Retirement Income
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Eyewitness to History in the UK

By Joseph A. Tomlinson, CFP *Thu, Mar 20, 2014*

Our guest columnist, who spends part of each year in Britain, offers this exclusive analysis of the implications of the announcements about retirement regulation and annuities by Britain's top treasury official yesterday.

Splashed across the front pages of British newspapers this morning were headlines such as “Pension Power to the People,” and “Millions Freed from Annuity Trap.”

Yesterday was the annual Budget Speech in Parliament where, George Osborne, Chancellor of the Exchequer (head of the Treasury) delivered the ruling party’s budget for the upcoming year. This event carries much more import than the publication of the President’s budget in the US, because in Britain the changes in the budget actually get implemented—some with immediate effect.

The big surprises in the speech were the sweeping changes affecting retirement savings including:

- A near abolition of longstanding rules that required converting “pension pots” of retirement savings into annuities.
- Raising the limit on amounts that can be set aside in tax-advantaged Individual Savings Accounts (ISAs), which operate similar to Roth IRAs in the US.
- Introducing enhanced government-backed one and three-year savings bonds for retirement that pay above market rates—2.8% for 1 year, 4% for 3 years.
- Setting up an arrangement for free face-to-face financial advice to be delivered to those close to retirement age.

The annuity changes were the bombshell. Osborne announced, “No longer will anyone be forced to buy an annuity.” This came as such a surprise that a *Daily Mail* columnist Quentin Letts wrote that a quick scramble took place in the press box as reporters asked each other, “What in the heck is an annuity.”

For decades, the rules applying to annuities have been that people could save for retirement in either employer-sponsored DC plans or private pensions with tax deferral similar to traditional IRAs, but individuals were required to purchase annuities with such savings by the age of 75 or face severe tax penalties. There were also severe tax penalties for pulling money out of such savings.

This forced annuitization has become increasingly unpopular with the elderly population as the combination of low interest rates and improving longevity has reduced annuity payouts to half the level they were 15 years ago.

There have been other complaints about the insurers offering the annuities—high expense charges built into the products, confusing sales practices making it difficult for people to compare annuity offerings of different companies, and products failing to meet customer needs, e.g. annuities without survivorship benefits sold to couples. Unlike in America, where annuities are rarely mentioned in the popular press, anti-annuity stories are a regular feature in the British newspapers.

So the Budget speech including the annuity changes were a clear attempt by the Conservatives, led by David Cameron and George Osborne, to cater to the retired and near-retired population. There is an election coming in 2015 and the elderly have much higher voter-participation rates than the younger members of British society.

There are a lot of behavioral biases against annuities, partly because people are not good at understanding the relationship between savings amounts and economically equivalent lifetime income. But rather than helping people better understand these tradeoffs, the government in power has instead chosen the politically expedient approach. It has attacked annuities with pointed phrases such as, "recognizing that people have the maturity to decide how to manage their retirement savings," and "You've earned it, you should decide what to do with it."

Yet there were a few questions raised by television reporters on the evening news last night such as, "Aren't people likely to throw away their savings early in retirement, and then become a burden on society?" The government response was that we need to let people take responsibility for their own well-being and the State Pension (more generous at the low end than US Social Security) is there to keep people out of poverty even if they do blow through their savings.

Also, unlike in the US, health care expenses are not a worry in Britain because of the NHS (although long-term care does pose challenges).

There were even a few financial experts on the news who spoke up in favor of annuities, pointing out the value of lifetime income. However, when asked if they would buy an annuity today, the response was typically, "Not at these low interest rates. I'd wait for rates to rise."

No one got into the subtleties of, What does one do with the savings while waiting? Nor did anyone make the point that parking money at a zero interest rate and waiting to buy until rates rise may leave one in the same place economically as buying an annuity now. (With the new subsidized savings bonds, however, there may be a way to make delay strategies more effective than with earning market rates on parked money.)

There is a strong likelihood that Britain will see an explosion of new offerings for ways that people can invest their savings, and many of these will be dubious—e.g., some of the "buy-to-let" property schemes playing on the substantial recent increases in home values (the term "bubble" occasionally appears).

One of the aspects of this major retirement savings overhaul that is quite different than in the US is the lack of powerful business lobbies influencing the changes. These changes are likely to be a boon to mutual funds and other investment businesses, but so far there is nothing in the press about powerful investment industry lobbyists promoting the changes.

There is quite a bit in the press, however about stocks of insurance companies that offer annuities, getting killed in yesterday's and today's trading. Many general insurers were down as much as 13% and one specialty annuity provider lost 55% of its value. The insurance companies have powerful lobbies, but they have not been able to thwart these changes.

What seems to happen in the UK is that election campaigns only run a month or so and campaign funding is restricted. Consequently, elections are won by satisfying the needs of the British people. Perhaps a cynical, but realistic, view is that these reforms are a case of playing to popular taste and satisfying short-term needs, while sacrificing the long term.

For those of us who appreciate the value of secure lifetime income, these reforms seem to be taking a giant leap backwards rather than finding a better way forward.

In terms of political expediency, there might also be a question of: How will the Conservatives widen the net and also attract votes from the many who have no retirement savings. They have an answer for these folks as well in the new Budget—a reduction in tax on beer and bingo! Happy retirements ahead, one way or the other, for all our friends in the UK.