OXFORD ECONOMICS

The macroeconomic impact of shopping around for retirement income

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Contents

Executive Summary

This paper was commissioned by the Pension Income Choice Association (PICA). It examines the macroeconomic implications of implementing its policies to encourage people who have invested in defined contribution pension schemes to review their options prior to retirement.

Pensioners tend to live on low incomes …

- According to one measure, just under a quarter (23%) of pensioners currently live in poverty. This is 2.5 million people.

- But future generations of pensioners will be significantly poorer than the current generation. The erosion of state pensions; significant reductions in employer pension contributions as firms switch from defined benefit to defined contribution 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.

But currently many people who have invested in defined contribution pension schemes are not maximising their retirement incomes …

- Despite the best efforts of the authorities and firms within the pension industry to raise awareness of the Open Market Option, the majority of purchasers of annuities or other types of retirement incomes decide to stay with their existing pension savings provider rather than shop around.

- In 2009, a 65 year old male and female about to purchase a fixed income annuity can increase their annual income after retirement by switching from the lowest to the highest paying provider by an average of 19% and 22%, respectively.

- PICA believes government action is necessary to ensure that the default option should be for everyone to review which provider they purchase their retirement income from.

How much could pensioners' incomes increase as a result of the government implementing PICA's policies?

- The implementation of PICA's policies is estimated to increase pensioner incomes by £13.9 million in 2010. This is equivalent to around £169 per policy holder.

- If PICA's policies were implemented, pensioners are estimated to gain £3,308 million in extra income in today's prices between 2010 and 2030.

What would the other macroeconomic impacts be?

- Between 2010 and 2030, the implementation of PICA's policies is estimated to increase consumer spending by £2,075 million in current prices. As well as increasing pensioners' standard of living, it will create additional jobs and contribute to Gross Domestic Product (GDP).

- The implementation of PICA's policies is likely to improve the Exchequer's finances by £6.7 million in 2010 (through savings on social security payments and increased income and indirect taxes). These effects are estimated to enhance the Exchequer's finances by £1,668 million between 2010 and 2030.

- The implementation of PICA's policies would lead to some distributional impacts between retirement income providers. It would also lower the retirement income providers' profitability. The increase in competition in the industry may lead to some longer term increases in productivity.

1. Introduction

This paper was commissioned by the Pension Income Choice Association.[1] It examines the macroeconomic implications of implementing its policies to encourage people who have invested in defined contribution pension schemes to review their options prior to retirement. In particular, to consider whether to exercise their Open Market Option (OMO). So rather than just purchase their retirement income from the provider with which they have saved their defined contribution pension, to shop around to secure the most appropriate product with the best rate for them. The objective is to secure a significant increase in the annual income of those who invested in a defined contribution pension over their retirement.

The paper is organized as follows:

- Section 2 investigates retired households' current income levels and the reasons why future generations of pensioners' incomes are expected to decline.
- Section 3 looks at how much purchasers of retirement incomes can gain from shopping around. It then details PICA's policies aimed at increasing the number of people reviewing their options prior to retirement.
- Section 4 develops a stylised model to capture the impact of PICA's policies on the current and future income streams pensioners receive from purchasing annuities. It estimates the increase in income pensioners will receive each year out to 2030.
- Section 5 looks at the impact PICA's policies will have on pensioners' consumer spending, Exchequer revenues and existing sellers of retirement incomes.
- Section 6 concludes.

[1] See www.pica.org.uk for more information.

2. Retired households' income

This section investigates retired households' current income levels and why they are expected to decline in future.

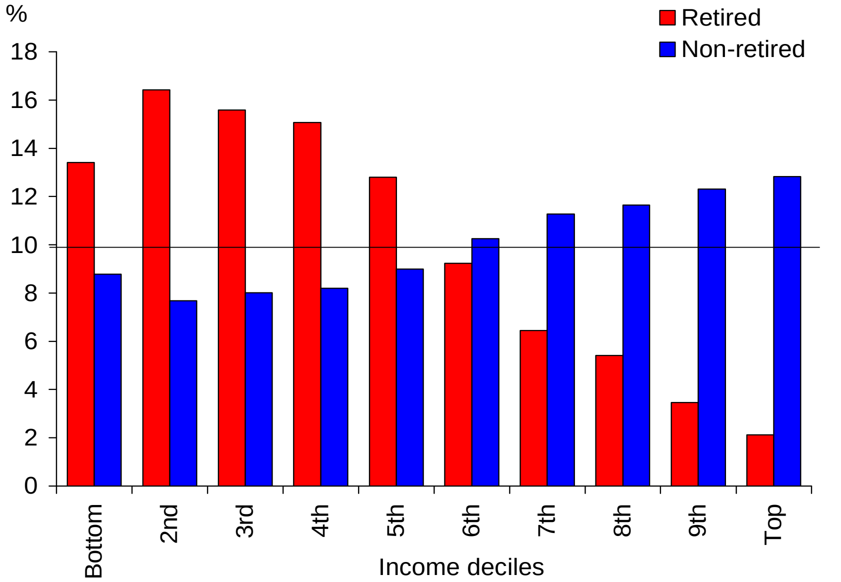
The main points are:

- Retired households currently have a low income relative to other households.
- One widely used measure of relative poverty is people with less than 60% of median income. Just under a quarter (23%) of pensioners' incomes fall below this threshold. This is 2.5 million people.
- While retired households' current disposable income may be low, there is even greater cause for concern about future generations of pensioners' income. This is mainly because of greater longevity, demographic trends and the switch between defined benefit to defined contribution pension schemes.

2.1. Retired households' current income

Many retired households currently receive a very low income. ONS (2009) shows retired households are concentrated towards the bottom of the income distribution.[2] When households are ranked by disposable income in deciles, retired households are over-represented in each of the five lowest deciles (Chart 2-1). Conversely, they are under-represented in the top five deciles. Nearly two thirds of retired households (61%) are in the bottom four deciles (Chart 2-1). This compares to a third (33%) for non-retired households.

Chart 2-1: Proportion of retired and non-retired households in each disposable income decile in 2007/8



Source : Oxford Economics and ONS (2009)

[2] ONS, (2009), 'The effects of taxes and benefits on household income, 2007/8'.

Looking at what that means in practice, on average retired households received a gross income of £17,727 in 2007/8 (Table 2-1). After income tax, employees National Insurance Contributions for those with part-time jobs and Council Tax, the average retired household was left with a disposable income of £15,348. This is less than half the average for non-retired households (of £32,194).

Table 2-1: Retired households' disposable income in 2007/8

Types of income, taxes and benefits per household	Quintile groups of retired households					
	Bottom	2nd	3rd	4th	Top	All
Original income						
- Earnings	£55	£122	£471	£538	£1,049	£447
- Occupational pensions	£981	£2,458	£4,234	£7,118	£17,116	£6,381
- Investment income	£459	£482	£550	£1,067	£6,756	£1,863
- Other income	£43	£106	£104	£140	£64	£91
- Total	£1,537	£3,168	£5,359	£8,863	£24,985	£8,782
Cash benefits						
- Retirement pension	£5,776	£6,794	£6,773	£7,023	£6,840	£6,641
- Other contributory benefits[a]	£88	£203	£176	£96	£110	£135
- Non-contributory benefits[b]	£988	£2,011	£2,794	£2,683	£2,370	£2,169
- Total	£6,853	£9,008	£9,743	£9,802	£9,320	£8,945
Gross income	**£8,390**	**£12,176**	**£15,102**	**£18,665**	**£34,306**	**£17,727**
Income tax	£149	£365	£694	£1,282	£4,904	£1,479
Employees' NIC	£8	£3	£31	£ 22	£69	£27
Council tax & NI rates	£873	£715	£690	£868	£1,224	£874
Disposable income	**£7,360**	**£11,092**	**£13,687**	**£16,493**	**£28,109**	**£15,348**

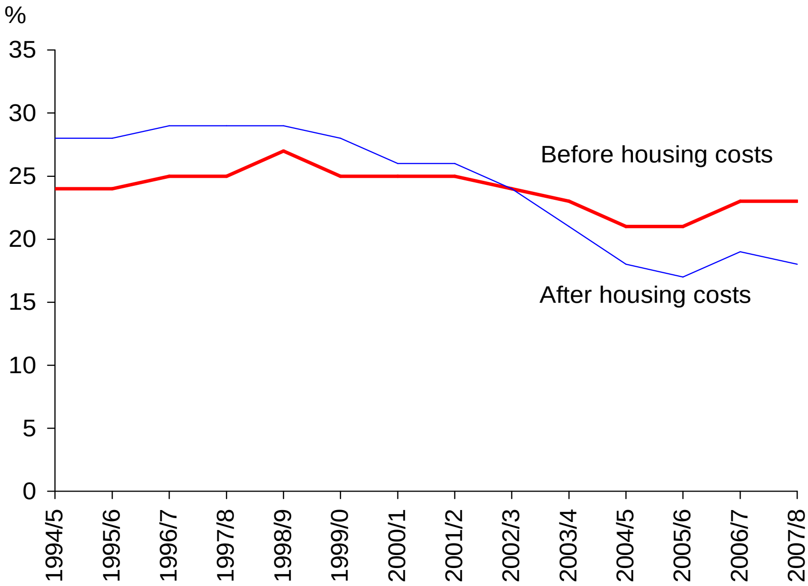
Source: Oxford Economics and ONS (2009)

[a] Includes Incapacity Benefit, Job Seeker's Allowance (contribution based) and Widows' benefit.
[b] Includes amongst others Attendance Allowance, Disability Living Allowance, Housing Benefit, Income Support and Pension Credit,

A common measure of poverty used by both the EU's statistical agency Eurostat and in the UK by the Department of Work and Pensions (DWP) is the number of people with income below 60% of median income. DWP (2009) shows 23% of pensioners' equivalised income was below the 60% threshold before housing costs in 2007/8 (Chart 2-2).[3] This equates to 2.5 million people. After housing costs are taken into consideration 18% were below the 60% threshold in 2007/8. This is 2.0 million pensioners.

[3] DWP (2009), 'Households below average income (HBAI) 1994/5-2007/8'.

Chart 2-2: Percentage of pensioners falling below 60% of contemporary median income



Source : DWP (2009)

2.2. Future trends in retired households' income

While retired households' current disposable income may be low, there is even greater cause for concern about future generations of pensioners' income. Tables 2-1 and 2-2 show the main types of retired households' current incomes. In 2007/8, the state retirement pension made up 37% of the average retired households' gross income (Table 2-2). It made up a significantly higher percentage of the lowest quintiles income: the poorest two fifths of retired households are reliant on the state pension for 69% and 56% of their gross income. Occupational pensions rank second, providing 36% of the average retired persons income. Higher income pensioners tend to be more reliant on occupational pensions: providing half the top quintiles' income. Non-contributory benefits rank third, providing 13% of retired households' income. Investment income ranks fourth at 11% for the average retired household.

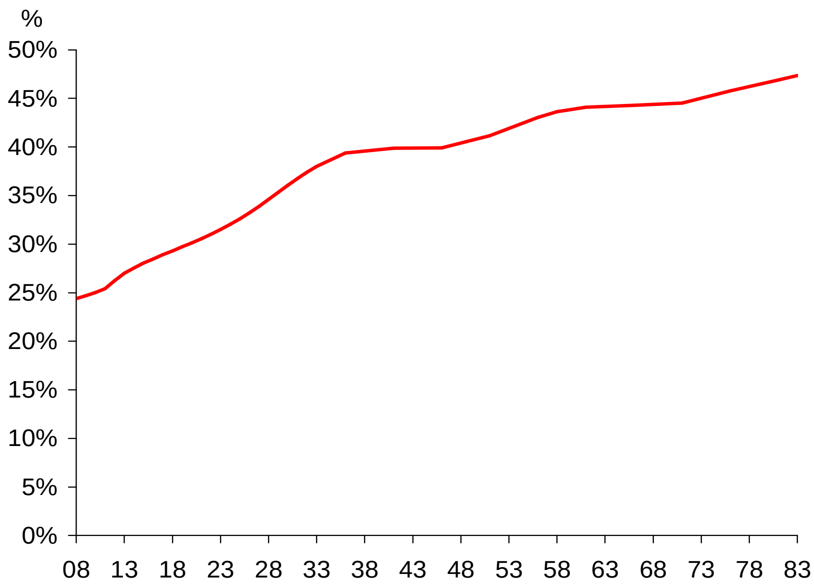
Table 2-2: Sources of retired households' gross income in 2007/8

	Quintile groups of retired households					
	Bottom	**2nd**	**3rd**	**4th**	**Top**	**All**
Original income						
Earnings	1%	1%	3%	3%	3%	3%
Occupational pensions	12%	20%	28%	38%	50%	36%
Investment income	5%	4%	4%	6%	20%	11%
Other income	1%	1%	1%	1%	0%	1%
Total	18%	26%	35%	47%	73%	50%
Cash benefits						
Retirement pension	69%	56%	45%	38%	20%	37%
Other contributory Benefits	1%	2%	1%	1%	0%	1%
Non-contributory	12%	17%	19%	14%	7%	12%
Total	82%	74%	65%	53%	27%	50%
Total	100%	100%	100%	100%	100%	100%
Total gross income[(a)]	£8,390	£12,176	£15,102	£18,665	£34,306	£17,727

Source: Oxford Economics and ONS (2009)
[(a)] Gross income before Income Tax, National Insurance Contributions and Council Tax Benefit/Rates Rebates.

The value of the state pension faces several threats. First, public sector finances have deteriorated significantly since the onset of the recession. This is likely to mean the Government will be looking to both decrease expenditure and raise additional tax income over the foreseeable future. Second, demographic changes due to greater longevity and in the short term ripples from the Baby Boom generation mean the number of working age people per pensioner is likely to decline. Chart 2-3 shows the number of over 65 year olds will increase from around 25% of 15 to 64 year olds to 37% by 2030. State pensions are financed on what is termed 'a Pay-As-You-Go basis'. This means that the today's pensions are financed by taxation on current workers' earnings. The future increase in the number of pension recipients relative to the size of the working population will increase the contribution workers need to make. They may be unwilling to sacrifice the necessary amount of income.

Chart 2-3: Over 65-year olds as a percentage of 15 to 65-year-olds



Source : Oxford Economics and Government Actuary's Department

The income future retired households receive from occupational pensions is expected to decrease. This reflects the switch from defined benefit to defined contribution pensions. While there is nothing inherently wrong with defined contribution pensions, contribution levels are generally lower. PICA (2009) argues "In 2007, the average employer contribution rate for defined benefit schemes was 15.6% of salary, compared with 6.5% for defined contribution schemes."[4]

Greater longevity also means that investment income will need to last for longer. ONS (2009) shows males and females who were aged sixty in 2006 will on average live for another 21.1 and 24.1 years.[5] Retirement savings therefore have to be spread over a longer time period than ever before. This decreases the amount they can be depleted each year, lowering annual income.

These threats to future generations of pensioners' income are arising when their numbers are predicted to increase. The Government Actuary's Department predicts the number of over 65-year olds in the UK will increase form 9.9 million in 2008 to 15.5 million in 2030.

[4] Pension Income Choice Association (2009), 'Optimising value in retirement'.
[5] ONS (2009), 'Population Trends', Autumn, Table 5.1.

3. Why is the exercising the Open Market Option important?

This section looks at how much purchasers of retirement incomes can gain from shopping around. It then reviews PICA's policies aimed at increasing the number of people coming up to retirement who seek to increase their retirement income by moving providers.

The main points are:

- In 2009, a male and female about to purchase a fixed income annuity can increase their annual income by an average of 19% and 22%, respectively by switching from the lowest to the highest paying provider. This differential is below that in 2008, but above that in the previous two years.
- PICA believes government action is necessary to ensure that the default option should be for everyone to review which provider they purchase their retirement income from.

3.1. Differences in annuity rates offered by different providers

The analysis in Section 2 shows that 23% of pensioners' incomes are below 60% of the median income level in the UK. Moreover, there are good reasons to believe pensioners relative poverty will increase in future, due to the increase in longevity and switch from defined benefit to defined contribution pensions. It is therefore critical that those approaching retirement both now and in the future make the most of their assets.

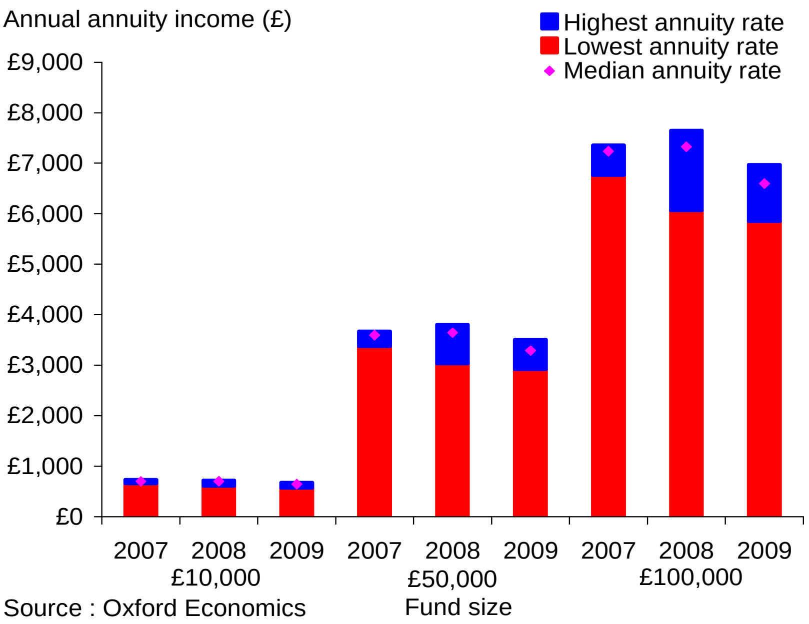
Those approaching retirement with a company or private pension plan have the choice of which type of annuity or other retirement income to purchase with their pension pot. Once they have made this decision, they then need to select a provider to purchase the product from. This is an important choice. In their analysis of annuity rates, the Financial Services Authority (FSA) (2008) found "a gap of around 20% between the top and bottom annuity rates, with just over half of the providers' rates within 10% of the cheapest rates available."[6] Put more simplistically, a person coming up to retirement could boost their annual retirement income by up to 20% by shopping around.

An analysis of the annuity rates offered by eight major annuity providers (AEGON, Aviva, AXA, Canada Life, Friends Provident, Legal & General, The Prudential, Scottish Widows and Standard Life) also shows the benefits of shopping around. Chart 3-1 shows the minimum, median and maximum fixed income annuity rates the eight providers offered to a 65 year old male with a pension pot of £10,000, £50,000 and £100,000, respectively. In 2009, a male nearing retirement with a £10,000 pension pot can increase his annual retirement income by £106 (or 19% of the minimum rate) a year by switching from the provider offering the lowest to the highest rate. This is similar to the gains he could make at the end of 2008 (19%), and above those in the previous two years (11% in 2006 and 14% in 2007). A male with a £50,000 pension pot could increase his retirement income by £589 each year (or 20% of

[6] The Financial Services Authority, (2008), 'A regulatory update from the Insurance Sector Team', Issue No. 13, April.

the minimum rate) by shopping around in 2009. The differential between the maximum and minimum annuity rate on offer is below that at end-2008 (25%), but significantly above that in 2007 (9%) and 2006 (12%). A 65 year old male with a £100,000 pension pot could increase his annual retirement income by £1,118 a year (or 19% of the minimum) by selecting the provider offering the highest rate. Again, this is below the potential gain at end-2008 (26%), but above that in 2007 (9%) and 2006 (12%).

Chart 3-1: The annuity rates offered by eight providers to a 65 year old male



Source : Oxford Economics

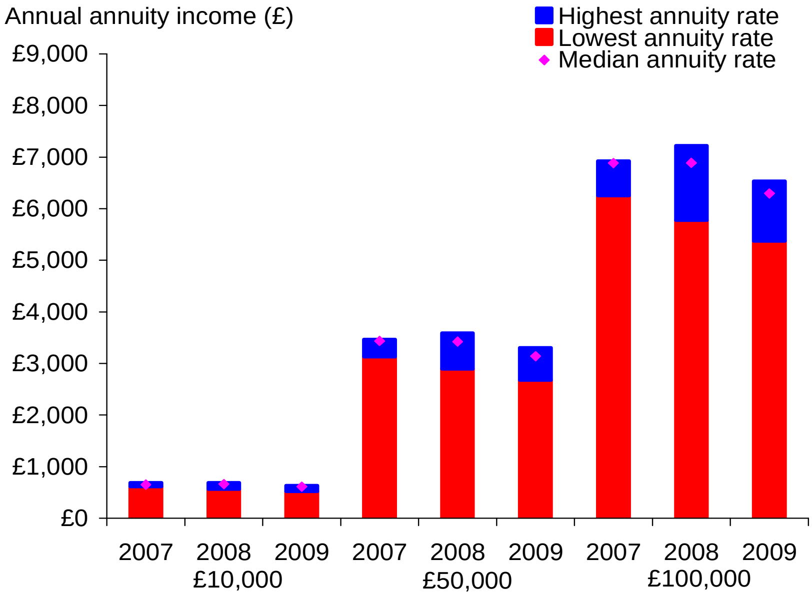
The annuity rates offered to females are slightly lower than those offered to males due to their greater longevity. Chart 3-2 undertakes an analogous comparison to Chart 3-1 for a 65 year old female approaching retirement with a pension pot of £10,000, £50,000 and £100,000, respectively. By shopping around a female with a £10,000 pension pot in 2009 could boost her annual retirement income by £109 each year (or 21% of the minimum) by switching from the provider offering the lowest to the highest rate. As for a male with the same size fund, this is the same gain available at end-2008 (21%), but above that available in 2007 (12%) and 2006 (14%). A 65 year old female with a fund of £50,000 in 2009 could increase her retirement income by £626 a year (or 23% of the minimum) by shopping around. Again, this is below the gain in 2008 (24%), but above that in 2007 (11%) and 2006 (13%). A 65 year old female with a pension pot of £100,000 in 2009 could increase her annual income after retirement by £1,160 each year (or 22% of the minimum) by adroit provider selection. The gain is below that in 2008 (25%), but above that in 2007 (11%) and 2006 (13%).

Analysis of the benefits of shopping around for enhanced annuities suggest the gains may be even larger. In 2009, a male with a £10,000 pot could gain 21% by moving from the lowest to the highest provider.[7] This compares to 23% at end-2008. A female with the same sized pot could gain 22% in

[7] Enhanced annuity rates are sourced from Moneyfacts and contain different providers from the fixed income annuities comparison.

2009 and 24% at end-2008.

Chart 3-2: The annuity rates offered by eight providers to a 65 year old female



Source : Oxford Economics

Over the past few years, the authorities have made a number of efforts to make people approaching pensionable age aware of the benefits of shopping around for their retirement income. One aspect of this is to make people aware they can switch from the company with which they have saved for their pension with to a company providing retirement incomes. This is known as the Open Market Option (OMO). In their analysis of the annuity market, HM Treasury (2006a) comments "It has been a longstanding Government policy that individuals can shop around for their annuity rather than remaining with the provider with whom they made their pension saving with. By exercising this so-called Open Market Option (OMO) an individual may obtain a better deal taking into account their personal needs and aspirations."[8] HM Treasury (2006b) announced a review of the workings of the OMO to facilitate this aim.[9] HM Treasury (2008) lists a package of measures to improve the OMO for both personal and occupational pension schemes.[10]

Despite the efforts of the authorities and firms within the pension industry to raise awareness of the OMO, the majority of purchasers of retirement incomes decide to stay with their existing pension savings provider. In 2008, 37% of people exercised their OMO to change their retirement income provider (Chart 3-3). This compares to 27% in 2000. There is therefore some evidence of a slight increase in the numbers of people coming up to retirement exercising their OMO.

[8] HM Treasury, (2006a), 'The annuities market', December. Page 24.
[9] HM Treasury, (2006b), 'Pre-Budget report', December.
[10] HM Treasury, (2008), 'Outcome of the review of the Open Market Option' in '2007 Pre-Budget report and comprehensive spending review', December.

Chart 3-3: Percentage of people exercising the OMO

Source : Oxford Economics and Association of British Insurers (ABI)

It should be stressed not all individuals will or should exercise their right to buy an annuity from a different provider. That will depend on what different firms offer in respect of rates and types of annuity. In some cases an existing pension plan provider may actually offer the best deal. But people coming up to retirement age should make an informed choice in order to maximize their income in retirement. Rather than purchasing from their existing provider due to: consumer inertia and apathy; lack of awareness; complex application forms; length of time it takes to transfer funds from one provider to another; difficulties in finding a provider willing to provide a quote; etc.

3.2. Pension Income Choice Association's policies

To achieve a material change in the numbers of people reviewing their options at retirement, The Pension Income Choice Association (PICA) believes government action is necessary to ensure that the default option should be for everyone to review their options at retirement. Their policies fall into two categories:[11]

Improved communication

PICA proposes all pension schemes should adopt three stages of communication in the run up to retirement:

[11] PICA's policies are spelt out in full in 'Optimising value in retirement' which is available from www.pica.org.uk.

Stage 1

This would be a relatively short communication 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.
• Brief descriptions of the types of retirement income product available and their suitability for different clients.
• Examples of the potential benefits of exercising the OMO (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.

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 compare rates/charges. 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 scheme what should be done with the fund.

Recommendations for people with smaller funds

• 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.

• 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.

• The FSA comparative tables are a very helpful tool and should be extended to include all companies and all retirement income solutions.

• 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).

4. How much would PICA's policies increase pensioner income?

In this section, a stylised model is developed to capture the impact of PICA's policies on current and future income streams pensioners receive from purchasing retirement incomes.

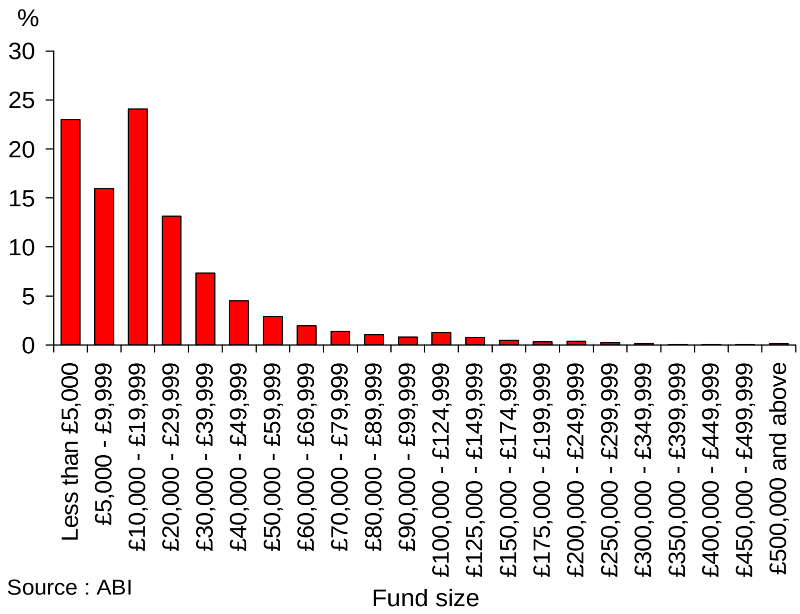
<u>The main points are:</u>

- The implementation of PICA's policies is estimated to increase pensioner incomes by £13.9 million in a single year. This is equivalent to around £169 per policy per year.
- If PICA's policies were implemented in 2010, pensioner incomes are estimated to be £304 million higher by 2030. This is a cumulative gain of £3,308 million between 2010 and 2030.

4.1. The impact of PICA's policies in a single year

The starting point of the model is the number and type of people retiring in 2009. The people retiring this year are split by age, gender and the fund size they have available to purchase an annuity. Age and gender impact the annuity rate available for each fund size. The extent of a person's fund affects the size of the annuity rate. Chart 4.1 shows the Association of British Insurers' (ABI) data on the distribution of fund sizes at retirement for persons of all ages and both genders for 2009. It shows the most common fund size is £10,000 to £19,999 and nearly 40% of annuities are purchased with a fund of less that £10,000.

Chart 4-1: Distribution of fund size for all ages, 2009Q1

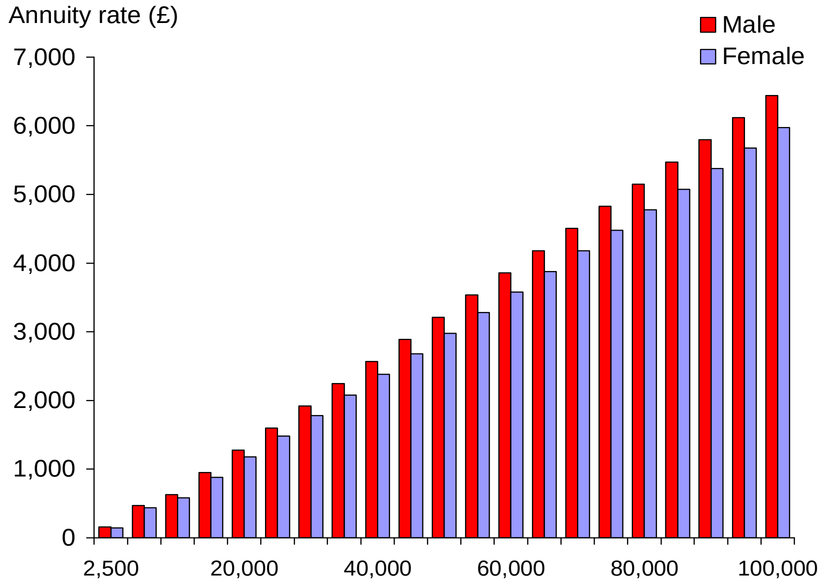


Source : ABI

In the model it is assumed that 37% of people exercise the OMO in 2009. This is the actual percentage ABI data (see Chart 3-3) suggest did exercise their OMO in 2008. Financial Services Authority (2003) suggests that people with larger funds available to buy an annuity are more likely to exercise the OMO.[12] In the model the rate at which people exercise the OMO by fund size is adjusted accordingly, while ensuring the average remains at 37% for all people approaching their retirement.

Data are available on annuity rates from the ABI. To model the rates pensioners receive if they do not shop around (namely, exercise their OMO), it is assumed they receive the lowest rate of those on offer. The lowest annuity rates available split for each gender and fund size is shown in Chart 4-2.

Chart 4-2: The lowest OMO annuity rates for a 65 year old for various fund sizes in 2008



Source : Oxford Economics and ABI

Exercising the OMO allows people to use providers which offer higher annuity rates. This boosts the income people will receive in retirement. As has been seen from the analysis in Section 3, the gain from shopping around varies by fund size and over time. In the model, it is assumed that people exercising the OMO option benefit by receiving a 10% higher annuity rate than the lowest rate on offer for their age and gender in the Open Market. This percentage was selected on the basis of evidence in FSA (2008) and was agreed in consultation with PICA during the study.[13] It is a conservative assumption relative to the average gains of 16% for males and 17% for females the analysis in Section 3.1 suggests have been available over the previous four years.

[12] Financial Services Authority, (2003), 'Purchasing annuities and an examination of the impact of the Open Market Option', Consumer Research Paper No. 2, November.

[13] The study found "a gap of around 20% between the top and bottom annuity rates, with just over half of providers' rates within 10% of the cheapest rates available". As half of the rates examined were within 10% of the cheapest rates, we may reasonably assume that the average rate is in the region of 10% above the worst rate. The difference between worst and best rates is 20%, so there is potentially a 10% gain on the worst rate on average.

Combining the data on the number of annuities purchased by people retiring (split by age, gender and fund size) and the annuity rates available to them gives an income stream for pensioners. Using the assumption about the higher annuity rates available for those exercising the OMO gives the additional income stream potentially available for pensioners in the current year. However, there are three further factors that we need to consider:

(a) The impact of PICA's policies on the numbers exercising the OMO

The implementation of PICA's policies will increase the percentage of pensioners who exercise their OMO. The extent of the likely increase is unknown. In the model it is assumed that no one with a fund size below £10,000 would be encouraged to exercise the OMO as often open market providers will not take on funds of less than this value. For all other fund sizes, the central assumption is that half (50%) of those who currently do not take the OMO change provider because of the policy change. As a variant, the results are also calculated for 75%.

A key point is that the change in policy will make people more aware of both the existence and the true benefits of the OMO, and improve the experience of exercising the OMO so it easier and less costly. This effectively expands the choice available to people purchasing annuities or other retirement incomes between different providers and in turn will spur greater competition between companies. Pension providers are likely to offer improved rates in general to people purchasing retirement incomes in order to retain them, including those who may not even consider the OMO or those who did consider it but decided against exercising the Option. Thus the benefits from the new policy would not just be restricted to those extra savers exercising the OMO. The central 50% assumption could therefore be viewed as a measure of the overall benefit to all purchasers of annuities as a result of the new policy, whether or not they decide to take the OMO.

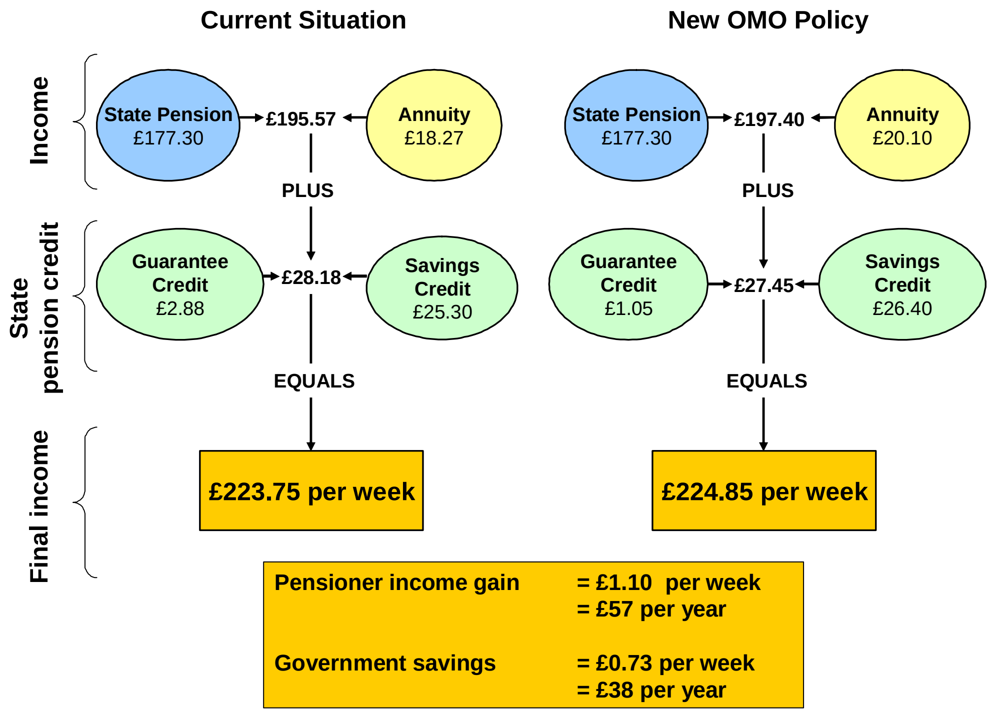
In our model we have assumed that 50% of those people currently not exercising the OMO with a fund size greater than £10,000 might do so with the policy changes proposed (equivalent to around 30% of all funds not currently exercising the OMO). While in some senses this can be considered as illustrative, it should be noted that the ABI's (2009) research into pre-retirement wake-up packs, following the introduction of new guidelines, shows that 31% of people either do not know or believe that you can only purchase an annuity from your current pension provider.[14] FSA (2003) research published after the introduction of the "wake-up letter" shows that 31% did not consider exercising the OMO due to reasons that could be labelled under the headings; inertia; limited knowledge; and limited confidence.[15] There is therefore considerable scope for the policy changes proposed by PICA to impact the numbers exercising the OMO.

Recall that the model uses the assumption that those with larger funds have a higher propensity to be already taking the OMO than those with smaller funds; so implicitly the model assumes that this policy change has the greatest impact on those with fund sizes between £10,000 and £50,000.

[14] ABI (2009), 'Pre-retirement wake-up packs', ABI Research Paper No. 18.
[15] FSA (2003), 'Purchasing annuities and an examination of the impact of the Open Market Option', Consumer Research Paper No.22.

Case Study 1: John, age 65 and married

John is 65 and has been the main income provider for him and his wife all their lives. They receive the full Basic State Pension for couples of £152.30 a week, plus a State Second Pension of £25 per week based on John's earnings-related contributions. On retirement he had a pension fund of £15,000 and purchased an annuity giving them £18.27 per week (£950 a year). Their income is therefore £195.57 per week. This is below the state guarantee amount of £198.45 per week for a couple, so they receive guarantee credit of £2.88 a week. In addition their income (before adding on the guarantee credit) is above the savings credit starting point of £153.00. This means they are entitled to savings credit working out to £25.30 a week. Their final income, including pension credit, is therefore £223.75 per week.



Under the new policy assume their annuity income would increase from £18.27 to £20.10 (a 10% increase). Their income before pension credit would rise to £197.40. Their guarantee credit would fall to £1.05 a week (a fall of £1.83). However the extra annuity income means they would be entitled to more savings credit and so they would receive £26.40 a week (an increase of £1.10). John and his wife would now have a final income of £224.85 per week. This would be an increase of approximately £1.10 per week (equal to the increase in savings credit) or £57 a year.

From the point of view of the Exchequer it would not have to pay as much guarantee credit to the couple. It would have to pay more savings credit, but the increase would be less than the gain from paying less guarantee credit. The Exchequer therefore would pay £0.73 less in overall pension credit to the couple. This would equal a government saving of £38 a year.

In summary, the benefit of the new OMO policy would be £57 per year to John and his wife and £38 to the government. Thus there would be a 60%-40% split in the gains between the couple and the state.

(b) The split of the extra income between pensioners and the Exchequer

For those pensioners with a lower income stream who receive some form of government pension credit, the benefit from shopping around for their retirement income will be split between themselves and government savings through reduced state support. The model assumes that 40% of the benefit from those with fund sizes between £10,000 and £30,000 goes to the government through lower social security payments, but for those with larger fund sizes 100% of the benefit goes to the pensioner. The percentages are based on stylised models of individuals with different fund sizes in different circumstances (e.g. single versus married and varying levels of state pension, etc). Two of the stylised models of individuals are included as case studies to illustrate the distribution of income between the pensioner and the Exchequer.

(c) Enhanced annuities

Some pensioners will derive additional benefits from being eligible for enhanced annuities.[16] It is assumed of the people who benefit from the policy change, 19% would get an enhanced annuity, and that the average income received is 17% higher than a standard annuity. The 19% figure is selected on the basis it is the percentage of enhanced annuities within "external" policies in 2008 sourced from ABI data. The 17% figure is the extra income a moderate-enhanced annuity pays compared with a standard policy according to data provided by Hargreaves Lansdown.

On the basis of these assumptions, we estimate that the implementation of PICA's policies would generate an additional £13.9 million of income for pensioners in 2010. It is equivalent to around £169 per policy per year. To give a sense of scale, this compares to the 2009/10 level of Winter Fuel Allowance of £250 for households with someone aged over 60 or £400 for households with someone aged. [17]

As a variant, the results have been calculated assuming 75% of people exercise their OMO rather than 50% (excluding those with funds less than £10,000) and the gain from shopping around is 15%. This leads to pensioners gaining £31.3 million in income in 2010.

4.2. Impact of PICA's policies on pensioner income over time

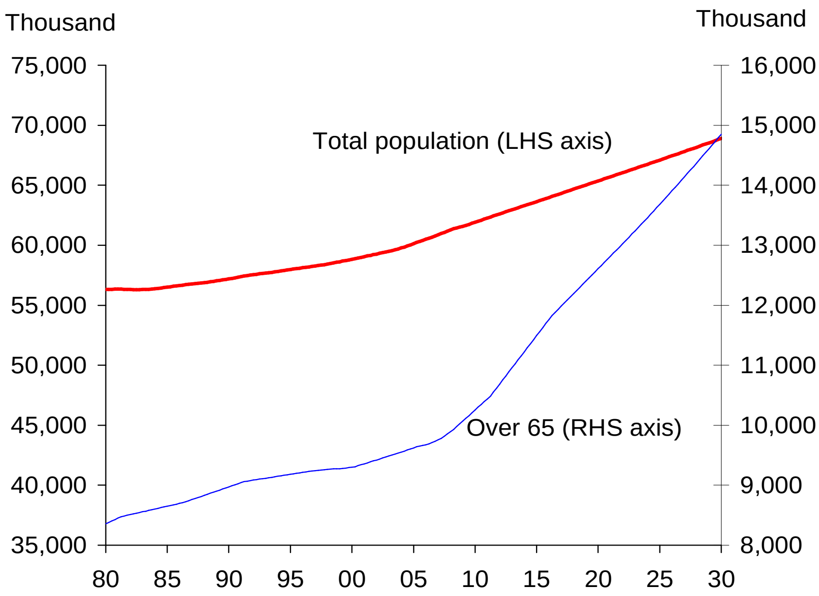
PICA's policies will not just have an impact on a single year. The extra income that the pensioners exercising the OMO receive in the first year will continue for ever year they live. Furthermore, in every future year a new wave of retirees will also benefit if they are encouraged to exercise the OMO. The model has therefore been extended to estimate the extra income retirees will get over time. To calculate the future income, data and assumptions are required on the numbers of people coming up to

[16] Enhanced annuities are annuities which offer high rates in expectation for people with a lower than normal life expectancy due to having a medical condition.
[17] If a 100% of the people coming up to retirement exercise their OMO, households and government would gain £30 million in extra revenue in 2010.

retirement in the future; retirement rates by age and mortality rates by age.

Data on the numbers of people in the UK by age band is sourced from Oxford Economics' UK macroeconomic model. This suggest the number of people over 65 years old in the UK is forecast to rise from over 10 million in 2009 to just under 15 million by 2030 (Chart 4-3).

Chart 4-3: Forecasts for total population growth and growth in the over 65s

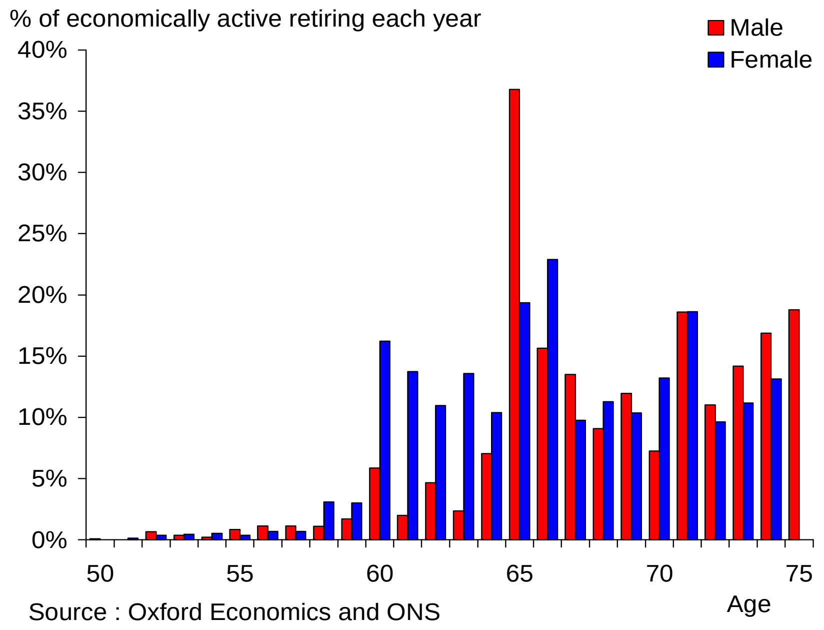


Source : Oxford Economics

Data on retirement rates for males and females by age has been sourced from the ONS' Labour Force Survey (LFS). This shows sharp increases in retirement rates for males at 65 and 70 years old (Chart 4-4). Female retirement rates increase at 60, 65 and 70 years old. The retirement rates show the percentage of that age group who were economically active in the previous year who retired in the present year.

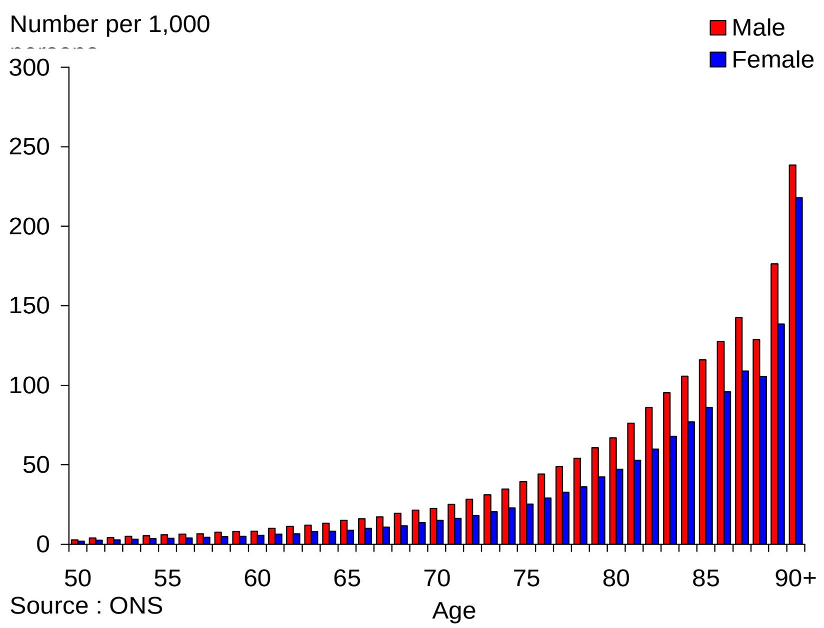
The model uses the LFS data on retirement rates by age as a starting point. This has been altered to reflect announced government policy on changes to the retirement age. Current policy is for the retirement age to go up to 65 for females by 2020, increasing to 66 between 2024 and 2026 for both genders.

Chart 4-4: Retirement rates by age



As well as new people retiring each year (who potentially could benefit from exercising the OMO), pensioners receiving income from annuities will die each year. Data on mortality rates by age has been sourced from the ONS. Unsurprisingly, it shows the proportion of people dying each year is a positive function of their age (Chart 4-5).

Chart 4-5: Mortality rates by age



The model also assumes a greater proportion of the retiring population will be purchasing an annuity or other retirement income in the future. This is to broadly reflect the introduction of personal accounts and the switch from defined benefit to defined contribution pension schemes. Data from the Pensioners' Incomes Series (produced by the ONS and Department for Work and Pensions) shows the proportion of recently retired pensioners in receipt of income from a personal pension has risen steadily over the last decade, from 7% in 1996/97 to 21% in 2006/07. Although this growth does not correspond precisely with the growth in annuities (from 2004-2008 the number of policies sold increased by around 30%), it does reflect the positive trend in the number of annuities purchased in recent years.

The model assumes the proportion of recently retired pensioners receiving a personal pension continues to grow in the future, but at a reduced rate than that seen in the last 10 years. This has been used to drive our projections of the growth in the number of annuities purchased.

The model assumes annuity rates will stay at their current level. This is a conservative assumption as current annuity rates are low (10% below their value of a year ago). This assumption has been used in the absence of a forecast of future annuity rates.

On the basis of these conservative assumptions, if PICA's policy changes are adopted in 2010, we estimate that overall pensioner income will be £304 million higher in 2030. Between 2010 and 2030, annuity holders or purchasers of alternative retirement income products gain £3,308 million in extra income in today's prices.

To illustrate, what this means in terms of net present value, pensioners retiring in 2010 will gain almost £188 million (using a 3.5% discount rate) in additional income over their lifetime.

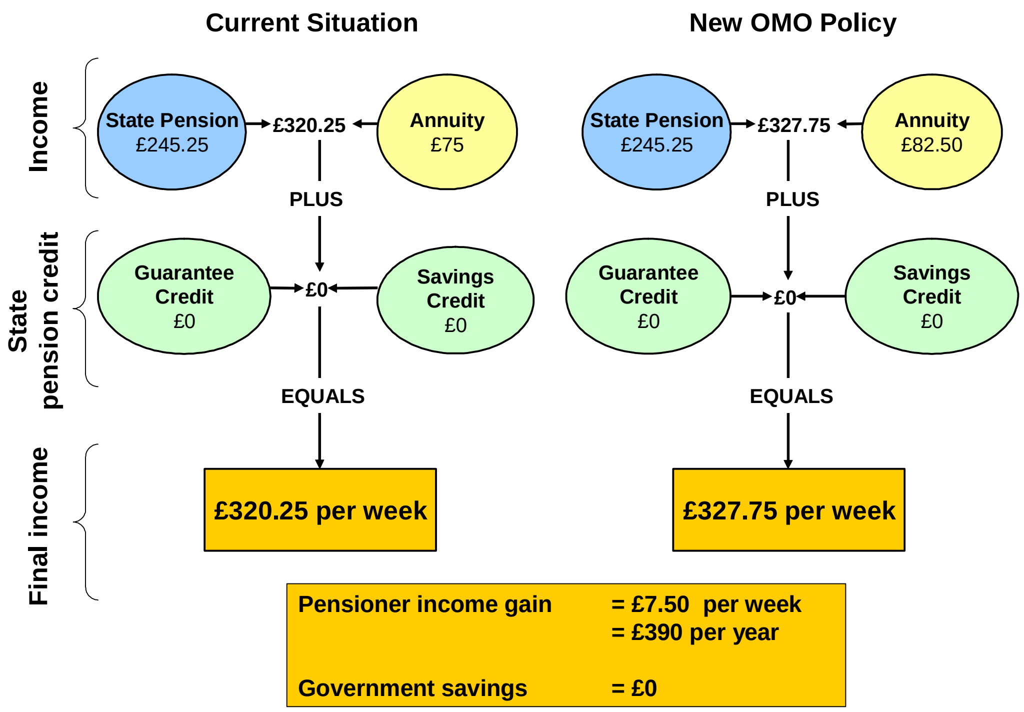
Using the less conservative assumptions of the variant (75% take up rate and 15% gain from shopping around), pensioners' income will be £684 million higher in 2030. This is a cumulative gain of £7,443 million between 2010 and 2030.

Case study 2: Margaret, aged 60 and single

Margaret is 60 and single. She receives the full Basic State Pension of £95.25 a week plus a State Second Pension of £150 a week. She had a pension fund of £75,000 and purchased an annuity which gives her £75 per week (£3,900 a year). Her income is therefore £320.25 per week. This is above the state guarantee amount of £130 for a single pensioner, so she does not receive guarantee credit from the state. Also her income is far enough above the savings credit starting point of £96 for a single pensioner that she does not receive any savings credit. Her final income is therefore £320.25.

Under the new OMO policy we assume her annuity income would increase from £75 to £82.50 (a 10% increase). Her improved annuity income would not affect her pension credit – she would still receive no pension credit. So her new final income would rise to £327.75, an increase of £7.50 per week or £390 a year.

The government would not save money as Margaret does not receive pension credit in the current situation. The benefits of the new policy would therefore entirely go to Margaret.



5. Other macroeconomic impacts

This section investigates the impact of PICA's policies on consumer expenditure, the Exchequer's payment of social security and tax receipts and the retirement income providers industry.

The main points are:

- The implementation of PICA's policies is likely to boost pensioners' consumer spending by £8.7 million in 2010 and £2,075 million in current prices between 2010 and 2030. This stimulus is likely to impact the food and drinks, household goods and services sectors and utilities first. It will boost employment and GDP in these sector's supply chains.

- The policies are estimated to improve the Exchequer's finances by £6.7 million in 2010 and £1,688 million (in current prices) over the 21 years between 2010 and 2030. The boost comes from savings on social security payments, and higher income and indirect taxes.

- The annuity or other retirement income providers offering the best rates will benefit from PICA's policies, while those offering the poorest will lose. The industry as a whole will suffer a reduction in profitability in the short-term. Increased competition is likely to enhance productivity over the longer term.

5.1. Increased consumer spending

The increase in income retired households receive from the implementation of PICA's policies can either be spent on consumer goods and services or saved. If it is used to fund increased consumer spending, this will generate additional economic impacts. These will initially be felt in the retail and leisure outlets where retired people spend the extra income they gain from exercising their OMO. But it will subsequently impact on these firms' supply chains. These are sometimes known as 'multiplier effects'.

To estimate the size of these multiplier effects it is necessary to calculate how much of the extra income retired households receive from exercising their OMO is spent on consumption. The ONS' Family Spending and Family Expenditure Survey collect data on different households' consumer spending. Constructed from this source, Table 5-1 shows the average amount retired households spend on consumption each week split by type in 2007 and the numbers of retired households in each type. The average amount (weighted by number of households) retired household spent in 2007 was £11,120. ONS (2009) suggests the average retired households' gross income was £17,727. Consumer spending therefore absorbs 63% of retired households' gross income.

Table 5-1: Retired households' expenditure in 2007

Type of retired household	Total household expenditure per year	Number of retired households (000s)
One person household not mainly dependent on the state pension for income	£9,604	2,780
One person household mainly dependent on the state pension for income	£8,564	650
One man, one woman retired households not mainly dependent on the state pension for income	£18,725	2,160
One man, one woman retired households mainly dependent on the state pension for income	£12,324	430
Weighted average	£11,120	

Source: Oxford Economics and ONS

If 63% of the additional income retirees gain by shopping around after the implementation of PICA's policy is spent, consumer spending is estimated to increase by £8.7 million in 2010. Over the 21 years (2010 to 2030 inclusive), it is estimated to increase consumer spending by £2,075 million. In the less conservative variant, these figures are £19.6 million and £4,669 million, respectively.

To get an idea of which industrial sectors will be most affected by the increase in retirees' income after the implementation of PICA's policies, we look at retired households' expenditure patterns. Retired households tend to spend more of their income on necessities such as food and housing, than non-retired households. Housing, fuel and power and food and non-alcoholic drinks absorb 37% and 39% of retired one adult households spending dependent on whether they are reliant on the state pension as their main source of income (Table 5-2). The figures for retired couple households are 28% and 38%, respectively (Table 5-3). Other major expenditure categories for one adult retired households are recreation and culture and household goods and services. Retired couple households also spend on recreation and culture, but transport ranks more importantly than household goods and services. It is these sectors that will receive the biggest boost from the additional demand from pensioners as a result of the implementation of PICA's policies.

Table 5-2: Expenditure of one adult households in 2007

Expenditure category	Non-retired		Retired (not dependent on state pensions)		Retired (dependent on state pensions)	
	£	%	£	%	£	%
Food & non-alcoholic drinks	24.10	*10%*	25.90	*16%*	24.30	*17%*
Alcoholic drinks, tobacco & narcotics	7.00	*3%*	4.60	*3%*	3.50	*2%*
Clothing & footwear	10.00	*4%*	6.40	*4%*	5.00	*3%*
Housing (net)[1], fuel & power	46.80	*19%*	34.10	*21%*	30.90	*22%*
Household goods & services	20.60	*9%*	15.80	*10%*	16.60	*12%*
Health	2.90	*1%*	4.90	*3%*	1.60	*1%*
Transport	40.60	*17%*	13.90	*9%*	13.20	*9%*
Communication	8.40	*3%*	5.50	*3%*	4.70	*3%*
Recreation & culture	32.00	*13%*	22.70	*14%*	24.00	*17%*
Education	3.60	*1%*	1.20	*1%*	0.00	*0%*
Restaurants & hotels	23.50	*10%*	9.70	*6%*	6.70	*5%*
Miscellaneous goods & services	21.70	*9%*	15.50	*10%*	13.40	*9%*
Other expenditure items	66.10	*22%*	24.40	*13%*	21.00	*13%*
Total expenditure	307.40	*100%*	184.70	*100%*	164.70	*100%*
Average expenditure per person	307.40	*100%*	184.70	*100%*	164.70	*100%*

Source: Oxford Economics and ONS

Table 5-3: Expenditure of one man, one woman households in 2007

Expenditure category	Non-retired		Retired (not dependent on state pensions)		Retired (dependent on state pensions)	
	£	%	£	%	£	%
Food & non-alcoholic drinks	49.70	*11%*	49.70	*16%*	45.20	*22%*
Alcoholic drinks, tobacco & narcotics	14.30	*3%*	9.30	*3%*	6.70	*3%*
Clothing & footwear	23.50	*5%*	12.10	*4%*	9.10	*5%*
Housing (net)[1], fuel & power	55.00	*12%*	38.60	*12%*	32.40	*16%*
Household goods & services	39.50	*9%*	25.40	*8%*	13.70	*7%*
Health	7.70	*2%*	8.60	*3%*	2.30	*1%*
Transport	79.40	*18%*	45.40	*14%*	24.70	*12%*
Communication	12.60	*3%*	8.10	*3%*	6.00	*3%*
Recreation & culture	70.50	*16%*	61.30	*19%*	30.20	*15%*
Education	3.10	*1%*	0.60	*0%*	0.0	*0%*
Restaurants & hotels	48.10	*11%*	25.30	*8%*	13.90	*7%*
Miscellaneous goods & services	40.30	*9%*	30.90	*10%*	17.10	*8%*
Other expenditure items	99.10	*18%*	44.70	*12%*	35.70	*15%*
Total expenditure	542.70	100%	360.10	100%	237.00	100%
Average expenditure per person	271.40	100%	180.10	100%	118.50	100%

Source: Oxford Economics and ONS

5.2. Impact on Exchequer revenues

The Exchequer will also benefit from the implementation of PICA's policies through reduced expenditure and greater tax receipts. Under the existing rules, the state guarantees pensioners a minimum income level of £130 a week if single or £198.45 if a married couple. Savings Credit also has a threshold. For pensioners with incomes below the minimum, any increase in income from exercising the OMO, will result in a decrease in social security payments. In 2010, the model estimates this saving to be £1.6 million. By 2030, the saving is estimated to be £43 million a year. Over the twenty one years (2010 to 2030 inclusive) the cumulative expenditure saving is estimated to be £478 million.

The increase in income pensioners receive will also be subject to tax if the pensioner's income is above the personal allowance (currently at £9,490 for people aged 65 to 74 in 2009/10 and £9,640 for over 75 year olds).[18] Given ONS (2009) suggests the top quintile of retired households' gross income was £34,306 in 2007/8 (which compares to the upper income tax threshold of £34,600 in 2007/8), it is likely this will be taxed at the basic rate of tax (20%) in future. This is estimated to generate £2.8 million in income tax in 2010. Over the 21 years between 2010 and 2030, it is estimated to generate £662 million in additional income tax.

The increase in consumer spending will also generate additional indirect tax receipts. Pensioners will have to pay VAT on most goods and excise duty on any alcohol, tobacco or petrol they purchase. ONS (2009) shows on average retired households spent £2,936 in 2007/8 on indirect taxes. Weighting together the different types of retired households' consumer expenditure by the numbers of people in each group suggests the average retired person spent £11,120 on consumption. Indirect taxes therefore make up 26% of retired people's consumer expenditure. On this basis, the £8.7 million rise in consumer expenditure in 2010 is likely to increase indirect taxes by £2.3 million. The £2,075 million rise in consumer spending as a result of the implementation of PICA's policies over the 21 years between 2010 and 2030 is likely to generate £548 million in additional indirect taxes.

Adding the savings on social security payments, income and indirect taxes together suggests the implementation of PICA's policies is likely to improve the Exchequer's finances by £6.7 million in 2010. These three effects are estimated to enhance the Exchequer's finances by £1,688 million over the 21 years between 2010 and 2030. In the less conservative variant, the figures are £15.1 million in 2010 and £3,798 million between 2010 and 2030.

5.3. Impact on pension providers

If PICA's policies are implemented, increasing numbers of retired households will switch away from the firm with which they have saved for their pension to providers selling annuities or other retirement incomes which provide a better rate. In the short-term, this is likely to have distributional effects. The firms with which people saved are liable to lose the revenue and profits they made on selling retirement

[18] HM Treasury, (2009), 'Budget 2009: Building Britain's future', April.

incomes. In contrast, the firms to which they switch will make additional revenue and profits. In practice, the extent of the distributional effects is likely to depend on the response of the providers which offer pension saving schemes. They may want to keep selling the same volume of annuities to their existing pension saving customers, so will increase the annuity rates they offer to become more competitive.

Overall, it is important to acknowledge there will be a contraction in annuity providers' profitability. The firms gaining the business will earn lower profits than existing providers as they offer higher rates. As a consequence, some of the gross benefits calculated in Sections 4 and 5 have to be netted off against the loss in provider profitability. Some of the increase in consumption and multiplier effects will make a net positive contribution, as pensioners are likely to have a higher marginal propensity to consume than pension providers' shareholders.

Over the longer term, the industry will benefit in some ways through increased competition. The economics profession argues that competition has a positive effect on firm productivity. This may occur for three reasons. First, it may force existing providers of retirement incomes to become more efficient, as lower rates forces firms to reduce costs in other ways to make the same margin. Second, increased competition will mean low productivity/inefficient firms will exit the market to be replaced by new firms with more efficient procedures. At the same time high productivity/efficient firms will see their market share grow. Overall efficiency and productivity will improve through this process of market selection. Third, it may increase the incentive to innovate, although this is not a universally held view.[19]

To the extent that the increased competition in the domestic market leads providers to become more efficient, it will help providers compete against foreign firms. This should lead to greater sales abroad and less import penetration of the domestic market.

[19] The famous Austrian economist Joseph Schumpeter argued that competition reduces the incentive for firms to innovate as any gains will disappear when rival firms catch up. This is known as the 'Schumpeterian effect'.

6. Conclusions

Just under a quarter of Britain's pensioners currently live in poverty. It is likely future generations of pensioners will be significantly worse off. Greater longevity and demographic trends threaten the future value of the state pension. The switch from defined benefit to defined contribution pensions is likely to lower the future value of occupational pensions. Increased longevity means that pensioners' savings will have to last longer, decreasing the amount they can be depleted each year to provide income.

But at the moment many people who have invested in defined contribution pensions do not maximize their income by exercising their OMO. They stick with the provider which undertook their pension investment. 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.

Using various conservative assumptions, this paper develops a model of the potential gains in pensioner incomes that could arise from the implementation of PICA's policies. The model estimates PICA's policies could increase pensioners' incomes by £3,308 million in current prices between 2010 and 2030. It is estimated to boost pensioners' consumer spending by £2,075 million over the same time interval. This additional expenditure in the economy would generate more jobs and boost the UK's GDP. The policies will also save the Exchequer £1,688 million between 2010 and 2030. The policy would have implications for providers of retirement incomes. There would be distributional effects in favour of those offering the most competitive rates. The industry as a whole would experience a fall in its profitability.