



# Pointmaker

## AUTO-PROTECTION

### AUTO-DRAWDOWN AT 55, AUTO-ANNUITISATION AT 80

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*“By providing financial protection against the major 18th and 19th century risk of dying too soon, life insurance became the biggest financial industry of that century .....Providing financial protection against the new risk of not dying soon enough may well become the next century’s major and most profitable financial industry”.*

*– Peter Drucker, “Innovate or die”, The Economist, 25 September 1999.*

### SUMMARY

- This paper proposes the introduction of “auto-protection” for those reaching private pension age. This is currently 55, which is far too early: it should be swiftly raised to 60. The objective is to substantially reduce exposure to financial risks in later life, including the premature exhaustion of savings, thereby also helping to protect the state.
- Auto-protection should have two distinct components:
  1. **“auto-drawdown” at private pension age**, in the form of an income drawdown default of between 4% and 6% of pot assets, per annum. Providers should be encouraged to provide a low cost, diversified default fund for undrawn assets; with economies of scale could help to deliver larger retirement incomes than otherwise; and
  2. **“auto-annuitisation” of residual pots, at the age of 80.** This would facilitate the collective hedging of individuals’ exposure to the unquantifiable risks of longevity. It would also remove later-life exposure to investment markets risks and, through indexation, cost of living inflation.
- To be clear, everyone should be free to opt out of one or both phases of auto-protection to pursue alternatives, consistent with 2015’s liberalisations. There is no desire to prevent people from doing what they want with their own savings.
- The introduction of auto-protection would address a major policy inconsistency, whereby the state nudges and incentivises people to accumulate retirement savings, only to desert them at the start of decumulation.



## 1. BACKGROUND

In early 2015 the Centre for Policy Studies published a paper proposing the introduction of a default at age 55, dubbed “auto-protection”.<sup>1</sup> This was in response to the imminent arrival of “pensions freedoms” (April 2015), ending the requirement to annuitise a pension pot from private pension age. The concern is that from the age of 55, some people will inevitably make poor financial decisions that could put them into pensioner penury, perhaps to then fall back on the state for support.

The paper proposes that upon reaching the age of 55, savers would be automatically directed towards a not-for-profit national annuities auction house: essentially, a marketplace with all annuity providers bidding on a daily basis for annuity business. The idea is that this would automate the process of shopping around (akin to making the exercise of the OMO mandatory), and add to pricing tension. All transaction prices would be published online, introducing transparency that is currently lacking.

To be clear, auto-protection is about risk management not, for example, the elimination of choice: were auto-protection in place, one could always opt out to pursue alternatives, consistent with 2015’s liberalisation.

The paper, supported by both the TUC and a Conservative peer, attracted a lot of comment. Managers of large workplace benefits schemes (including DC pensions) were very supportive of the auto-protection concept, but cool towards the proposed form of protection (annuitisation at the age of 55), reiterated in a survey reported by Professional Pensions magazine: 70% said “no”. The irreversibility of annuitisation is clearly a major deterrent: people value flexibility. This, however,

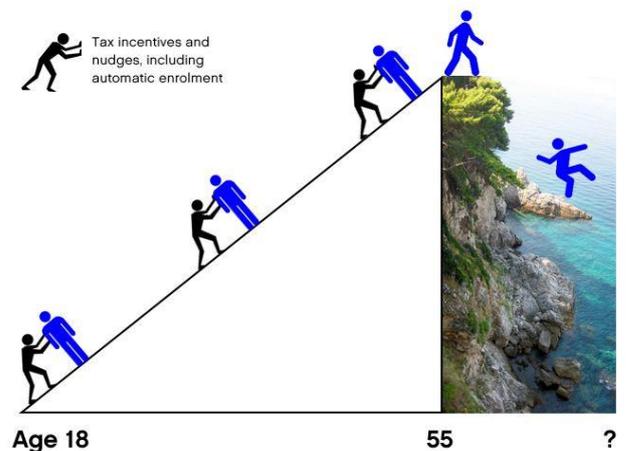
does not shed light on whether the majority are wholly opposed to *any* at-retirement default.

## 2. PRIVATE PENSION AGE

### 2.1 From 55, you are on your own

Some may consider that there are some fundamental contradictions between the principles underpinning auto-enrolment and “freedom and choice”. Today, people are encouraged to save for retirement but, unlike the grand old Duke of York, they are then abandoned at the top of the hill (aged 55), left vulnerable to their own irrational predilections (and scammers). Indeed, the hill has a cliff edge, with individuals left to play chicken with their life expectancy, manifest in the risk of running out of money before death (the “risk of ruin”).

Figure 1: From 55, you are on your own



### 2.2 Private pension age of 55: far too early

The lack of policy symmetry around the age of 55 should be addressed, but first we should recognise that today’s private pension age of 55 is far too early. Although scheduled to rise to 57 in 2028, and thereafter to be set at ten years below the State Pension age, it should be increased to 60, as fast as politically possible.

<sup>1</sup> *Auto-protection at 55*; Michael Johnson, 10 February 2015.



### 3. AUTO-DRAWDOWN

#### 3.1 Harness inertia

Automatic enrolment has demonstrated the benefit of harnessing inertia, opt out rates being very low: it should be complemented with the introduction of auto-drawdown. Indeed, the author feels some responsibility to pursue it because in 2010 he proposed the abolition of the requirement to annuitise, *provided that both the state and the individual were protected from downside risks*.<sup>2</sup> This conditionality would appear to have been forgotten. The challenge lies in designing the optimal default (not least because there is no “correct” answer). Meanwhile, the decumulation risks remain.

#### 3.2 Whither annuities?

Surveys repeatedly find that when people are asked about what they want from their defined contribution (DC) retirement savings, typically 70% express a desire for an inflation-protected, secure income until death, i.e. a lifetime annuity, although few people describe it as such. Indeed, surveys suggest that *most* people do not appreciate that an annuity *is* a pension: a brand issue. Meanwhile, the guarantee inherent in an annuity, providing security at the price of flexibility, is under-value.

In periods of “normal” interest rates, an annuity is, for most people, probably more appropriate than any other decumulation default. That said, there will always be exceptions, including people who, after purchasing an annuity, find

that their circumstances change. Annuities’ inflexibility could then be significantly detrimental.

Lifetime annuities, in particular, possess a unique advantage: as insurance against longevity risk, they have no competition. But we are not living in “normal” times, at least not by any historic measure: significant quantitative easing (QE) has seen to that.<sup>3</sup> Since 2015’s liberalisation the demand for annuities has collapsed, down 90% by volume and 70% in value: for many, cash in hand is more attractive than a regular income stretching into the future, a decision encouraged by historically low annuity rates.<sup>4</sup>

In parallel, given the diminishing demand for annuities, the supply side of the market is contracting, and therefore becoming less competitive. Aegon left the market in early 2016, selling its entire annuity book to Legal & General and Rothersey Life. Standard Life has pulled out of the open market and LV has withdrawn from both the open and closed markets. And now Prudential has just announced that it is to pull out of annuity market entirely, to focus its retirement business on retirement drawdown products. And therein lies a clue for a decumulation default.

#### 3.3 A drawdown default

Perhaps the most simple form of drawdown default (“auto-drawdown”) would be for a fixed percentage of pot value to be realised each

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<sup>2</sup> *Simplification is the key; stimulating and unlocking long-term saving*, Michael Johnson, CPS, June 2010. Downside risks including running out of money, and falling back on the state.

<sup>3</sup> The Bank of England holds about 27% of total gilts issuance, having purchased £375 billion of gilts between 2009 and 2012, and a further £60 billion since August 2016 (plus up to £10 billion of corporate

bonds), amid uncertainty over the Brexit process and worries about productivity and economic growth.

<sup>4</sup> In 2013, 90% of retirees took annuities, with 5% each opting for cash and income drawdown. But in 2015 (i.e. post-liberalisation), the figures were 9%, 61% and 30%, respectively, and in Q3 of 2016, 15%, 56% and 29%, respectively. The recent dominance of cash is partly attributed to the small average pot size. *FCA data*.



year (perhaps paid monthly), from the age of 55, unless the saver instructed otherwise. The undrawn pot would remain invested, with the saver assuming investment risk on an ongoing basis.

Table 1 compares three different drawdown rates and the remaining percentage of the initial pot size after 15, 20 and 25 years, assuming a 2% real asset growth rate.

**Table 1: Residual pot size for different drawdown rates and timeframes**

		Years of drawdown		
		15 years	20 years	25 years
Drawdown rate per annum	4%	73%	66%	59%
	5%	62%	53%	46%
	6%	53%	43%	35%

After 20 years at a 5% drawdown rate, for example, the residual assets would be some 53% of the initial amount, potentially leaving a substantial amount available to meet care home costs, purchase an annuity to cover the tail end of longevity risk, or to pass on to subsequent generations.

If auto-drawdown were to be introduced, the drawdown rate could either be set by the Government Actuary's Department (GAD), or perhaps individual providers could be free to select a rate, of between 4% and 6%, say. However this range may slightly underestimate the challenges of maintaining a sustainable drawdown rate, i.e. it should be lower. In the US, 4% is used as the "rule of thumb".

Note that as the pot size diminished, so would the size of successive drawings, i.e. drawdown income would fall through time. Conversely, annuity incomes are usually fixed or inflation-linked. This reduction in income over time could

be partly ameliorated (albeit at the price of additional complexity) by setting the drawdown rate at 4% for the first ten years, say (ages 55 to 64), then 5% (65 to 74), and then 6% until 80. The residual pot size would then be 69%, 59% and 48% of the initial amount, after 15, 20 and 25 years, respectively.

Unlike when purchasing an annuity, with drawdown, savers would not have to relinquish control over a substantial capital sum in favour of the industry, which many are reluctant to do. In addition, market timing risk would be diminished because asset realisation would be spread over many years. Furthermore, savers would no longer have to fund annuity providers' regulatory and capital costs.

Once in drawdown, people would of course retain the flexibility to annuitise, or to withdraw all of their remaining capital.

A materiality threshold should be considered, with pots smaller than £3,000, say, excluded from the drawdown default. This would also ease the administration burden.

### 3.4 A default fund

#### (a) Minimise decision making

Auto-drawdown would require people to decide what to invest in, and then assume the allied investment risks. Given that *most* people are uncomfortable with making "investment" decisions (some are paralysed by the wide choice), plus the widespread disengagement with pensions, the drawdown default should be accompanied by a low cost, diversified default fund. Asset allocation considerations should include:



- mitigating downside volatility, to reduce the “sequence of returns” risk in drawdown.<sup>5</sup> Significant assets would be drawn down over the early years, so investment risk would have to be relatively low, with a focus on downside measures of risk;
- a higher risk allocation to produce a real return over longer time horizons; and
- ensuring sufficient liquidity to accommodate “leavers” (i.e. people requesting *all* of their capital at once, i.e. embracing 2015’s liberalisation).

A default fund would remove the dilemma of which assets to sell (for cash) ahead of any drawdown, and could, for example, complement NEST’s default accumulation fund.

#### **(b) The Warren Buffett income drawdown plan**

Default fund designers may like to consider the “Sage of Omaha’s” guide to safely living off a pension pot. In his 2014 annual letter to the shareholders of his company, Berkshire Hathaway, Buffet cut through complexity, by recommending that 90% be put into a very low cost S&P 500 index tracker fund, and 10% into liquid assets, such as short-term government bonds.<sup>6</sup> The former is to provide a steady income stream (generated by selling units, i.e. drawdown), the latter serving as a buffer to plug income shortfalls (arising when selling units into a weak market).

Of his suggested approach, Buffett said “*I believe the long-term results from this policy will*

*be superior to those attained by most investors, whether pension funds, institutions or individuals, who employ high-fee managers.”*

Buffet’s 90% / 10% allocation has been back-tested by sceptics who consider it to be excessively risky. One paper studied rolling 30-year periods between 1900 and 2014, using an initial drawdown rate of 4%, subsequently adjusted for inflation.<sup>7</sup> For US stocks and bonds, Buffet’s portfolio was exhausted before the end of the 30 years in only 2.3% of the periods under review. And when the drawdown rate was reduced from 4% to 3%, the 90% / 10% portfolio’s failure rate dropped to zero. Simplicity to the fore?

## **4. AUTO-ANNUITISATION AT 80**

### **4.1 Contrarian thoughts**

“Freedom and choice” is a very recent phenomenon: a significant proportion of those currently cashing in their personal pension pots are wealthy property owners who have *already* retired, receiving risk-free DB pensions. They are not dependent on income drawdown and, thus, are not exposed to the “risk of ruin” inherent in DC pot exhaustion. Consequently, today’s generally positive perception of the liberalisation is unlikely to prove representative of the experiences amongst future retiree populations, increasingly reliant on (modest) DC pots. They will be much more exposed to market price vagaries, incorporating technical risks such as the “sequence of returns” risk which, given recent robust markets, is yet to be experienced.<sup>8</sup>

<sup>5</sup> The risk of lower or negative asset returns early in the drawdown period. Any subsequent asset growth is then derived from a smaller asset base than otherwise, resulting in less drawdown income than otherwise.

<sup>6</sup> The UK equivalent is a FTSE 100 index tracker such as Vanguard’s: total annual charges of 0.1%.

<sup>7</sup> Javier Estrada, IESE Business School in Barcelona, July 2016. Estrada drew his data from the Dimson, Marsh, and Staunton database of global investment returns, based on inflation-adjusted total returns.

<sup>8</sup> The risk of lower or negative asset returns early in the drawdown period. Any subsequent asset growth is



Another consideration is the change in the perception of risk, as people age. Older people are more risk-averse; they attach more value to certainty, and some will become less inclined to assume longevity risk, for example. Consequently, annuities become more attractive as people age, *relative* to income drawdown (and older annuitants increasingly benefit from the inherent mortality cross-subsidy). Given this, annuity proponents' claims that the recent collapse in annuity sales is partly due to purchase *delay*, rather than a decision to never buy an annuity, has some credibility.

Finally, interest rates and bond yields will eventually rise, perhaps coinciding with convincing evidence of at least a *slowdown* in the rate of improvement in life expectancy (or even a reverse?). Annuity pricing could then become more attractive than today, relative to income drawdown. Consequently, any income drawdown default should be subject to periodic review, to take account of any material changes in annuity market conditions.

#### **4.2 Socialise life expectancy...by default?**

One of the consequences of the 2015 liberalisation is a substantial reduction in the risk pooling ("collectivisation") of life expectancy, via annuity books. But many people are not well placed to assume this risk by themselves. Given the aforementioned contrarian thoughts, perhaps we should consider introducing a second, later-life default: a longevity risk hedge, to kick in around the age of 80, say (with the right to opt out): "auto-annuitisation".<sup>9</sup> This could take the form of a lifetime annuity (joint-life for couples), purchased via an annuities auction house using undrawn assets in the default fund.

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then off a smaller asset base than otherwise, resulting in less drawdown income than otherwise.

In addition to longevity risk protection, auto-annuitisation would be under-pinned by an economic rationale. It is cheaper to purchase protection collectively (i.e. as part of the bulk purchase for each year group) than as an individual. But any assessment of value for money would depend upon how long the annuitant lived...and could therefore only be determined posthumously.

### **5. GOVERNANCE**

Auto-protection must be accompanied by a robust (trust-based) governance framework for the decumulation default funds, including complete cost transparency and a charge cap. A key role for governance would be to conduct regular reviews of the drawdown rate, to ensure that it were sustainable in light of potential changes in investment markets, inflation and life expectancy.

The default funds should be included on the forthcoming pensions dashboard, and auto-protection should be supported by ready access to advice (or guidance).

### **6. WHAT IS THE ROLE OF THE STATE?**

#### **6.1 What of paternalism?**

Is it the role of the state to protect the individual from himself? There is no "correct" answer, but both components of auto-protection (auto-drawdown and subsequent auto-annuitisation) should appeal to advocates of state paternalism (predominately on the political Left) and, because of the opt-outs, free marketeers attracted to the notion of individual empowerment. Auto-protection would also protect the state from some individuals who may otherwise run out of money before dying

<sup>9</sup> The age of 80 could be a little early, depending upon one's view of future improvements in life expectancy.



(consciously or inadvertently): it would reduce the extent to which longevity risk falls on the taxpayer.

Meanwhile, there is mounting evidence from abroad, notably Australia (where there is almost no culture of annuitisation), supporting the concept of decumulation defaults (i.e. auto-protection). A landmark report<sup>10</sup> recommended improving financial efficiency during decumulation through greater use of risk pooling to significantly increase retirement incomes, by:

- (i) removing barriers to new product development; and
- (ii) using behavioural biases (including inertia) to encourage, rather than discourage, the use of products that provide longevity risk protection.

These sentiments resonate with auto-protection's underlying intentions, which also include harnessing economies of scale via the default fund, to increase incomes.

## 6.2 Bring back a Minimum Income Requirement?

An alternative approach to mitigating the "risk of ruin", following the 2015 liberalisation, would be to reintroduce a Minimum Income Requirement (MIR).<sup>11</sup> This would require retirees to evidence that they had a secure minimum annual income (which would include the State Pension) of at least £15,000 (say), before being eligible for flexible drawdown. As a protection it is simple, but such a policy U-turn would be politically difficult to implement: "freedom and choice" is popular.

## 6.3 Product development

The National Employment Savings Trust (NEST) has put considerable thought into products

aimed at mass market decumulation. This is entirely sensible given NEST's role in providing its members with a default accumulation fund, as part of automatic enrolment. However, the Government has recently announced that (taxpayer funded) NEST will not be permitted to enter the drawdown market, citing the risks of "*unduly distorting market competition and stifling innovation in an emerging area*". Instead, it will keep the issue "*under active review in light of market developments*", i.e. to wait for market failure to become evident before enabling NEST to proceed.

This stance is regrettable, not least because determining whether market failure had indeed materialised would likely be contentious, followed by a protracted process to resolve it. It also risks disillusioning NEST: far better for NEST to keep the industry "keen", helping to spur innovation and competition in the decumulation arena.

Meanwhile, it is clear that the industry is struggling to develop simple, secure, low cost drawdown products, a challenge compounded by the public's unrealistic expectation for affordable products that combine flexibility with certainty.

## CONCLUSION

Auto-protection would ensure that savers reaching the age of 55 were not left to wallow in indecision when pondering the complexities of decumulation. Introducing it would bring the policy philosophy behind decumulation closer to that for the accumulation phase.

An initial income drawdown default would substantially reduce both the "risk of ruin" and exposure to pot conversion fraud. Default funds' economies of scale should help deliver larger

<sup>10</sup> Australian Government; *Financial System Inquiry Final ("Murray") Report, Chapter 2: Superannuation and retirement incomes*; November 2014.

<sup>11</sup> Budget 2014 cut the MIR for retirees entering flexible drawdown from £20,000 to £12,000 (April 2014), and then scrapped it entirely from April 2015.



retirement incomes than otherwise, which would help to sustain economic growth as the population ages.

The subsequent auto-annuitisation of residual pots would facilitate the collective hedging of individuals' exposure to the unquantifiable risks of longevity. It would also remove later-life exposure to investments market risk and, through indexation, cost of living inflation.

However, any debate about what is the "right" form of defaults at 55 and 80 should not be allowed to overshadow a more fundamental issue: the pots of *most* people at retirement are likely to be too small. Consequently, we have to recognise that unless working life savings contributions are substantially increased (i.e. doubled), then many people are likely to run out of money before dying irrespective of the design of any retirement default.

## THE AUTHOR

Michael Johnson is a Research Fellow of the Centre for Policy Studies and a highly regarded pensions analyst. He originally trained with JP Morgan in New York and, after 21 years in investment banking, joined Towers Watson, the actuarial consultants. More recently he was Secretary to the Conservative Party's Economic Competitiveness Policy Group.

He is the author of more than 40 influential pensions-related papers for the Centre for Policy Studies (all of which can be freely downloaded from [www.cps.org.uk](http://www.cps.org.uk)). He is consulted on pension reform by serving Ministers and shadow Ministers, the DWP Select Committee and the House of Lords Select Committee on Public Service and Demographic Change.

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