"Swimming against the tide? Increasing flexibility to withdraw money from private pensions in the UK"

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For several decades the UK has had legislation that requires that the majority of funds saved in tax-favoured defined contribution pensions should be used to purchase an annuity in retirement. For a long time the UK has been unusual in having this kind of compulsory annuitisation but recently a number of other countries – notably the United States and Australia – have started to think about moving in this direction. However, just as others have started to do this, the UK government dramatically and unexpectedly announced (in April 2014) that they would remove this requirement. The law was changed with effect from 6 April 2015. This article explains how the law has been changed, what the effects might be, and how widely the effects might be felt.

Prior to April 2014, most people with a defined contribution (DC) pension faced a strong incentive to buy an annuity with their pension fund by the age of 75 because otherwise they faced a tax charge of 55% on assets withdrawn from the fund (either during their lifetime or after death). If they chose to purchase an annuity before age 75, they could take up to one-quarter of their fund tax-free and use the remainder of their pot to purchase an annuity, with the annuity income then being taxed at their marginal income tax rate.

This restriction made the UK very different from most other countries, which typically do not have annuitisation requirements of this kind. It also contributed to the UK having a much larger – and arguably better functioning – annuity market than most other countries. In 2013, around £12 billion (€16.5 billion) worth of annuities were sold in the UK; the vast majority of these were bought using funds from DC pensions, rather than being 'voluntarily' purchased. This compulsion mitigates the 'annuity puzzle' – so much discussed by academics in other countries.

Private pensions are an important part of the retirement income landscape in the UK. Compared to other developed countries, the UK has relatively limited state pension provision, meaning that private pensions – both employer-provided and individually-arranged – have for a long time provided a significant proportion of retirement income, particularly for higher earners. Furthermore, private sector employers have rapidly moved away from offering defined benefit pensions over the last two decades, meaning that DC pensions have rapidly grown in importance, particularly for currently younger cohorts.

The government were keen to promote the abolition of compulsory annuitisation as giving people "greater freedom over how they access their pension savings". There was relatively little debate of some of the potential costs of abandoning compulsory annuitisation. As an economist, three particular risks sprang to mind.

- The risk of moral hazard – that individuals might spend their pension fund too quickly and fall back onto state-funded means-tested support later in retirement. There is evidence that this is

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how people respond in the Australian system – one of the facts that led the recent Murray Review to advocate a move towards more widespread annuitisation. However, we should be cautious of drawing direct lessons from the Australian experience because their state pension is fully means-tested – increasing the incentives to run down other assets – while many pensioners in the UK are likely to avoid means-testing.

- The problem of myopia – that individuals are too focussed on the present and so might spend too much money early in retirement and come to regret it later on. Evidence from household survey data suggests that people in the UK do significantly underestimate their life expectancy – by around two years on average for men, and four years for women.
- The risk that abandoning compulsory annuitisation will lead to greater adverse selection in the annuity market. The UK is notable for having a relatively large and well-functioning annuity market compared to other countries, which might be attributed to the existence of compulsory annuitisation. There is a risk that removing this will cause prices to rise and for many to be priced out of the market. Certainly there was a sharp drop in sales of annuities in March 2014 when the policy change was announced. However, the annuity market in Ireland seemed to survive a similar policy change that was enacted there in 1999.

How people and markets will actually respond to the changes announced in March 2014 will depend, at least in part, on who it is that has been affected: How much DC pension wealth do they have? What other forms of retirement resources do they hold? What are their other characteristics?

In practice, two groups of people were (even prior to March 2014) not subject to compulsory annuitisation. First, those with only small amounts of money in DC pensions were able to withdraw the whole amount, receiving one-quarter tax-free and facing tax at their marginal rate on the other three-quarters. This applied to up to three pension pots worth no more than £2,000 (€2,800) or to all pension funds if an individual's total private pension wealth was below £18,000 (€25,000). This is known as 'trivial commutation'. Second, those relatively well-off individuals who could demonstrate that they had at least £20,000 a year of other secure annuitised income could withdraw as much as they wanted from their remaining pension funds and face tax at only their marginal rate (known as 'flexible drawdown'). What was announced in March 2014 was essentially that the flexibilities available to those with small pots or a high level of annuitised income would be extended to all. Since April 2015, all individuals aged 55 and over have been able to withdraw as much as they want from their DC pension funds and face income tax at their marginal rate (rather than 55%), with 25% of all withdrawals being tax-free.

Using data from the English Longitudinal Study of Ageing (ELSA) collected in 2010–11, we can examine how many people might be affected by the reform in the next few years and how these people might respond. A significant fraction of individuals currently approaching retirement will be entirely unaffected by last year's announcements – either because they have no money in DC pensions or because they were already eligible for trivial commutation or flexible drawdown. We estimate that about half of men and two-thirds of women (or six-in-ten of all) aged between 55 and 59 have no money held in DC pensions. There are two other smaller groups of individuals who are also likely to be unaffected by the announcements – those whose DC pots are below the trivial commutation thresholds (8%) and those who we estimate will have at least £20,000 of secure annuity income from other sources (2%). This leaves just under four-in-ten men and just over two-in-ten women (or three-in-ten of all those) aged between 55 and 59 who will experience greater flexibility as a result of the changes. This means that nearly 60% of those likely to get additional flexibility are men.

The amount of money held in DC pension funds by this group of people varies widely. Half of them have less than £53,000 (€73,000), but one-in-four of them hold more than £116,000 (€159,000) in DC pension funds. However, DC pension wealth is only one component of the household wealth portfolio for this group. There is considerable variation in the importance of DC wealth within the portfolios of those likely to get greater flexibility: for around half of them DC wealth accounts for less than 10% of their total household wealth. For just over half of those likely to be affected, DC wealth is their only form of private pension wealth, but just over a quarter actually hold more wealth in DB pensions than in DC funds. Private pension wealth as a whole makes up on average a third of total household wealth for those who might get greater flexibility.

Overall the group who might get more flexibility has higher average wealth than those unlikely to be affected by the reforms: we estimate that those getting more flexibility have median wealth (including the present discounted value of state pension income) of £680,000 (€934,000), compared to £550,000 (€760,000) among those unaffected.

Those affected are generally in better health, better educated and more likely to own their own house than the average. They also expect to live longer. Some of these characteristics – in particular the higher levels of education and relatively high wealth – suggest that those who will get greater flexibility in the short-term might be relatively well-placed to receive, and to act appropriately upon, information, guidance and advice that they are given over how to manage their own finances. However, there might still be concern about how well-placed individuals will be to exploit these new 'freedoms'. Our own recent analysis (forthcoming in the *Journal of Pension Economics and Finance*) suggests that there is variation in how DC pension holders navigate annuitisation decisions and that those with better numeracy and previous experience of complex financial products were more likely to shop around for an annuity rather than buy direct from their original pension provider.

The fact that those who will be affected are in relatively good health and expect to have a greater than average chance of living to older ages also raises the stakes in the decisions these people will be making. This will potentially increase the costs of making an inappropriate decision.

The risk of moral hazard (i.e. the possibility that people might spend all their funds quickly and then fall back onto taxpayer-funded means-tested benefits) might not be such a risk in the short-term since the vast majority of those most likely to get the greater flexibility are home owners (and thus unlikely to qualify for the main means-tested benefit for which they could be eligible, which is a benefit that covers the cost of rent) and on average have significant other assets in addition to their DC funds. However, the picture is likely to look different in the longer-term as DC pension coverage becomes much more widespread. The number of people affected in later cohorts is likely to be much larger, and their characteristics more diverse than what is described here. The reforms could have wide-ranging implications for the level and profile of individuals' retirement incomes, their welfare, demand for different financial products, and demands on publicly funded means-tested support for pensioners. It will be important to monitor behaviour and the functioning of the annuity market over the coming years to ensure that individuals achieve decent retirement incomes under the new system.