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Lifetime Annuity Income is the Key to Life

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THE UK FREEDOM AND CHOICE IN PENSION ACT

People are living longer than ever; fertility rates are at a record low and projected to drop even further; interest rates are at historic lows. So, what does the U.K. government do in response? It reverses a mandatory annuitization of Pillar II employer-sponsored defined contribution pensions with the Taxation of Pensions Act, widely known as the Freedom and Choice in Pensions Act of 2014. But, more about this shortly.

WHEN FUNDS RUN LOW

My grandmother died at 102 years old. She lived a good life and was relatively healthy. While this could be a model for an argument that people are living longer, it is not. It is also not an argument that my family has good genes. More concerning to me than how long my grandmother lived is her cause of death. The medical records probably show that she died of heart failure, or maybe respiratory failure. Some may say that she simply died of old age. I, however, know the truth. My grandmother died because she ran out of money.

About nine months before her death, her son (my uncle) moved her to a nursing home after 101 happy years in her own home. Only in the last five years did my grandmother require at-home aides and only during her final two years in her home did she require 24-hour care. This is quite expensive and even with support from the grandchildren, USD 8,000 per month is a large bill to pay. Therefore, my uncle moved her to a nursing home and she died.

When my grandfather died 25 years earlier, he left my grandmother a nice sum of money to live on, but he could not have imagined that she would continue to live for another 25 years. Had my uncle consulted the only actuary in the family, he (I) would have suggested a lifetime, payout annuity. While my grandmother would not have been able to live the same style of life that she had grown accustomed to while my grandfather was alive, she would be secure with the knowledge that she would have a steady income for life, and she would probably still be alive today (at age 109).

PROBLEMS WITH THE U.K. PENSION SYSTEM

Lifetime income is important for everyone, but most important during times of low interest rates. The U.K. had a fantastic system in place—automatic enrollment into an employer-sponsored defined contribution plan (called Pillar II in most of the world except for the U.S., with Pillar I being social benefits and Pillar III being personal savings) and mandatory annuitization in most cases at retirement. But there were some problems with this system.

First, most people used the annuitization option inside of their pension plan. Retirees had the option to annuitize with any company and could easily shop rates, but like the rest of us, people are lazy and just chose the annuity inside the plan. Annuity providers fought to have their products inside these pension plans. However, once inside, companies knew that most people would annuitize to their product and offered less than attractive rates inside of plans thus distressing the U.K. Government.

Second, interest rates were (and still are) so low that longevity assumptions become too transparent. When interest rates assumed in annuities are about 5 percent, it is difficult for the average person to determine what longevity assumptions are utilized. With the effects of longevity and compound interest at work, a 65-year old person would calculate that he or she would only have to live to age 80 or 85, for example, and determine that an annuity was a good choice.

However, with rates hovering around 1 percent, it becomes a simple exercise for the average person to calculate that for GBP 100,000, a monthly annuity of GBP 350 beginning at age 65 means that the person has to live to age 90 to recoup his or her "investment." Although people are living longer, the average person may struggle with an investment option that has benefits only if he or she lives to age 90 or beyond.

This is one of my personal pet peeves with the way annuities are sold. In the U.K., annuities are sold by advisors or banks and both seem to sell them as investments. We do the same in the U.S.—selling annuities as investments. Look at the product called Variable Annuities. Such a small percentage of policyholders annuitize that it is a wonder why this product name continues to exist. Annuities are insurance against the policyholder living too long and this is how annuities should be sold!

Third, Pillar II annuity payments are taxed similarly to how they are taxed in the U.S. Since the pensions are funded with pre-tax monies, they are fully taxed on withdrawal. Her Majesty's Revenue and Customs (HMRC) would much prefer lump

sum withdrawals of Pillar II funds so it can collect more in tax revenues. HMRC sees all of the money in these pension funds and drools. (In all fairness, HMRC was actually against the Freedom and Choice in Pensions Act. It was the government that was drooling). While not yet proven, it seems logical that too much money withdrawn early would cause elderly poverty levels to rise in the future. Could it be that politicians are not too concerned about delaying this issue to the future at a time when they may not be in office any longer? I know, I am a skeptic.

This is a quote from the then Chancellor of the Exchequer, George Osborne, about why the Freedom and Choice in Pensions Act was enacted:

> "This government believes in the principle of freedom. Individuals who have worked hard and saved responsibly throughout their adult life should be trusted to make their own decisions with their pension savings, and the reforms I announced at Budget will deliver just that."

Should the average person be trusted to make a financial decision that includes investment and longevity assumptions? Are these people even given the correct tools in schools or at work to fully understand the issue? Actuaries, who study for years and take continuing education courses on these topics, still argue over assumptions and discount rates. Maybe Mr. Osborne should have put in place a Financial Literacy Act prior to the Freedom and Choice in Pensions Act to make sure that people learned about annuities and had the proper tools to make the right decisions.

In addition, the government allowed people to save these monies on a tax-deferred basis. The entire reason for allowing this is so that people would use the money for retirement and not be dependent on the state. Taking the entire pension savings and purchasing a boat hardly achieves this goal.

In trading email messages with Steve Webb, the Minister for Pensions, during the time that the Freedom and Choice in Pensions Act (the Act) was discussed and passed, I learned some very interesting facts. According to Mr. Webb, the current government wanted to shed the "nanny state" label. It felt that the perception amongst the U.K. population was that government thinks it knows best.

Interest rates were a key factor in the decision. With rates tumbling, the private annuity market was seen as in trouble. And, with retirees not shopping for the best rates, the government felt that retirees were being taken advantage of. It is interesting that the government wanted to lose the "nanny state" characterization but it suddenly knew what was best for people with respect to annuitization.

Only time will tell if the U.K. made the correct choice, and it may be a long time. While withdrawal rates increased greatly since the passage of the Act, there is no indication yet that these withdrawals will cause harm to the government. It may be that old-age poverty levels will actually decrease in the short term, but increase in the long term. This is because with higher levels of lump sum withdrawals, retirees will be spending money in early years meant for use much later into retirement. The U.K. government may have passed on a gift to future generations that will be difficult to compensate for. With lower fertility rates, subsidizing the elderly who deplete savings and become dependent upon the state, will be spread amongst an ever-decreasing number of workers.

A POSSIBLE SOLUTION

With interest rates currently so low, it is not really prudent to purchase a lifetime annuity with the entire Pillar II savings account as was done previously. However, "drawing down" the monthly benefit that would have been paid if interest rates were higher is not the answer either. Retirement money will simply run out too quickly. What could be done is a simple ladder approach. Take a certain percentage of the money, say 10–20 percent, and purchase lifetime income. The same could be done in each of the next number of years so there is an average of current interest rates.

By laddering your annuities one can assure himself or herself that an annuity wasn't purchased at the worst possible time. It would give at least some comfort to retirees and, at the same time, lock in much needed lifetime income. While people may have to take a small stepdown in standard of living at the time of retirement, people can rest assured that this somewhat lesser lifestyle will continue forever.

Had my uncle thought to contact me when making his poor financial decisions for his mother, my grandmother might still be alive today—reading the same books as me, telling me about her world travels and giving me invaluable family information not available anywhere else. She was also an inspiration for my four children. I miss my grandmother and hope that an entire generation of Brits do not fall to the same fate because of the Freedom and Choice of Pensions Act.

Disclaimer: The views expressed in this article are those of the author and are not necessarily those of the Society of Actuaries or the International Section.

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