

Response to HMT consultation: removing the requirement to annuitise by age 75

Summary

- I. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.
- II. The previous Labour Government required individuals to use any private pension savings they had remaining by age 75 (after taking a 25% tax-free lump sum) to secure an income, generally through the purchase of a lifetime annuity.
- III. The current Government has proposed to remove the effective requirement to use private pension savings to purchase an annuity by age 75. The Government's stated policy objective is to make pension saving more attractive by giving individuals greater choice over how they can provide a retirement income for themselves. The Government's proposed approach would allow individuals to:
 - purchase an annuity;
 - invest their pension savings in an income drawdown arrangement, with a cap on the maximum allowed withdrawal, for their entire retirement (capped drawdown); or,
 - withdraw unlimited amounts from their pension savings from age 55 until death (flexible drawdown), provided they can demonstrate that they have secured a minimum income sufficiently high to prevent them from exhausting their savings prematurely and falling back onto means tested benefits.
- IV. The Government is consulting on the detail of how the new approach might work. This response outlines the evidence that the PPI considers relevant to the Government's consultation and focuses especially on the trade-offs between risks and flexibilities for individuals that could result from the new approach.

- V. The Government's proposed approach would provide individuals with greater flexibility than under the current effective requirement to purchase an annuity by age 75. However the current proposed approach would also expose individuals who choose not to buy an annuity to risks that they would not have previously been exposed to (eg. longevity risk).
- VI. If the Government proceeds with the current proposed approach to accessing pension savings then it will need to carefully consider what level to set the caps for capped drawdown at and at what level to set the MIR. Both of these decisions will have implications for the level of risk individuals choosing these options are exposed to. These decisions will also affect the level of risk posed to the Government of people falling back on to means-tested benefits during their retirement.
- VII. A limit, at any level, on the amount that people can withdraw in capped drawdown will involve a trade-off between: setting the cap low enough to ensure that individuals do not run out of money before the end of their retirement (and end up relying on the state through means tested benefits); and, setting the cap high enough so that individuals are not made to forgo consumption.
- VIII. Simple, fixed limits are more likely to pose risks to individuals. Research shows that simple limits may not provide as much insurance against longevity risk and the risk of forgoing consumption as more flexible approaches to drawing down income. For example:
- Using a limit of *a fixed percentage of the equivalent available annuity rate* (as under the current system) can lead to the danger of running out of funds before the end of retirement.
 - Using a limit of *a fixed percentage of the fund size* hedges more longevity risk than using a fixed percentage of the equivalent available annuity rate, but this approach often involves very small withdrawals of fund capital and therefore might lead individuals to forgo some consumption.
- IX. Complex withdrawal strategies, such as withdrawal strategies that vary with age and fund performance, are more effective at ensuring that individuals do not deplete their funds, or run the risk of forgoing consumption. However complex approaches to withdrawal will not be easy to regulate using simple cap limits and require high levels of financial knowledge from consumers or an ability to pay for ongoing advice and fund management.

- X. The Government will need to carefully consider how to define the Minimum Income Requirement (MIR), what level to set it at and what income should be allowed to qualify.
- XI. There are three main means-tested benefits which pensioners may be eligible for: Pension Credit (Guarantee Credit + Savings Credit), Housing Benefit and Council Tax Benefit.
- XII. If the Government wishes to set the MIR at a level, which would keep people off Guarantee Credit, then they could set the MIR at or above the current Guarantee Credit Level of £132.60 per week in 2010. Assuming that inflation increases at expected levels, many pensioners would be able to meet this MIR for a 30-year retirement if they had full BSP entitlement and at least half of the maximum S2P entitlement. Pensioners with full BSP entitlement, no S2P entitlement and no other occupational pension entitlement may be able to remain above an MIR for a 30-year retirement, set at the Guarantee Credit level, by purchasing an RPI-linked annuity with around £55,000, or by purchasing a level annuity with around £85,000.
- XIII. If the Government wishes to set the MIR at a level which would keep people off Pension Credit (Guarantee Credit + Savings Credit), then they could set the MIR at the minimum income level above which people are no longer eligible for Pension Credit, £183.90 per week in 2010. An individual with no occupational pension entitlement may be able to stay above an MIR at this level for a 30-year retirement by purchasing an RPI-linked annuity with between £35,000 and £165,000 or by purchasing a level annuity with between £55,000 and £240,000 depending on their state pension entitlement. Around 15% of current annuity purchases are above £40,000 suggesting that some individuals would be able to meet an MIR set at the Pension Credit level.
- XIV. Pensioners with some Occupational pension entitlement (which are predominantly Defined Benefit pensions) may find it easier to meet an MIR without purchasing an annuity. For example, an individual receiving a full BSP (£97.65) and the median level of occupational pension entitlement (£104) would begin retirement with a weekly income of £201.65 and would be able to satisfy an MIR for around 10 years, set at Pension Credit level (£183.90 in 2010) with just their state and occupational pension income. To satisfy the MIR for 30 years they would need around £60,000 to purchase an RPI-linked annuity (or around £85,000 to purchase a level annuity). However an MIR set at the Pension Credit level would not necessarily keep people from becoming eligible for Housing Benefit and Council Tax Benefit.

- XV. Individuals who have incomes high enough to make them ineligible for Pension Credit may still be eligible for Housing Benefit or Council Tax Benefit. If the Government wishes to set the MIR at a level which would keep most people off Pension Credit, Housing Benefit and Council Tax Benefit, then they could set the MIR at an income level above which the majority of people are no longer eligible for these benefits, between £600 and £770 per week in 2010.¹ An individual with no occupational pension entitlement may be able to stay above an MIR at the level needed to stay off Pension Credit, Council Tax Benefit and Housing Benefit, for a 30-year retirement, by purchasing an RPI-linked annuity with between £985,000 and £1.3m depending on their state pension entitlement. As less than 1% of current annuity purchases are £200,000 and above (Table 4) it is unlikely that many people would be able to afford to purchase an annuity that would satisfy an MIR at this level.
- XVI. Larger than anticipated changes in inflation might cause the income threshold for means-tested benefits to rise. The Government may wish to include an extra level of required income in the MIR, above calculations of means-tested benefit eligibility, as insurance against inflation increasing above average levels.

¹ Based on average eligible rents and maximum eligible rents

Introduction

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help commentators and decision-makers to take informed policy decisions on pensions and retirement provision.
2. This response focuses on the evidence that the PPI considers relevant to the Government's decision making in relation to removing the effective requirement to annuitise by age 75.
3. The PPI is currently undertaking a research project (the Retirement Income and Assets Project), comprised of a series of reports, exploring how people can use income and assets to meet their needs in retirement. The fifth report in the series explores the implications of lifting the effective requirement to purchase an annuity by age 75 and is being sponsored by a consortium made up of: the Association of British Insurers, the Department for Work and Pensions, the Investment Managers Association, Partnership, Prudential UK and Europe, and Which? This response draws on the research from the Retirement Income and Assets Project.

Needs in retirement

Private pensions are one of the sources of income that individuals use to support their income needs, which generally vary during retirement

4. The primary purpose of pension savings is to provide retirement income for individual's needs in retirement and therefore a consideration of potential options for accessing pension savings must be placed within the context of individual's income needs in retirement.
5. Though there are several ways to approach a calculation of income needs in retirement, it is difficult to calculate a single figure that will meet income needs for all individuals for their entire retirement. Needs and preferences can vary for pensioners several times during their retirement as their mobility and health levels change
6. While the vast majority of pensioners (95%) receive some income from state pensions in retirement, many pensioners use a varied basket of assets and income to support themselves (including other

savings and investments, private pensions, state benefits and earnings).²

7. The way individuals access and use their different income sources in retirement will depend on:
 - the options available to them,
 - individual's needs for income, and
 - individual spending preferences.

Risks associated with accessing private pension savings

Different methods of accessing pension savings pose different levels of risk and offer different levels of flexibility

8. There are three main methods by which individuals could theoretically access private pension savings in retirement, though regulatory systems (and, to some extent, employer decisions) affect the way individuals in different countries and with different kinds of private pensions can access their pension savings. The three main methods for accessing private pension savings are:
 - *Securing a lifetime income* – securing a guaranteed lifetime income, for example, through purchasing an annuity.
 - *Scheduled withdrawals* – withdrawing income at set or varying levels (without a lifetime guarantee) often with the option to continue to grow the capital fund, (for example, through income drawdown, or through a variable annuity).
 - *Withdrawing pension savings as a lump sum* – withdrawing all or a portion of the pension savings as a lump sum to either spend or re-invest
9. Each method of accessing private pension savings poses varying levels of 'income-related' risk for individuals. The main income-related risks that are associated with accessing private pension savings are:
 - *Longevity risk* - the risk that individuals run out of money before their death.
 - *Inflation risk* - The risk that one's income may lose value relative to the price of the goods and services purchased to meet needs in retirement.
 - *Investment risk (of capital loss)* - the risk that market fluctuations or poor investment strategies will deplete the investment capital.

² DWP (2010) *The Pensioners' Incomes Series 2008-09*

- *Risk of missing out on investment growth* – the risk that a fund will be under-exposed to equities and miss out on investment growth.
 - *Mortality drag* – the risk (incurred when one defers purchasing an annuity) of an invested pension fund yielding less investment return than required to make up for missing out on the mortality cross-subsidies contained in an annuity pool (see paragraph 29 for an in-depth explanation of mortality drag and mortality cross-subsidies.)
 - *Risk of forgoing consumption* - the risk that individuals might under-spend due to worries over running out of money.
 - *Time-of-purchase risk*³ – the risk, especially relevant to lifetime annuities, that one is locked into a product with poor returns because rates are unfavourable at the time of purchase.
 - *Irrevocable decision risk* - The risk of making a purchase decision that is irrevocable (for example, purchasing a lifetime annuity) which does not turn out to best meet income needs or cannot meet needs that change (for example, when health problems develop) because of illiquidity.
10. The above list is not exhaustive. Accessing private pension savings can carry many other risks for individuals including:
- the risk of pension provider insolvency,
 - the risk of changes in need or personal circumstances,
 - the risk of not recouping the initial purchase price of a retirement income product due to an early death.
11. One of the main retirement income related risks for individuals is the risk of having insufficient income in retirement to have an adequate standard of living (as a result of not saving or not saving enough). However, in the interests of brevity and focus, this response has focused on the main risks that are associated with accessing pension savings.
12. Some risks are more serious than others. Risks that relate to losing the entire pension fund (*investment risk of capital loss*), or relate to depletion of the fund before the end of retirement (*longevity risk*) could result in an individual experiencing more financial hardship than risks which relate to receiving a lower income in retirement or relate to missing out on growth or inflation increases.

³ Antolin (2008) Policy Options for the Payout Phase: OECD Working Papers on Insurance and Private Pensions, No. 25 OECD

13. Therefore, if an individual uses a method of accessing pension savings which protects them against *longevity risk* and the *investment risk of capital loss*, but exposes them to other risks, then this individual would usually be in less danger of severe poverty or low income than individuals who access pension savings using a method which exposes them to *longevity risk* and/or the *investment risk of capital loss* (regardless of the other risks that they are protected against).
14. Using pension savings to secure an income, generally through a lifetime annuity, is the only method of accessing pension savings, which protects individuals against both *longevity risk* and the *investment risk of capital loss*.
15. The following table (Table 1) examines the 3 main methods of accessing pension savings and assesses the degree to which each method protects against the main risks to individuals when accessing private pension saving.

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Table 1: the three main methods of accessing private pension savings and their level of protection against different types of risk (x = no protection, ü = low, üü = medium, üüü = high protection)

	Longevity risk	Inflation risk	Investment risk of capital loss	Risk of missing out on investment growth	Mortality drag	Risk of forgoing consumption	Time-of-purchase risk	Irrevocable decision risk
Secure income (e.g. annuities)	üüü	ü this risk depends on whether the annuity is indexed, and what it is indexed to	üüü	ü some annuities are investment linked	üü the amount of protection depends on when the annuity is purchased	üüü	ü consumers may have some choice over when to purchase an annuity	x
Scheduled withdrawals (e.g. drawdown)	ü the level of longevity risk is determined partly by the level of withdrawals allowed	ü ü funds may be depleted or investments may not grow with inflation	x	üüü	x	ü individuals may not withdraw enough to meet consumption needs	üü individuals may miss out on purchasing an annuity when rates are favourable	üüü
Withdrawing pension savings as a lump sum	x	üü The level of inflation risk will depend on whether and how the lump sum is reinvested	ü any lump sum portion invested may be vulnerable to investment risk	üü If the lump sum is invested it has the opportunity to grow	x	x	üü individuals may miss out on purchasing an annuity when rates are favourable	üü people may spend their lump sum early in retirement

Individuals look for varying levels of flexibility in accessing and using their pension savings

16. There is variation in the levels of flexibility individuals look for from their pension savings. For the majority of individuals, the primary purpose of saving in a pension fund will be to provide themselves with an income in retirement. However, for some individuals it is important that they have flexibility regarding:
 - when they access their pension savings (before and during retirement),
 - how much income they are allowed to withdraw,
 - whether they are able to continue to grow their savings during retirement, and
 - whether they are able to leave any remaining savings as inheritance after their death.

17. The level of flexibility allowed by the different methods of accessing pension savings can be measured by examining the extent to which each method allows freedom for:
 - *Level of withdrawal* - choice in the amount of money withdrawn
 - *Growth* - Potential to grow the capital
 - *Bequest* - Potential to leave money as inheritance

18. However there is generally a trade-off between flexibility and risk, the more flexibility a method allows the more the individual is generally exposed to income related risks during their retirement. The following table shows the trade-off between flexibility and risk in the three main methods.

Table 2: the three main methods of accessing private pension savings and the trade-off between level of risk and level of flexibility

Method	Risks exposed to	Risks protected against	Flexibilities
Secure income (e.g. annuities)	<p><i>Risk of missing out on investment growth</i> though some annuities are investment linked</p> <p><i>Time-of-purchase risk</i></p> <p><i>Irrevocable decision risk</i></p> <p><i>Inflation risk – unless annuity is index linked</i></p>	<p><i>Longevity risk</i></p> <p><i>Investment risk (of capital loss)</i></p> <p><i>Mortality drag: if purchased in time</i></p> <p><i>Risk of forgoing consumption</i></p>	<p><i>Level of withdrawal: low level of flexibility – there will be a range of options at time of annuity purchase</i></p> <p><i>Growth: low flexibility – unless it is an investment linked annuity</i></p> <p><i>Bequest: no flexibility –(except for guaranteed annuities)</i></p>
Scheduled withdrawals (e.g., drawdown)	<p><i>Longevity risk</i></p> <p><i>Investment risk (of capital loss)</i></p> <p><i>Risk of forgoing consumption</i></p>	<p>Partial protection from the following risks:</p> <p><i>Risk of missing out on investment growth</i></p> <p><i>Time-of-purchase risk</i></p> <p><i>Irrevocable decision risk</i></p> <p><i>Inflation risk</i></p>	<p><i>Level of withdrawal: medium level of flexibility – within maximum and minimum withdrawal caps</i></p> <p><i>Growth: high flexibility – to grow fund</i></p> <p><i>Bequest: medium flexibility – level of effective flexibility to leave as bequest dependent on tax treatment</i></p>
Withdrawing pension savings as a lump sum	<p><i>longevity risk</i></p> <p><i>Risk of forgoing consumption</i></p> <p>The level of <i>inflation risk, risk of capital loss and risk of missing out on investment growth</i> will depend on whether lump sum is reinvested</p>	<p>Partial protection from the following risks:</p> <p><i>Risk of missing out on investment growth</i></p> <p><i>Time-of-purchase risk</i></p> <p><i>Irrevocable decision risk</i></p>	<p><i>Level of withdrawal: High flexibility</i></p> <p><i>Growth: High flexibility</i></p> <p><i>Bequest: High flexibility</i></p>

The Government is lifting the effective requirement to annuitise by age 75

19. The previous Labour Government required individuals to use any private pension savings they had remaining at age 75 (after taking a 25% tax-free lump sum) to secure an income. This was generally done through the purchase of a lifetime annuity though, since 2006, people have been allowed to invest their fund in Alternatively Secured Pension (ASPs).⁴ High taxes on the bequest of ASP funds and a low cap on the amount individuals can withdraw have made ASPs an unattractive option for many pensioners.
20. The current Government has temporarily lifted the requirement to effectively annuitise by age 75, as a transitional measure until the Government's new approach has been determined and new regulations are put in place.
21. The Government has proposed to remove the effective requirement to purchase an annuity by age 75 and has proposed to put regulations in place which will allow individuals to:
 - Invest their pension savings in an income drawdown arrangement, with a cap on the maximum allowed withdrawal, for the entirety of an individual's retirement. The Government is calling this approach '*Capped Drawdown*'.
 - Withdraw unlimited amounts from their pension savings, provided that they can demonstrate that they have met a minimum income requirement. The Government intends the level of minimum income requirement to be high enough to prevent individuals from exhausting their savings prematurely and becoming eligible for means-tested benefits. The Government is calling this approach '*Flexible Drawdown*'.
22. The Government has sought views on:
 - What level of cap to use in capped drawdown,
 - How to appropriately reform the pensions tax framework,
 - How high to set the Minimum Income Requirement (MIR),
 - What income should be considered for the MIR,
 - How often the MIR should be reviewed,
 - Whether the MIR should differ for individuals of different ages and household groups,
 - How the changes might affect the UK annuity market,
 - Whether there may be any unintended consequences of the changes.

⁴ ASPs were initially intended only for those with principled religious objections to the pooling of mortality risk, though take-up has spread beyond the target group that ASPs were intended for

23. This response outlines the evidence that the PPI considers relevant to the Government's consultation and focuses especially on the trade-offs between risks and flexibilities for individuals that could result from the new regulations.

Setting a drawdown cap

Capped Drawdown allows individuals more flexibility but poses more longevity risk for individuals than conventional lifetime annuities

24. The Government intends to place a cap on the amount of income individuals can withdraw from their capped drawdown arrangements if they have not satisfied the MIR. The purpose of the cap is to ensure that individuals do not withdraw at such high levels that they deplete their savings during their retirement and end up relying on the state through means tested benefits.
25. **A limit, at any level, on the amount that people can withdraw will involve a trade-off between: setting the cap low enough to ensure that individuals do not run out of money before the end of their retirement; and, setting the cap high enough so that individuals are not made to forgo consumption.**
26. **Simple, fixed limits are more likely to pose risks to individuals.** Research⁵ shows that simple limits may not provide as much insurance against **longevity risk and the risk of forgoing consumption** as more flexible approaches to drawing down income. For example:
- Using a limit of *a fixed percentage of the equivalent available annuity rate* (as under the current system) can lead to the danger of running out of funds before the end of retirement.
 - Using a limit of *a fixed percentage of the fund size* hedges more longevity risk than using a fixed percentage of the equivalent available annuity rate, but this approach often involves very small withdrawals of fund capital and therefore might lead individuals to forgo some consumption.
27. **Complex approaches to drawdown, such as withdrawal strategies that vary with age and fund performance, are more effective at ensuring that individuals do not deplete their funds, or run the risk of forgoing consumption.**⁶ However complex approaches to withdrawal will not be easy to regulate using cap limits and require high levels of financial knowledge from consumers or an ability to pay for ongoing advice and fund management.

⁵ IMA (2008) *Research Paper: modelling income drawdown strategies*

⁶ IMA (2008) *Research Paper: modelling income drawdown strategies*

28. **When assessing the potential implications of different drawdown strategies there is a trade-off between withdrawal strategies that provide simplicity and are easy to understand, but bring greater risks, and withdrawal strategies, which provide more security but are more complex and difficult to understand.**
29. If individuals remain in capped drawdown instead of buying an annuity they face risks that annuities would have provided protection against. The main risks that individuals in capped drawdown will be exposed to are:
- *Longevity risk* - the risk that an individual lives for longer than they expect to, and have made financial provision for, and deplete their pension savings before their death.
 - *Mortality drag* - when an individual purchases a lifetime annuity, they benefit from *mortality cross-subsidies*. This is because those who purchase lifetime annuities and then live for less than average life expectancy *subsidise* those who purchase annuities and live for longer than average life expectancy. The longer an individual remains in drawdown, the more they miss out on the mortality cross-subsidies they would have received from a lifetime annuity. The amount of yearly loss grows with age, as does the amount of investment return that an individual would need to make up for the lost cross-subsidy. By the time an individual is aged 74, they could need to receive around 6.5% in investment growth (per year) from drawdown to make up for the lost cross-subsidy.⁷
30. The effect is compounded by the fact that average (total) life expectancy increases with age, e.g. a 70 year old purchasing annuity will *not* automatically be expected to live for 5 years less than a 65 year old purchasing an annuity. The 70 year old will have a higher average life expectancy than the 65 year old and may be expected to live, for example, 3 or 4 years less than a 65 year old. As a result, the annuity rate that people receive will be affected by the age at which they purchase their annuity and the provider's calculations of life expectancy.
31. In order to compensate for the longevity risk and for missing out on the mortality cross-subsidy, an individual in a drawdown arrangement might need a cap on withdrawals that is lower than 100% of what they would have received from an equivalent annuity.

⁷ www.williamburrows.com/dd/mortalitydrag.aspx

Age related caps might prevent smoothing consumption during retirement

32. One of the concerns regarding capped drawdown is that individuals using drawdown are at risk of running out of money before the end of their retirement. Therefore, one possible option would be to place a low initial cap on withdrawals that increases as individuals age, in order to prevent people from withdrawing too much of their fund in early retirement.
33. However a strategy, which allows people higher caps in later retirement, may still put individuals at risk of fund depletion, particularly as any withdrawals are likely to be larger relative to the size of the remaining fund. Caps that increase with age may also unfairly disadvantage those who, for reasons of health, location or social class, have lower life expectancies than others of their same age.
34. An alternative option would be to allow people a higher cap when they are younger and then reduce the cap as they age when the mortality cross-subsidies in an equivalent annuity would be higher. However this strategy would reduce the amount of income people could receive from their fund as they aged, and could result in very low caps being imposed in later retirement in order to make up for the higher caps at the start,⁸ making it difficult to smooth consumption during retirement.
35. **An option, which would compromise between the different risks, could be to have a steady, low cap, which allowed people to draw income at similar levels throughout their retirement.**
36. **Individuals in capped drawdown arrangements may forgo consumption in an attempt to preserve their capital fund.** There is evidence from the US,⁹ that allowing more flexibility in accessing pension savings can motivate individuals to forgo consumption in order to preserve their capital. Capped drawdown arrangements provide less security than a lifetime annuity. The lack of security could lead to individuals compensating by withdrawing at lower amounts than are needed to meet basic needs in retirement.
37. **The level of risk that using capped drawdown poses will be relative to the level of savings and assets held by an individual.** For individuals with large pension pots and substantial savings and assets the risk of capped drawdown leading to depleting savings

⁸ According to simulations run by Partnership

⁹ Gale, *et al.* (2009) *Automatic. Changing the Way America Saves* Brookings Institute Press, Washington D.C.

before the end of retirement, or the risk of forgoing consumption to the point of serious deprivation, are likely to be reduced.

38. **Capped drawdown allows more flexibility than conventional annuities**, and gives individuals more flexibility than conventional annuities to:
- withdraw income in variable amounts and therefore meet changing needs for income during retirement,
 - grow their funds,
 - leave some of their funds as inheritance.

Setting the MIR

39. **What income should count towards a Minimum Income Requirement?**

The Government would like to give individuals more flexibility in accessing their pension savings, while also ensuring that individuals do not deplete their savings too quickly and end up becoming eligible for means-tested benefits during their retirement. Therefore, the Government's Consultation proposes to require that individuals secure an income [the Minimum Income Requirement (MIR)] sufficiently high to keep them above eligibility for means-tested benefits throughout their retirement, before being allowed to access their pension savings without a cap.

40. The Government is consulting on the scope of what income should be allowed to constitute 'secure income' and they have specified that they would like MIR income to:

- be currently in payment (i.e. not a deferred entitlement)
- be guaranteed for life, and
- take into account reasonable expectations of the future cost of living.

41. The Government intends to require MIR income to be currently in payment in order to avoid the situation of individuals securing an MIR through deferred income and then becoming eligible for means-tested benefits before their secure income comes in to payment. **However, disallowing deferred income might result in a situation in which some individuals are not allowed to access their pension savings until their sixties when they have reached SPA and/or the age at which their occupational pension comes into payment.**

42. Some individuals may have non-secure income and assets at such a high level that they are very unlikely to become eligible for means-tested benefits. **An alternative would be to allow non-secure income and assets above a certain level to count towards the MIR if**

individuals can prove that they will, in future, have a secure source of income at the MIR level. This would be similar to the Irish system in which qualifying individuals with savings above a certain level are allowed flexible access to pension savings if they put aside a certain amount of their savings in an 'approved fund' (similar to a drawdown fund).

43. The consultation document specifies that income used to satisfy the MIR will need to take account of increases in the cost of living. The document states that the Basic State Pension (BSP) and Additional State Pensions will both count towards the MIR.
44. The Government also proposes that Occupational Pension income in payment that is uprated annually by a minimum of Limited Price Indexation (LPI) will also count towards the MIR.
45. The Government has proposed that income from escalating annuities would count towards the MIR, provided that it increases by at least LPI but that income from a level annuity will not count towards the MIR at all. This seems at odds with the fact that the vast majority of annuities currently purchased are level annuities. There may well be an argument for discounting the value of the level annuity income more heavily than income from an escalating annuity, in order to reflect the fact that inflation will erode the value of the level annuity. However, to exclude income from level annuities altogether risks creating market distortions in the demand for level and escalating annuities.

How should the Government set the MIR level?

46. Setting the MIR level is not straightforward. The Government has stated that the appropriate level of the MIR should protect the Exchequer from the risk of an individual falling back on the state. The level of the MIR could therefore be linked to the levels of income that individuals or households would need to have to make it very unlikely that they would fall back onto state benefits.
47. There are three main means-tested benefits that pensioners can currently claim. The Pension Credit which is composed of Guarantee Credit + Savings Credit, Housing Benefit and Council Tax Benefit.
48. Table 3 illustrates how much an individual might need to have in savings in order to purchase an annuity that would allow them to remain above the MIR, for a 30 year retirement, set at four different levels of means-tested benefit entitlement. These calculations assume that people have different levels of state pension entitlement and that individuals have no other sources of occupational pension income

(e.g. defined benefit pensions) that would count towards the MIR. Para 59 shows how the situation differs for a pensioner with a median amount of occupational pension income.

49. The individuals in Table 3 are all able to stay above a means-testing threshold throughout their retirement with a level annuity of a high enough value. **It could be an option, therefore, to allow individuals to secure their income with a level annuity, or with income that increases by a different index than earnings, if they secure the income at a high enough level to remain above a means-testing threshold for the entirety of their retirement.**

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Table 3: Level of income and size of annuity purchase required to keep pace with inflation of the MIR set at 4 different levels of means-tested benefit entitlement

Level of BSP and S2P ¹⁰	Guarantee Credit ¹¹		Pension Credit (Guarantee Credit + Savings Credit)		Average eligible rent (£288) ¹² Pension Credit + Housing & Council Tax Benefit		Max eligible rent (£400) ¹³ Pension Credit + Housing & Council Tax Benefit	
	Required weekly income 2010: £132.60 2040: £496.63		Required weekly income 2010: £183.90 2040: £688.76		Required weekly income 2010: £596.20 2040: £2,178.54		Required weekly income 2010: £768.50 2040: £2,802.73	
	RPI-linked annuity	Level annuity	RPI-linked annuity	Level annuity	RPI-linked annuity	Level annuity	RPI-linked annuity	Level annuity
Full BSP (£97.65) No S2P	£55,000	£85,000	£165,000	£240,000	£985,000	£1,450,000	£1,330,000	£1,955,000
Full BSP (£97.65) ½ S2P (£63.50)	£0	£0	£100,000	£145,000	£920,000	£1,355,000	£1,265,000	£1,860,000
Full BSP (£97.65) Full S2P (£127)	£0	£0	£35,000	£55,000	£860,000	£1,260,000	£1,200,000	£1,770,000
Full BSP (£97.65) Occupational Pension (£104)¹⁴	£0	£0	£60,000	£85,000	£880,000	£1,295,000	£1,225,000	£1,800,000

¹⁰ BSP increased by greater of earnings, CPI or 2.5%, S2P increased by CPI

¹¹ Up-rated by earnings

¹² Assumes maximum Housing Benefit eligible rent of £288 (based on average over 65 eligible rent, DCLG table 735) assumes eligible rent is only up-rated by CPI

¹³ Assumes Housing Benefit eligible rent is capped at £400 maximum (maximum cap for a 4 bedroom house), assumes eligible rent is only up-rated by CPI

¹⁴ Median receipt

The Government could set the MIR at the level of the Guarantee Credit, £132.60 per week in 2010.

50. If the Government wishes to set the MIR at a level, which would keep people off Guarantee Credit, then they could set the MIR at or above the Guarantee Credit Level of £132.60 per week in 2010. Assuming that inflation increases at expected levels, many pensioners would be able to meet this MIR for a 30-year retirement if they had full BSP entitlement and at least half of the maximum S2P entitlement. Pensioners with full BSP entitlement, no S2P entitlement and no other occupational pension entitlement may be able to remain above an MIR set at this level by purchasing an RPI-linked annuity with around £55,000, or by purchasing a level annuity with around £85,000.
51. However, individuals may have income above the Guarantee Credit level and still be eligible for the means-tested benefits of Savings Credit, Housing Benefit and Council Tax Benefit.

The Government could set the MIR at the level needed to reduce the likelihood of individuals falling back onto Pension Credit, at £183.90 per week in 2010

52. If the Government wishes to set the MIR at a level which would keep people off Pension Credit (Guarantee Credit + Savings Credit), then they could set the MIR at the minimum income level above which people are no longer eligible for these benefits, £183.90 a week in 2010. An individual with no occupational pension entitlement may be able to stay above an MIR at this level by purchasing an RPI-linked annuity with between £35,000 and £165,000 depending on their state pension entitlement. Alternatively, an individual who purchased a level annuity with between £55,000 and £240,000 would also be able to meet an MIR set at the Pension Credit level, depending on their state pension entitlement.
53. Individuals who have incomes high enough to make them ineligible for Pension Credit may still be eligible for Housing Benefit or Council Tax Benefit. The level of income at which people are still eligible for Housing Benefit and Council Tax Benefit is much higher than the level at which people cease to be eligible for Pension Credit. This is because Housing Benefit eligibility is related to the rent people pay. Eligibility for Housing Benefit is only gradually withdrawn as people's incomes rise.

The Government could set the MIR at the level needed to reduce the likelihood of individuals falling back onto Pension Credit, Council Tax Benefit or Housing Benefit at average levels of rent, at £600 per week in 2010

54. The MIR could be calculated based on the level of weekly income needed to reduce the likelihood of individuals falling back onto Pension Credit, Housing Benefit or Council Tax Benefit.
55. An MIR set at this level, using average levels of rent eligible for Housing Benefit, would be very high at around £600 per week in 2010. An MIR set at this level may not insure that all people who secure an MIR will never need to rely on means-tested benefits, but would reduce the likelihood of people falling back onto Housing Benefit, when compared to an MIR set at the Pension Credit level.
56. An individual with no occupational pension entitlement may be able to stay above an MIR at £600 a week in 2010 by purchasing an RPI-linked annuity with between £860,000 and £985,000, depending on their state pension entitlement.
57. Pensioners with some Occupational Pension entitlement (which are predominantly Defined Benefit pensions) may find it easier to meet an MIR without purchasing an annuity. For example:
- We assume that an individual receives:
 - Ø Full entitlement to BSP (£97.65)
 - Ø No entitlement to S2P¹⁵
 - Ø The median level of occupational pension entitlement (£104)¹⁶
 - This individual begins retirement with a weekly income of £201.65 and would be able to satisfy an MIR for around 10 years, set at both Guarantee Credit and Pension Credit level (£183.90 in 2010) with just their state and occupational pension income. To satisfy the MIR for 30 years they would need around £60,000 to purchase an RPI-linked annuity (or around £85,000 to purchase a level annuity).
 - However, this individual would not be able to satisfy an MIR set at a level above eligibility for Pension Credit, Housing Benefit and Council Tax Benefit using only their state and occupational pension income.

¹⁵ The majority of DB scheme members are contracted out of S2P

¹⁶ DWP (2010) *The Pensioners' Incomes Series 2008-09*, calculations assume occupational pension is uprated by LPI

If the Government wants to set the MIR at a level above a calculation of maximum entitlement for all means-tested benefits then it may be higher than most people could afford, at around £770 per week in 2010

58. If the Government wishes to set the MIR at a level, which would completely keep people off Pension Credit, Housing Benefit and Council Tax Benefit, then they might need to set the MIR at around £770 per week in 2010. This weekly income required to remain ineligible for Housing Benefit is very high because the maximum allowed eligible rent for Housing Benefit is £400 per week.¹⁷ An individual with no occupational pension entitlement may be able to stay above an MIR at this level by purchasing an RPI-linked annuity with between £1.2m and £1.3m depending on their state pension entitlement.
59. As less than 1% of current annuity purchases are above £200,000 (Table 4) it is unlikely that many people would be able to afford to purchase an annuity that would satisfy an MIR at this level.

¹⁷ Eligible rent levels for Housing Benefit rise in line with CPI from 2013/14

Table 4:¹⁸ Average percentage of annuities purchased, by size of annuity purchase, between 2001 and 2009

Size of annuity purchase	Average percentage of annuities purchased between 2001 and 2009 ¹⁹
Less than £5,000	29%
£5,000 - £9,999	17%
£10,000 - £19,999	22%
£20,000 - £29,999	12%
£30,000 - £39,999	6%
£40,000 - £49,999	4%
£50,000 - £59,999	3%
£60,000 - £69,999	2%
£70,000 - £79,999	1%
£80,000 - £89,999	1%
£90,000 - £99,999	1%
£100,000 - £199,999	3%
£200,000 and above	1%

60. An alternative approach that could be considered by the Government is to link the MIR to a measure of the minimum expenditure needed for retirement income. The JRF's Minimum Income Standards suggest that a single person may need an income of £147 a week before housing costs for a single person, or £222 a week after housing costs for a couple.²⁰ However, at an MIR at these levels there will still be risks that individuals or households could fall back onto state benefits, particularly in later retirement if retirement income is not fully protected against inflation.
61. **Setting the MIR will involve consideration of the trade-off between:**
- minimising the risk of individuals becoming eligible for means-tested benefits but placing the MIR so high as to exclude many individuals from the option of satisfying it, and
 - placing the MIR low enough to give more individuals the option of satisfying it, but exposing the Government to more risk of individuals becoming eligible for means-tested benefits in retirement.

¹⁸ ABI stats, cash figures by year

¹⁹ Figures add up to more than 100% due to rounding

²⁰ Joseph Rowntree Foundation (2008) using data from the 2008 Expenditure and Food Survey, ONS

It might be worth considering the future costs of Long Term Care when calculating where to set the MIR.

62. Today's 65 year olds will need care costing, on average, £30,000 during their retirement.²¹ Care for someone in a residential home might cost around £12,500 per year on average for care, plus around £14,000 per year for the cost of accommodation.²² Some pensioners might be able to satisfy the MIR when they are younger and healthier but may then need to rely on the state when their care costs become high in later retirement.

It could be unfair to disabled people to include entitlement to disability benefits in MIR calculations

63. Some individuals may develop disabilities or health problems during later retirement. Eligibility for means-tested benefits can be higher for people who have a limiting disability or health problem. Therefore it might seem that an option would be to consider the potential cost of disability related benefits when setting the level of the MIR.

64. However it could be unfair to disabled people to include entitlement to disability related increases or benefits in an MIR calculation. **Disability benefits are intended to pay for needs over and above the standard cost of living and should not be included in assessments of the income people need to meet basic needs.**

Varying the MIR by age or household status may make sense but it could introduce further complexity to the system

65. **Individuals of different ages will face different levels of risk in retirement, and one potential option would be to link MIR to age.** An individual aged 55, might need a high MIR in order to provide against longevity risk, i.e., the risk of having a long retirement or the risk of having income needs that change during retirement (for example, as a result of developing health problems) and to provide against the risk of high inflation rates during retirement. An individual aged 80 or above will face less longevity and inflation risk as their remaining retirement is likely to be shorter than that of a younger individual. Younger individuals, in their fifties and sixties may need a higher level of protection against risk, through having a higher MIR, than those in their seventies, eighties and nineties. However, varying the MIR by age could introduce greater complexity into the system.

²¹ HM Government (2009) *Shaping the Future of Care Together* TSO

²² Forder J, Fernández J L. (2009) *Analysing the costs and benefits of social care funding arrangements in England: technical report*, www.pssru.ac.uk p. 20, Table 13.

66. **Couples and single individuals might have different income needs in retirement.** Pensioners in a couple will generally need less income per person than single pensioners, in order to meet their needs. Therefore there may be an argument for allowing pensioners in couples to have a lower MIR than single pensioners. However, this introduces greater complexity into the system.

It will be important that the MIR is reviewed regularly to account for cost of living changes. The timing of the reviews could be linked to changes in indices associated with the MIR.

67. The timing of the MIR reviews should reflect changes in MIR indexation, for example:
- If the MIR is linked to Guarantee Credit then the MIR should be reviewed when the Guarantee Credit level is changed.
 - If the MIR is linked to the Minimum Income Standard then the MIR should be reviewed when the Minimum Income Standard is reviewed.
 - If the MIR is linked to inflation, for example, expenditure or earnings, then the MIR should be reviewed when there are substantial changes in inflation rates.

68. Larger than anticipated changes in inflation might cause the income threshold for means-tested benefits to rise. The Government may wish to include an extra level of required income in the MIR, above calculations of means-tested benefit eligibility, as insurance against inflation increasing above average levels.

Advice and information

The new proposals give consumers greater choice but consumers will need to decide which option or options they wish to use, which has implications for the provision of advice and information

69. Removing the effective requirement to annuitise means that individuals will have to choose between purchasing an annuity, entering capped drawdown or securing a minimum income and withdrawing the rest of their savings flexibly.
70. **Allowing more flexibility in accessing pension savings may mean that some individuals might make decisions that do not best meet their income needs (as a result of either receiving inappropriate advice, or lacking the necessary information).** It will be extremely important that providers of advice and information (including the Money Guidance programme) deliver accessible, correct and sometimes tailored advice and information to individuals in order to ensure that individuals do not select a withdrawal option that could jeopardise their pension savings or result in pensioners experiencing a lower standard of living. Individuals with similarly sized pension pots may have different advice needs and may face different risks. For example,
- An individual with a large pension savings pot but very little other savings and assets might be eligible to satisfy the MIR and flexibly withdraw their remaining pension savings. This individual may benefit from a careful approach to withdrawal, in order to avoid depleting the remainder of their savings before the end of their retirement as the MIR may not be sufficient to provide them with a standard of living which matches the one they experienced in working life.
 - However, an individual with a similarly sized savings pot and a substantial amount of other savings and assets may be running fewer risks if they satisfy the MIR and then flexibly withdraw their remaining savings because they will have other assets to fall back on if they deplete their savings

71. **Even if individuals receive the correct advice and information, the negative perception of annuities could lead some individuals to choose to enter capped drawdown or to satisfy the MIR and withdraw the remainder of their savings flexibly, when a lifetime annuity would have been the best option for them.** Annuities will still be the best option for the majority of individuals, who have relatively modest pension pots, because the alternative option of capped drawdown is likely to be too expensive for many people to manage. Individuals with small pots are also exposed to more risks in drawdown than individuals with larger pots as small pots are at greater risk of depletion before the end of retirement and may be less able to deal with market fluctuations. However, the negative associations many consumers have with annuities might mean that some individuals don't make the annuity choice when they come to access their pension savings.
72. **It is essential that advice and information providers work to ensure that the public image of annuities does not prevent those for whom an annuity is the best option from purchasing them.**
73. **It will be important to ensure that individuals do not see capped drawdown and annuities as an 'either/or' choice.** For some individuals it might be appropriate to have some of their savings in capped drawdown and use some to purchase an annuity. Research suggests that some individuals may be able to increase their consumption levels, while incurring very little risk, if they invest the majority of their savings at the beginning of retirement and switch savings over into annuities progressively during their retirement.²³

Unintended consequences

New regulations on accessing pension savings may have unintended consequences for the choices consumers make and for the provision of retirement income products

74. There are several potential unintended consequences that could arise from the Government's proposed approach to accessing pension savings.
75. The lifting of the requirement to annuitise may result in some individuals declining to purchase an annuity even if an annuity is the best option for them. This could be as a result of receiving incorrect advice or because individuals have a negative perception of annuities.

²³ Maurer, R. Somova, B. (2009) *Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?*

76. A reduction in annuity purchases by those for whom an annuity would be the best option could lead to:
- *Some pensioners receiving lower incomes in retirement from capped drawdown than they would have if they had purchased a lifetime annuity* - This could be as a result of low caps, fund depletion or as a result of pensioners withdrawing below maximum levels in order to preserve their fund capital.
 - *Some pensioners becoming eligible for means-tested benefits* - Pensioners who enter capped drawdown and then lose too much fund capital due to market fluctuations or higher than expected longevity might become eligible for means tested benefits in later retirement.
 - *Some pensioners paying more to manage their pension funds* - the costs of managing a drawdown account could be much higher than the one-off commission paid when purchasing an annuity, as drawdown accounts require ongoing management.
77. **Some individuals may purchase escalating annuities even when a level annuity would better provide for their needs in retirement if, as proposed, the MIR only recognises escalating annuities.** The consultation document suggests that the MIR will need to take into account reasonable expectations of the future cost of living, and suggests an intention to require that an annuity purchased in order to satisfy the MIR be escalating. If it becomes a requirement that individuals purchase an escalating annuity in order to satisfy the MIR, individuals may start to think that escalating annuities are the best option for them, however for some individuals, (individuals with shorter life expectancies or with incomes only just above a means-tested benefit level), a level annuity will often be a better option.
78. **If many individuals start to buy escalating annuities in order to satisfy the MIR or because they believe as a result of the new regulations that escalating annuities are the best type of annuity to purchase, then the cost of escalating annuities might rise.** This would mean that for each £1,000 spent on purchasing an annuity, the rate of pension income would be lower. Government issued index-linked gilts, of which there is a low supply, back escalating annuities. A higher demand might cause the Government to offer lower returns on the gilts which, in turn, could cause the price of annuities to increase and the amount received relative to purchase price of annuity may be lowered.

79. A potential, positive consequence of the Government's proposed approach may be that many individuals with higher incomes, and therefore often higher life expectancies, might leave the annuity market and access their pension savings through capped or flexible drawdown arrangements. A reduction of the average life expectancies of those in annuity pools could result in an improvement in the annuity rates on offer, if the annuities are priced correctly and pension incomes are raised.
80. **The regulations could have a knock-on effect for members of DB schemes.** There is some scope for the new approach to make DB schemes seem relatively inflexible in comparison to DC schemes in future, and therefore less attractive to DB scheme members. In an extreme scenario, members of DB schemes may leave their schemes for more 'flexible' DC arrangements.
81. **Individuals are going to require education to help them understand and navigate the new system of accessing pension savings.** The cost for providers of this education (including internal retraining costs) could be very high. This may especially impact upon providers of free advice and education e.g., charities and advice services.