with people with smaller funds.

Here is a list of our key recommendations:

- Process improvements, like ABI/Origo 'Options' campaign and flexible commission structures being offered by many providers for smaller funds, mean that there are IFAs who are prepared to offer advice to smaller funds. These and other initiatives aimed at making it economically viable for IFAs to process smaller annuities should be encouraged. Indeed, all providers should be required to sign up to the 'Options' campaign
- A registry of advisers who are prepared to offer advice to people approaching retirement with funds of less than £50,000 should be maintained and promoted with details of any limit each IFA may impose on minimum fund size.
- Employers and trustees should be encouraged to establish a policy on providing access to financial advice and information for retiring employees aided by the development of guidance on best practice. The guidance would cover:
  - Appointing an IFA or annuity broker to offer advice for all members approaching retirement.
  - Nominating a member of staff able to provide information and generic guidance and support.

- Allowing employees nearing retirement time off to attend a retirement workshop.
- Accepting transfers into the scheme from other pension arrangements to aggregate small funds.

The trustees or the employer's pension governance committee should monitor the effectiveness of the process. This would cover the timescales of the purchase process, how many employees take advice (and how many take the open market option) and the performance of the adviser.

The NAPF is also urged to add a fourth core test to its Pensions Quality Mark which would expressly review the adequacy and extent of the arrangements in place to ensure employees are supported at retirement.

- Direct to consumer propositions should be encouraged. There is a dearth of direct to consumer propositions in this space. This is largely a by-product of the complexity of annuity processing. There are a number of initiatives that should make annuity processing more efficient.

For the majority of people with funds of less than £20,000 the issue will be largely driven by a desire to find the annuity that offers the highest income. This shouldn't be markedly different from shopping for car insurance and online solutions should be encouraged. It is often said that older people don't use the Internet. While this is still true of very old people, it is not true of people approaching retirement. In research over a three month period last year, 63% of 55-64 year olds claimed to have used the Internet

- The FSA comparative tables are a very helpful tool and should be extended to include all companies and all types of annuity.

- The Money Guidance pilot, assuming it is successful, is an obvious way to offer help to people with small funds to better understand their options. It is appreciated that there are other important priorities for this project to help people better manage their financial affairs but, at the earliest opportunity, consideration should be given to deepening the support that could be given at retirement.
- A review of the trivial commutation limits to help people who would not otherwise be able to take advantage of these changes (because of the size of their funds).

**It is our belief that the combination of encouraging everyone to review their options at retirement, by making this the default option, plus the continued development of industry initiatives is the only strategy that will have an immediate impact on this issue.**

**It is rare to identify an opportunity that could make a difference to the finances of hundreds of thousands of people without any significant costs to the public purse or requiring substantial investment by companies or personal sacrifice by individuals.**

**This is such an opportunity.**

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## Conclusions

Many people will struggle to finance a comfortable retirement in the future. They may attempt to mitigate the impact of this by retiring later, working during retirement, leveraging the equity in their homes or simply tightening their belt and making economies wherever they can. All of these measures will help, but one obvious step people can take is to carry out a proper review of their options at retirement.

This is not just about choosing the best rate. The array of retirement income options available means that for today's retirees it is a two step process: Firstly, making sure they select the most appropriate product type for their particular needs and then, secondly, securing the most advantageous terms. The potential benefits of this approach can be significant

Too few people undertake a thorough review of their options. While some people will not or cannot benefit from reviewing their options, many others can. The evidence suggests it is the less well off who are less likely to undertake a review. These are the very people who need to make the most of their assets if they are to avoid financial hardship during retirement.

There are a number of initiatives in progress that it is hoped will help solve this problem, but it is our view that these initiatives, valuable though they are, will not create a material change in the numbers of people who review their retirement income options quickly enough. Time is not on our side.

More than 600,000 people will turn 65 next year rising to more than 800,000 in 2012. It is important that all these people make the most of their retirement savings. For example, currently around 1 in 3 people use the open market option. If 1 in 2 people could benefit by moving their assets, and can be encouraged to do so, hundreds of thousands of more people would improve their retirement income over the next 10 years.

To achieve a material change in the numbers of people reviewing their options at retirement, PICA believes government action is necessary to ensure that the default option should be for everyone to review their options at retirement.

PICA hopes that the recommendations in this report will be adopted by each of the main political parties. It intends to engage with politicians from all sides to agree how this proposal can most effectively be introduced. PICA also believes it is important that existing initiatives are supported and encouraged and will work with all interested parties to promote the need for everyone to properly review their initiatives at retirement.

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