The implications of ending the effective requirement to annuitise by age 75

Introduction

Until recently, people with Defined Contribution (DC) pension savings were effectively required by Government regulations to purchase an annuity with their pension fund by the time they reached age 75. Since April 2011 the Government has lifted the effective requirement to annuitise. This Briefing Note summaries the main findings of a PPI research report[1], which estimates the number of people who might be able to take advantage of the new flexible options for accessing private DC pension savings and explores the possible impact of this policy change on low, median and high earners.

Table 1: Around 600,000 to 700,000 or around 5% of people aged 55 to 75 in 2010 could use Capped Drawdown

	Could use Capped Drawdown in 2010	Could use Capped Drawdown by SPA (but not in 2010)	Total who could use Capped Drawdown in 2010 or by their SPA
Numbers of people aged between 55 and 75 who could use Capped Drawdown	600,000 to 700,000	300,000	900,000 to 1 million
Percentage of all people aged 55 to 75 in UK	5%	2%	7%
Percentage of people aged 55 to 75 in the UK with uncrystallised DC pension savings	22% to 26%	11%	33% to 37%

Source: PPI calculations based on data on the income and savings of people currently aged between 55 and 75 in 2010, some of whom are still in work (and still accumulating savings).

People now have more options regarding accessing their private DC pension savings

The Government has removed the effective requirement to annuitise. What this means in practice is that from April 2011, individuals with DC savings are still permitted to purchase an annuity at any point after the age of 55, however they are no longer required to purchase an annuity upon reaching a specific age.

The new regulations allow people with private DC pension savings, who have not trivially commuted, to access their savings at any point after reaching the age of 55 using one, or a combination of, three options: purchasing an annuity, Capped Drawdown, or Flexible Drawdown.

People can invest some or all of their pension savings in Capped Drawdown

Income drawdown arrangements are investment vehicles, designed specifically for DC pension savings, that allow people to continue to grow their funds while also taking an income, previously up until the age of 75. The new legislation allows people to remain in income drawdown with no age restriction, however the amount of permitted withdrawal has been reduced from 120% of what people would have received from an equivalent annuity to 100%. The new facility is called 'Capped Drawdown'.

People with sufficient income can withdraw unlimited amounts - Flexible Drawdown

Under the new legislation people have the option of 'Flexible Drawdown' under which they can withdraw funds from an income drawdown account in unlimited amounts, provided that they meet the Government's Minimum Income Requirement (MIR). The MIR requires that people demonstrate that they have a secure pension income already in payment and guaranteed for life of at least £20,000 per year (in 2011).

The new flexibilities may bring risks for individuals

The new regulations will give people more flexibility to potentially grow their pension savings during retirement and to attempt to preserve some of their fund to leave as inheritance. For people with large savings and a high appetite for risk, the changes will be very welcome and could be beneficial. However, individuals deciding to use the new methods may also be exposed to more risks to their retirement income. For example, income drawdown provides individuals with more scope to try to grow their pension fund, but it also exposes them to the risks of poor investment returns (investment risk) and to the risk of depleting their funds before death (longevity risk).

Annuitising will remain the safest and most appropriate option for the majority of people

In 2010 the vast majority of people aged between 55 and 75 would not have had large enough private pension pots or sufficient other income and assets to be able to bear the investment and longevity risks associated with Capped Drawdown and would not have been able to meet the MIR. For the majority of people, annuitising will still be the safest and most appropriate way of accessing their private DC pension savings because of the security annuities provide.

Around 5% of people aged between 55 and 75 in 2010 could potentially use Capped Drawdown[2]

There is no regulatory restriction on the size of pension pot a person needs to enter income drawdown, however many IFAs recommend people need a pension pot of a minimum of between £100,000 and £250,000 as well as other income and assets in order to ensure people can bear the investment risk and longevity risk associated with drawdown.

If it is assumed, for illustrative purposes, that people with pots of £100,000 or more might be in a position to purchase an income drawdown product, then, based on existing market data and analysis, PPI estimates suggest that around 600,000 to 700,000 people (around 5% of all those aged between 55 and 75 in 2010) could potentially make use of Capped Drawdown because they are either already in income drawdown or have enough DC pension savings to enter Capped Drawdown (Table 1). A further 300,000 might be able to use Capped Drawdown by their State Pension Age assuming they continue working and saving in a pension at their current rate.

Around 2% of people aged between 55 and 75 in 2010 could potentially use Flexible Drawdown

PPI estimates suggest that around 200,000 people (around 2% of people between age 55 and 75 in 2010) could have sufficient pension income and DC pension savings to meet the MIR and be able to access Flexible Drawdown (Table 2). A further 500,000 might be able to use Flexible Drawdown by their SPA.

Table 2: Around 200,000 or around 2% of people aged 55 to 75 in 2010 could use Flexible Drawdown

	Could use Flexible Drawdown in 2010	Could use Flexible Drawdown by SPA (but not in 2010)	Total who could use Flexible Drawdown in 2010 or by their SPA
Number of people aged between 55 and 75 who could use Flexible Drawdown	200,000	500,000	700,000
Percentage of all people aged 55 to 75 in UK	2%	4%	5%
Percentage of people aged 55 to 75 in the UK with uncrystallised DC pension savings	7%	19%	26%

Source: PPI calculations based on data on the income and savings of people currently aged between 55 and 75 in 2010, some of whom are still in work (and still accumulating savings).

More people might be able to use Capped or Flexible Drawdown in future

Part of the reason why such low numbers of people between the ages of 55 and 75 in 2010 might be able to access Capped or Flexible Drawdown is related to the historically low levels of DC saving in the UK. However, the decline in DB pension provision has led to an increase in people saving in DC schemes, which is likely to increase when auto-enrolment into pension savings begins in 2012. It is likely that over the next few decades, the number of people reaching retirement with DC savings will increase and that in the future more people will have an opportunity to access Capped or Flexible Drawdown.

The new legislation is unlikely

to directly impact low earners

On the whole, the new policies are unlikely to impact directly on people who earned at low earnings and have small private pension pots in retirement. Some people with small pots might try to delay or avoid buying an annuity as a result of the new policy, however annuities will still provide the safest and most appropriate way for the majority of low earners to access their private pension savings. The new policies could have the potential to either increase or decrease annuity rates depending on the behaviour of people accessing pension savings and the way providers decide to respond.

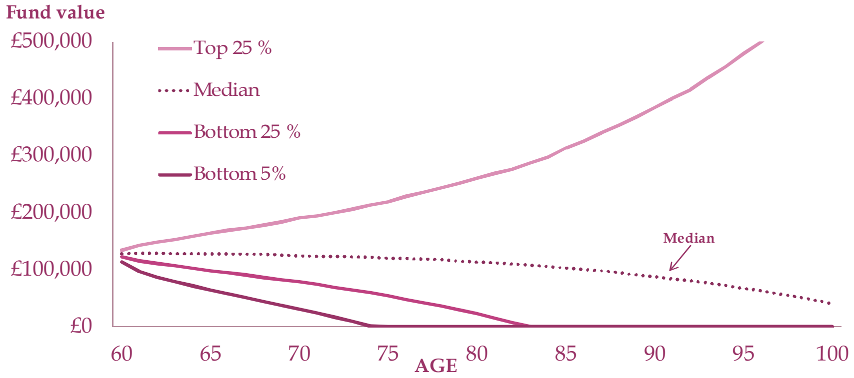
Median earners may start to use existing products in a more flexible way

Median earners are unlikely to have large pension pots and high levels of other income and assets, and it is likely that for many people who earn at or around median levels during working life, purchasing an annuity will still be the safest and most appropriate way to access their private pension savings. However there are likely to be greater numbers of people reaching retirement with DC pension savings in future. These changes, coupled with the removal of the requirement to annuitise, could encourage people to take a more flexible approach when using existing annuity products.

However, there are greater risks involved with using more flexible annuities, for example, variable annuities can expose individual's funds to greater investment risk than lifetime annuities.

Chart 1: An individual could have a 36% chance of losing their fund by age 89 when withdrawing 100% of annuity value

A high earning woman's fund value when invested in Capped Drawdown with withdrawals of 100% of an equivalent annuity, nominal figures



Data is illustrative, no allowance is made for 3-yearly revaluations of allowed withdrawal
Source: PPI stochastic modelling, based on Barclays Capital Equity Gilt Study (2011)

High earners are more likely to use Capped and Flexible Drawdown

People who earned at high or very high earnings during working life are more likely to reach retirement with a pension pot large enough to use Capped Drawdown or, in some cases, meet the MIR and flexibly withdraw their remaining pension savings.

Capped Drawdown allows individuals the flexibility to potentially grow their fund, vary their level of withdrawals within the limits set by Government and leave some capital as inheritance, while purchasing an annuity does not. However there is a trade-off as people in Capped Drawdown run more risk of depleting their funds and may need to withdraw from their accounts at lower levels than they would receive from an annuity in order to preserve their funds. Withdrawing from Capped Drawdown at the maximum allowed level could result in depleting the fund if investment returns are low.

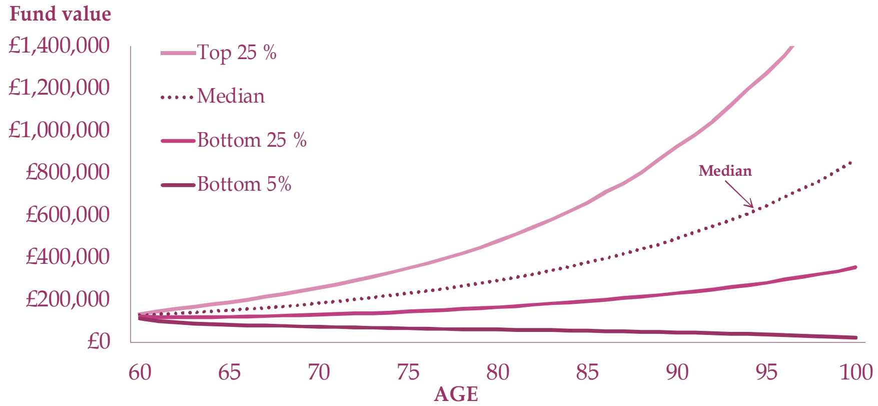
The following examples illustrate how withdrawing from Capped Drawdown at different levels could impact the risk of depleting funds.

Based on PPI modelling, a hypothetical high-earning woman investing in Capped Drawdown at SPA in 2010 and withdrawing income at 100% of an equivalent annuity would have a 36% chance of losing her fund completely before her death if she lives for average life expectancy, until age 89 (Chart 1).

Withdrawing at less than 100% of the maximum allowed level is one way to help insure against the risk of running out of funds before death. A hypothetical high-earning woman investing in Capped Draw-

Chart 2: An individual could have a 2% chance of losing their fund by age 89 when withdrawing 50% of annuity value

A high earning woman's fund value when invested in Capped Drawdown with withdrawals of 50% of an equivalent annuity, nominal figures



Data is illustrative, no allowance is made for 3-yearly revaluations of allowed withdrawal
Source: PPI stochastic modelling, based on Barclays Capital Equity Gilt Study (2011)

down at SPA in 2010 and withdrawing at 50% of an equivalent annuity has only a 2% chance of depleting her fund entirely before her death, if she lives until age 89 (Chart 2).

In reality, people in Capped Drawdown will undergo investment reviews, and revaluations of the equivalent annuity which could be bought with the fund size every three years. These reviews and revaluations are likely to help protect people from depleting funds too quickly in most cases.

For people with high levels of income and assets, high appetites for risk and for whom conserving a portion of their fund as an inheritance is important, Capped Drawdown could be an attractive, and potentially profitable way to access private pension savings. For example: under the 100% withdrawal scenario a hypothetical woman investing in Capped Drawdown at SPA in 2010 has a 33% chance of doubling her fund in nominal terms by age 89 (Chart 1). Under the 50% withdrawal scenario she has 72% chance of doubling her fund in nominal terms by her death (Chart 2).

However, Capped Drawdown is unlikely to be suitable for people who are highly dependent on the income they receive from their private pension savings.

High earners are more likely than median to low earners to access Flexible Drawdown

Some high earners may be able to meet the MIR and withdraw their remaining DC savings flexibly. People who have met the MIR may not face the same levels of risk to their pension savings as those solely using Capped Drawdown, as people who have met the MIR will have a secure income for life of at least £20,000pa.

Conclusions

The Government has removed the effective requirement to annuitise and introduced new regulations which give people more flexibility to potentially grow their pension savings during retirement and to attempt to preserve some of their fund to leave as inheritance. For people with large savings and a high appetite for risk, the changes will be very welcome and could be beneficial. However, individuals deciding to use Capped and Flexible Drawdown may also be exposed to more risks to their retirement income. The Government will need to ensure that people have access to clear, appropriate and accessible advice and information to ensure that they understand both the potential upsides but also the inherent risks involved in accessing private DC pension savings more flexibly.

For more information on this topic, please contact
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[1] PPI (2011) *Retirement income and assets: the implications of ending the effective requirement to annuitise by age 75* www.pensionspolicy-institute.org.uk

[2] Estimates of people who could access Capped and Flexible Drawdown based on existing market data and analysis of English Longitudinal Study of Ageing WAVE 4 , SPA assumed to rise to 65 for women by 2018 and 66 for everyone by 2020 as per original Coalition proposals in pensions Bill 2011