# Pensions, fairness and Lamborghinis: Budget changes to the annuities market are a lesson in the fallacies of freedom



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*The change made to pension schemes in last week's Budget calls into question the basic definition of what a pension is. True, the current annuities market is highly flawed, yet the new measure not only fails to address the existing problems sufficiently, it also brings about several perverse consequences.* ***Craig Berry*** *argues this is a measure that will fail spectacularly, even on its own terms.*

From April 2015, individuals in defined contribution pension schemes will no longer be required to 'annuitise' their pensions saving, that is, turn their pot of savings into a lifelong, regular income by purchasing an annuity product from an insurance company. Boris Johnson's response typified the free-wheeling, ultra-neoliberal attitude behind this apparent liberation (announced in last week's budget by George Osborne) by rejoicing in the pensions minister's suggestion that savers will be able to buy a Lamborghini rather than being forced to annuitise, and describing the measure as 'power to the people'.

In making such arguments, the coalition government are playing upon popular concerns (which have, ironically, emanated most strongly from the financial sector's left-wing critics) that the annuities market is replete with 'rip-off' deals, using this sentiment to justify a radical individualisation of the last major aspect of the pensions system that has a collective element. But the freedom that will be unleashed by this measure is fallacious and unfair.

This is not to suggest that the annuities market is functioning effectively. This market (as I have argued previously) is in fact highly flawed, for three principal reasons: firstly, the irreversible decision on how to annuitise is far too complex, and plagued by information asymmetries between consumers and providers. Secondly, people with relatively small savings pots (that is, low earners saving only modest amounts throughout their working life) are not able to secure decent incomes via this market when they annuitise on an individual basis. Through annuities, insurance companies 'collectivise' the longevity risk, but the consumer is buying access to this mechanism with a pot composed of only their own savings.

Thirdly, precisely because the savings phase is individualised, savers have to 'disinvest' from riskier assets as they approach retirement, because they are about to embark on an irreversible annuity purchase. This disinvestment limits the potential value of individuals' savings.

Does the change announced at the budget help to alleviate any of these problems? In terms of the complexity of decisions, the government says the change will be accompanied by a new 'right to advice' for people reaching retirement. This is potentially useful given that little advice is available to those with modest savings. However, the £20 million allocated to new advice services is a tragically tiny amount. And the annuities market, although structurally flawed, was already heading in the direction of more transparency and guidance, due to various provider-led and regulatory initiatives. Most importantly, the change clearly makes decisions at the point of retirement infinitely *more* complex: individuals still have a very complex decision to make, only now it is not merely between different types of annuities and providers, but also the countless other things that could be done with their money.

In terms of modest pensions saving pots, this change will, at best, make very little difference. In a world of automatic enrolment into pensions saving, those who end up with relatively small pots will be low-to-middle earners. Almost by definition, this group will have few other sources of financial security in retirement (the state pension notwithstanding), and so will need to annuitise even though they are no longer required to do so. A bad annuities deal is better than no deal at all. The government's hope appears to be (I'm assuming a modicum of strategic thinking on the government's part) that ending the requirement to annuitise would mean insurance companies would have to work harder to win customers, as their market would no longer be captive. However, the change is just as likely to make the market *less* competitive by driving some providers out, as the Institute for Fiscal Studies has warned (most insurers' share values fell in the wake of the budget, suggesting shareholders will want them to move away from a market that will now be more difficult to operate in).

*(Credit: SalFalko)*

In terms of the incentive to disinvest, not only does this change fail to alleviate the problem, it makes it significantly worse. In defined contribution pensions, because savings are entirely individualised, people opt for more risk-averse investment strategies as they approach retirement. This is what Hilary Salt calls 'reckless prudence' – it is bad for individuals because they miss out on higher returns, and it is bad for the wider economy because the riskier investments are, on average, those with greater long term economic benefits, such as infrastructure and, to a lesser extent, equities – a point made forcefully by Emran Mian of the Social Market Foundation. I have written previously about the missed opportunity represented by the emergence of defined contribution saving for pension fund investments in the real economy. This change exacerbates this problem, because individual saving pots will not only be over-prudently invested in the run-up to retirement, many will stick with this strategy post-retirement as they opt for investment 'drawdown' products rather than handing their cash over to an insurance company to invest collectively.

There are some who believe that this move towards greater individualisation will actually herald a rebirth of collective provision, in the form of 'collective defined contribution' (CDC). These schemes mimic traditional defined benefit schemes by operating a single investment fund for all members of the schemes. One of the barriers to the development of these schemes in the UK is that the requirement to annuitise prohibits the possibility of purchasing a *nominal* annuity from within your own scheme's fund – without this 'self-annuitisation', CDC has little value. This 'Trojan horse' argument is, however, probably wishful thinking. I agree with Nigel Stanley that although the budget change will enable some savers (probably higher earners) to establish or join bespoke investment vehicles offering a form of self-annuitisation, the prospect of CDC becoming a mass market pension product depends on greater compulsion, not greater freedoms. In a CDC scheme, cashflow is crucial, and members must be denied the opportunity to remove a huge chunk of cash from the scheme any time they choose, for the sake of the fund's investment efficiency. In return for this constraint, individuals would receive much higher investment returns, and benefit from stronger scheme governance.

The change also brings several perverse consequences. Firstly, Chris Huhne (among others) has warned about the impact on the housing market of allowing affluent retirees to unlock their pensions saving and invest in the buy-to-let market. Secondly, one of the reasons the coalition has made this change may be because it artificially increases tax revenues over the forecast period, while reducing them over the longer term: affluent retirees will immediately incur a large tax bill when they unlock all or most of their pension, yet this merely means they will pay less tax later on as their savings do not result in a regular, taxable income. Thirdly, and disturbingly, because pensions saving will now be fully accessible at retirement, it may qualify as an asset in the means-test for social care support – therefore hugely reducing the public support for care available to anybody with a defined contribution pension. These consequences, while seemingly perverse, may not be entirely *unintended* – they certainly fit with the government's wider efforts to boost the housing market, cut the budget deficit, and retrench the welfare state.

Above all, this change calls into question the basic definition of what a pension is. A pension is supposed to provide a regular, guaranteed retirement income. The government will argue that the new flat-rate state pension serves this function. But it must also be acknowledged that the new state pension will be much less generous for most people, therefore increasing individuals' reliance on private pensions for retirement security. This basic definition of a pension also lies behind the tax relief system that incentivises pensions saving, and the recently established minimum employer contributions into their employees' savings pots.

Yet we can, to some extent, leave these principled objections to the budget change aside. This is a measure that will fail, spectacularly, even on its own terms.

*Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting. Image: Exotic Car Life*

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