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The Pension Research **Forum**

2008

Annuitisation and retirement –
how can the member experience be improved?

Watson Wyatt
Worldwide

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Introduction

Defined contribution (DC) pensions are increasingly the 'standard' vehicle for future pension accrual for all private sector employees, rather than just new joiners. With many employers, we are seeing the first cohorts of workers for whom DC pensions will form a significant part of their income in retirement. Consequently the issue of fund conversion, or decumulation, is moving up the agenda for employers, trustees and workers alike.

Whilst much recent research has focused on the choices employees face on entry to the pension plan – whether to join, how much to contribute and what investment funds to choose[1] – much less has been done to examine employee behaviour when they reach retirement.

In this report we address this area by focusing on the key issues facing employees in the annuity market when they reach retirement. This study tackles four key themes. First, we discuss the recent trends in annuity rates and the uncertainty surrounding rates in the future. Secondly, we analyse current market practices and employee behaviour. Thirdly, we examine employee perceptions of the annuity market and finally, we examine how the 'at retirement market' is evolving and its likely future direction.

Before we do this, however, we examine the current size of the DC market at retirement and review its recent trends.

The Watson Wyatt Pension Research Forum

Meaningful data on UK pension issues is limited. In particular, there has been scant research into the general needs and behaviour of employees and pension scheme members. Such data would be extremely valuable in building insight and understanding into the effects of different forms of pension provision in the UK. It is with the desire to investigate and discuss such areas of pension provision that Watson Wyatt has established the Pension Research Forum.

The Forum is made up of a number of the UK's most prestigious and largest employers as well as the UK's largest insurance company pension providers.

For further information about the Pension Research Forum, or the results contained in this report, please contact Gary Smith (gary.smith@watsonwyatt.com)

The annuity market

In the last decade we have observed a widespread switch from defined benefit (DB) to DC pension provision. Now DC is the norm for new employees – with, 82 per cent of FTSE 100 companies offering DC pension plans to new joining employees by the end of 2007[2]. Moreover, as previously mentioned, DC pension plans are increasingly the norm for **all** private sector employees – with nearly one-third of private occupational scheme members now in DC pension plans. This number would be considerably higher if we were to account for Group Personal Pension (GPP) plans or Stakeholder arrangements[3].

With the impending introduction of Personal Accounts, we are likely to see a further step-change in the progression towards a pension landscape dominated by provision of the DC form. In combination, the cross-over to a majority DC world is expected within the next five years.

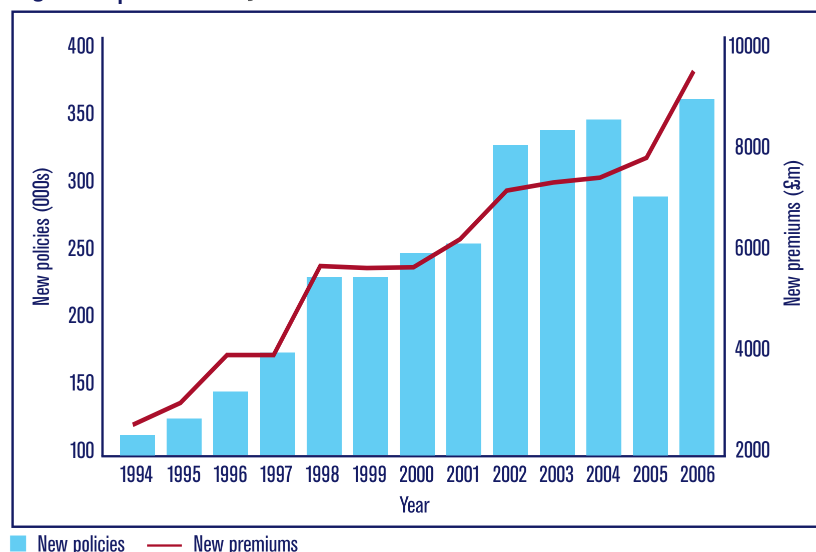
Yet the impact on those close to retirement has, so far, been limited, as most recent pensioners have limited accumulated funds in DC pension plans. Nevertheless, we are now beginning to see rising numbers of workers for whom their DC pension is likely to be their main form of income in retirement. This trend is expected to escalate rapidly over the next 10 years, with future cohorts of retirees having worked longer spells as members of DC pension plans.

Figure 1 highlights this upward trend in the annuity market. From 1994 to 2006 we have seen an approximate 9 per cent per annum increase in new policies and a similar trend in new premiums. Moreover, this trend is expected to increase markedly in the future. In 2007 the annuity market was worth some £13.6 billion and Watson Wyatt calculations suggest that the market will grow 20 per cent per year for the next five years.

These trends signify the growing scale of the annuity market and its likely impact on employees.

This report focuses on the choices employees currently face when they come to retirement, the decisions they make and how the market for annuities is likely to develop in the future.

Figure 1 | The annuity market



Source: Association of British Insurers

Annuity rates

There has been a long-term decline in annuity rates since the 1980s, due to increases in life expectancy and reductions in interest rates. This is shown in Figure 2 where we plot the average annuity rates from the 1950s to the present day. In addition, we calculate a synthetic annuity rate – an approximation that is derived from historical mortality rates and interest rates. This shows how closely annuity rates follow trends in mortality expectations and interest rates.

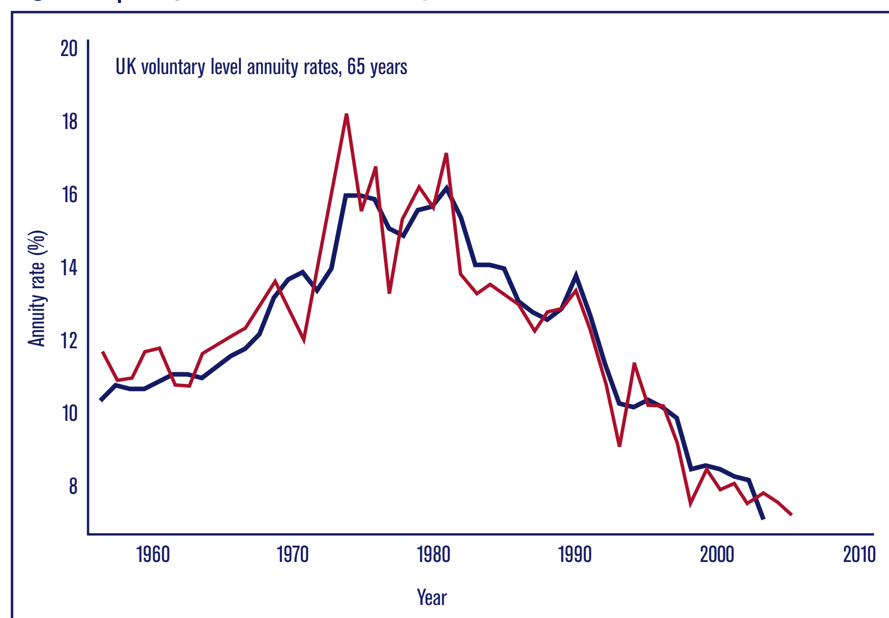
Hence a retiree, with a fund of £50,000 at retirement would have received an average annuity of £3,575 compared to £7,850 for those retiring in 1980. Based on current estimates, life expectancy will increase further in the future and annuity rates are likely to continue to deteriorate[4]. Moreover, mortality improvements will induce greater reductions in rates for annuities with any form of guarantee or inflation protection, when compared to level annuities.

This is something employees typically do not consider in their current retirement plans and may require further communication.

The risks to employees are not just the long-run deterioration in annuity rates. In addition, even within a single-year we can observe quite large variations in annuity rates according to when the individual retires. The variance in annuity prices has declined over time, yet even so in the last five years the year-to-year difference in rates ranges from -10 per cent to +5 per cent.

Finally, there is a wide disparity in annuity rates across annuity providers. Harrison et al (2006)[5] report that the difference in annuity rates (comparing the best rate in the market with that offered by the existing pension) can be as high as 30 per cent.

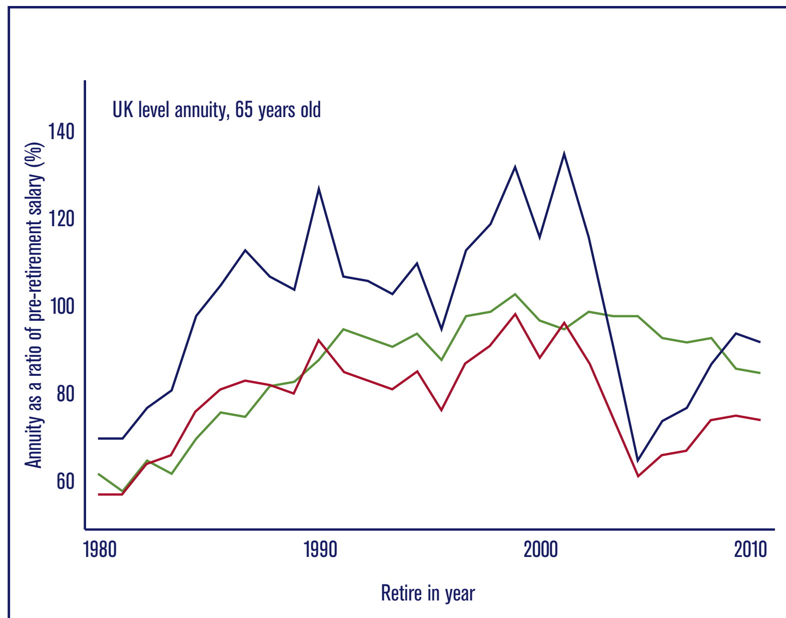
Figure 2 | Long-term trends in annuity rates



Average annuity rate — Synthetic annuity rate

Source: Average Annuity rates, Cannon and Tonks (2004)
Source: Synthetic annuity rates derived from mortality tables and 10-year bond yields

Figure 3 | Replacement ratios from DC pension plans



— 100% equity — 65% equity; 35% bond — Lifestyle

Source: Watson Wyatt calculations based on a typical employee contributing 9 per cent of earnings for 40 years with a fixed investment strategy

Recent research by the Association of British Insurers (ABI, 2008) suggests a much lower figure is typically true for the average employee at retirement. Examining 23 firms, comprising 92 per cent of the conventional annuities market by premiums and 88 per cent of contracts, they find 17 of the 23 firms offer (single-life level) annuity rates that are above 95 per cent of the best open market rate. The lowest rate observed was around 89 per cent. For less commonly sold products the disparity was greater, with an internal rate observed as low as 77 per cent in one case. Yet, when one examines the picture for the average employee the percentage gains range from 3 per cent to 7 per cent. However, these figures exclude a number of firms with poorer annuity rates.

Hence, whilst for many employees the gains are modest, but important, there still remains a large group of retirees for whom 'shopping around' is critically important for their retirement income.

In addition to these potential benefits, there are large gains for those who qualify for an enhanced or impaired life annuity and the ABI suggest this could be up to 40 per cent of annuitants. As a consequence, decisions taken by employees on whether to use the open-market option or select an enhanced/impaired life annuity can represent a major impact on their retirement income.

This discussion has so far focused on the annuity rates facing employees at retirement and the risks they pose. Yet, we have not touched on potentially the largest source of uncertainty over retirement outcomes – investment returns. In Figure 3 we show the potential volatility in annuity income, as a proportion of the employee's salary pre-retirement (this is known as the replacement ratio).

We assume individuals had contributed into a DC pension plan all their working lives. In each year they contribute 9 per cent of their salary, which grows in line with average

wage growth in the economy. At retirement, they annuitise their DC pension fund immediately, with a single-life level annuity[6]. Figure 3 then reports the pension incomes (as a fraction of pre-retirement earnings) that would have prevailed over the last 20 years.

Whilst this is a hypothetical experiment (employees retiring in 1980 would not have invested in the stock market over their entire working lives and few would do so for the full 40 years anyway) it clearly highlights the potential volatility in annuity incomes.

Two results emerge. First, the downward trend in annuity rates is not typically observed in pension incomes – the positive performance of the stock-market over the post-war period outweighs the decline in annuity rates. Nevertheless, we do observe a sharp downturn after 2000 with the 'dot-com' crash in stock markets. Secondly, this shows that movements in stock markets can lead to drastically reduced incomes according to when the individual retires (and their investment choices). This is moderated by investing in lifestyle funds, but at some cost to retirement incomes in most 'normal' time periods.

These results affirm the key risks that face employees when planning for their retirement: the terms at which they purchase an annuity are liable to deteriorate in the future and are also likely to be quite dependent on the time at which they retire and their investment choices. While this is well known amongst practitioners, they are much less well understood by employees.

In the next section we turn to the issue of employee choice and examine the decisions individuals make at retirement.

"... there still remains a large group of retirees for whom 'shopping around' is critically important for their retirement income."

Annuity choices

Data

To examine the choices and behaviour of employees at retirement we examine two samples of recent retirees, who purchased annuities in 2006 or 2007:

- pension provider data – a sample of 11,300 retirees from seven pension providers (including both occupational and contract-based DC pension plans)
- annuity broker data – a sample of 2,800 retirees from a large annuity broker (including occupational and contract-based DC pension plans as well as AVC arrangements from both their corporate and individual broking business).

In both sets of data only around a third of the sample were female – a reflection of the wider pension/labour market for older workers at this time. Similarly, annuitants were usually younger than the typical retiree (around 20 per cent retired before they were 60 and over two-thirds before they were 65). This potentially reflects a wealthier sample of employees, with greater retirement wealth. Whilst in the future we may expect a shift to later retirement – with greater encouragement to work until older ages – this trend has not yet emerged in the data.

Figure 4 reports the average fund values for different types of workers at retirement. The average fund value (premium) is £17,000 in our provider sample and £19,500 in the data from the annuity broker's corporate business. Broadly comparable data are reported by the ABI (2008). They find that the average premium for an annuity purchased internally was £13,000 and £24,000 for annuities purchased externally. Overall the figure was £16,000.

The typical situation currently is one of employees reaching retirement with relatively small fund values. In our provider sample nearly a third of employees reach retirement with a fund of less than £5,000, over half with a fund of less than £10,000 and two-thirds with a fund less than £15,000[7]. In many cases this will reflect the relatively short existence of DC pension plans and many current retirees are likely to supplement these funds with other pension income (for example a DB pension from a prior employer). In the future, with longer durations of saving into DC pension plans,

Figure 4 | Average fund values

	Provider	Broker corporate	Broker personal
AVC		£12,500	£23,700
GPP/personal/stakeholder	£16,200	£25,900	£59,500
Occupational	£18,500	£20,700	£54,400
Male	£20,100	£21,100	£67,000
Female	£12,000	£16,200	£37,400
Overall	£17,200	£19,500	£56,500

we would expect these fund values to increase quite sharply.

Nevertheless, these figures do highlight a potential issue for current retirees. With many employees holding DB pensions they may exceed the limit for trivial commutation, but hold (possibly multiple) small pots, which are unattractive to annuity providers. Choice amongst annuity providers will be limited and annuity rates potentially inferior.

A second issue highlighted by Figure 4 is that females typically arrive at retirement with far smaller pension funds. In 2007, the average accumulated fund of a female was only 60 per cent as large as a male. In the future, as women reach retirement with longer working lifetimes and hence greater accumulated funds, this difference will be moderated. Yet, there remains cause for concern in the short term as to whether many employees generally, and women in particular, will have sufficient retirement savings.

Choices at retirement

On retiring, an employee will be offered the option of purchasing an annuity from an insurer. In addition, in nearly 20 per cent of large employer's DC plans, employees can still obtain an annuity from the plan and around 3 per cent can choose to adopt an income drawdown strategy (Watson Wyatt's *FTSE 100 DC Pension Plan Survey, 2007)*.

One of the first choices an employee will typically face is whether to pursue the open-market option for their annuity product.

Figure 5 shows how frequently members use this option. In the provider annuity data, some 27 per cent of employees purchase an annuity via the open-market option (OMO), compared to around a third for the annuity market as a whole (ABI, 2008).

Those in occupational pension schemes, where there is a greater degree of communication and guidance, are more likely to purchase an OMO annuity, with nearly half doing so. By contrast, less than

Figure 5 | The open market option

	Percentage using the OMO
Overall	26.1%
GPP/stakeholder/personal	16.6%
Occupational	47.2%
Retire at age less than 60	24.8%
Retire at age 60-65	26.5%
Retire at age greater than 65	32.3%
Fund less than £10,000	22.3%
Fund £10,000	29.0%
Fund £50,000 to £99,999	27.9%
Fund £100,000 or more	36.3%

Source: Provider annuity data

a fifth of retirees from a GPP, stakeholder or personal pension purchase an annuity using the OMO. As the average fund size is not markedly different across these pension types (see Figure 5), this difference in annuity choice cannot be ascribed to differences in fund values.

In the short term, employers, trustees and providers will need to promote the OMO more, as required by the Financial Services Authority (FSA).

Apart from the type of pension, the main determinant of whether the individual has purchased an annuity via the open-market option is, unsurprisingly, the fund value. Some 36 per cent of those with the funds of more than £100,000 at retirement used the OMO, compared to 22 per cent of those with funds valued less than £10,000.

The relation between fund value and the use of the OMO is unsurprising – there remains limited choice for those with low fund values and those employees with greater funds are also more likely to discern the potential value from exercising this choice.

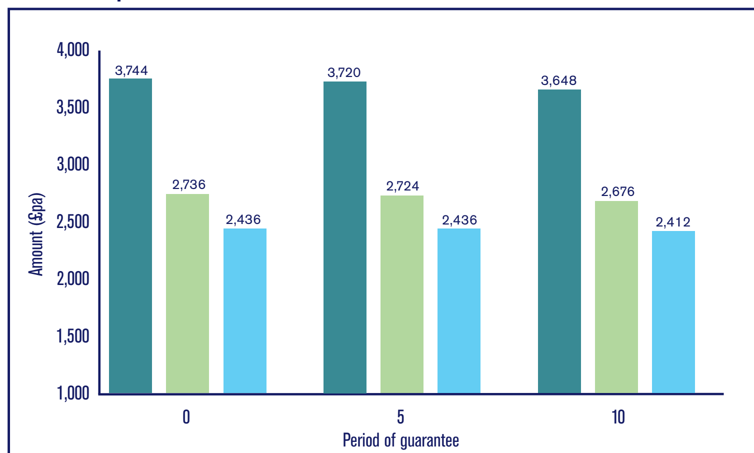
This point is reinforced in Figure 4, where we can see that typical fund values are far higher amongst the annuity broker's individual business, those who have chosen an OMO, than those prevailing amongst their corporate clients.

Additionally employees face choices over the type of annuity to purchase. Traditionally this has taken three dimensions:

- whether to purchase a level or escalating annuity (for example, one that keeps pace with inflation)
- the length of the guaranteed term of payment
- whether to purchase a single or joint life annuity (that is, one that pays potentially benefits to the employee's surviving spouse on death).

Figure 6 shows how the best published annuity rates varied across different product options (as at October 2007). There is a large additional expense to protecting the value of the annuity in real terms, with a greater than 50 per cent difference in the best rates between a level and RPI-linked annuity. By contrast, there is a less than 3 per cent difference in pricing between 0-year and 10-year guarantees.

Figure 6 | Difference in annuity rates



Escalation

Level | 3 per cent | RPI

Source: Best annuity rates from the FSA's Comparative Tables database (Oct 2007)
Figures based on a fund of £50,000; male; single life annuity; non-smoker

Figure 7 | Percentage choosing a level of annuity

	Member buying a level annuity
AVC	92%
GPP/personal/stakeholder	92%
Occupational	72%

Source: Provider annuity data

Given these differences in rates, what do people choose? The vast majority of retirees choose a level annuity, with ABI figures suggesting 93 per cent opt for this option. This may be due to a myopic evaluation of the values of protecting retirement income against inflation[8]. Or rather that, currently, annuities are not typically forming the bulk of retirement income and other income sources are providing this security.

Nevertheless, as Figure 7 shows, the purchase of income protection is significantly more likely amongst employees retiring with an occupational pension. This may be a result of greater guidance in an occupational pension scheme or occupational schemes favouring index-linked annuities (for example, as the default on which quotations are made) or that the fund is of greater significance to the individual.

The typical retiree not only chooses a level annuity, and so forgoes protection against inflation risk, but also typically purchases a single-life annuity and thus also foregoes any reversionary spousal benefits should they die. In Figure 8, we can see in our samples, only 20-40 per cent of retirees purchase some form of reversionary spousal benefits. Across the market as whole, almost two-thirds of annuities sold were single-life annuities (ABI, 2008). For many retirees this choice may be a sensible one, they may be single or they (or their partner) have alternative pension arrangements that provide such security. A number may though be making choices based on a myopic evaluation of the annuity terms or simply choosing the default they are offered.

Figure 8 | Percentage choosing single or joint-life annuities

	Provider	Broker corporate	Broker personal
Single-life	79%	57%	65%
Joint-life	21%	43%	35%

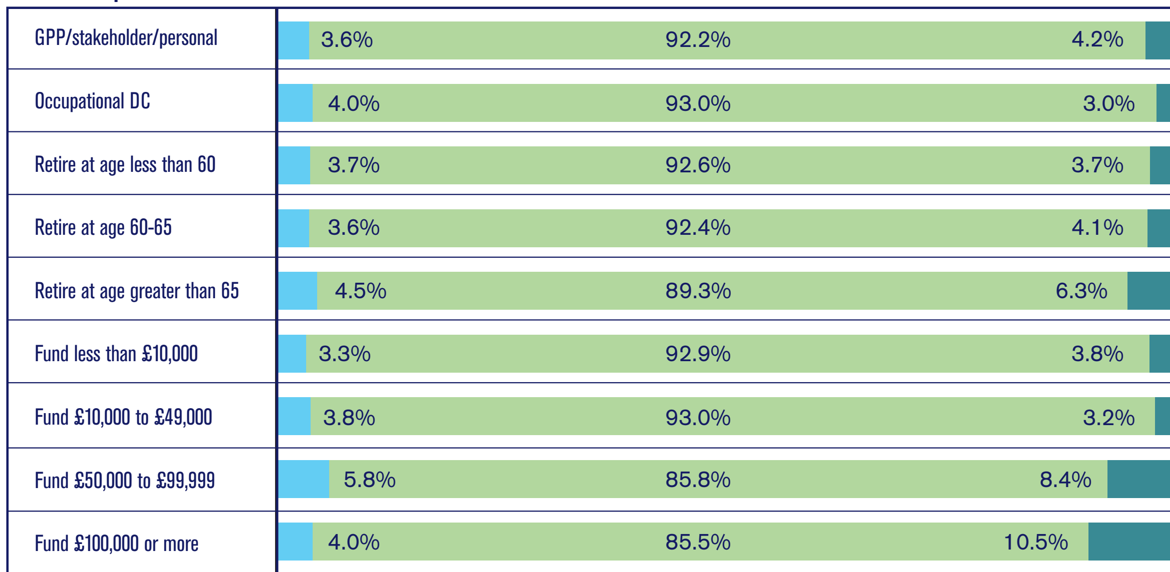
As a result, many spouses may not be protected in the event of a retiree's early death. The impact of such an event can though be mitigated if the employee chooses the option to purchase an annuity with a guaranteed term (which pays out for a minimum period). Surprisingly then, despite the relatively low additional cost, purchasing additional insurance (via a longer guaranteed payment period) remains relatively unpopular.

As can be seen in Figure 9, the overwhelming choice amongst retirees is to opt for a guaranteed payment term of five years. This is typically the default option in the industry and inertia is likely. Many employees may not realise a 10-year guarantee exists, nor the costs (which in some situations can be minimal).

> **The vast majority of retirees choose a level annuity, with ABI figures suggesting 93 per cent opt for this option.**

Nonetheless, some groups of retirees do seem to perceive the value of these guarantees – with their purchase being more popular amongst older retirees and those with larger fund values, though differences do remain relatively minor.

Figure 9 | Consumer choice – guaranteed terms (years)



0 years   5 years   10 years

Source: Provider annuity data

Summary

The annuity market offers a large menu of choices: the level of guarantee, the level of protection against inflation, whether to purchase a single life annuity or one with spousal benefits, and whether to use an external annuity provider. Yet, by-and-large, annuity choice can typically be characterised by single-life annuities, without inflation protection for a guaranteed term of five years. This is largely the industry standard and in many cases may be a suitable choice for employees, especially where the annuity is complimented by a DB pension.

However, for future retirees, where the annuity will form a larger part of their retirement incomes, alternative choices are likely to be required. Indeed, the annuity market has started to move slowly away from standard annuities, with additional options becoming increasingly available with the advent of impaired life and enhanced annuities, as well as drawdown products.

Nevertheless, with greater consumer choice, the associated difficulty for employees to deduce which of the options are most appropriate for their needs will increase. If, in the future, individuals increasingly opt for phased retirement, the additional complexity in annuity choices will be a considerable burden on employees.

In the next section we discuss employees' perceptions of annuities, before discussing these new developments in the annuity market.

Attitudes to annuities

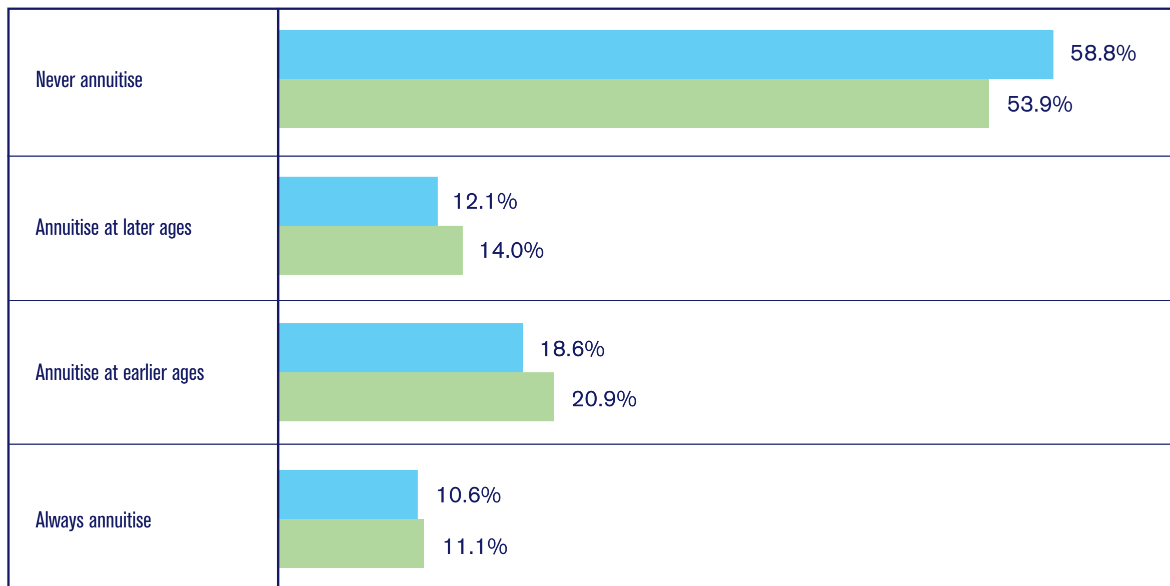
Whilst most economic models suggest annuities are 'optimal' in most circumstances, in those countries where annuity purchase is not compulsory, annuity purchase is uncommon. The evidence also suggests that, whilst uncommon, those people who do indeed choose to annuitise are in fact happier in retirement (Panis, 2004). Despite this, in the UK, where annuity purchase is mandatory, it is unpopular – at least amongst a vocal minority.

This contradiction, between what is considered optimal and consumer preferences, was explored by Gardner and Wadsworth (2004) who examined consumer attitudes to annuities. Our research revealed that the majority of pension scheme members would never annuitise if possible (see Figure 10). This was independent of the age at which the hypothetical choice was offered and was common to all socio-economic groups. Those with less education, income or poorer health were more likely to be opposed to annuitisation.

Four key issues were identified for employee dislike of the annuity proposition:

- concerns about the loss of flexibility
- exposure to loss of value on early death
- individuals place a low value on income security relative to the lump-sum
- a distrust of the institutions issuing annuities.

Figure 10 | Attitudes to annuities



Pension members
All DC

Source: Watson Wyatt survey
3,511 respondents aged 50-64

The research finds there is a substantial core of potential retirees that are hostile to annuities and this is consistent across employee groups. Dislike of the proposition seems to reflect a low regard for the positive features of annuities (security and sustainability of income) with concerns about possible weaknesses (loss of flexibility and exposure to loss of value on early death). An appropriate response may include employee education. Indeed, an ABI report (2005) found that most individuals did not understand the basics of annuities and what happens to the accumulated fund at retirement.

There is a wide disparity in individual needs and preferences, according to family circumstance, lifestyle choices and the extent of other retirement income. In recent years we have seen a number of new products emerge in the annuity market and the growth in the availability of annuities whose rates reflect longevity expectations will help meet the requirements of some of those with poorer life expectations. As a result, employees are more likely to have the flexibility to more closely match their individual needs.

Yet, as a consequence of this greater degree of choice, the decisions employees face at retirement are much more complex. In the following section we examine the evolution of the annuity market and the new product choices that are emerging.

Developments in the at-retirement market

The annuity market is growing rapidly. Whilst in the past it was dominated by a small set of standard annuity products, we are now witnessing many new products becoming available on the market. To list but a few of annuity products currently available:

- traditional annuities
- enhanced annuities
- investment linked annuities
- variable annuities
- capital guaranteed annuities
- unsecured pension (short-term annuities, income drawdown)
- alternatively secure pension.

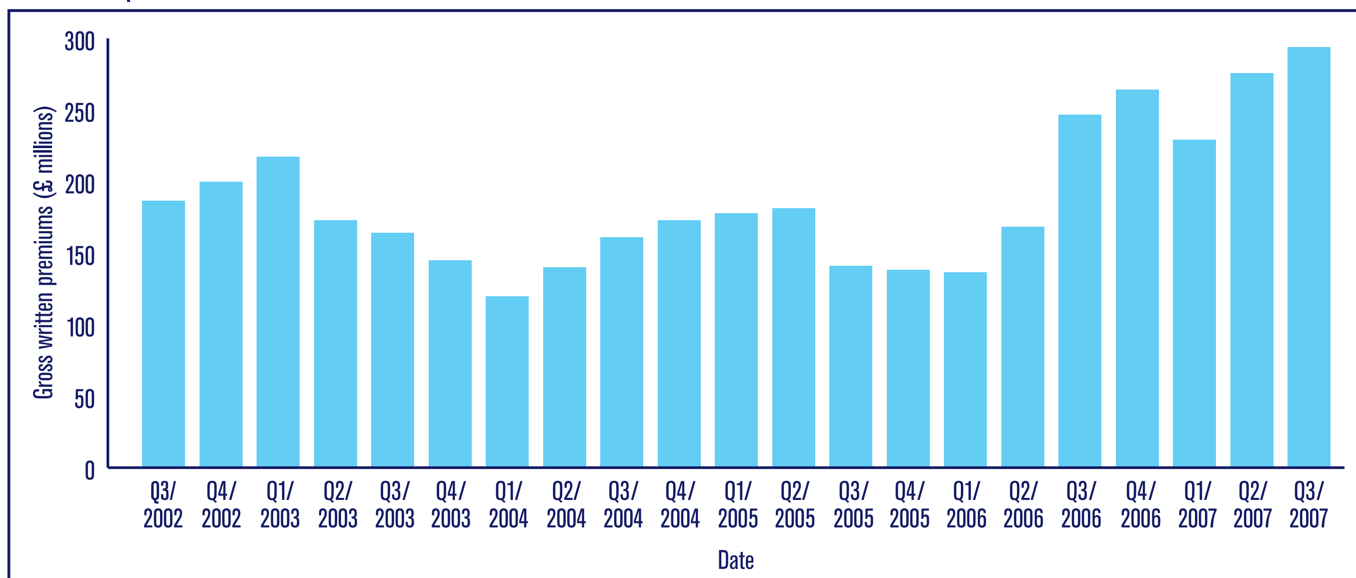
With this degree of choice, the decision on which annuity product to purchase becomes increasingly difficult. When one considers other external factors (for example, trivial commutation, phased retirement, and so on) the complexity of the situation is further heightened. In this section we examine some of the new products available and discuss some of the complexities they may introduce for employees.

Enhanced annuities

Impaired life (or enhanced) annuities pay a higher income to employees on the expectation of a shorter expected lifetime. This can be as the result of a medical condition (for example, cancer, heart disease, and so on) or lifestyle factors (for example, smoking, obesity, and so on). Typically they require a simple medical questionnaire to be completed but further medical evidence may sometimes also be required.

Figure 11 reports the trend in the size of the market for enhanced annuities. Whilst the trend is volatile, the recent past has seen persistent growth.

Figure 11 | The impaired life annuity – market size



Source: Association of British Insurers and Watson Wyatt

Whilst the market for enhanced annuities has been growing in recent years, its market share has remained fairly constant. As Figure 12 shows, around 10 per cent of all annuities purchased, and 20 per cent of annuities purchased via the open market option, are impaired life annuities. Given it is estimated that between 35 per cent and 40 per cent of the population may be eligible for these enhanced annuities there would still seem large scope for growth in this market [9].

There does then appear to be a role for employers, pension schemes and providers to communicate the benefits of enhanced annuities to employees. For those who do qualify, the potential income gains in their retirement income can be significant and this option is potentially under utilised.

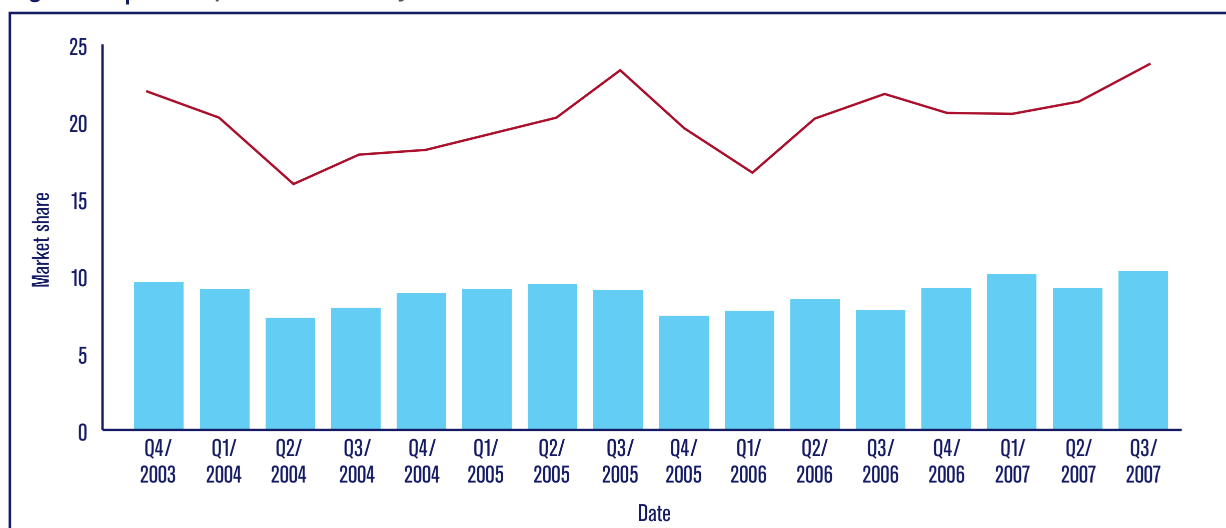
However, should this market continue to grow, it will have an adverse effect on the annuity rates faced by the rest of the population. If the less healthy are taking out impaired life annuities, then the remaining employees will on average be more healthy (with longer life expectancies) and therefore the annuity rates they face will deteriorate.

The trend in selling impaired life annuities then implies that annuity rates will continue to worsen for standard (healthy) annuitants. This makes conventional annuities less attractive for healthier employees, who may increasingly look at alternatives such as income drawdown or other new alternative products.

Income drawdown

For those individuals who want to exercise more control over their pension fund, income drawdown may be suitable. Here individuals can take tax-free cash at retirement and keep the remainder invested in investment markets. Within limits, the individual decides how much income to receive and the annuity will be paid directly out of the investment fund. Before A-Day, those with income drawdown [10] were required to annuitise their remaining funds by the age of 75. However, in order that those with pension funds remaining at age 75 are not forced to buy an annuity, since A-Day individuals can instead take out an alternatively secured pension (ASP).

Figure 12 | The impaired life annuity – market share



Market share of conventional annuities: Total annuities — OMO annuities

Source: Association of British Insurers and Watson Wyatt

The advantage of following a drawdown strategy is that individuals benefit from maintaining an exposure to equities, but, as a result, a significant reduction in income is possible. Aside from investment risk, there are a number of additional drawbacks from income drawdown:

- For those individuals who do purchase an annuity there is an implicit cross-subsidy from those who die young to those who die later. For those individuals who follow a drawdown strategy, the benefit of not losing the capital on death is then offset by the loss of this cross-subsidy. This loss is known as 'mortality drag'.
- Annuity rates may deteriorate during the drawdown period.
- Charges on drawdown facilities are often heavy.

As a result of these risks, drawdown has typically been viewed as suitable only for people with large pension funds – in order to cope with the possible fluctuations in income and capital associated with investment performance.

Indeed, by the end of 2007 only around 6 per cent of retirees choose income drawdown. Yet, due to greater fund values, sales were some £3 billion compared to £11 billion for conventional annuities.

With annuity rates likely to remain low and lengthening retirement horizons, the popularity of drawdown type products is indeed likely to grow in the future – as the advantages of allowing a portion of the retirement fund to grow with investment start to outweigh some of the risks.

How does the performance of drawdown compare to a traditional annuity in practice?

In Figure 13, we report the return on investment that is required for drawdown from age 65 to 74 to be a better option that purchasing an annuity at age 65. The typical investment return required to do better than a standard annuity is around 5.5 per cent per annum in nominal terms, or 1.9 per cent in real terms.

Figure 13 | What return on investment is required for drawdown from age 65-74 to be a better option?

Annuity rates per £100,000	Level	3% Increases	RPI
At age 65	£7,477	£5,496	£4,845
At age 74	£9,936	£7,912	£7,116
Break-even returns	5.5% pa	5.5% pa	1.9% pa real

Source: Watson Wyatt calculations (October 2007)

What investment strategies satisfy these break even criteria? Figure 14 reports the range of replacement ratios (pension income relative to final salary) associated with different drawdown strategies.

As was previously seen in Figure 3 the replacement ratios (the level of pension income relative to final salary) from investing in a DC pension plan invested in equities are typically very uncertain. Similarly, we can observe from Figure 14 the performance associated with drawdown products can be highly variable and adopting a post-retirement drawdown strategy tends to dramatically increase the range of possible retirement incomes.

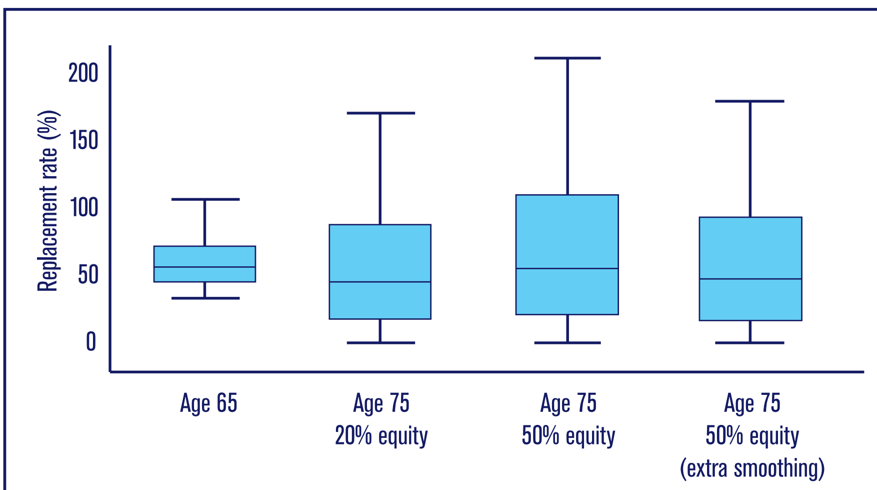
In comparison with a traditional annuity product, the breakeven drawdown strategy (on average) is based around a 50 per cent exposure to equities. As a consequence, we can say that, for many investment strategies, traditional annuities generally provide a higher income than drawdown. The decision of whether to purchase an annuity or a drawdown product then revolves around an evaluation by the individual employee of the risks versus the rewards.

Annuities then appear reasonable value for money, even at age 65, especially if we account for the increased probability of loss with drawdown products and the likelihood that annuity rates may deteriorate further over the next 20 years. In this context, there appears a role for employers and providers to educate employees that annuities are actually a reasonable deal.

For drawdown to be preferable, the individual must be willing to bear the risk of relatively high exposure to equities during retirement, or to place a high weight on the bequest motive, or have a high desire for flexibility.

Nevertheless, there is a large difficulty for employees considering the drawdown approach – these products are highly complicated and are highly difficult to communicate. Given the lack of engagement of employees with their pensions during the accumulation phase, there remain major obstacles to individuals making complicated decisions regarding their post-retirement income.

Figure 14 | Range of retirement outcomes associated with different drawdown strategies



Source: Watson Wyatt calculations
Figure shows range of outcomes from 5th to 95th percentile
Box shows range from lower quartile, to median, to upper quartile

Hence, whilst drawdown may be attractive for some, there remain large doubts whether it can move beyond being a niche product for the very rich. There does seem a role for greater advice, the cost of which will typically be borne by the employee, though as drawdown becomes more acceptable, employers may review this.

Variable annuities

Recent years have seen the gradual introduction of variable annuities into the UK. Variable annuities were first introduced in 2005, but the last two years has seen a series of new product launches into the marketplace.

These products have yet to generate significant volumes of business relative to the existing annuity markets, but have generated significant interest. This interest is partly driven by an expectation that consumers who are dissatisfied with the low-risk traditional annuity will increasingly want to have more exposure to equity growth in their retirement incomes, but will not want to move fully to a higher risk income drawdown approach.

As a variable annuity is akin to income drawdown with additional guarantees – it is viewed as an attractive and flexible product for annuitants and one that has already proved very popular in the US and Japan.

A variable annuity is not a product but a description of any unit-linked product with a guarantee. Variable annuities have a number of key features:

- The annuitant invests in unitised funds, typically invested in a mixture of equities and bonds. Hence, they have the opportunity to match their preferred risk-return profile.

Figure 15 | Variable annuity guarantees

Member buying a level annuity	
Guaranteed Minimum Death Benefit (GMDB)	A guaranteed benefit on death that may increase as the fund grows.
Guaranteed Minimum Accumulation Benefit (GMAB)	A guaranteed minimum growth level (fund value) at a defined date. A mechanism to lock in gains over a set time period.
Guaranteed Minimum Income Benefit (GMIB)	A guaranteed minimum amount that may be used to secure a lifetime annuity at a fixed time on guaranteed terms.
Guaranteed Minimum Withdrawal Benefit (GMWB)	Effectively a guaranteed income for a set period or for life (guarantee can increase with value of fund).

- In addition, the annuitant typically purchases some form of protection against their exposure to investment markets (see Figure 15).
- The policy holder also normally has the flexibility to modify their choices over the life of the product.

A wide range of designs are then possible with different combinations of variable annuities. As a result they are very flexible to meet the preferences of different types of employees. As an alternative to a traditional annuity, a variable annuity combines income drawdown with a Guaranteed Minimum Withdrawal Benefit (GMWB). Hence, they can combine both the guaranteed income of an annuity and the possible upside of income drawdown.

This flexibility is, however, though associated with higher ongoing charges and it is not clear whether employees will get enough value from the guarantees to justify the charges when compared to the alternatives (with-profit and unit-linked annuities, conventional annuities and income drawdown).

As a result, whilst variable annuities may be suitable for some employees, the extent of choice and flexibility does imply that employees need to be very clear of the risks and charges they face and does require a large degree of financial literacy to make an informed choice.

Conclusion – implications for employees at retirement

Over the years, there have been a number of evolutions in the at-retirement market. However, with the exception of income drawdown, which has become popular for a minority of wealthy employees, the typical choice of an employee reaching retirement is still the traditional annuity (single-life, level, five-year guarantee).

After A-Day, there has been a greater opportunity to innovate with a possible move away from conventional annuities to a wider range of products. The products that have been introduced have tended to show greater transparency and a higher element of self management. However, they are complicated and, even when packaged into a simplified product, the average employee may not understand them. There is then an increased need for education, guidance and even possibly the provision of advice at retirement.

This increased flexibility in at-retirement products is in part a reaction to the dislike of the annuity proposition by many employees. Annuities are often perceived as poor value, people dislike the 'compulsory' element and their lack of flexibility. Yet, the only other viable options to an annuity are much more complex. People also seem to underestimate the advantages of an annuity (security, terms of annuity are relatively good) and possibly more should be done to communicate the value of the annuity proposition.

Employees typically show little understanding of the at-retirement market and their options. Giving information to employees upon retirement is too late to help them make sensible decisions – especially for those interested in the more complex products.

These issues will become more complex in the future. Currently most employees retire with a relatively small accumulated DC pot (on average around £20,000) which restricts their choice. Moreover, they will often have other (DB) retirement savings – and for many employees this means they may not worry unduly about inflation or spousal benefits when making their annuity choice. As future generations reach retirement, having accumulated more years and funds in DC pension plans, the issues around choice at-retirement will become increasingly prominent. Who will be responsible for helping employees? It seems likely that employees will turn, at least in part, to their employers and to trustees, who will face increased demands on them as a result.

Footnotes

[1] For example, see Watson Wyatt Pension Research Forum: *The right pension decisions – how do employees make them?* (2006).

[2] See Watson Wyatt FTSE 100 DC Pension Plan Survey (2007).

[3] Source: 2007 Annual Survey of Hours and Earnings – Pension Analysis, Office for National Statistics.

[4] See CMI (2007).

[5] Harrison, D., Byrne, A. and Blake, D. (2006).

[5] We assume the employee works from age 20 to 65 and contributes 9% to their pension in each year. Their salary grows according to national average wage inflation. The fund is invested in UK equities during their working lives and annuitised with a level annuity on retirement.

[7] Individuals whose pension savings are in **total** worth less than the ‘trivial commutation limit’ of £16,000 (2007–08) can currently take their entire pension fund as a lump sum. HM Revenue and Customs have announced plans to permit occupational pension schemes to pay trivial commutation lump sums of up to £2,000 without the necessity to take into account benefits in other registered schemes.

[8] Or an underestimate of the extent they will be affected by inflation.

[9] This may be somewhat constrained by the fact that in many cases employees with more severe health problems may also have smaller accumulated fund values – which are unattractive for the external market.

[10] Following A-Day, income drawdown plans became known as unsecured pensions (USPs).

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For further information please contact:

Gary Smith
+44 (0) 20 7227 2460
gary.smith@watsonwyatt.com

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watsonwyatt.com

21 Tothill Street, Westminster, London, SW1H 9LL UK
Telephone +44 (0) 20 7222 8033
Fax +44 (0) 20 7222 9182

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