

Securing a Retirement Income ^x
discussion paper
The Personal Accounts Delivery Authority
response
Stephen Wynn

1. False assumptions

This paper contains too many assumptions:

- 1. Annuities are value for money.**
- 2. Everyone wants or needs to secure a retirement income from the personal accounts scheme, rather than have access to capital.**
- 3. This income should be supplied by the industry, rather than the personal accounts scheme itself.**
- 4. People cannot move their funds out of personal accounts altogether before they retire.**

The Government says:

"The Government is committed to encouraging more people to save for their retirement." ^x

People are much more likely to save rather than say, spend money on a cruise, ^x if they can subsequently change their mind and in fact spend the money on the cruise. In return for saving people should be able to withdraw their saving when they want to.

The discussion paper says: "For most members, we believe that a lifetime annuity will be the most appropriate product .. ". Assuming people want, or need a regular income from an annuity when they retire, is not treating them with respect. The United Kingdom Shareholders' Association (I am a member), said in its response to the 1999 green paper *Partnership in Pensions*:

"Annuities ensure that the saver's income will not fall or cease during retirement. However, a high price is paid for that certainty:

- annuities generally provide a far lower level of total return than is available from stockmarket investments, resulting in a much lower level of retirement income;**
- there is also nothing left in the fund to cover the extra cost of long-term care, should it become necessary. We should like to see further liberalisation of the rules for annuity provision, for all forms of private pension savings.**

Our view is that savers should only be obliged to buy an annuity

sufficient to provide an adequate retirement income¹, and should be free, if they wish, to use any

- to buy health insurance, long-term care insurance;
- to keep those assets invested in the scheme and to withdraw funds when required, taxed as income. On the death of the saver, we would expect any remaining sum to become part of a spouse's pension assets or to be subject to tax as an inheritance.

We also believe that savers who wish to continue working should be allowed to defer part or all of their annuity purchases at least until the age of 80, or even indefinitely." ^x

A contributor to a discussion commented:

"A couple with two full state pension incomes who owned their own home should be able to manage a reasonably comfortable retirement. But if they had no savings they might still have intermittent problems in coping with housing maintenance, car replacement etc.

This could provide a useful role for the PA accounts. For many people the PA accounts are unlikely to grow beyond the current maximum limit (17.5k index linked) available to be turned into a cash lump sum via the trivial commutation system. ..

Offering PAs as a hybrid lump sum savings scheme/conventional pension would also avoid all the costly hassle of administering small annuities." ^x

2. "Delivered by the private sector"

The Pensions Minister, James Purnell, said: "The personal accounts scheme will be delivered by the private sector." ^x This is similar to being advised on bank bailouts by bankers. ^x The government seems to have so many advisers who are bankers, ^x that the bank bailouts are also "delivered by the private sector". The DWP Secretary, John Hutton, said that the private sector has "the expertise and experience" to "deliver" a "value for money solution":

"Hutton says the government wants a 'value for money solution' adding in his view the private sector has 'the expertise and experience' to deliver this along with a good service to consumers.

..

However David Taylor, the joint Labour and Co-operative MP for North West Leicestershire, says while the idea of delivering personal accounts through a modern organisation within a framework set out by government is fine, he says the idea of it being delivered by the private sector will make people nervous. And he warned given the track record of the private sector, he does not feel it is the 'natural area of society or the economy' to give responsibility for delivering such an important system." ^x

Asking the private sector to "deliver a solution" will of course result in a solution which tends to benefit the private sector. That is, it will have relatively high charges. The white paper *Personal Accounts: a new way to save*^x refers to "the relatively high charges of pension products" (1.3). This consultation is part of this delivery by the private sector. It is largely about annuities, which are one of those pension products with relatively high charges. The private sector did not make a success of delivering value for money personal pensions. Stakeholder pensions are described as "run in the interests of members",^x What does this mean in practice? Is it anything more than a throw-away line? The PADA "Myth buster" says:

"The personal accounts scheme will be an independent pension scheme run by a Trustee Corporation in the interests of its members."^x

But judging from this PADA report on securing an income in retirement, it is not being *formulated* in the interest of members. The 2006 white paper *Personal accounts: a new way to save* said:

"Personal accounts will be delivered using private sector expertise, working within a remit set by the Government with members interests at its core".^x

Industry interests are "at the core" since it is being delivered by the industry.

3. "Partnerships"

The board of PADA seems to be dominated by industry interests with no representatives of consumer groups - like the board of the FSA. Wikipedia says:

"The composition of the FSA board appears to consist mainly of representatives of the financial services industry and career civil servants. There are no representatives of consumer groups. As the FSA was created as a result of criticism of the self - regulating nature of the financial services industry, having an independent authority staffed mainly by members of the same industry could be perceived as not providing any further advantage to consumers."^x

A first leader in the Financial Times about the recent resignation of Sir James Crosby from the FSA, says:

"He was a non-executive director of the watchdog while still at HBOS, and became deputy chairman the year after he quit the bank. his type of relationship is too cosy. .. Lord Turner, its chairman, has made a robust start." (12/2/09)^x

He was a director of the FSA, and also the Chairman of the Remuneration Committee from 11 December 2007.^x Christopher Rodrigues, chief executive of Bradford & Bingley was also a director of the FSA and on the Remuneration

Committee. ^x Lord Turner is a former Vice Chairman of Merrill Lynch Europe, which is another "cosy relationship". An article by the IFA Alan Steel *Relationship between regulators and those they oversee* concludes:

"The inescapable fact is that there is an almost incestuous co-relationship at the very top of the financial tree between the regulators and those they oversee. In the UK, many of the senior positions in the regime are held by former bankers. In the US, Madoff himself was a former chairman of Nasdaq.

For regulation to be more than an exercise in box-ticking, there has to be a comprehensive shake-up of the regime's constitution and determined effort to ensure that regulators themselves come from different backgrounds from the people they oversee allowing them to do their job with objectivity, impartiality and plain common sense." ^x

This "partnership" is promoted by exchange of staff "on secondment". This happens in other areas such as government procurement of computer systems:

"Richard Granger, charged with running the procurement and delivery of the £6.2bn Connecting for Health NHS IT modernisation project was rumoured to have been lured from his position as partner at Deloitte Consulting by a £250,000 salary." ^x

The word "partnership" occurs in so many areas of government, such as Public Private Partnerships, ^x that it seems to be a general approach to government, and moreover one which is intrinsically undemocratic. ^x Stakeholder pensions were described as "a partnership with financial service companies" in the green paper *Partnership in Pensions*:

"Stakeholder pension schemes will develop in a number of ways. All are likely to involve a partnership with financial service companies." ^x

The Chairman of the personal accounts scheme should not be appointed by the government, that is the Secretary of State. He is likely to appoint someone from the industry, so that the scheme will be run for the benefit of the industry. This happens with the FSA. It is "captive to the industry it regulates" ^x - like the SEC in the US. ^x The Chairman, Adair Turner, is a former Vice President of Merrill Lynch. The Chairman of the personal accounts scheme should be appointed, or at least approved by, a representative organisation of the members.

The FSA claims to be "helping consumers", which in practice means helping the industry to sell products. The discussion paper on securing an income in retirement seems intended to help the industry sell annuities. In short, the personal accounts scheme seems like a mini FSA! The 2002 Sandler Review says:

"The root cause of the problems in the retail savings industry is consumer weakness." (10.89) ^x

The industry is too powerful, in comparison. This is for a variety of reasons. Consumers do not have sufficiently strong representative organisations. The FSA cannot be sued. The government does not have to enact European Directives. ^x It did not even reply to the report of the European Parliament about Equitable Life. ^x The credit crunch has been caused by removing barriers between retail banking and investment banking:

"New estimates suggest the government's recent bailout of RBS and Lloyds TSB will cost the tax payer up to £1.5 trillion." ^x^x

"Removing barriers" seems to be a government approach to all problems, ^x including personal accounts. ^x

4. "Leave you open to rip-offs"

A problem with personal pensions as an investment is that you are locked-in and unable to withdraw your cash (at least without a penalty and into another pension scheme). This results in zombie funds. ^x Paul Flynn MP asked a question about this in 2006 starting:

"That this House is shocked by the atrociously poor returns on the £95 billion invested in closed zombie funds that are impoverishing small investors of 13 million pension, small savings and endowment policies; ... " ^x

Members of the personal accounts scheme should not be locked-in. A contributor to a discussion said:

"I dislike systems that leave you open to rip-offs from managers because you can't move funds, or ones where Brown and his ilk can tax because they are short of cash." ^x

Another contributor said:

"What bothers me about pensions - all types - are the following:

1) They are essentially an expectation marketed to you by some big powerful institution. You pay in real money now and, hopefully, in 35 years they will still be about and prepared to deliver on it. If the expectation starts getting diluted, you can't do anything much about it. You can't call it a day and get what's left of your money back out.

2) The providers can and do change the rules-in-play as it suits them. Again you can't do anything to guard against such things and you can't give it up as a bad job and recover your funds.

3) Governments keep moving the playing field, let alone the goal posts. When I started work you had to join the company scheme by law. Then came SERPS and contracting out. AVCs can't be

taken as cash any more, the retirement age can be put up faster than you can grow old" ^x

Giving a choice of funds will encourage a sense of ownership. But then investments will be in limbo land where they cannot be spent or transferred out of the scheme. Moreover when members retire they have to be "converted" into a "source of retirement income". So that people will have to buy a product from the industry. This is the advantage of ISAs:

"Many of you don't like the idea of your savings being locked away until you reach your fifties or sixties. That's exactly what happens with a pension scheme where you won't normally be able to get your hands on any cash until you retire.

But with an ISA you have access to your money whenever you need it. Of course, I'm not suggesting you raid your savings carelessly, but it's good to know there are funds available in an emergency.

The opportunity to draw on your ISA savings whenever you like gives you the freedom to vary the amount and frequency of income. It's much more difficult to adapt income taken from a pension.

Once you retire, your expenditure is unlikely to be evenly spread throughout the year, so you can alter your withdrawals to suit your own personal spending pattern. .. Most pension savers will only be able to take an income from their pension by converting it into an annuity." ^x

Personal accounts should be more like ISAs than pensions. An article in *ThisIsMoney* says *Pensions consistently disappoint* ^x because "they are paying their fund manager for doing a half-baked job." There is a considerable literature on this topic such as *Pensions not better than ISAs*. ^x I agree that:

"Too much of the benefits of the tax privileges of pensions goes to the pensions industry, rather than the pensioner." ^x

Contributions to personal pensions are before income tax (though not before national insurance, like occupational pensions). But then this tax concession is largely taken away, because income from pension annuities is subject to income tax. The industry benefits from this arrangement because the amount saved is larger than it would be without this arrangement, which generates a larger income from charges calculated as a percentage of capital.

The discussion paper says:

"Members will be able to retire any time between age 55 and 74 inclusive."

A contributor to a discussion points out:

"There is no future Guarantee whatsoever that PA benefits would be available at 55, rather than subsequently being locked in til the State Pension date of age 68 for many entrants." ^x

Members of the personal accounts scheme should be able to withdraw capital at any time, otherwise they will be "open to rip-offs". This discussion is taking place in the shadow of the various scandals, mainly resulting from reckless expansion: Equitable Life (recent reports: ^x ^x), Northern Rock, Bradford and Bingley, Icelandic banks, RBS, HBOS. The latter is described as "a total failure of all key aspects of governance", by the Ex-head of Group Regulatory Risk. ^x

A lesson of the Equitable scandal is surely that funds should not be locked-in because the government is not able to regulate the industry properly. Equitable has been described as "a regulation-free zone". ^x Being "regulation-free" can lead to corruption. ^x Members of the personal accounts scheme should be able to withdraw their capital at any time, as cash which they can spend, that is not

5. Promoting sales

When people retire the personal accounts scheme should allow members to receive the income from their investments rather than this income be reinvested. This can be described as a switch rather than a "conversion". The discussion paper says:

"Retirement savings can be converted into a number of different sources of retirement income, including annuities, income drawdown and alternatively secured pensions."

The discussion paper seems to be concerned with promoting the sale of annuities. It is part of the sales culture, such as: *HBOS chased sales with little regard for risk, says former exec.* ^x The aims of the FSA are concerned with sales: "promoting efficient orderly and fair markets" and "helping retail consumers achieve a fair deal". ^x The Financial Services and Markets Act has a sales orientation. "The protection of consumers" has a sales orientation in comparison to "the protection of savings". The Act says in Section 5:

"(2) In considering what degree of protection may be appropriate, the Authority must have regard to-

- (a) the differing degrees of risk involved in different kinds of investment or other transaction;**
- (b) the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;**
- (c) the needs that consumers may have for advice and accurate information; and**
- (d) the general principle that consumers should take responsibility for their decisions."**

(a) - (d) relate to sales. "Decisions" means decisions to buy or sell. What other decisions could there be?

6. "Little awareness and understanding"

The paper says that people do not have much understanding of pensions and annuities. Most people find such financial topics a nuisance, and would prefer not to think about them. The discussion paper says:

"Complexity of the decision making process highlights the fact that individuals have what is known in economics as bounded rationality . This can be defined as individuals possessing limited cognitive abilities, which constrain their abilities to make welfare optimising decisions."

"Surveys of financial awareness highlight the fact that many people lack the financial knowledge to understand the complexities of the annuities market. Public understanding of pensions and especially annuities tends to be very poor."

"The majority of respondents had little awareness and understanding of pensions and annuities, often this was virtually non-existent."

"Research by the PADA (2008) stated that awareness of annuities was very limited and the understanding of what such decisions might involve was virtually non-existent even among those who had retired . This study also concludes that not only were individuals unaware of the need to make decisions about annuities but they also had little understanding of the underlying concepts surrounding annuities."

7. "Maximise choice"

Even though according to the discussion paper people have "bounded rationality", "limited cognitive abilities" and "often virtually non-existent" "awareness and understanding", it wants to "maximise choice". But only provided this is choice of a product from the industry. The consultation document says that the personal accounts scheme will establish a panel of annuity providers for people who do not want to choose an annuity from the open market. This might be called "guided choice".

The personal accounts scheme should arguably provide its own annuities, or at least bulk purchase. The discussion paper says:

"Discussions with industry have revealed very little appetite for this approach."

Of course not, because it is less profitable for the industry. The word "choice" is mentioned 95 times. When people retire they are advised to "shop around".

"But shopping around for an annuity can make a significant difference to the amount of retirement income an annuitant can get, and we believe it is important that the personal accounts scheme members should feel able to exercise this option with confidence."

"Shop", "shopper", "shopping" is mentioned 23 times. It seems unfair to require people to make a choice from:

"As purchasing an annuity is frequently seen as an extremely difficult process, many individuals may not have the financial ability or will to deal effectively with the available information."

But surely, having chosen an annuity of a particular type listed on page 18, all people need is a list of these annuities ranked by the rate provided. They can then choose the one providing the best rate. The difficulty of choosing an annuity seems to be exaggerated in the discussion paper.

8. The yield

The discussion paper says:

"The UK pricing survey published in March 2006 by DWP suggested annuities are fairly priced."

This is *Survey of Annuity Pricing* (2006) (Research Report 318) by Edmund Cannon and Ian Tonks, ^x which is described by the Treasury as "the most comprehensive ever UK annuities pricing survey". ^x I wrote an article about this paper. ^x They have published a more recent paper (2009) (Research Report 563 ^x) with the same title. This says that money's worth is declining.

It would be helpful to give interest rates in the same tables money's worth values in the Surveys, so that it is immediately clear what interest rates are being used, as the calculation is highly dependent on interest rates. The values in the tables in Chapter 6 in the second Survey, can surely not be described as value-for-money, especially the latest year 2007. Particularly poor are price-indexed annuities. In *Table 6.5 Money's worth 65-year old male real (RPI-linked) CPA lives* the 2007 values are: 0.744 0.710 0.782 0.708 0.780. The discussion paper reports this in Footnote 43 for the earlier Survey:

"suggests that the value for money of escalating annuities is worse than that of level annuities"

This in contrary to the Second Report of the Pensions Commission which led to the personal accounts scheme and seems to like annuities. It mentions "annuity" ("annuities", "annuitisation") 250 times, "drawdown" only 13 times. On page 384 it says:

" Guidance to individuals approaching retirement with NPSS funds should set out the advantages in principle of price-indexed annuities.

But individuals should be free to decide if they wish to purchase non-indexlinked annuities.

The argument in favour of the former approach is that it could deliver better value for customers. The arguments for the latter are that: (i) the annuity market is fairly efficient and transparently priced; ... "

But in my opinion, for annuity calculations to be credible, it is necessary to show them on a spreadsheet, such as on my website (www.comparativetables.com/spread.htm).^x It is necessary to exhibit actual calculations rather than just "a survey". The table on page 52 of the PADA discussion paper is headed "Example". An "example" of what? This is Table 4.3 in the 2006 Survey which is headed: "Example of money's worth calculation". But it is inadequate as a calculation of money's worth, because it is not using mortality tables. The annuity in this example is not good value because:

"This means that 49 pence out of every pound would be paid back to the individual and 51 pence would go to the life insurance company." (84.3)

The topic of how annuities are priced or "money's worth" produces arguments about: 1) choice of mortality tables, 2) long-term interest rates. The calculation is highly dependent on the latter. These arguments are reduced if we only calculate a "yield". Savers are interested in the yield. This does not depend on market interest rates. Money's worth is politics. The yield is the rate of interest at which the premium for the annuity has to be invested for there to be exactly nothing left when he dies, taking probability into consideration.

9. Industry misnomers

"Fairly priced" and "transparently priced" seem vague, because annuities have completely hidden charges. The 2006 *Survey of annuity pricing* says:

"With-profits mean that the pension fund is invested in a with-profits fund of an insurance company, so that annual bonuses are generated, which allow the annuity payments to grow." (page 45)

Not necessarily. In the case of Equitable Life with-profits annuities payments have declined. "Income drawdown" in the discussion paper is another Equitable misnomer:

"My 'Managed Pension' has in practice proved to be a wholly mismanaged one, with 'income drawdown' being a misnomer for 'capital drawdown'."^x

A further example is "due diligence" in Barclays Wealth:

"Having submitted Fairchild and Madoff to our comprehensive Due Diligence program, we concluded that this fund was an attractive opportunity for our clients." ^x

And then there is Standard Life's "cash fund". ^x There are further examples of such financial industry misnomers. "A personal pension" is not really a pension, which according to the Oxford English Dictionary is: "A regular payment .. ". ^x

10. Conclusion

The personal accounts scheme is becoming too complicated, with too many restrictions. There should not be a choice of funds. Members should be able to withdraw their capital at any time. It should be possible to receive the investment income on retirement without "converting" the capital to some kind of industry "product". It should have a Chairman and board members appointed by, or approved by, a representative organisation of the members.

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