

DC in practice



Retirement options – helping your members

Key points

The at-retirement market is expected to grow significantly over the coming years.

Members nearing retirement face an increasingly complex array of choices.

The important risks associated with retirement options are rarely understood by members of DC pension plans.

Timely advice and guidance should help boost the value of a member's retirement income.

Assistance should start early enough to enable members the opportunity to really consider both their current personal and financial circumstances as well as their future requirements.

Decumulation practices, including the support framework, need to be kept under regular review to ensure that they remain appropriate.

Introduction

During the last decade there has seen a widespread switch from defined benefit (DB) to defined contribution (DC) pension provision, to the extent that typically DC is the standard for new employees.

In reaction to this change, trustees and employers are now investing a significant amount of time and money into the provision of retirement income for their employees through their DC pension arrangements. This has included focusing on the choices faced by employees such as whether to join, how much to contribute and which investment fund(s) to choose.

To date, one of the areas which has received little attention is the issue of converting the members DC pension account into an income (commonly referred to as the decumulation process).

Over the last few years, there have been a number of reports and papers released which have focused on this issue. In particular, the Pensions Regulator published guidance in May 2008 entitled 'Member retirement options' which rightly emphasised the importance of the decumulation stage.

With an increasing number of workers for whom DC pensions will form a significant part of their retirement income, this subject has become a 'hot topic' for many employers and trustees.

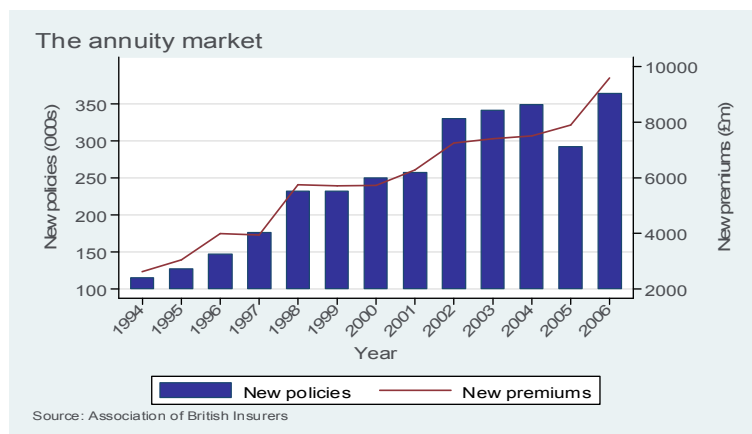
Watson Wyatt has recently undertaken an in-depth assessment of the at-retirement market and the results of this research are outlined in our Pension Research Forum report entitled 'Annuitisation and retirement – how can the member experience be improved?'

In this paper, we will provide you with a brief summary of its key findings including an overview of the at-retirement market, an insight to current member behaviour and annuity choices and a practical guide to how you could help your members.

Recent trends in the annuity market

Over the period from 1994 to 2006, there has been significant growth in the annuity market (see Figure 1 overleaf) and this growth is also expected to continue for the foreseeable future.

➤ Figure 1 | The annuity market



At the same time as this growth, there has been a long term decline in annuity rates; due principally to falling interest rates and improvements in mortality. This decline is also expected to continue as life expectancy improves further.

Coupled with this trend, members are faced with two other factors affecting the level of retirement income provided by an annuity:

- annuity rates are regularly changing;
- there can be a wide disparity in annuity rates between providers.

Our research therefore concluded that there still remains a large group of DC members for whom 'shopping around' at retirement for an annuity will be critically important for their retirement income.

Developments in the 'at-retirement' market

Members nearing retirement face an increasingly complex array of retirement income options. In addition to a traditional annuity, members can now choose from:

- enhanced/impaired life annuities
- investment linked annuities
- variable annuities
- capital guaranteed annuities
- unsecured pensions (short-term annuities and income drawdown)
- alternatively secured pensions (after age 75).

Whilst on the one hand this greater choice is to be welcomed, the degree of choice now available to members makes the retirement process increasingly complicated.

Member behaviour

Despite the wide range of retirement income options available, the typical choice of an employee at retirement is still the traditional annuity. This is not particularly surprising as our research highlighted the current average value of a DC pension account at retirement is relatively low (approximately £25,000 to £30,000).

Our research also highlighted that approximately 27% of members shop around at retirement and purchase an annuity via the open-market option (OMO) compared to around a third for the annuity market as a whole (ABI, 2008).

It was however noted that members of occupational DC pension arrangements, where there is a greater degree of communication and guidance, are more likely to secure an OMO annuity, with nearly half doing so.

“ We all think that when you reach a certain date, your pensions all click in and it all happens automatically. It was only when I approached that date that I realised there were lots of options. ”

(Male, recent annuitant, fund size between £40K and £100K)

Source: Department of Work and Pensions (2008), Research Report No 515



It is therefore clear that in the short term, employers, trustees and providers still need to do more to promote shopping around.

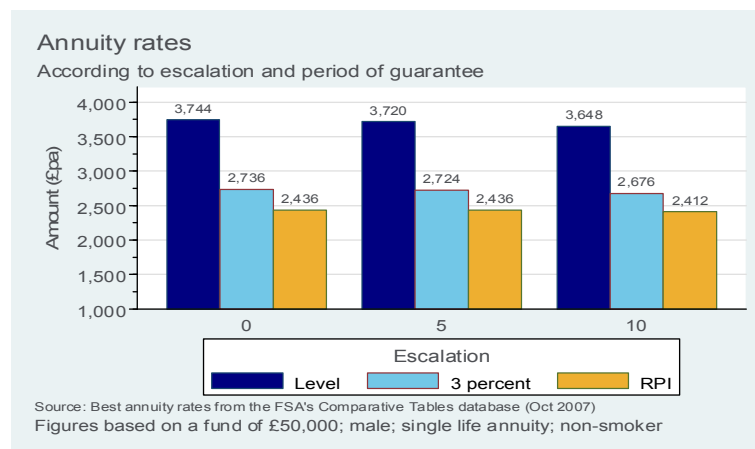
Annuity choices

Once the decision has been made by a member to purchase an annuity, they will need to decide on its features. Traditionally, the choices have been as follows:

- whether to purchase a level or escalating income
- whether the income should be on a single or joint life basis
- whether to have the income guaranteed to be paid for a specific period of time

These choices affect the initial level of the annuity to varying degrees as illustrated in Figure 2.

Figure 2 | Difference in annuity rates



In practice, the vast majority of members elect a level annuity (figures from the ABI suggest this could be as high as 93 per cent) and therefore forego any form of inflation protection.

Additionally, our research revealed that the typical member also purchases a single life annuity rather than opting for some level of reversionary income for their spouse.

This behaviour may arise from a number of factors, for example:

- the desire to maximise income whilst the member is still 'young'
- personal circumstances (the member may be single or their spouse may have their own pension provision)

However, in a significant number of cases, a member's choice is likely to be due to a short term evaluation of the annuity terms or they may simply opt for the default shown in the annuity illustration.

Lastly, our analysis showed that the overwhelming choice amongst retirees is to opt for an annuity which is guaranteed to be paid for five years. This is typically the default option in the industry and again inertia is likely. Many DC members may not realise that a 10-year guarantee option exists, nor the cost (which in some situations can be minimal).

“ I am looking most at a level-lifetime annuity, to get as much money now as I can whilst I am fit ... I am thinking of getting a small part-time job, if I need to increase my income ... ”

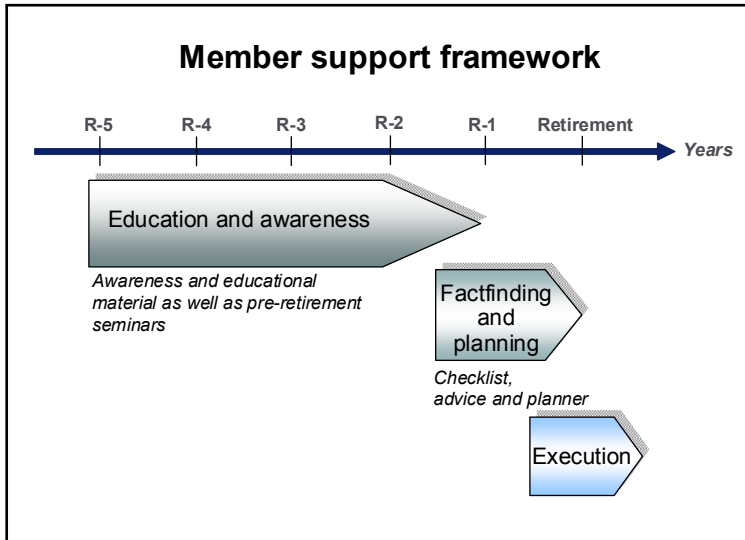
(Female, prospective annuitant, fund value between £15K and £40K)

Source: Department of Work and Pensions (2008), Research Report No 515

➤ Helping your members

Our research indicates that most employees do not appear to understand the options available to them. As a result, it is easy to conclude that they are going to need a lot more help if they are going to successfully navigate the at-retirement market.

Many trustees and employers are initiating thorough reviews of their current decumulation practices, including considering whether their members actually know what they need to do and, most importantly, how critical the decisions are that they make during this stage.



We believe that timely advice and guidance should not only boost the value of a member's retirement income but it could also do much to enhance both the brand value of the pension arrangement and the sponsoring employer.

This assistance should start early enough to enable members the opportunity to really consider both their current personal and financial circumstances as well as their future requirements.

The support offered in the early stages could be provided via a number of different media including online, paper and face-to-face communications. Assuming that these stages are effective, the process of securing the benefits should be fairly simple.

Conclusion

The DC market is expected to rapidly grow over the coming years. This means that the proportion of members for whom DC benefits will form a significant part of their retirement income will also increase. As a result, it is likely that there will be an even greater range of at-retirement options available.

With greater consumer choice, the associated difficulty for members to decide which of the options are most appropriate for their current and future needs will increase.

As part of a scheme's governance process, employers and trustees should therefore regularly review their decumulation practices, including the support framework, to ensure that they remain appropriate for the scheme and its members.

Further information

For further information, or if you would like a copy of the Pension Research Forum report 'Annuitisation and retirement' please contact your Watson Wyatt consultant, or:

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