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Retirement income and assets: the implications of ending the effective requirement to annuitise by age 75

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Introduction 1

Summary of conclusions 3

1. What are the risks associated with different methods of accessing private pension savings? 7

2. How do people currently access private pension savings? 18

3. What are the implications of removing the requirement to annuitise? 28

4. The impact on individuals who had low earnings during working life 46

5. The impact on individuals who had median earnings during working life 54

6. The impact on individuals who had high earnings during working life 64

7. How could an early access policy interact with a more flexible approach to accessing private pension savings? 72

Appendix: modelling methods and assumptions 77

Acknowledgements and contact details 83

References 84

Introduction

Until June 2010, individuals with Defined Contribution (DC) pensions were effectively required to annuitise any remaining private pension savings (after taking an optional 25% tax-free lump sum) by age 75. As a response to calls for more flexibility, the Government has removed the effective requirement to use private pension savings to purchase an annuity by age 75.[1] The Government's stated policy objective is to make pension saving more attractive by giving individuals greater choice over how they provide a retirement income for themselves. From April 2011, people will be allowed from the age of 55 to access their private pension savings through one, or a combination of the following methods:

- Purchasing an annuity at any point,
- Investing their pension savings in an income drawdown arrangement with no upper age limit and with a withdrawal cap of 100% of what they would have received from an equivalent annuity. The Government is calling this approach ***'Capped Drawdown'.***
- Withdrawing unlimited amounts from their pension savings, provided that they can demonstrate that they have a secure income already in payment, guaranteed for life of £20,000 per year in 2011. The Government is calling this approach ***'Flexible Drawdown'***.

This report explores how the new legislation could impact on the risks people face when accessing private pension savings and on individual financial outcomes in retirement.

Chapter one examines the income needs that individuals have in retirement and explores how different methods of accessing private pension savings could expose individuals to different types and levels of risk.

Chapter two explores current trends in how individuals with Defined Contribution pension savings access their private pension savings and what these might indicate about future behaviour.

Chapter three explores the potential impact of removing the requirement to annuitise by age 75, and the proportion of pensioners that might be able to use Capped or Flexible Drawdown.

Chapter four explores the potential impact on individuals who earned at low earnings during their working life.

Chapter five explores the potential impact on individuals who earned at median earnings during their working life.

[1] www.hm-treasury.gov.uk/d/consult_age_75_annuity_responses.pdf

Chapter six explores the potential impact on individuals who earned at high or very high earnings during their working life.

Chapter seven explores how a more flexible approach to accessing private pension savings could interact with policies that allow early access to pension savings.

Summary of Conclusions

The Coalition Government has removed the effective requirement to purchase an annuity by age 75 and, from April 2011, will allow people to access their pension savings in a more flexible way. From the age of 55, people will be allowed to access their private Defined Contribution (DC) pension savings through one, or a combination of the following, methods:

- Purchasing an annuity at any point.
- Investing their pension savings in an income drawdown arrangement with no upper age limit and with a withdrawal cap of 100% of what they would have received from an equivalent annuity. The Government is calling this approach ***'Capped Drawdown'.***
- Withdrawing unlimited amounts from their pension savings, provided that they can demonstrate that they have a secure income already in payment, guaranteed for life of £20,000 per year in 2011. The Government is calling this approach ***'Flexible Drawdown'***.

For the vast majority of people, annuitising is likely to remain the safest and most appropriate option for accessing private DC pension savings
In 2010 the vast majority of people aged between 55 and 75 would not have had a large enough private pension pot to be able to bear the investment and longevity risks associated with Capped Drawdown and would not have been able to meet the Minimum Income Requirement (MIR). For the majority of people, annuitising will still be the safest and most appropriate way of accessing their private DC pension savings.

A small proportion of people might be able to use Capped or Flexible Drawdown
From April 2011, people will be permitted, from age 55, to remain in income drawdown, 'Capped Drawdown,' with no upper age limit. The Government has placed a cap on the amount of income that people can withdraw, at 100% of an equivalent annuity. 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, around 600,000 to 700,000 people 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 (which have not yet been used to purchase an annuity) to enter Capped Drawdown. This includes those already in income drawdown arrangements as well as those individuals who have more than £100,000 in uncrystallised DC pension savings, some of these people will still be working and contributing to their pensions.

- This represents around 5% of all people aged between 55 and 75 in 2010 and around 22% to 26% of people aged between 55 and 75 with uncrystallised DC pension savings.

A small proportion of people might have enough income and savings to meet the Minimum Income Requirement (MIR) but relatively few will be able to use Flexible Drawdown

The Government has legislated to allow people over age 55 to access their private pension savings in a more flexible way, provided that they can demonstrate that they have a secure source of pension income in payment and guaranteed for life, the Minimum Income Requirement (MIR) at a level high enough to prevent them from 'falling back on the state' through means-tested benefits. The Government has set the MIR at £20,000pa in 2011, and intends to periodically review this amount. Income from state pensions, Occupational Pensions, and annuities can all count towards the MIR.

- Around 700,000 to 1m people between age 55 and 75 in 2010 could have enough pension income in payment to meet an MIR of £20,000pa using income from: state pensions, occupational scheme pensions, existing annuities, or uncrystallised DC savings which could be annuitised. This represents between 5% to 8% of people between age 55 and 75 in 2010.

However, the majority of people who could meet the MIR are unlikely to be able to take advantage of Flexible Drawdown, which is where an individual can withdraw unlimited amounts from their DC savings, provided that they can demonstrate that they have a secure income of at least £20,000pa. Many of the people who can meet the MIR in 2010 will have mainly state and Defined Benefit (DB) pension income which cannot be withdrawn. Those already in receipt of DB pension income cannot transfer out of their schemes and convert their savings into DC savings. However, people who are still accruing DB entitlement could transfer out of their schemes into DC pension saving funds in order to meet the MIR in future and use Flexible Drawdown for the remainder of their DC pension savings

- Around 200,000, of the 700,000 to 1 million people who could meet the MIR, could have sufficient pension income and DC pension savings to meet the MIR and have some DC savings left over to access flexibly. This is around 2% of people between age 55 and 75 in 2010 and around 7% of people between age 55 and 75 in 2010 with uncrystallised DC pension 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 the historically low levels of DC saving. However, the decline in DB pension provision has led to an increase in people saving in DC schemes,

which is likely to be compounded 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 impact on 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.

The impact on median earners

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 to using existing annuity products.

However there are risks involved with using annuities that are more flexible than conventional annuities, such as fixed term or flexible annuities. These types of annuities could expose people to greater levels of investment risk (flexible annuities) or the risk that annuity rates are lower when the fixed period comes to an end than they were at the time of the initial annuity purchase (fixed term annuities).

The impact on high earners

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 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. For people with high levels of

income and assets, high appetite 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. Frequent investment reviews in Capped Drawdown should help people to mitigate risks by changing investment strategy or lowering withdrawal rates if their investments are not faring well.

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 they will have a secure income for life of at least £20,000pa.

Chapter one: what are the risks associated with different methods of accessing private pension savings?

This chapter examines the income needs that individuals have in retirement and explores how different methods of accessing private pension savings could expose individuals to different levels and types of risk.

The primary purpose of pension savings is to provide for individual's needs for income in retirement. Therefore, this report considers potential options for accessing pension savings within the context of individuals' income needs in retirement. 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.

Income needs can be assessed in terms of basic needs or desired levels of income

Calculations of income needs can be divided into two main categories:

- Measures of minimum income required to meet basic needs; and,
- Measures of the income required to enable individuals to achieve their desired standard of living in retirement.

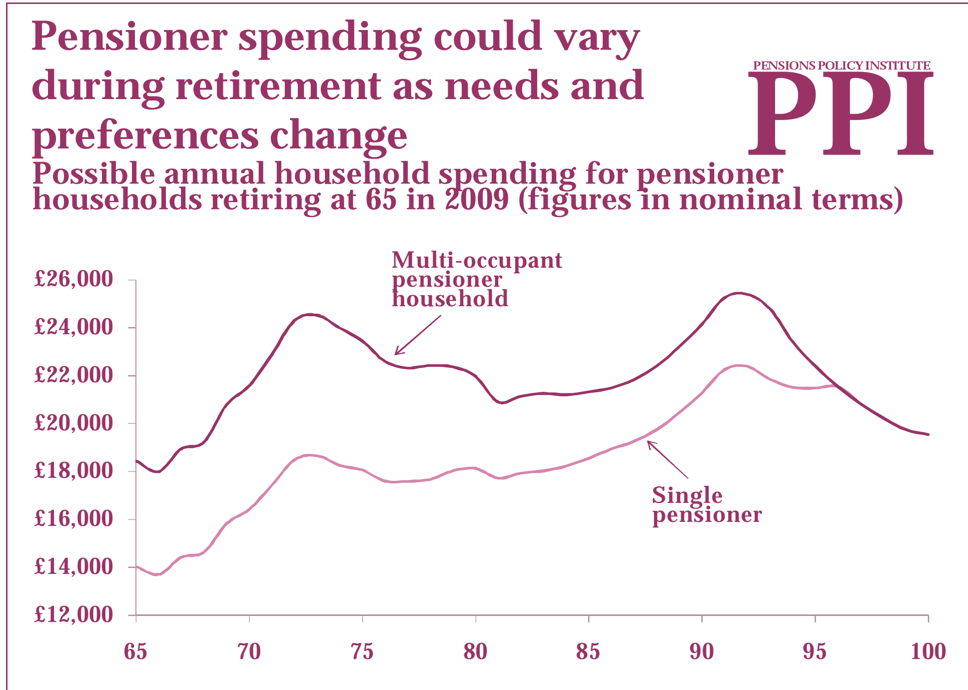
Minimum and basic income measures[2] provide calculations of how much income a pensioner might need to meet basic needs but exclude consideration of desired standards of living in retirement. Using a Minimum Income calculation, a single pensioner would require an income of £128.55pw (AHC)[3] in 2010, to achieve a minimally acceptable standard of living.[4]

Measures based on a replacement rate of working life income or on average consumption can give an indication of how much income pensioners might need in order to achieve desired standards of living in retirement. A median-earning man with a weekly income at the point of retirement of around £460pw[5] might need a gross weekly retirement income of around £320pw to meet a 70% replacement rate of working life income (and recreate working-life living standards).[6]

However, the levels of income needed by pensioners will generally vary during retirement as needs, expectations and spending preferences change (Chart 1).

[2] JRF (2010), www.minimumincomestandard.org, see also relative poverty line
[3] After Housing Costs – after rent/mortgage, water rates and council tax have been subtracted
[4] HMT (2010a) figure from JRF Minimum Income Standard
[5] 50th percentile, age-specific earnings, Labour Force Survey (2008)
[6] Pensions Commission (2004) and PPI calculations

Chart 1[7]



A typical pensioner might spend more on recreation and leisure in early retirement, decrease spending around age 75 as they become less mobile, increase spending once again around the age of 85 as a result of disability or health needs and then decrease spending in their 90s as mobility is reduced to a very minimal level.[8] Any individual pensioner's needs and expectations may be for lower spending than depicted in Chart 1 or for higher spending if, for instance, they acquire disabilities as they age.

Income sources vary between households

After State Pension Age (SPA), individuals are likely to meet their income needs from a variety of sources. State pensions are the most common source of retirement income; 95% of pensioners currently receive income from state pensions.[9] However 71% of pensioners also receive investment income, 68% and 59% receive income from private and occupational pensions respectively, 30% receive income from means-tested benefits, 23% receive income from disability benefits, 15% receive income from personal pensions, and 18% receive income from earnings.

[7] Life Trust, cebr (2008), data assumes 2.5% inflation (altered from original data which assumed 2.3%)
[8] PPI (2009a)
[9] DWP (2010a) tables 3.3, 3.4, 3.5, 3.6, 3.7, 3.8, 3.9, 3.10

Income from private pensions and other savings and assets can help individuals stay out of poverty in retirement

The Basic State Pension (BSP) and Pension Credit are calculated to provide a level of income together that would ideally allow individuals to afford to meet their basic minimum needs. In 2010, Guarantee Credit (the first element of Pension Credit) tops up a pensioner's state pension income to £132.60 per week (£202.40 per week for a couple).[10]

Individuals who receive income only from state pensions and/or state benefits in retirement may only be able to afford to meet their basic needs (though some individuals may forgo some 'necessary' expenditure in favour of discretionary spending). However individuals who only receive income from state pensions and/or state benefits may be unable to afford all 'necessary items' if, for example, they do not claim the means-tested benefit they are entitled to,[11] or if they have needs for higher than average spending because of needs arising from location, household structure or health problems.[12] Despite the provision of Pension Credit, 1.8 million pensioners (16% of total pensioners) currently live on incomes below the relative poverty line.[13]

Individuals who have additional income from private pensions and other assets and savings are less likely to be in poverty and may be able to afford higher levels of discretionary spending, though many will use at least some portion of their extra income for meeting basic needs as well (for example, food, housing, care).

Income from private pensions and other savings and assets can help individuals recreate working-life living standards

Pensioners who were on a high income during working life might use income from private pensions and other savings and assets to fill the gap between state pension income levels and a level of income which will allow them to recreate working life living standards.

The level of income that individuals will need from other savings and assets to achieve desired standards of living will depend on the level of income that the state provides. In countries with very high state provision, other savings and assets can be used for discretionary spending. In countries with low state provision, other savings and assets may be needed to prevent deprivation, poverty or reliance on means testing.[14] Income from state pensions in the UK gives individuals on

[10] Not all pensioners will necessarily receive the minimum amount of Pension Credit. Some pensioners may not claim Pension Credit even if they are entitled to it and some pensioners may not be eligible for full Pension Credit because of the value of their capital.
[11] Pension Credit is taken up by about two thirds of the individuals who are entitled to it, Age Concern (2008)
[12] PPI (2009a)
[13] Below 60% of median income AHC, DWP (2010b) table 6.3tr, 6.1tr
[14] Antolin (2008)

average a replacement rate of just over 30%.[15] The Pensions Commission suggested that benchmark replacement rates could range from 60% for high earners to 80% for low earners. Individuals in the UK may need to generate a substantial proportion of their working-life income in retirement from private pensions and other savings and assets in order to recreate working-life living standards.

There are 3 main methods of accessing income in retirement, each associated with different levels of risk and flexibility

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:[16]

- ***Securing a lifetime income*** – securing a guaranteed lifetime income, for example, through purchasing an annuity or from an Occupational Scheme pension paid directly through an employer sponsored pension scheme.
- ***Scheduled withdrawals*** – withdrawing income at set or varying levels (without a lifetime guarantee) often with the option to continue to potentially grow the capital fund, for example, through income drawdown, or through a flexible annuity.
- ***Withdrawing pension savings as a lump sum*** – withdrawing the entire pension savings as a lump sum to either spend or re-invest.

Each method of accessing private pension savings poses varying levels of risk to an individual's retirement income (Table 1). The main income-related risks that are associated with accessing private pension savings are:

- ***Longevity risk*** - the risk that individuals could run out of money before their death.
- ***Inflation risk*** – The risk that one's income may lose value relative to the price of goods and services.
- ***Investment risk (of capital loss)*** - the risk that market fluctuations or poor investment strategies will deplete a fund's capital.
- ***Risk of missing out on investment growth*** – the risk that a fund will be under-exposed to equities and miss out on investment growth, as a result of investment strategy.
- ***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 cross-subsidies contained in an annuity pool
- ***Risk of forgoing consumption*** - the risk that individuals might under-spend due to worries over running out of money.

[15] Antolin (2008), figure 1 – 30.8%
[16] Antolin (2008)

- ***Time-of-purchase risk***[17] – 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. This risk could also apply to income drawdown, if an income drawdown product is purchased at a time of poor market performance.
- ***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.
- ***Counterparty risk*** -The risk that the provider defaults on their promise to the individual due to the behaviour of a third party.[18]
- ***Insolvency risk*** – The risk that the provider of a pension fund (or pension income, through the form of an annuity or income from an Occupational Pension Scheme) becomes insolvent. People in this situation are generally eligible to receive some compensation from the Financial Services Compensation Scheme or the Pension Protection Fund.

The above list is not exhaustive. Accessing private pension savings can carry many other risks for individuals including:
- 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.

Nevertheless it should also be recognised that for many people the main retirement income related risk 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).

Not all risks are equally serious

Some risks are more serious than others. Risks related to losing some or all of the pension fund before death could result in an individual experiencing more financial hardship than risks which relate to missing out on growth, or inflation related increases.

Therefore, if an individual uses a method 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 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).

Using pension savings to secure an income, generally through a lifetime annuity or Defined Benefit (DB) pension, is the only method of accessing

[17] Antolin (2008)

[18] This could include occasions where the product offers a guarantee of income and the provider hedges the risks in the derivatives market and then their counterparty defaults

pension savings which protects individuals against both ***longevity risk*** and the ***investment risk of capital loss.***

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

Alongside protection from risk, individuals look for varying levels of flexibility 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, some individuals place a high value on having 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.

The level of flexibility associated with a particular method of accessing pension savings can be measured by examining the extent to which the method allows people control over:

- ***Level of withdrawal*** - choice in the amount of money withdrawn
- ***Growth*** - potential to grow the capital
- ***Bequest*** - potential to leave money as inheritance

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 (Table 1).

Table 1: 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)	***Risk of missing out on investment growth*** though some annuities are investment linked ***Time-of-purchase risk*** ***Irrevocable decision risk*** ***Inflation risk*** – unless annuity is index linked	***Longevity risk*** ***Investment risk (of capital loss)*** ***Mortality drag-*** if purchased in time ***Risk of forgoing consumption***	***Level of withdrawal:*** low flexibility – there will be a range of options at time of annuity purchase ***Growth:*** low flexibility - unless it is an investment linked annuity ***Bequest:*** low flexibility - guaranteed annuities provide some and joint life annuities can provide income to a dependent
Scheduled withdrawals (e.g., drawdown)	***Longevity risk*** ***Investment risk (of capital loss)*** ***Risk of forgoing consumption***	Partial protection from the following risks: ***Risk of missing out on investment growth*** ***Time-of-purchase risk*** ***Irrevocable decision risk*** ***Inflation risk***	***Level of withdrawal:*** medium flexibility– up to maximum withdrawal cap ***Growth:*** high flexibility - to potentially grow fund ***Bequest:*** medium flexibility - level of effective flexibility to leave as bequest dependent on tax treatment
Withdrawing pension savings as a lump sum	***longevity risk*** ***Risk of forgoing consumption*** The level of ***inflation risk, risk of capital loss and risk of missing out on investment growth*** will depend on whether lump sum is reinvested	Partial protection from the following risks: ***Risk of missing out on investment growth*** ***Time-of-purchase risk*** ***Irrevocable decision risk***	***Level of withdrawal:*** high flexibility ***Growth:*** high flexibility ***Bequest:*** high flexibility

The level of income that the state provides will affect the level of risk people face when accessing private pension savings

The level of working-life income people receive from state pensions varies from country to country. At the higher end, some state pensions provide, on average, working-life replacement rates of between 80% to 100% (Greece, Luxemburg, Netherlands, Spain, and Austria). While at the lower end, some countries replace, on average, less than 20% of working life income (Mexico, Iceland, and Australia).[19]

The level of working life income replaced by a country's state pension will have a direct impact on how people are affected by regulations on accessing retirement income. People in countries with low levels of state provision will be more dependent on income from private pensions and other savings and assets to help them achieve a satisfactory level of income in retirement, or remain out of poverty (and above thresholds for means-tested benefits if applicable).

In countries in which only a low level of working life income comes from the state on average, a high level of flexibility in accessing private pension savings may pose more risk for individuals than in countries where state pensions replace a substantial proportion of working life income.[20]

However there is no actual correlation between the level of restriction in accessing private pension savings and the level of replacement rate income provided by the state pension.[21]

[19] Antolin (2008), Figure 1
[20] Antolin (2008)
[21] Antolin (2008)

Box 1: free access to lump sums in the USA – a case study of the relationship between risk and flexibility

Historically, the majority of US pensioners who had saved for their retirement received their pension income directly from their employer through Defined Benefit (DB) pension schemes. However, there has been a recent decline in DB provision and an increase in DC provision (which is expected to grow rapidly with auto-enrolment into 401(k)s).[22] The US Government allows people to take their entire private pension savings as a lump sum and it is expected that many future US pensioners with private pension savings will be able to take a lump sum at retirement.

While free access to lump sums allows the highest levels of flexibility there are concerns amongst the US policy community that increases in longevity (and a shift from DB to Defined Contribution (DC)) could cause many pensioners to outlive their private pension savings in future, especially medium to high earning individuals who are less likely to meet their replacement rates through social security (the US state pension).[23] Researchers predict that up to half of people currently reaching or close to retirement are likely to run out of their private savings before their death.[24]

There is evidence that many individuals find the management of their lump sum stressful and that in some cases people conserve so much of their savings that they experience substantial drops in their standard of living. There is concern that some people may not have the resources to manage their retirement income effectively, and that financial advice and fund management may seem too expensive to many pensioners.

Key stakeholders have proposed a solution of auto-enrolling individuals into 2 year, fixed term annuities at the point of retirement and, after two years, giving individuals the option to continue with a lifetime annuity.[25] They hope this approach might help individuals to understand the value of annuities whilst allowing an opt-out for those who decide that annuities aren't right for them. Allowing individuals a trial annuity period may help overcome some of the behavioural and attitudinal barriers that prevent individuals from purchasing lifetime annuities.[26]

[22] DiCenzo, J (2007)
[23] Gale *et. al* (2009) (Chapter 6&7)
[24] VanDerhei, J. Copeland, C. (2010)
[25] Gale, Iwry, John, Walker in Gale *et. al* (2009) Chapter 6
[26] For example, evidence shows that many individuals in the USA feel that purchasing an annuity represents a 'loss' of the lump sum of their retirement savings. A period of annuitisation may change this perception and they may see the removal of their annuity payments as a 'loss' after the two year trial period.

Box 1: continued…

However, the US annuity market is not well developed, and US annuities are expensive.[27] Less than 2% of pensioners in the USA currently have an annuity.[28] Low exposure to annuities, coupled with their high price, has led many individuals in the USA to have both a poor understanding of and a negative attitude towards annuities.[29]

Conclusions

The US Government has allowed people the highest levels of flexibility in accessing pension savings; however they are finding that this isn't necessarily the best way to meet everyone's income needs in retirement.

Until June 2010, there was an effective requirement to use any remaining private pension savings to purchase an annuity by age 75

Until June 2010, UK regulations required individuals to use any private pension savings they had remaining at age 75 (after taking an optional 25% tax-free lump sum) to secure an income through either a lifetime annuity or an Alternatively Secured Pension (ASP). In practice, the limits on withdrawals from ASPs and the tax treatment of death benefits meant that, for many individuals with private pension savings, purchasing a lifetime annuity was the only viable option for accessing their private pension savings after age 75.

The Government set up the effective requirement to annuitise in order to ensure that individuals have an adequate income in retirement

The Government set the effective requirement to purchase an annuity by age 75 because they wanted individuals to use their private pension savings to provide a 'secure income in retirement' that would not be depleted and result in individuals relying on means-tested benefits. The Government has previously argued that they provide ***"tax relief on pensions in order that savings produce an income in retirement."***[30]

However there has been on-going debate regarding annuitisation and whether it is the best way for all people to utilise their wealth in retirement and whether other methods of accessing pension savings might be able to provide security as well as providing flexibility to individuals in regard to: potentially growing pension funds; the level of withdrawals; and, leaving some savings as bequest.

The Coalition Government has announced that from April 2011 they will remove the effective requirement to purchase an annuity by age 75 and will introduce alternative options which would allow people to access

[27] US Annuities are concentrated amongst individuals with medium to high incomes (and higher than average life expectancies). US annuity prices are generally higher as a result, as they have been calculated using the high average life expectancy of their membership pool.
[28] Gale *et. al* (2009)
[29] Gale *et. al* (2009)
[30] HMT (2006)

their retirement savings more flexibly.[31] This report explores the potential implications for individuals of the Governments new legislation.

Conclusions

There are three main methods by which individuals could theoretically access private pension saving in retirement. Each method of accessing private pension savings poses varying levels of 'income-related' risk for individuals. Some risks are more serious than others. Risks that relate to losing some or all of the pension fund (***investment risk of capital loss***), or relate to depleting the entire fund before death (***longevity risk***) could result in an individual experiencing more financial hardship than risks that relate to receiving a lower income in retirement or relate to missing out on growth, or protection from inflation.

Alongside protection from risk, individuals look for varying levels of flexibility from their pension savings. 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.

[31] HMT (2010a)

Chapter two: how do people currently access private pension savings?

This chapter explores current trends in how individuals with Defined Contribution (DC) pension savings access their private pension savings and what these might indicate about future behaviour.

There has historically been more flexibility allowed in accessing private pension savings before age 75

Up until June 2010, people were required to use their private pension savings to purchase either a lifetime annuity or an Alternatively Secured Pension (ASP) by the age of 75 after taking 25% of their savings as a tax-free lump sum. People with savings below a certain level (currently £18,000)[32] are allowed to trivially commute their entire pot and take it as a lump sum.[33]

However, there has always been a high level of flexibility allowed to people in accessing and being given the potential to grow pension funds before the age of 75. Up until the age of 75 people have had the option of doing one or a combination of things with their private DC pension savings. They could, at any time after the age of 55:[34]

1. Take 25% of their pension savings as a tax-free lump sum,
2. Leave their pension savings in their pension fund[35] and continue to receive tax relief on investment returns and any contributions,
3. Invest in an income drawdown arrangement,
4. Purchase a non-standard annuity, for example, a temporary annuity[36] or an annuity which varies with investment income,
5. Purchase a lifetime annuity.

An analysis of how people access their pension savings before age 75 could give us some indication of how people may access pension savings after age 75, when they are no longer required to purchase an annuity.

The majority of people take a tax free lump sum from their private pension savings

People are permitted to take 25% of their private pension savings (or up to 25% of their accumulated Defined Benefit (DB) fund) as a tax-free lump sum from the age of 55. In 2008 around three quarters of people took a 25% tax-free lump sum when they accessed their private or occupational pension savings. There is variation in how people use their tax-free lump sum in retirement. A YouGov survey conducted in 2008 suggested that

[32] The trivial commutation limit has been decoupled from the Lifetime Allowance since 2010 www.hm-treasury.gov.uk/d/restricting_pensions_summary141010.pdf
[33] 25% of the lump sum will be tax-free and the rest will be taxed at the individual's income tax rate
[34] Age 50 prior to April 2010
[35] With or without continuing to contribute
[36] Temporary annuities often include a guarantee that a lump sum will be paid out to designee if the annuitant dies before the end of the fixed period

around half of people who take their lump sum save at least a portion of it for future use and around a quarter invested at least a portion in stocks, shares or investment trusts. However, some people spend their lump sums to make home improvements, pay off debts, assist dependents or make large purchases (for example, a car or second home) (Table 2).

Table 2:[37] **use of tax-free lump sums in 2008**

People used some portion of their tax-free lump sum for the following:	
Put it in savings for the future	52%
Used it for home improvements	31%
Invested in stocks, shares or investment trusts	24%
Paid off all or some of the mortgage	22%
Went on holiday	18%
Paid off credit card/ unsecured loans	17%
Bought a new car	17%
Treated myself to things I'd always wanted	14%
Gave some money to my children	13%
Gave some money to other relatives/ dependents	4%
Bought a second home/ holiday home	2%
Paid school fees for children/ grand children	1%
Paid medical costs	1%

Currently, the majority of people take an annuity when they want to access their pension income

After people stop working, they may wish to immediately use their private pension savings to top up their income if they don't feel their existing income (from state pensions, occupational pensions and/or any other savings and assets) is high enough to provide them with an adequate standard of living.

For people with smaller pots, who need an immediate and secure income from their private pension savings, routes of accessing their savings other than a conventional annuity may not be an option. Alternative routes, such as using some or all of pension savings to purchase a flexible or temporary annuity or invest in income drawdown are not as secure as a conventional lifetime annuity and can be expensive as they tend to involve commission and on-going management fees.

- Drawdown products charge on average around 5% of the initial fund value in advice and management charges over the life of the contract

[37] YouGov plc. (2008) "Pension Funds" survey, sample size for lump sum data: 548, permission granted for use by YouGov. Republication of the statistics contained in this table requires direct permission from YouGov, and is not authorised by the PPI.

(which is higher than the equivalent charge for an annuity, typically 1–1.5%).[38] There is no regulatory restriction on the size of pot a person needs to purchase an income drawdown product and the suitability of drawdown may depend on a number of factors including other savings and income, and the ability to cope with the risk of loss. Many IFAs recommend a pension savings pot of between £100,000 and £250,000 (as well as access to other income and assets) are necessary to ensure people can bear the longevity risk and investment risk associated with drawdown.[39]

- In the future, the way income retirement products are priced will change as a result of the Retail Distribution Review (RDR). After the RDR proposals are implemented in 2013, providers giving regulated advice will no longer be allowed to receive commission on retirement income products and will instead need to develop clear structures of 'advisor charging'. The purpose of the RDR proposals is to ensure that there are no longer perverse incentives for providers and advisors to give biased advice and that all advisors are qualified to an accepted minimum level. It is not known yet whether the new policy will affect the costs of these products for consumers.

Almost all people with private pension savings currently purchase an annuity before the age of 75

Only around 1% of individuals with private pension savings above the commutation limit currently wait until the age of 75 to purchase an annuity (Table 3).[40] Around 70% of annuities purchased in 2009 were by people under the age of 65 and only 4% of annuities purchased were by people over the age of 70.

Table 3:[41] Pension annuities sold in 2009 by age of annuitant[42]

Age range	Percent of annuity purchases
54 and under[43]	17%
55 -59	17%
60-64	37%
65-69	25%
70-74	3%
75	1%

[38] HMT (2006)
[39] www.find.co.uk/my_find/for-ifas/ifa-research/ifa-guide-to-unsecured-pensions-vs-enh-ann, www.pensions-guide.co.uk/drawdown.shtml, www.telegraph.co.uk/finance/personalfinance/pensions/2727782/Income-drawdown-policies-raising-more-questions.html, www.sharingpensions.co.uk/income_drawdown.htm
[40] ABI 2009 data & HMT (2006)
[41] ABI 2009 data
[42] May include some annuities which are not lifetime annuities for example, flexible annuities
[43] In 2010, the age individuals are allowed to access private pension savings raised from 50 to 55 – some of the recent annuity purchases by people aged 50 to 54 may have been motivated by a desire to annuitise before the age was raised to 55

The vast majority of people purchase an annuity with some portion of their private pension savings before they are required to, at age 75. One inference that could be taken from this is that most people would annuitise even if they were not required to. However there may be factors currently influencing people's behaviour, which may no longer apply after the requirement to purchase an annuity is removed and after other pension reforms, such as auto-enrolment have been put in place.

Around 95% of annuity purchases are under £100,000

The vast majority of annuities are purchased with relatively small pension pots. Around 95% of annuities purchased over the last decade were purchased with pension pots of £100,000 or less, and around 80% were purchased with £30,000 or less (Table 4). People with pension pots of under £100,000 are unlikely to be able to bear the longevity and investment risks associated with investing some portion of their pension savings in income drawdown, or use some or all of their savings to purchase a flexible or temporary annuity unless they have other significant sources of pension income. For the majority of people, purchasing a lifetime annuity has been the safest and most appropriate way to access their private pension savings when they need to convert it into an income.

Table 4:[44] Average percentage of annuities purchased, by size of annuity purchase, between 2001 and 2009[45]

Size of annuity purchase	Average percentage of annuities purchased between 2001 and 2009
Less than £5,000	28%
£5,000 - £9,999	17%
£10,000 - £19,999	22%
£20,000 - £29,999	12%
£30,000 - £39,999	7%
£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%

[44] ABI stats, cash figures by year

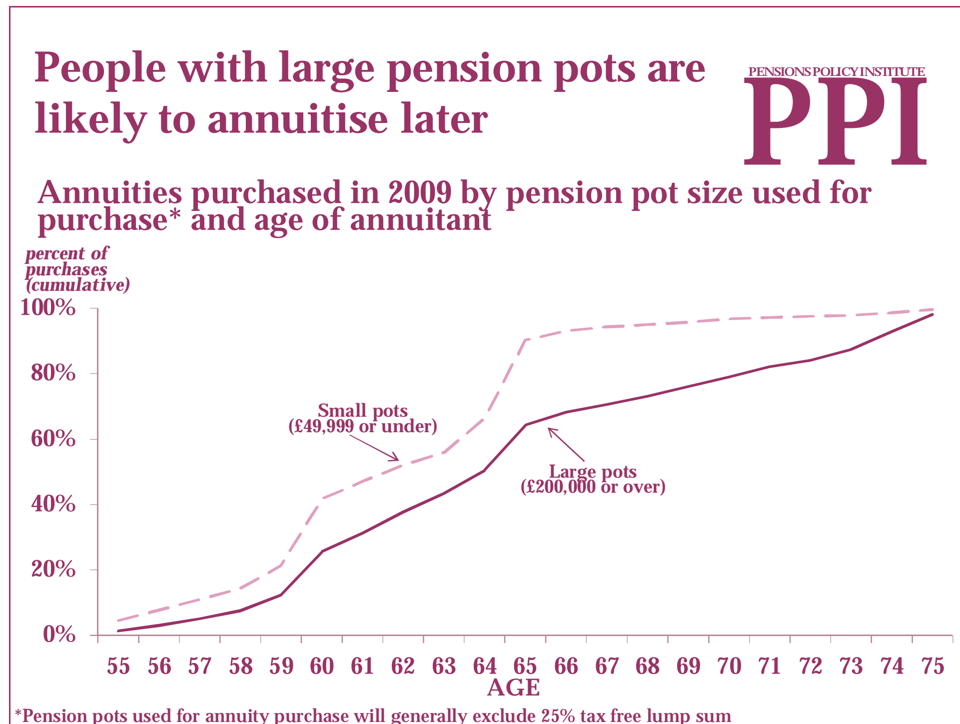
[45] Includes annuity purchases from original pension fund provider and annuity purchases on the open market

People with large pots are likely to annuitise later

People with large pension pots (e.g., over £200,000) are more likely than those with small pots to wait until later ages to purchase an annuity with some or all of their private pension savings (Chart 2). This could be because people with larger pots are also more likely to have other savings and assets, or earnings, to rely on in early retirement, or because people with larger funds might feel more motivated to attempt to continue to grow some or all their fund through a drawdown product before buying an annuity.

People with smaller pots (e.g., under £50,000) often purchase an annuity earlier than those with larger pots. People with smaller pots may purchase an annuity with all of their private pension savings earlier, because they need access to an income and expensive products such as drawdown may not be appropriate for them.

Chart 2[46]



The security of lifetime annuities may be one of the motivations behind their purchase

Compulsion and a need to access income may not be the only motivations behind the purchases of lifetime annuities. Many people value a 'regular' and 'guaranteed' income in retirement.[47] Lifetime annuities guarantee to pay a fixed or escalating income at an agreed level for the rest of an individual's life, even if the individual lives for longer than expected, or if underlying investments held by the annuity provider suffer losses. The

[46] ABI stats, pension annuities sold by size of fund & age of annuitant, 2009 Q1 – Q4
[47] ABI (2005)

guarantees and security provided by annuities protect individuals against both longevity risk and the investment risk of capital loss, and may provide the motivation behind a proportion of annuity purchases.

Annuities score well on 'Money's Worth Ratios'

The value of annuities can be measured by their 'Money's Worth Ratio'. The Money's Worth Ratio (MWR) can be defined as 'the percentage of initial annuity purchase price that people receive back from their annuity before their death (gross of tax).'

For example, if an individual purchases an annuity with £10,000 and receives £10,000 from his annuity in income during his retirement, before paying any income tax, then his MWR would be 100%.

Between 1994 and 2007, annuities for men averaged a MWR of around 90%.[48] 90% is considered a 'good MWR' for pension annuities, because MWR assumptions take account of calculations of 'reasonable' administrative charges and 'normal profit' for providers. However, the MWR of annuities has reduced over the last decade or so, due to increases in the average life expectancy of annuitants.[49] In 2002 the average MWR was around 94% and 92% for men and women respectively. In 2007, the average MWR was around 88% and 86% for men and women respectively.[50]

It could be argued that anything short of a 100% return on one's initial purchase price is not 'value for money'. However, lifetime annuities provide life-long security and protection from loss alongside an income. People who live for longer than expected may receive more than 100% of their initial purchase price back during their retirement. Therefore, when people purchase annuities, they are really buying insurance against living longer than expected.

It should not be assumed that a Money's Worth Ratio of below a pre-determined percentage is necessarily bad value for money. The value of an annuity lies not just in the return it provides but in the security of having insurance against a longer life.

People value the security of annuities but do not like the inflexibility

While the security of annuities is valued by some individuals, many people feel they should be allowed to do what they like with their own pension savings and object to being compelled to buy an annuity with all of their pension savings.[51] For some people, annuities are objectionable because they do not allow specific flexibilities:

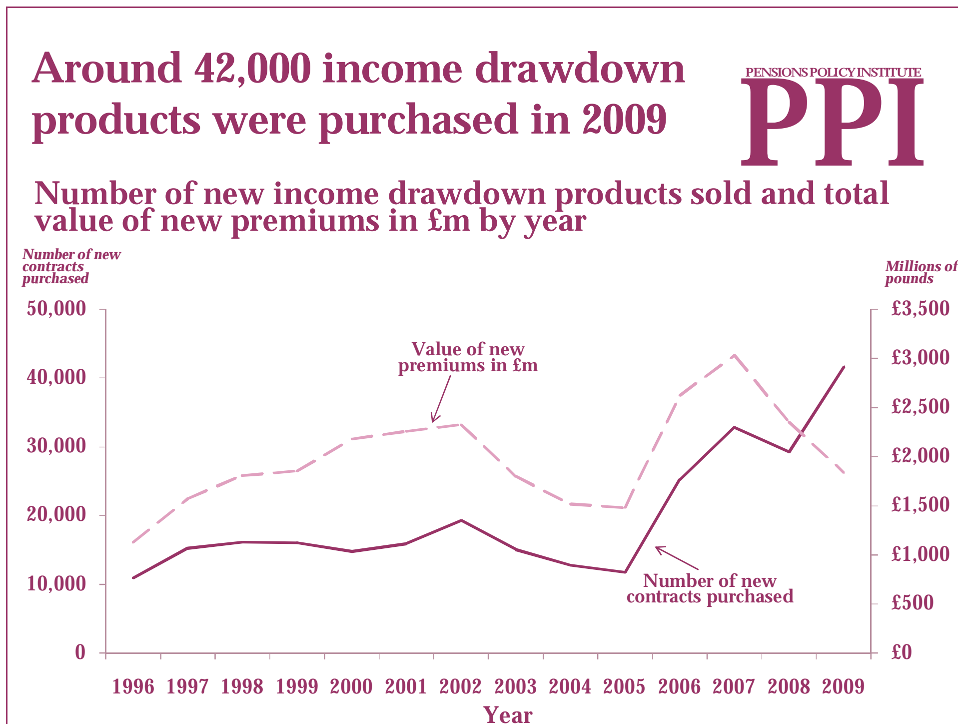
[48] Cannon, Tonks, (2009)
[49] Developments in the enhanced annuity market have led to more people with short life expectancies leaving standard annuity pools and purchasing enhanced annuities. This has lea to acceleration in the increase of life expectancy in standard annuity pools.
[50] Cannon, Tonks, (2009)
[51] ABI (2005)

- People who wish to leave some of their savings as inheritance might object to the structure of annuities, which do not allow people who die after the age of 75 to leave any unspent portion of their pension savings as inheritance, except for their 25% lump sum.
- People who desire more flexibility in accessing their income in retirement might feel that annuity income streams are too inflexible to meet changing income needs during retirement, or might object to the limited opportunities to potentially grow their fund available in most lifetime annuities.

A minority of people purchase income drawdown products

In 2009, income drawdown accounted for 8%[52] of retirement income product[53] purchases. The total number of drawdown contracts purchased has grown from around 11,000 purchases in 1996 to around 42,000 purchases in 2009. However, the proportion of retirement income products bought as drawdown has remained fairly steady since the inception of drawdown in 1996 when they accounted for 7% of retirement income products purchased. This is because purchases of annuities have risen at a similar rate to drawdown purchases. In 1996 around 147,000 annuities were purchased and in 2009 around 462,000[54] annuities were purchased (Chart 3).

Chart 3[55]



[52] ABI stats – Retirement Income Products – 1994 to present
[53] Annuity and drawdown products, excluding equity release products
[54] All figures sourced from ABI stats – Retirement Income Products – 1994 to present
[55] ABI stats, income drawdown products sold by year and value of new premiums, 1996 - 2009

People could use existing annuity products in a more flexible way

There is flexibility within existing annuity provision:

- People can purchase annuities with income that escalates in line with prices or by a fixed percentage. Escalating annuities allow people to protect themselves against ***inflation risk***, which can be especially important in times of high inflation or if people live for a very long time after purchasing their annuities. Only around 3% of annuitants currently purchase escalating or Retail Price Index (RPI)-linked annuities.[56] Part of the reason for the low numbers purchasing escalating annuities is that escalating annuities pay out lower rates in the early years than a level annuity.
- Investment linked annuities allow people to continue to invest and potentially grow their initial capital, until the age of 90, although these annuities contain more risk than conventional, lifetime annuities. Around 6% of current annuitants purchase investment linked annuities.[57]
- People with illnesses, disabilities or lifestyle characteristics (for example, smoking or obesity) that are life-limiting may be eligible to purchase an enhanced annuity. Enhanced annuities pay income at a higher rate than standard lifetime annuities on the assumption that the annuitant will live for less than average life expectancy. According to industry data, around 51% of current retirees might be eligible for an enhanced annuity, however only around 10% of eligible annuitants purchased an enhanced/impaired annuity in 2010.[58]
- Annuitants with dependents can ensure that their dependent continues to receive an income after the annuitant's death by purchasing a joint life annuity; however joint life annuities pay out a lower rate in return for the guarantee. Around half of people for whom a joint life annuity was an option, purchased one in 2010.[59]

Using the Open Market Option could improve annuity rates

People are not required to purchase an annuity from the pension provider that holds their pension fund, and can shop around for the provider who offers the best rates for a household's particular needs.[60] The facility to purchase an annuity from an alternative provider is known as the Open Market Option (OMO). Rates for the same annuity products vary widely between providers at any given time and in some cases people could improve their annuity rate by up to 30% by purchasing an annuity from a different provider.[61] In 2010 around 70% of annuitants shopped around and around a third of annuitants actually purchased annuities from other

[56] ABI (2010b)
[57] ABI (2010b)
[58] ABI (2010b)
[59] ABI (2010b)
[60] The FSA provides an annuity rate comparison tool - www.moneymadeclear.fsa.gov.uk
[61] HMT (2006)

providers.[62] Many people are disadvantaged by not taking up the OMO, and the Treasury is currently looking at ways to improve uptake.[63]

In many cases people could improve their retirement incomes, or better meet their income needs by searching for the best annuity for their needs. While people could purchase annuities that protect against inflation, pay increased amounts for ill health, or provide investment returns, the vast majority of annuitants (85%) purchase level annuities.[64]

Level annuities provide the same fixed amount of income each year. They do not offer individuals any protection from the risk of inflation, which results in the value of the annuity income eroding over time. However, for many people, level annuities might be the best way of accessing their private pension savings, especially for those with very small private pension savings pots or those likely to have shorter lives. An individual might need to live until age 89 in order to receive the same total amount of income from his escalating annuity (3%) as he would have received from a level annuity.[65] A different rate of inflation would change the value that an escalating annuity provides to an individual.

Inflation will affect the value of annuity income

The vast majority of annuity income is taken on a level basis. However, a significant increase in inflation could erode the real value of annuity income during retirement. Given that most annuity income is currently taken in the form of a level income the modelling in this paper is based on people taking a level annuity or equivalent however this income would be at significant inflation risk.

People could use a combination of drawdown and annuities to help meet income needs

For some individuals it might be appropriate to have some portion of their savings in drawdown and use some portion to purchase an annuity. Some individuals may be able to increase their consumption levels, while incurring less risk of running out of money, if they invest the majority of their savings into drawdown at the beginning of retirement and switch savings over into annuities progressively during their retirement.[66]

[62] ABI (2010b)
[63] HMT (2010b)
[64] ABI (2010b)
[65] Scottish Widows figure, based on FSA annuity tables 23 February 2010
[66] Maurer, R. Somova, B. (2009)

Conclusions

An analysis of how people access their pension savings before age 75 may give us some indication of how people may access pension savings after age 75, when they are no longer required to purchase an annuity.

- The vast majority of people annuitise before they are required to and around 70% of annuities that were purchased in 2009 were by people under the age of 65.
- Around 8% of retirement income product purchases each year are of income drawdown products.
- People with smaller pots (e.g., under £50,000) often annuitise earlier than those with larger pots, possibly because they need access to their private pension savings and expensive products such as drawdown and flexible annuities may not be appropriate for them.
- People with pension pots of under £100,000 are unlikely to be able to bear the longevity and investment risks associated with investing in income drawdown, or purchasing a flexible or temporary annuity. Therefore, for the majority of people, purchasing a lifetime annuity has historically been the safest and most appropriate way to access their private pension savings when they need to convert it into an income.
- Compulsion and a need to access income may not be the only motivations behind the purchases of lifetime annuities. The guarantees and security provided by annuities protect individuals against both longevity risk and the investment risk of capital loss, and may provide the motivation behind a proportion of annuity purchases.
- People could improve their annuity rate by shopping around for the best rate on the open market. Using different types of annuities, such as fixed term annuities, flexible annuities or enhanced annuities could help some people to better meet their needs. However, for some people with private pension savings, a lifetime annuity will still provide the best way to meet income needs in retirement.

Chapter three: what are the implications of removing the requirement to annuitise?

This chapter explores the potential impact of removing the requirement to annuitise by age 75, and the proportion of pensioners that might be able to access their private pension savings more flexibly today and in the future by using Capped or Flexible Drawdown.

The Government has changed the rules regarding access to private pension savings

From April 2011 the Coalition Government is removing the effective requirement to purchase an annuity by age 75, though those reaching age 75 from 22 June 2010 have been allowed to delay annuitising until new regulations are put in place. From April 2011 people will still be able to purchase an annuity at any point from age 55; however the new regulations will also allow people to:

- Invest their pension savings in an income drawdown arrangement with no upper age limit and with a withdrawal cap of 100% of what they would have received from an equivalent annuity. The Government is calling this approach *'Capped Drawdown'.*
- Withdraw unlimited amounts from their pension savings, provided that they can demonstrate that they have a secure income already in payment, guaranteed for life of £20,000 per year in 2011. The Government is calling this approach *'Flexible Drawdown'*.

All income withdrawn from Capped and Flexible Drawdown will be taxed at an individual's marginal tax rate. A recovery tax charge of 55% will be levied on funds left as a bequest from Capped or Flexible Drawdown accounts.

It is possible that removing the effective requirement to annuitise may see a move away from annuitisation

Whether people with private Defined Contribution (DC) pension savings will continue to annuitise when it is no longer required will depend on several factors:

- individuals' attitudes and financial behaviour,
- market changes, product development and availability,
- advice and information.

The perception that annuities are poor value for money may prevent some individuals from annuitising, if it is no longer compulsory

The perception held by some people that annuities do not provide value for money, (and that insurance companies are unfairly profiting from people's savings)[67] could lead some people to choose not to buy an annuity in future.

[67]Orszag (2000)

In some cases, the negative perception people have of annuities is a result of a lack of understanding about how annuities work. Many people are not aware that annuities are priced on a pooled basis, and that annuitants are in fact subsidising each other. Therefore, people may believe that if they die before receiving back the value of their annuity purchase price then the insurance company is making a profit, rather than using the excess capital gained from annuitants who die sooner to fund the annuities of those who live for longer than expected.

There are also behavioural characteristics that can motivate people not to purchase an annuity even when it might be the most appropriate option for them, for example, loss aversion and hyperbolic discounting.[68]

The inflexibility of annuities may motivate people not to purchase them if they are no longer compulsory

People who value flexibility more than they value protection against longevity and investment risks might also be motivated to avoid buying an annuity once they are no longer compulsory. However, the proportion of people who would stop purchasing annuities under a new system would depend on how the new system impacted the type and availability of retirement income products on the market.

Product development could affect the choices people make under a new system

People who reach retirement with private pension savings, and don't have enough savings to meet the Minimum Income Requirement (MIR), will be able to choose between purchasing an annuity, entering Capped Drawdown, or a combination of the two approaches. Whether or not people choose to put all of their money into Capped Drawdown rather than purchasing an annuity with some or all of their savings will depend on the availability of appropriate products and whether IFAs or advisors are willing to sell or recommend particular products. Many IFAs currently suggest that pension savings pots of between £100,000 and £250,000, and access to other income and assets, may be necessary for individuals to afford to bear the longevity and investment risks associated with income drawdown. It will be essential that people who take out Capped Drawdown receive advice as to whether it is appropriate for their particular circumstances; therefore it will be important that income drawdown remains an advised product.

However, it is possible that, as a result of the removal of the requirement to annuitise, more people will start to view drawdown as an alternative to, or as a product to use in combination with, annuities and therefore the market for drawdown products could grow. Product providers may respond to the changes in legislation by designing a wider variety of drawdown products, possibly some aimed at people with smaller pots

[68] For a list of behavioural characteristics and their definitions see Elliot *et. al.* (2010)

(for example, group managed drawdown products which would reduce management fees for individuals).

The behaviour of product providers will play a role in determining individual outcomes from the new legislation

It is possible that the negative perception some people have of annuities[69] combined with the removal of compulsion, could lead some individuals to want to invest some or all of their pension savings into Capped Drawdown when using their pension savings to purchase a lifetime annuity would have been a safer and more appropriate option for them. If providers are willing to offer drawdown products to people who may not be able to bear the associated risks, then this could result in a larger proportion of people with small pots entering Capped Drawdown in future. It will be essential that standards of ethical behaviour and accountability are maintained across the product market in order to prevent people from taking on unsuitable levels of risk.

Annuity rates could be affected by the changes

The new policies may affect the annuity rates that providers offer, though it is not yet clear whether the new policies are likely to cause annuity rates to rise or fall. The new policies could create competing influences on annuity rates:

- If the removal of the requirement to annuitise causes many of those with large pots to leave the annuity market and enter Capped Drawdown, there may be effects on the rates offered by annuity providers. It is possible that if people with large pots, who are likely to be higher earners and have higher than average life expectancies, leave annuity pools then there will be a reduction of the average life expectancies of those in annuity pools. This could result in an improvement in the annuity rates on offer, if the annuities are priced correctly.
- However, if many high earners leave annuity pools this could result in less competition amongst annuity providers to provide optimal rates and could cause rates to fall.
- A reduction in higher income individuals purchasing annuities could also cause the costs of purchasing an annuity to rise. If many of those with larger pots leave annuity pools and annuity providers find they are dealing increasingly with large amounts of small pots, they might not be able to keep administrative costs from rising, as the average fee they can charge for each product (expressed as a percentage of purchase price) will have lowered.

[69]Orszag (2000)

Providers of advice and information will play a crucial role in determining how people behave under a new system
The Government's new legislation will mean that some people reaching retirement will have to choose to use one or a combination of the following options to access their pension savings: purchasing an annuity, entering Capped Drawdown (which can be used in combination with annuities) or securing a minimum income and withdrawing the rest of their savings flexibly. Advisors and providers of information will need to be able to provide clear advice and information to people about which option might be most appropriate for their circumstances. In some cases, a combination of the options may be most appropriate, for example, using Capped Drawdown and then purchasing an annuity in later life.

Providers of advice and information may need to work to ensure that the negative perception of annuities is not a barrier to their purchase
Even if individuals receive appropriate advice and information, the negative perception of annuities could lead some individuals to choose to enter Capped Drawdown 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 death 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.

There may be negative consequences for people who choose not to annuitise in future
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 delays purchasing a lifetime annuity, the more they miss out on the mortality cross-subsidies they would have received from a lifetime annuity. This is known as ***mortality drag.*** 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%[70] in investment growth (per year) from their fund to make up for the lost cross-subsidy they would have received had they bought an annuity at SPA.[71] The 6.5% does not include investment management charges which would need to be paid separately.

[70] Nominal figure, does not include inflation
[71] www.williamburrows.com/dd/mortalitydrag.aspx

The effect is compounded by the fact that average life expectancy increases with age, e.g. a 70 year old purchasing an annuity will ***not*** automatically be expected to have five years less to live than a 65 year old purchasing an annuity in the same year. The 70 year old will have a higher average life expectancy than the 65 year old (for example, a 70 year old in 2010 is expected to live until age 87, and a 65 year old in 2010 is expected to live until age 86).[72] 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 their life expectancy.

There are potential risks and issues for advisors and product providers

Providers of products and advice often act as the only bridge between people and the products they use to access their pension savings. A significant burden of responsibility will lie with providers to ensure that:

- products are sold to people with the appropriate characteristics,
- negative associations some people have with annuities do not prevent people for whom annuities will be the best option from choosing them,
- the introduction of Capped Drawdown does not open the door to the selling of drawdown products to people who cannot bear the underlying risks.

The product and advice industry are having to cope with several major legislative changes and a new compliance regime (RDR)

However, the product and advice industry is currently undergoing significant changes in order to cope with several major legislative changes including: implementation of the Retail Distribution Review (RDR) requirements, changes to the way tax relief is granted to pension savings, changes connected with auto-enrolment (and the requirements for qualifying pension schemes), and the introduction of Capped and Flexible Drawdown as of April 2011. The need to cope with all of these changes and complying with the RDR has already caused some representative bodies to argue that industry is overburdened and that coping with all of the current changes and future reforms has been expensive and time-consuming.[73]

The Government can play an important role in ensuring good outcomes for individuals and helping them make decisions

It will be very important that the Government works closely with industry and consumer groups to find the best way to support industry in ensuring that they can continue to provide a good service to individuals. There is scope for the Government to assist industry by ensuring that all people saving for and approaching retirement are

[72] GAD life expectancy tables 2008 – based on principal projections
[73] ABI (2010a)

given accessible and relevant information to enable them to make the best choices for their individual needs.

For the vast majority of people, annuitising is likely to remain the safest and most appropriate option for accessing private DC pension savings

In 2010 the vast majority of people age 55 and over would not have had enough private pension savings to be able to afford the longevity and investment risks associated with Capped Drawdown and would not have been able to meet the MIR. For the majority of people, purchasing an annuity will still be the safest and most appropriate way of accessing their private DC pension savings.

The next section explores the numbers and proportions of people aged between 55 and 75 who might be able to make use of the new methods of flexible access to pension savings.

Box 2: Analysis of ELSA[74] data to estimate current entitlement

The following estimates use data on the income and savings of people aged between 55 and 75 to estimate who in this age group might be able to use Capped or Flexible Drawdown. It is unlikely that many people over the age of 75 in 2010 would be able to use Capped or Flexible Drawdown as they would have been required to annuitise their private DC pension pot by age 75.[75]

The estimates are based on an analysis of the income and savings of people aged between 55 and 75 in 2006, rebased to make an estimation of the income and savings of people aged between 55 and 75 in 2010.[76] In 2010 there were around 13 million people aged between 55 and 75 in the UK.

To consider how many people could use Capped Drawdown, the analysis uses data on the amount of DC pension savings people have that has not yet been converted into an income (uncrystallised DC savings), including those already in income drawdown accounts. There were around 2.7 million people aged between 55 and 75 in 2010 with uncrystallised DC savings.

To consider how many people may have income above the MIR level, and how many people may be able to meet the MIR and flexibly drawdown savings, the analysis considers income from state pensions, Defined Benefit (DB) pensions and annuities, and also takes into account any uncrystallised DC savings.

Some people with DC savings may be in a trust-based Occupational Pension Scheme. These people would need to transfer out of their scheme into a contract-based DC savings scheme if they wanted to access their pension savings through an individual annuity purchase or through Capped or Flexible Drawdown.

How many people may be able to make use of Capped Drawdown?

From April 2011, people will be permitted, from age 55, to remain in income drawdown, 'Capped Drawdown,' with no upper age limit. The Government has placed a cap on the amount of income that people can withdraw, at 100% of an equivalent annuity. The cap is intended to protect people from depleting their funds too quickly, alongside other safeguards such as mandatory investment reviews to be held every 3 years for those under age 75 and yearly for those over age 75.

[74] PPI analysis of Wave 3 English Longitudinal Study of Ageing (ELSA) data, 2006, see appendix for further discussion of analysis

[75] Excluding a small minority who used their pension pot to purchase an ASP

[76] 2006 income levels which have been uprated to 2010 price levels

Box 3: Who might be able to use Capped Drawdown?

There is no regulatory restriction on the size of pot a person needs to purchase an income drawdown product, however many IFAs recommend a pension savings pot of between £100,000 and £250,000 (as well as access to other income and assets) are necessary to ensure people can bear the investment risk and longevity risk associated with drawdown.

In reality the size of pension savings pot an individual has is only one factor that determines whether or not income drawdown might be appropriate for them. Other factors include: individual appetites for risk, availability of other income and assets (e.g., state and DB pension income), age, household structure, and health.

The following analysis uses £100,000 as a benchmark pot size in order to make estimates regarding the likely proportion of people who might be able to access a Capped Drawdown account, however this does not provide a definitive projection of everyone who could use Capped Drawdown. In reality some people with pots of over £100,000 might not be appropriate for Capped Drawdown and some people with pots under £100,000 may be appropriate.

Around 600,000 to 700,000 people aged between 55 and 75 in 2010 could have enough private DC pension savings to use Capped Drawdown

Estimates of how many people might have an income drawdown contract vary. They range from estimates regarding the number of people with contracts to estimates of the number of actual contracts in force. The most recent available data indicates that there may be between around 200,000[77] to 250,000[78] people in an income drawdown arrangement (2009 & 2010 figures). The 200,000 to 250,000 estimate includes some people between the ages of 50 and 54 as, prior to April 2010, people could access their private pension savings from the age of 50. After April 2010 people were no longer allowed to access private pension savings before age 55 and therefore people must now be aged 55 or older to open an income drawdown account.

Everyone who has an income drawdown contract will automatically have their arrangements converted to Capped Drawdown arrangements after April 2011.

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 of ELSA,

[77] HMT (2010c), estimate of current people in drawdown

[78] ABI stats on current number of drawdown contracts in force. Some people may have more than one contract in force.

around 600,000 to 700,000[79] people aged between 55 and 75 in 2010 could potentially make use of Capped Drawdown (Chart 4). This includes those already in income drawdown arrangements as well as those individuals who have more than £100,000 in uncrystallised DC pension savings (DC pension savings which have not yet been used to purchase an annuity). This represents around 5% of total people aged between 55 and 75 in 2010 and around 22% to 26% of people aged between 55 and 75 with uncrystallised DC pension savings (Chart 5).

It is not necessarily the case that all people with pots of £100,000 or above are appropriate candidates for drawdown. Some IFAs recommend that a pot of at least £250,000 is necessary to ensure people can afford the high charges in drawdown and bear the market risks.[80] People might find the risks of drawdown easier to bear if they have high levels of other income and assets as well as their DC pension savings.

How many people may be able to secure the Minimum Income Requirement?

The Government is legislating to allow people over age 55 to flexibly access their private pension savings, provided they have a secure source of lifetime income (the Minimum Income requirement, MIR) at a level high enough to prevent them from 'falling back on the state' through means-tested benefits. The Government has set the MIR at £20,000 per year in 2011, and intends to periodically review this amount. The Government intends to allow both level and escalating income to be used to meet the MIR, as long as it is secure. The Government will allow any pension income, including income from annuities, state pensions and occupational pensions, to be used to meet the MIR on condition it is currently in payment and guaranteed for life.

Around 700,000 to 1 million people might be able to meet an MIR of £20,000pa

Around 700,000 to 1m people between age 55 and 75 in 2010 could have enough pension income in payment to meet an MIR of £20,000pa (Chart 4), from:

- **State pensions,**
- **DB pensions,**
- **Existing annuities, or**
- **DC savings which could be annuitised.**

[79] PPI analysis of Wave 3 ELSA data, HMT (2010c), ABI statistics. The range is given due to uncertainty in the current numbers of people in income drawdown arrangements and to allow for the growth in the number of drawdown arrangements between 2006 when the ELSA data was collected, and 2010. Data may include some people age between 51 and 54. See appendix for further information

[80] www.find.co.uk/my_find/for-ifas/ifa-research/ifa-guide-to-unsecured-pensions-vs-enh-ann, www.pensions-guide.co.uk/drawdown.shtml, www.telegraph.co.uk/finance/personalfinance/pensions/2727782/Income-drawdown-policies-raising-more-questions.html, www.sharingpensions.co.uk/income_drawdown.htm

This represents around 5% to 8% of people between age 55 and 75 in 2010. The range represents uncertainty in the underlying data. Information is available on the level of private pension currently in payment per benefit unit, rather than for individuals. The bottom end of the range assumes private pension income is split equally between couples. The top end of the range assumes that the head of the household receives all of the private pension income.

The majority of the people who could meet the MIR receive a proportion of their secure income from state pensions. Around 200,000 to 400,000 of the people who could satisfy the MIR in 2010 are under State Pension Age (SPA).

State pension income could make up a significant proportion of the income people use to meet the MIR. In 2010, people with full Basic State Pension (BSP) and the maximum State Second Pension (S2P) entitlement could receive around £260pw from state pensions, which is equivalent to an annual income of £13,520.

Only around 200,000, of the 700,000 to 1 million people who could meet the MIR, have sufficient pension income and DC pension savings to meet the MIR and have some DC savings left over to access flexibly

People who have met the MIR will be permitted to flexibly drawdown from any remaining private DC pension savings they have. They will not be able to flexibly access any state or DB pension savings they may have once their DB pension is already in payment. The majority of the people who could meet the MIR in 2010 only have state and DB pension entitlement and no or very little DC savings and may not be able to take advantage of 'Flexible Drawdown'.

People who are accruing DB pension entitlement might still be able to take advantage of Flexible Drawdown if they transfer out of their DB fund and move their accrued entitlement into a DC pension saving fund. However, this would expose them to the risks associated with DC savings such as investment risks and the risk that annuity rates are poor at the point of retirement. Individuals who are already in receipt of their DB pension no longer have the option to transfer out of their scheme.

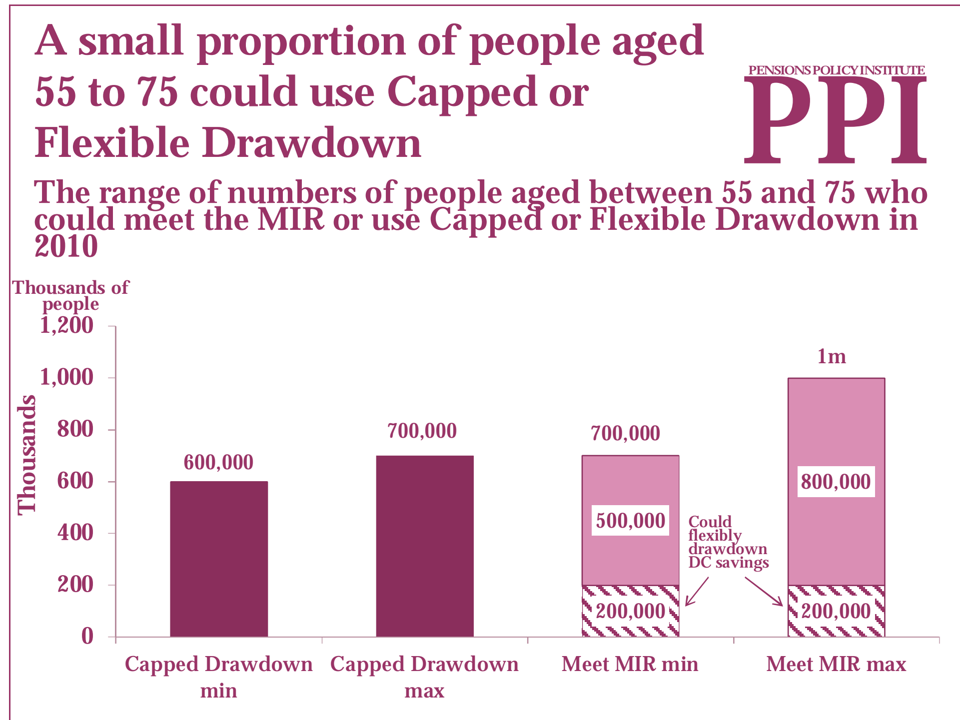
Around 200,000, of the 700,000 to 1 million people who could meet the MIR, have sufficient pension income and DC pension savings to meet the MIR and have some DC savings left over to access flexibly (Chart 4). This is around 2% of people between age 55 and 75 in 2010 and around 7% of people between age 55 and 75 in 2010 with uncrystallised DC pension savings (Chart 5).

Around 100,000 of these people are likely to have at least £50,000 left over in their DC pension savings to access flexibly after meeting the MIR.

Government estimates are that around 50,000 people currently in income drawdown could meet the MIR and withdraw some of their remaining DC pension savings flexibly. This is lower than the PPI estimate, which also includes people not currently in income drawdown arrangements. Government estimates that every year a further 12,000 people might be able to meet the MIR and flexibly drawdown savings.[81]

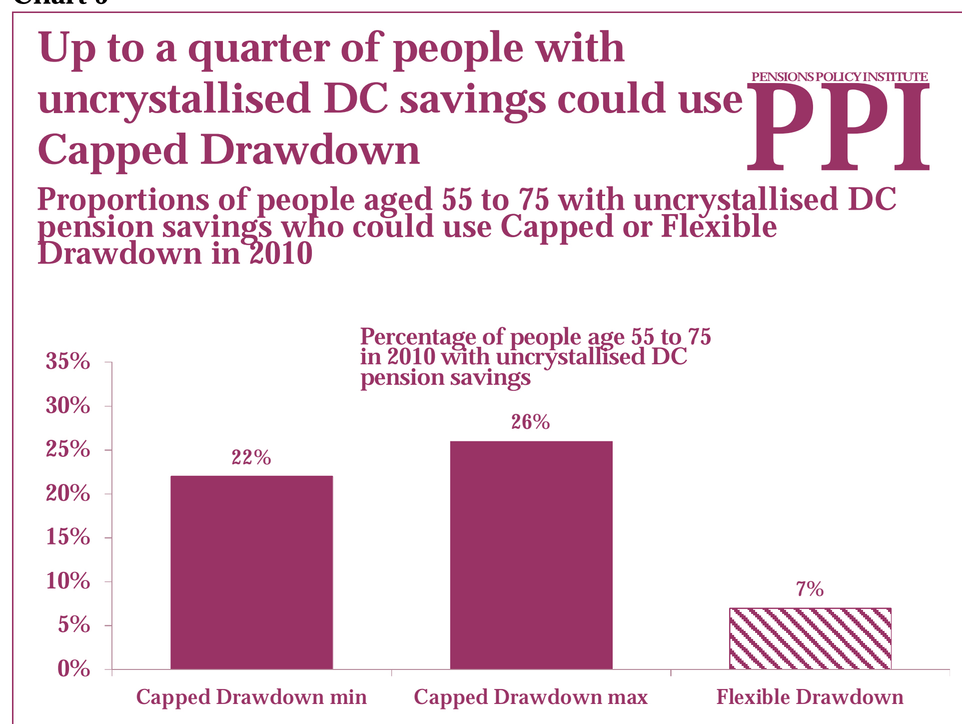
The choices people make about whether to use Capped or Flexible Drawdown will depend on several factors, including people's other income and assets, their anticipated income needs in retirement, and their appetite for risk. Some of the people who could use Capped or Flexible Drawdown may still decide to annuitise some or all of their DC savings. Some individuals may choose to enter Capped Drawdown for some of their retirement and then use some of their savings to secure an income and meet the MIR later on in retirement.

Chart 4[82]



[81] HMT (2010c) estimates based on FSA data
[82] PPI analysis of Wave 3 ELSA data, HMT (2010c), ABI statistics

Chart 5[83]



[83] PPI analysis of Wave 3 ELSA data, HMT (2010c), ABI statistics

How many people may be able to make use of Capped or Flexible Drawdown over the next few years?
The following analysis explores who might be able to make use of Capped Drawdown, or meet the MIR over the next few years.

Box 4: Analysis of ELSA[84] data to estimate future entitlement

The following analysis uses data on the income and savings of people currently aged between 55 and 75 in 2010 who are still in work (and still accumulating savings).

The analysis projects income and savings levels forward to make estimates regarding the likely levels people will have in future. These projections are used to estimate people's ability to meet the MIR or enter Capped Drawdown by the time they reach State Pension Age. They assume that individuals continue contributing to and accruing pension rights until reaching SPA. This is a very strong assumption and estimates are likely to represent the maximum numbers who may be able to use Capped and Flexible Drawdown in future.

The estimates of future entitlement concentrate on the same group as the estimates of those who could potentially access Capped and Flexible Drawdown now; people age 55 to 75. Ideally a detailed analysis would include younger individuals as well, who may be able to use Capped and Flexible Drawdown in future, but ELSA data does not cover individuals below the age of 50.

Around a further 300,000 people between age 55 and 75 in 2010 could have enough DC pension savings to use Capped Drawdown by SPA
If it is assumed that the minimum pension pot size needed to use an income drawdown product remains at around £100,000, then around a further 300,000 people between age 55 and 75 in 2010 who do not currently have enough savings to enter Capped Drawdown could have enough DC pension savings outstanding to potentially make use of Capped Drawdown by the time they reach SPA (Chart 6).

This represents around 2% of people between age 55 and 75 in 2010 and around 11% of people between age 55 and 75 with uncrystallised DC pension savings (Chart 7).

A further 900,000 to 1.1million people between age 55 and 75 in 2010 might be able to meet an MIR of £20,000pa by SPA
Assuming the MIR remains at around £20,000pa then around a further 900,000 to 1.1m people between age 55 and 75 in 2010 may have sufficient pension income in payment to meet the MIR by SPA (Chart 6). This represents around 7% to 8% of people aged between 55 and 75 in 2010.

[84] PPI analysis of Wave 3 ELSA data

The majority of these people will only be able to meet the MIR once they reach SPA and start receiving state pension income.

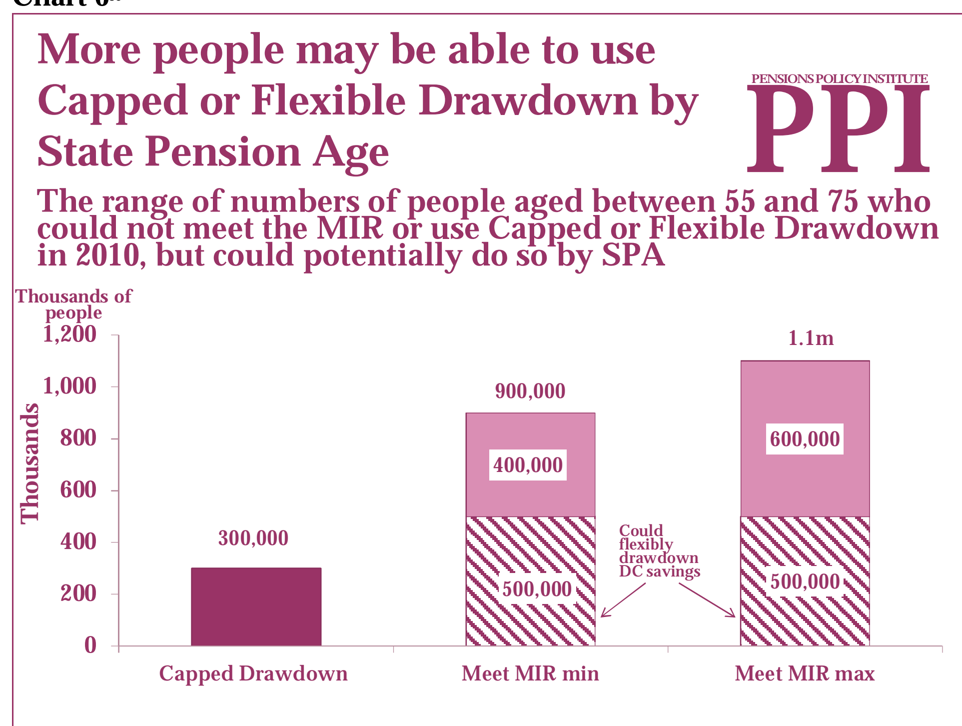
A further 500,000 people between age 55 and 75 in 2010 could have sufficient pension income to meet the MIR and have some DC savings left over to access flexibly by SPA

Assuming the MIR stays at around £20,000pa then around 500,000 of the 900,000 to 1.1m people between age 55 and 75 in 2010 who could meet the MIR by SPA, could have some DC savings left over after meeting the MIR to flexibly drawdown (Chart 6). This represents around 4% of people aged between 55 and 75 in 2010 and around 19% of people age between 55 and 75 with uncrystallised DC pension savings (Chart 7).

Some of the people who could potentially meet the MIR in future with income from state and DB pensions could choose to transfer their accrued pension entitlement out of their DB scheme into a DC pension saving fund. This could enable those who previously had no DC savings to be able to meet the MIR by purchasing an annuity with some of their fund and flexibly drawdown the rest of their savings.

However, the majority of people who could meet the MIR during the next decade are unlikely to be able to take advantage of Flexible Drawdown, as those with pension income above £20,000pa will have mainly state and DB pension savings.

Chart 6[85]



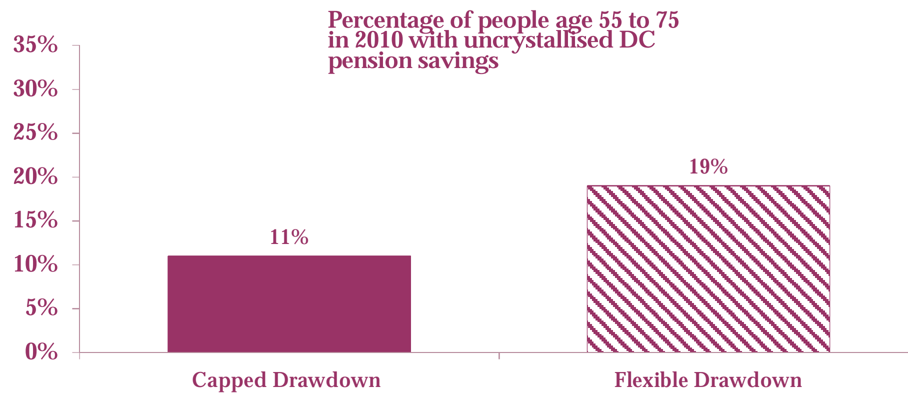
[85] PPI analysis of Wave 3 ELSA data, HMT (2010c), ABI statistics

Chart 7[86]

A larger proportion of people with DC savings could use Flexible Drawdown in future

PENSIONS POLICY INSTITUTE PPI

Proportions of people aged 55 to 75 with uncrystallised DC pension savings who could not use Capped or Flexible Drawdown in 2010, but potentially could be in a position to by the time they reach SPA



Part of the reason why such low numbers of people between the age of 55 and 75 in 2010 might be able to access Capped or Flexible Drawdown is the historically low levels of DC saving. However, the decline in DB pension provision has led to an increase in people saving in DC schemes, which is likely to be compounded when auto-enrolment into pension savings begins in 2012.

Active membership in DC schemes could grow to around 15 million by 2020 and around 17 million by 2050, compared to an estimated 5 million (in 2008).[87] 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.

Allowing early access to pension savings in the UK may reduce the chance some people have to flexibly access pension savings in retirement

Before the election, the Conservatives and the Liberal Democrats both pledged to explore the potential to give individuals greater flexibility in accessing part of their pension savings before age 55 (early access). The Coalition Government has issued a call for evidence on early access to pension savings[88] and is currently reviewing their responses.

[86] PPI analysis of Wave 3 ELSA data, HMT (2010c), ABI statistics
[87] PPI (2009b), PPI Aggregate Model
[88] www.hm-treasury.gov.uk/consult_early_access_pension_savings.htm

Allowing early access in the UK may have implications for people who wish to flexibly access their private pension savings in retirement. If people are allowed to access their private pension saving before retirement, as well as being able to access their pension more flexibly after retirement, they may be doubly exposed to risks to their retirement income levels. In some cases a person may be unable to use a flexible method of accessing their pension savings in retirement because they have reduced the size of their pension pot by accessing early. People with low levels of pension savings are unlikely to be able to use Capped Drawdown or meet the MIR. Chapter 7 further explores how a more flexible approach to accessing private pension savings could interact with policies that allow early access to pension savings.

Conclusions

For the majority of people reaching retirement, annuitisation is still likely to be the safest and most appropriate way of accessing their private pension savings. However, changes in the market, as well as individual behaviour could see some people move away from annuitisation in the future.

Whether people will continue to annuitise when it is no longer required will depend on several factors:

- Individual's attitudes and financial behaviour,
- Market changes, product development and availability,
- Advice and information.

By default, providers of products and advice often act as the only bridge between people and the products they use to access their retirement income. A significant burden of responsibility will lie with providers to ensure that:

- Products are sold to people with the appropriate characteristics,
- Negative associations some people have with annuities do not prevent people for whom annuities will be the best option from choosing them,
- The introduction of Capped Drawdown does not open the door to the selling of drawdown products to people who cannot afford the underlying risks.

There is great scope for the Government to assist industry by ensuring that all people saving for and approaching retirement are given accessible and relevant information to enable them to make the best choices for their individual needs.

For the vast majority of people, annuitising is likely to remain the safest and most appropriate option for accessing private pension savings

In 2010 the vast majority of people age 55 and over would not have had enough private pension savings to be able to afford the longevity and investment risks associated with Capped Drawdown and would not have been able to meet the MIR. For the majority of people, purchasing an annuity will still be the safest and most appropriate way of accessing their private DC pension savings.

How many people may be able to make use of Capped or Flexible Drawdown?

Tables 5 to 7 summarise the PPI's estimates of the numbers of people aged between 55 and 75 in 2010 in the UK who could use Capped Drawdown, could meet the Minimum Income Requirement or could meet the Minimum Income Requirement with some DC savings left over which could be withdrawn using Flexible Drawdown either in 2010, or at some point in the future before their SPA.

In 2010 there were 13 million people aged between 55 and 75 in the UK, of whom 2.7 million had uncrystallised DC pension savings. Table 5 shows that around 600,000 – 700,000 people aged between 55 and 75 in 2010 may be able to make use of Capped Drawdown in 2010. Around a further 300,000 may be able to use Capped Drawdown by their SPA.

Table 5: PPI Estimates of the numbers of people who might be able to use Capped Drawdown in 2010 or by their SPA, assuming a DC pension pot of at least £100,000 is required to 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 – 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%

Table 6 shows that around 700,000 to 1 million people aged between 55 and 75 could meet the Government's Minimum Income Requirement of having a secure pension income of at least £20,000pa in 2010. Around a further 900,000 to 1.1 million could not meet the MIR in 2010, but could meet it at some point in the future by their SPA.

Table 6: PPI Estimates of the numbers of people who might be able to meet the Minimum Income Requirement (MIR) of £20,000pa in 2010, or by their SPA

	Could meet MIR in 2010	Could meet MIR by SPA (but not in 2010)	Total who could meet MIR in 2010 or by their SPA
Number of people aged between 55 and 75 who could meet MIR	700,000 to 1 million	900,000 to 1.1 million	1.6 million to 2.1 million
Percentage of all people aged 55 to 75 in UK	5% to 8%	7% to 8%	12% to 16%

Table 7 shows that of the 700,000 to 1 million people who could meet the Government's MIR in 2010, only around 200,000 could meet the MIR and have some DC savings left over to withdraw flexibly in 2010. Around a further 500,000 people might meet the MIR and have some DC saving left over to withdraw flexibly by their SPA.

Table 7: PPI Estimates of the numbers of people who might be able to meet the MIR and who would have some DC pensions saving left over which could be withdrawn flexibly

	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%

Chapter four: the impact on individuals who had low earnings during working life

This chapter explores the potential impact of a more flexible approach to accessing private pension savings on individuals who earned at low earnings during their working life.

Under the new policy annuitisation is likely to remain the safest and most appropriate way of accessing private DC pension savings for the majority of low earners

Though people will no longer be required to buy an annuity in future, many people with smaller pot sizes may not be able to bear the longevity and investment risks associated with Capped Drawdown and are unlikely to be able to meet the Minimum Income Requirement (MIR). Providers and financial advisors may be unlikely to recommend drawdown to people with pots under £100,000 unless individuals have significant other assets and income. The majority of current low earners are unlikely to have pension pots or other assets of this size. Only around 1% of people aged 65 or over in 2010 have pots large enough to enter drawdown.[89]

For example, a low earner (earning in the bottom 30% of the UK earnings distribution) who, with his employer, contributes at average levels of around 9% of his salary[90] to a private pension for 40 years would reach SPA (in 2010) with a pot of around £58,000[91] after taking his 25% tax-free lump sum. This size of pot would generally be too small to be appropriate for income drawdown. Few low earning individuals will have made sustained contributions at this level throughout their working lives.

For the majority of low earners, annuities will still represent the safest and most appropriate way of accessing their private pension savings

People who purchase a lifetime annuity are trading opportunities for protection against risk, though lifetime annuities do pose some risks to individuals

People who purchase a lifetime annuity make a trade-off. They are giving up the opportunities to:

- potentially grow their pot further, and/or
- potentially leave a portion of their fund as inheritance.

In return for giving up these opportunities, they receive the security of a lifetime income and protection against living longer than they expect to and/or depleting their savings before their death (longevity and investment risk).

[89] PPI analysis of Wave 3 ELSA data
[90] ONS (2010)
[91] PPI Individual Model

However, purchasing a lifetime annuity is not devoid of risks for individuals. People who purchase lifetime annuities run the risks of:

- Living shorter lives than they expected and recouping only a small amount of the initial purchase price.
- Having a change in income needs later in life when their annuity rate is set and cannot be changed.
- Unexpected increases in inflation could cause the income from a level annuity to greatly lose value relative to the price of goods and services.

Purchasing a lifetime annuity in early retirement can mean people are unable to purchase an enhanced annuity when health problems develop

People who purchase lifetime annuities also run the risk of becoming eligible for an enhanced annuity when they no longer have the means to purchase one, thereby forgoing the increase in income they would have received had they been able to wait.

For people with small pots who need to access their income, waiting to purchase an annuity until the onset of health problems may not be an option as products such as drawdown (which enable people to access an income from their savings while delaying the purchase of a lifetime annuity) may not be available due to the costs and risks associated with these products.

Some low earners could postpone buying a lifetime annuity by purchasing a fixed term annuity, however there are risks involved

Unlike income drawdown products, fixed term annuities are available to people with small pots (generally of £10,000 or above). Some people might be able to make use of fixed term annuities to delay buying a lifetime annuity and thereby increase their chances of becoming eligible for an enhanced annuity. However there are some risks and costs, especially relevant for people with smaller pots, associated with purchasing a fixed term annuity:

- Individuals will generally need to pay a commission or product charge every time they purchase a new annuity, and therefore it could be twice as expensive for individuals to purchase a fixed term annuity followed by a lifetime annuity than it would have been if they had only purchased a single annuity.
- Annuity rates may be lower when the fixed period comes to an end than they were at the time of the initial annuity purchase.
- Some fixed term annuities carry investment risk (though some pay an agreed amount at the end of the fixed period).
- Pots that are very small will be reduced in size during the fixed term after subtracting commission, fees and the income paid to the annuitant. People with very small pots may find it difficult to find a provider willing to sell them an annuity at the end of their fixed term.

Though people could potentially gain by purchasing a fixed term annuity and then, if eligible, an enhanced annuity, people who are very dependent on the income they receive from their pension savings might not be able to afford to run the risk of reducing the income they will receive even further.

How could a more flexible approach to accessing private pension savings impact on 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 saving 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 future people accessing pension savings and the way providers decide to respond. If people with larger pension savings pots and higher life expectancies leave annuity pools, this could increase annuity rates. However, a reduction in competition between providers and a reduction in the size of average annuity purchase could lower annuity rates or increase product charges.[92]

Uses and limitations of hypothetical case study analysis

This report explores the way that hypothetical individuals with different earning and saving histories may be impacted by a more flexible approach to accessing private pension savings. Hypothetical case studies are useful for looking at how certain individuals may fare under certain assumptions, however these case studies should not be considered predictions of how any particular income group will fare in the future. Each hypothetical individual has a specific history of working and saving behaviour and the behaviour and experiences of other individuals of the same age and gender may be very different from those of the case study individuals.

[92] See Chapter Three for further discussion of the potential effect on annuity rates

Box 5: a low-earning man, aged 65 in 2010

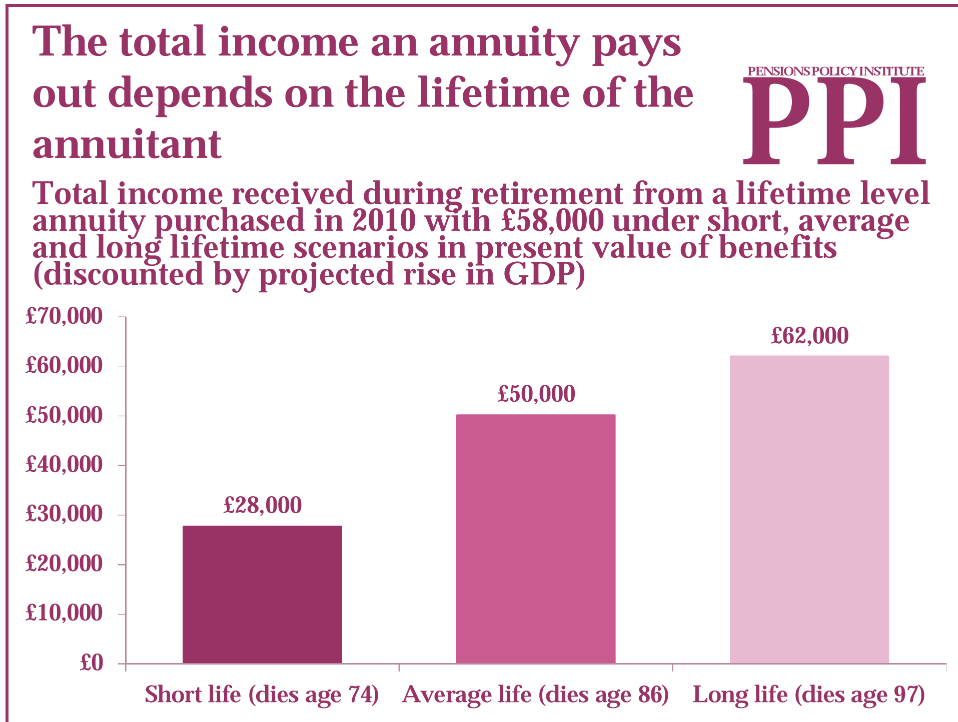
- He starts working full-time from age 16 in 1961.
- Throughout his working life he earns at low age-specific (30th percentile) earnings for a man.
- Between the ages of 25 and 65, he and his employer contribute to a DC pension scheme at 9% of total salary.[93]
- He dies at age 86 (average life expectancy).[94]
- Under a low life expectancy variant he lives until 74.
- Under a high life expectancy variant he lives until 97.
- His pension pot size at SPA, after taking a 25% tax-free lump sum is: £58,000

In order to illustrate how the lifetime income an individual might receive from an annuity could differ in relation to the length of their life, we assume a low earning man purchases an annuity with £58,000 in 2010 (Chart 8) and lives for:

- Shorter than average life expectancy for his age.
- The average length of time expected for his age.
- Longer than average life expectancy for his age.
- In all of the scenarios he receives the same level of yearly income from his annuity (in nominal terms) throughout his life.

[93] Average contributions to a DC occupational pension in 2009, employee 3%, employer 6.4%. ONS (2010)
[94] Average cohort life expectancy based on GAD life expectancy tables 2008 – based on principal projections

Chart 8[95]



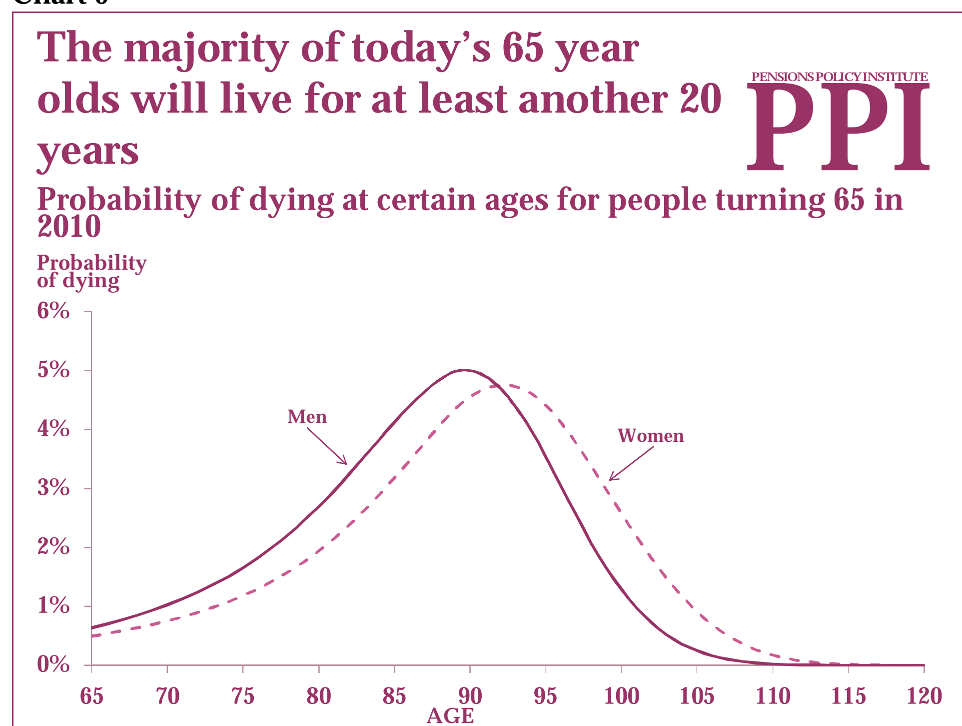
The amount of income an individual receives from their lifetime annuity is dependent on how long they live

- **Individuals who live for shorter than average life expectancy might receive significantly less than the value of their original annuity purchase price in total lifetime income.**
- **However annuities also provide the benefit of security and an income for life even for those who live for longer than average life expectancy.**
- **Some people who live very long lives may receive more than the purchase price of their annuity in total income.**
- **Though the individual in Chart 8 receives significantly less total income in the short life scenario than in the average and long life, he had the benefit of knowing his income was secure regardless of how long he lived.**

The value of an annuity lies in the security it provides. The majority of pensioners will live for close to the average life expectancy or beyond (Chart 9) and some could live for up to another 10 or 20 years beyond the average. Pensioners who live for longer than average life expectancy could benefit from the security of a lifetime income which does not run out when the value of initial purchase price has been paid out as income.

[95] PPI individual model, discounted to present value of benefits using projected rise in GDP assuming average annual nominal growth of just under 5%. See appendix for further information.

Chart 9[96]



Enhanced annuities can deliver a significant increase in income for pensioners

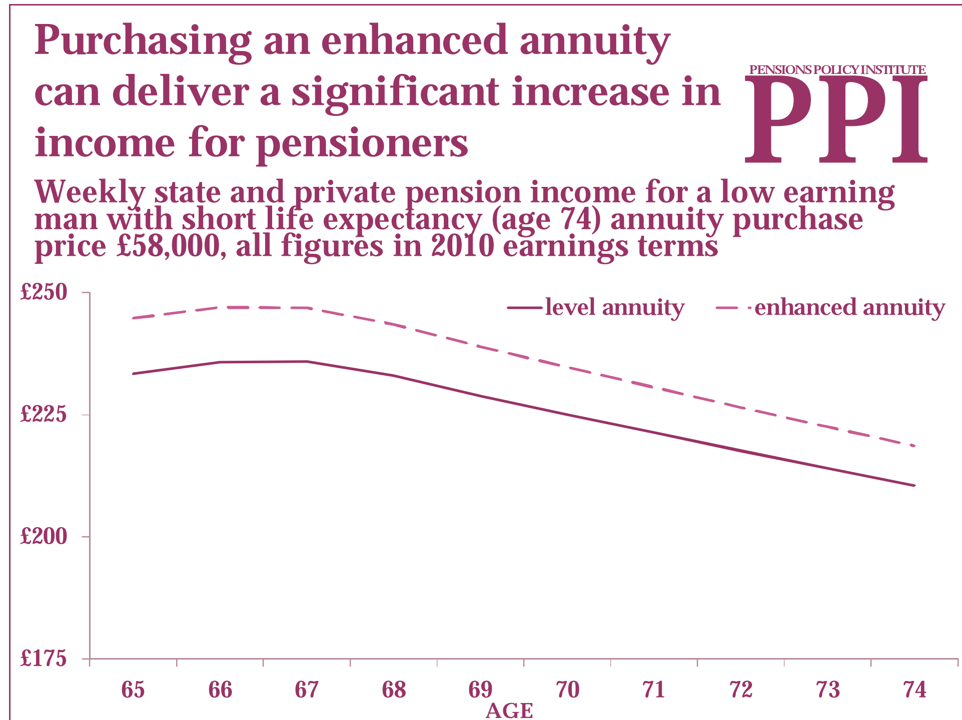
The income that an individual receives from a level annuity will be priced according to the average life expectancy for a person of their age and gender. However, people with illnesses, disabilities or lifestyle characteristics (for example, smoking or obesity) that are life-limiting may be eligible to purchase an enhanced annuity. Enhanced annuities pay income at a higher rate than standard lifetime annuities on the assumption that the annuitant will live for less than average life expectancy.

Around 40% of people over age 65 have a moderate or severe disability,[97] and many of these may be eligible for an enhanced annuity, however only around 10% of eligible annuitants purchased an enhanced/impaired annuity in 2010.[98] However, if all of the people who were eligible for an enhanced annuity purchased one, this could have the effect of depressing the rates of conventional lifetime annuities, as it would cause average life expectancies in conventional annuity pools to rise.

[96] PPI calculations based on CMIB PXA92 life tables
[97] Kellard *et. al.* (2006)
[98] ABI (2010b)

In order to illustrate the potential gain that an individual with health problems could receive by purchasing an enhanced annuity we assume that the low earning man purchases one at SPA and receives an uplift of 19% per year.[99]

Chart 10[100]



The individual in Chart 10 receives a higher weekly income under the enhanced annuity scenario than he does under the level annuity scenario. However, enhanced annuities are priced on the expectation that individuals will live for less than average life expectancy as a result of their health problems. Though the individual in Chart 10 receives a higher weekly income from his enhanced annuity, it is expected that he will die earlier under the enhanced annuity scenario and receive a similar level of total income to an individual living for an average amount of time with a level annuity.

The income streams in Chart 10 assume average annual earnings inflation of 4.5% per year. If inflation was higher or lower, the income streams would be different in real earnings terms.

[99] Estimate of average uplift, Partnership
[100] PPI Individual Model

Conclusions

On the whole, the new policies are unlikely to impact directly on people who earned at low earnings and have small private pension saving 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. However the new policies have the potential to affect annuity rates.

People who purchase a lifetime annuity make a trade-off. They are giving up the opportunities to potentially grow their pot further, and/or give a portion of their fund as inheritance. In return for giving up these opportunities, they receive the security of a lifetime income and protection against living longer than they expect to (longevity risk).

The value of an annuity lies in the security it provides. The majority of pensioners will live for around the average life expectancy, however many could live for up to another 10 or 20 years beyond average life expectancy. Pensioners who live for longer than average life expectancy could benefit from the security of a lifetime income which does not run out when the value of initial purchase price has been paid out as income.

Though people could potentially gain by purchasing a fixed term annuity and then, if eligible, an enhanced annuity, people who are dependent on the income they receive from their pension savings might not be able to afford to run the risk of reducing the income they will receive even further.

Chapter five: the impact on individuals who had median earnings during working life

This chapter explores the potential impact of a more flexible approach to accessing private pension savings on individuals who earned at median earnings during their working life.

For the majority of median earners annuitising will remain the safest and most appropriate way of accessing private DC pension savings
Like those who earned at low earnings during working life, people who earned at or around median earnings may not reach retirement with a pot large enough to open an income drawdown account or secure enough income to meet the Minimum Income Requirement (MIR).

For example, a median earner who, with his employer, contributes at average levels of around 9% of his salary to a private pension for 40 years could reach SPA in 2010 with a pot of around £75,000[101] after taking his 25% tax-free lump sum. This size of pot would generally be too small to be appropriate for income drawdown. Few lifetime median earners may be fortunate enough to have sustained contributions at this level throughout their working life.

Adequacy of retirement income is an issue for many people with low to median earnings. A replacement rate of 70% of working life income is what this hypothetical median earning man might aim for in retirement if he wants to have a similar standard of living to the one he had in working life.[102] If he chose to only use pension savings to provide retirement income, the median earning man would be able to achieve a replacement rate of 70% of working life income in his first year of retirement with income from his state and private pension if he contributed 1% more of his salary, at 10%.[103] This contribution rate would see him reaching SPA in 2010, with a pot of around £80,000, after taking his 25% tax-free lump sum.[104]

It is likely that for many people who earn at or around median levels during working life, purchasing an annuity will be the safest and most appropriate way to access private pension savings.

However, it is possible that the minimum pension saving pot size that a advisors recommend a person needs to have in order to bear the risks associated with income drawdown could be reduced in future. Product providers could respond to the changes in legislation by designing a wider variety of drawdown products, possibly some aimed at people

[101] PPI Individual Model
[102] Pensions Commission (2004)
[103] PPI Individual Model
[104] PPI Individual Model

with smaller pots (for example, group managed drawdown products which would reduce management fees for individuals).

Removing the requirement to annuitise could encourage people to use existing retirement income products more flexibly

There are likely to be greater numbers of people reaching retirement with Defined Contribution (DC) pension savings in future. Active membership in DC schemes could reach around 15 million by 2020 and around 17 million by 2050, compared to an estimated 5 million (in 2008).[105] There should also, ideally, be a greater number of people shopping around for the best type and rate of annuity in future. These changes, coupled with the removal of the requirement to annuitise, could encourage a more flexible approach to using existing annuity products.

It is possible to use existing annuity products in a more 'flexible' way which can help meet income needs as they change during retirement. The annuity market offers people a range of products which can be used to:

- delay or vary the income people receive in retirement,
- increase the income people receive in line with inflation,
- allow people to earn investment returns on their savings,
- provide higher levels of income to people with shortened life expectancies (e.g., people with serious health problems or people who smoke).

In order to illustrate how people can use existing annuity products to meet needs which change during retirement, the following analysis assumes that individuals use a combination of different annuity products during retirement.

There are a wide variety of annuity products available. The following analysis uses a few of the available annuity products on offer for illustrative purposes. This paper does not intend to imply that the products used in this analysis are better or worse than any of the products on the market that are not mentioned here.

[105] PPI (2009), PPI Aggregate Model

Some people may wish to delay purchasing a lifetime annuity

Many people will purchase a lifetime annuity at some point during their retirement, however some people may wish to delay the purchase, or purchase an annuity using only some of their savings, for a variety of purposes, including:

- Attempting to grow their pension pot further.
- Varying their level of income during retirement, by, for example taking a lower amount during the first few years of retirement (when people might have other income from earnings) and then buying an annuity later.
- Waiting until they are eligible for an enhanced[106] annuity.

Box 6: fixed term annuities

Fixed term annuities are purchased for a fixed period (e.g., 5 years) and can be used to provide an income during the term of the annuity. At the end of the fixed term the annuity provider returns the capital to the annuitant plus any investment returns (after subtracting for fees and income paid out) with which the individual can buy another annuity or retirement income product. People can choose, for a cost, to have their fixed term annuities guaranteed to pay out to a dependent upon the annuitant's death. If people choose not to have guarantees in their fixed term annuity they will lose the remainder of the fund if they die during the fixed period.

In order to illustrate how someone could use a fixed term annuity to delay the purchase of a lifetime annuity the following scenario (Chart 11) assumes that a median earning man:

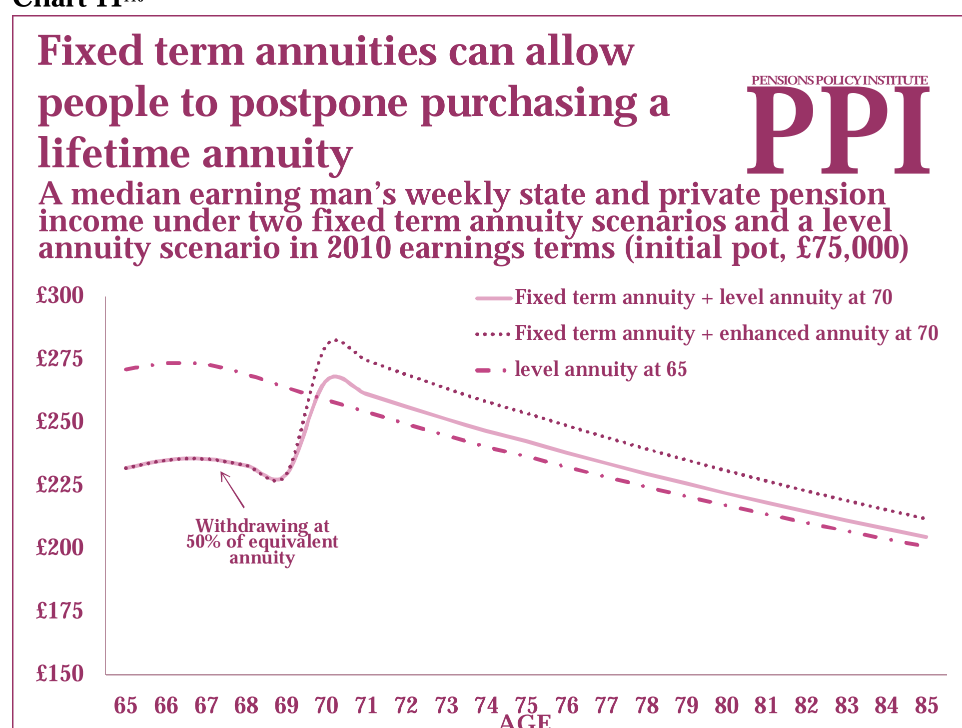
- Purchases a 5 year, fixed term annuity;
- Receives an income from his annuity at half (50%) of the Capped Drawdown withdrawal limit;[107]
- Purchases a level, single-life annuity at age 70; and, under an alternative scenario,
- Purchases an enhanced annuity at age 70.

[106] An annuity paid to people with life limiting illnesses, disabilities or lifestyle characteristics (e.g., smoking, obesity). Enhanced annuities pay out a higher income than standard lifetime annuities on the assumption that the annuitant is likely to live for less than average life expectancy.
[107] Maximum income that can be taken from a Capped Drawdown account is 100% of the income that would be available from an equivalent annuity calculated by GAD

Box 7: a median-earning man, aged 65 in 2010

- He starts working full-time from age 18 in 1963.
- Throughout his working life he earns at median age-specific (50th percentile) earnings for a man.
- Between the ages of 25 and 65, he and his employer contribute to a DC pension scheme at average levels of around 9% of total salary.[108]
- He dies at age 86 (average life expectancy).[109]
- His pension pot size at SPA, after taking a 25% tax-free lump sum is: £75,000
- In 2010 his total state pension entitlement (BSP and additional state pension) is £196pw

Chart 11[110]



Purchasing a fixed term annuity and withdrawing at 50% of an equivalent annuity allowed the individual to:

- Delay purchasing an annuity while keeping his fund secure.
- Potentially receive an investment return on his fund, though in some cases the investments may not perform well enough to yield returns.
- Take an income from his fund without having to enter a drawdown account.
- Buy a level annuity at higher rate and see an increase of 3% in his total state and private pension income at age 70, from what he would

[108] Average contributions to a DC occupational pension in 2009, employee 3%, employer 6.4%. ONS (2010)
[109] Average cohort life expectancy based on GAD life expectancy tables 2008 – based on principal projections
[110] PPI Modelling, enhanced annuity uplift based on Partnership data, all income net of tax

have received if he had purchased a level annuity at SPA (assuming annuity rates remain constant during the fixed period).

- And, in an alternative scenario, purchases an enhanced annuity that he may not have been eligible for at SPA, receiving an increase of 8% at age 70, in his total state and private pension income (assuming annuity rates remain constant during the fixed period).

The income streams in Chart 11 assume average annual earnings inflation of 4.5% per year. If inflation was higher or lower, the income streams would be different in real earnings terms.

Purchasing a fixed-term annuity carries risks and may result in individuals receiving less overall income during their retirement

Some people who purchase a fixed term annuity may actually see a decrease in the income they receive from their subsequent lifetime annuity if annuity rates drop sharply during the fixed term, or if their invested fund does not grow fast enough to make up for the missed mortality cross-subsidies in the annuity (***mortality drag***).[111] Fixed term annuities are not recommended for people who are dependent on having a guaranteed income for their lifetime.[112]

Part of the benefit that this median earning man gains from purchasing a fixed term annuity is due to the fact that he takes an initial income from it at only half of the maximum allowed rate, thereby preserving a portion of his fund and increasing the level of income he can receive in later life. Some people may not be able to afford to receive a lower income from their savings during their early retirement. However, for those who could afford to receive a lower income for some of their retirement perhaps because they are working part time or have other sources of income, fixed term annuities could provide more flexibility in the shape of income during retirement, though they do not guarantee individuals an increase in overall income levels during retirement, especially for those who do not live for long enough to recoup the income forgone during the fixed term. Individuals also have the option to take income from their fixed-term annuity at 100% of an equivalent annuity.

[111] See Chapter One for a discussion of mortality drag
[112] www.williamburrows.com/library/fixedtermannuity.pdf

Box 8: flexible annuities

Flexible annuities are annuities that allow people to earn investment returns while still maintaining some income security.

- When an individual purchases a flexible annuity, their fund is invested and has the potential to accrue investment returns, though in some cases, returns may be negative. Individuals are allowed to receive regular income from their annuity up to the maximum a person could receive from an equivalent level annuity.
- Every three years the amount of income an individual could receive from a level annuity purchased with the invested fund is reassessed. If the fund of the flexible annuity has grown because of investment returns, then the amount that could be received from a level annuity generally also grows. People can then receive an increase in income from their flexible annuity.
- Flexible annuities do not allow the fund holder to leave their remaining fund as an inheritance when they die (though people can purchase fixed-term guarantees or joint-life flexible annuities in order to provide support for dependents).
- If the value of the level annuity which could be purchased with the fund falls below a certain level, the flexible annuity converts into a traditional lifetime annuity with a guarantee of income for the remainder of the annuitant's life.
- People with flexible annuities can choose at any time to have their annuity converted into a lifetime annuity.

In order to illustrate how an individual could use a flexible annuity to receive an income and still continue to attempt to grow their fund, the following analysis (Chart 12) assumes that a median earning man purchases a flexible annuity[113] and remains in it until his death at age 86. The investment returns are modelled stochastically, (using 10,000 runs) and represent the range of possible outcomes of investment return from a flexible annuity.[114]

This analysis assumes:

- The individual invests his entire savings into a flexible annuity. In practice, some people may choose to invest some of their savings in a flexible annuity and some into a lifetime annuity, in order to provide themselves a greater level of security.
- The individual withdraws at 50% of an equivalent annuity under one scenario and at 100% of an equivalent annuity under an alternative scenario.
- The amount of permitted withdrawal is re-assessed every three years and the amount of income that could be received from a lifetime level annuity purchased with the fund is recalculated. The amount of

[113]These are made available to people with pots of around £35,000 minimum

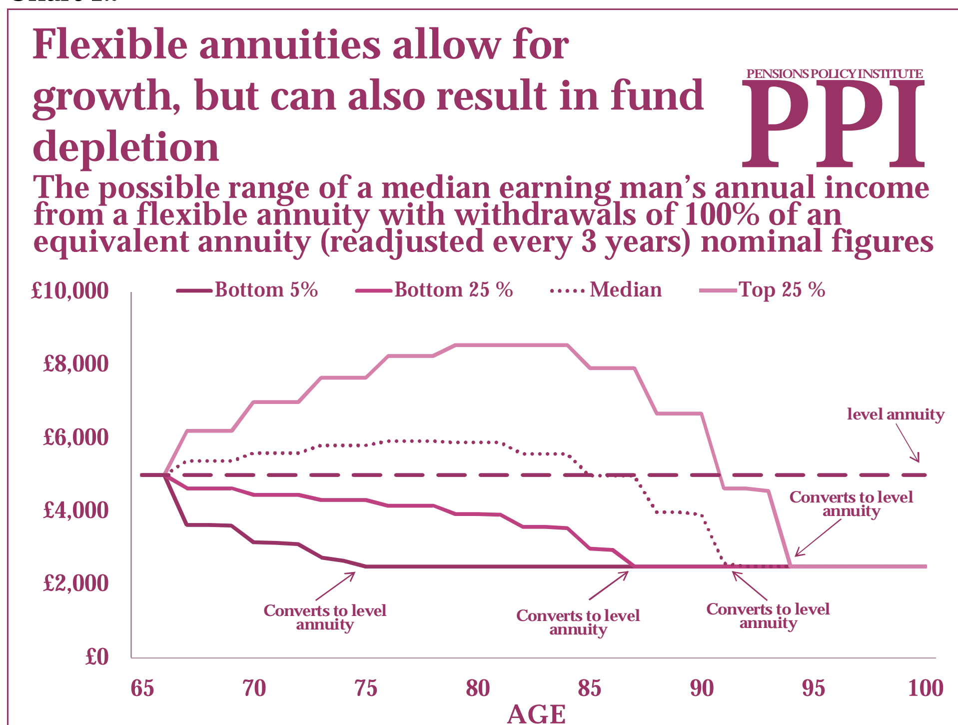
[114] Based on Barclays Capital Equity Gilt Study (2011), see modelling appendix

income taken from the flexible annuity is then increased or decreased in line with changes in fund value.

- If the value of the lifetime annuity that could be purchased with the fund falls below 50% ***(the 50% value cut off point),*** the flexible annuity automatically converts into a level, lifetime annuity and the annuitant receives a fixed income for the remainder of his life of 50% of the income he would have received from a level lifetime annuity if it had been purchased at SPA.[115]

The analysis assumes that a specific investment portfolio is used.[116] ***If the flexible annuity used a different investment portfolio, of lower or higher risk than the one in the analysis, the outcomes would be different.***

Chart 12[117]



Flexible annuities can provide the opportunity for potential fund growth but also bring more risk than conventional lifetime annuities

The individual in Chart 12 withdraws income from his flexible annuity at 100% of the income he would have received from a lifetime level annuity (£5,000pa).

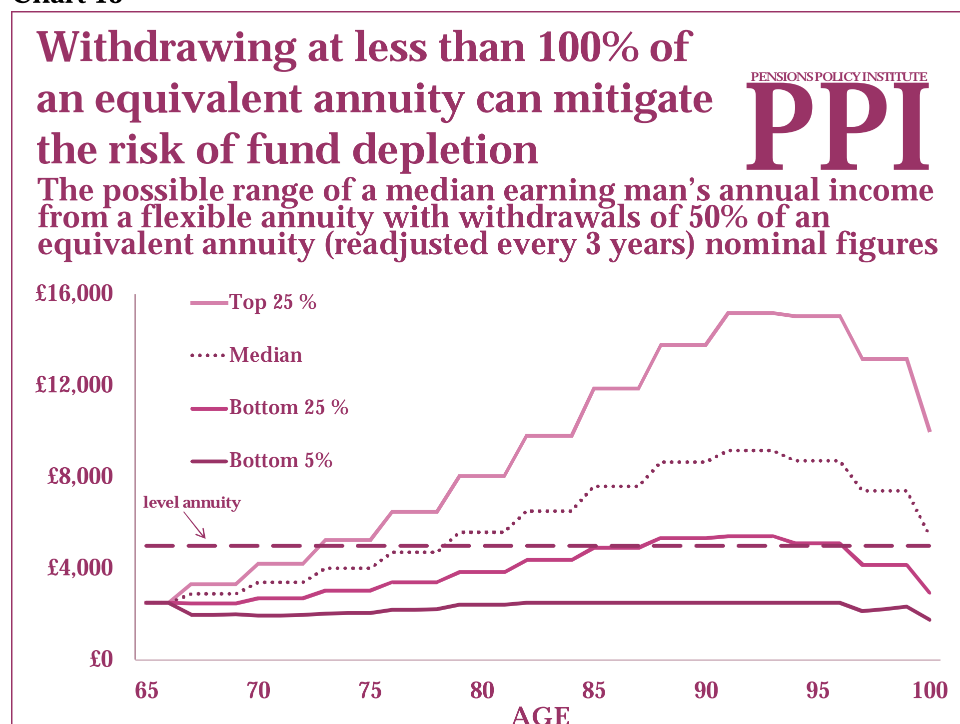
- In over 25% of the investment return scenarios, the individual receives less yearly income from his flexible annuity than he would have from a level annuity, from age 67 until his death.

[115] Consistent with Prudential Assurance flexible annuity
[116] 60% equities, 20% bonds, 20% cash
[117] PPI Modelling, based on Barclays Capital Equity Gilt Study (2011), with input from the Investment Management Association

- In 20% of the investment return scenarios (when it is assumed he lives until 86) his fund reduces to the 50% value cut off point and converts to a level annuity at some point during his retirement. (The converted level annuity pays out at half the income he would have received from the annuity if he had purchased it at SPA.)
- In over 50% of the investment scenarios, however, he is able to increase the yearly income he receives from his annuity for 20 or more years before the fund size starts to decline.
- If it is assumed that the man lives for long life expectancy, 97 years, he has 90% chance of his fund reaching the 50% value cut off point. This is partly due to his high level of withdrawals, at 100% of an equivalent annuity.

Chart 13 explores how the outcomes might differ if the individual withdraws at 50% of an equivalent annuity.

Chart 13[118]



Withdrawing at less than 100% of an equivalent annuity can help preserve funds in flexible annuities

When the individual withdraws at 50% of an equivalent annuity he has more chance of remaining above the 50% annuity value cut off line.

- In only 2% of the investment return scenarios does the fund convert to a level annuity if average life expectancy is assumed.
- Under a longer life assumption (death at 97) the fund only converts to an annuity in 3% of the investment return scenarios.

[118] PPI Modelling, LV= priced fixed term annuities, enhanced annuity uplift based on Partnership data

However, withdrawing at 50% of an equivalent annuity means the individual may have less income in early retirement than in the later years, which may not allow him to meet a spending pattern that involves peaks in both early and later retirement. He might be able to meet earlier spending peaks in retirement from other income and assets, if he has those available. Withdrawing at less than 100% of an equivalent annuity may mean that the individual receives less income during his lifetime than he would have from a conventional annuity, unless his investment returns are high enough or he lives long enough to recoup the loss. Flexible annuities do not allow people to leave the remaining fund at death (unless specific guarantees are bought) and so it would not be appropriate for an individual to reduce their level of income from a flexible annuity in the hopes of leaving a lump sum as a bequest.

Flexible annuities could allow individuals to increase their income later in their retirement, especially if they withdraw at levels below 100% of an equivalent annuity (Chart 13). However, flexible annuities also carry the risk of reducing income in retirement if investments perform badly. If individuals withdraw at 100% of an equivalent annuity they have 90% chance of reducing their income by 50% by the age of 97, though safeguards in flexible annuities should prevent income falling below 50% of an equivalent annuity.

Flexible annuities might be appropriate for people who wish to attempt to grow some or all of their fund and who can afford to bear the risks if investments do not fare well. An individual may be able to mitigate the risks involved in a flexible annuity by only investing a portion of their fund in a flexible annuity and using the rest to buy a conventional lifetime annuity. Individuals can also mitigate risks by withdrawing at lower levels, or changing the investment portfolio to one with lower risk levels. However, withdrawing at lower levels may make it harder to meet desirable spending in early retirement, unless the annuitant has other income sources. Individuals with high levels of income from other sources may find it easier to bear the risks involved in flexible annuities, such as the risk that significant increases in inflation decrease the relative value of annuity income.

Conclusions

- For the vast majority of median earners, annuitising will remain the safest and most appropriate way of accessing private DC pension savings.
- Removing the requirement to annuitise, an increase in DC savers and an increase in the numbers of people shopping around for better annuity rates could encourage people to use existing annuity products in a more flexible way to meet income needs which change during retirement.
- Fixed term annuities can be used to delay purchasing a lifetime annuity. Median earners with more substantial pots may be better able to bear the risks involved with purchasing a fixed term annuity in return for a potentially higher income in later retirement, than lower earners who are likely to reach retirement with relatively small pot sizes.
- The hypothetical median earning individual modelled increases the income he receives from his lifetime annuity by first purchasing a fixed term annuity which he withdraws income from at 50% of the income he would have received from an equivalent annuity, however he does not necessarily receive the same amount or more in total income than he would have from a level annuity unless he lives long enough to recoup the income forgone in early retirement.
- However some people who purchase a fixed term annuity may see a decrease in the income they receive from their subsequent lifetime annuity if annuity rates drop sharply during the fixed term annuity.
- Flexible annuities provide more security but are less flexible than income drawdown.
- Flexible annuities provide less security but are more flexible than conventional annuities.
- Flexible annuities can allow individuals to potentially increase their retirement income during their retirement, especially if they withdraw at levels below 100% of an equivalent annuity.
- Flexible annuities also carry the risk of reducing income in retirement if investments perform badly. If a man invests in a flexible annuity at SPA and withdraws at 100% of an equivalent annuity he has 90% chance of reducing his income by 50% by the age of 97, though safeguards in flexible annuities should prevent income falling below a certain level, for example, 50% of an equivalent annuity.
- Individuals can also mitigate risks of flexible annuities by withdrawing at lower levels, or changing the investment portfolio to one with lower risk levels. However, withdrawing at lower levels may make it harder to meet desirable spending in early retirement, unless the annuitant has other income sources, and may reduce total income received during retirement. Individuals with high levels of income from other sources may find it easier to bear the risks involved in flexible annuities.

Chapter six: the impact on individuals who had high earnings during working life

This chapter explores the potential impact of a more flexible approach to accessing private pension savings on individuals who earned at high or very high earnings during their working life (70th to 90th percentiles).

People who earn at high earnings and save consistently into a private pension during working life will find it easier to access pension savings flexibly in future

People who earn at high or very high earnings during working life are more likely to reach retirement with a pot large enough to open an income drawdown account or, in some cases, secure enough income to meet the Minimum Income Requirement (MIR) and flexibly access their remaining savings.

For example, a high earner (70th percentile) who contributed 15%[119] of her salary to a private pension for 40 years could reach SPA (in 2010) with a pot of around £123,500, after taking her 25% tax-free lump sum.[120] She should be able to access a Capped Drawdown account with a pot of this size.

Many high earners could choose Capped Drawdown over an annuity in future

The Government intends to allow people to invest their pension savings in an income drawdown arrangement, with a cap on the maximum allowed withdrawal (of 100% of an equivalent annuity) with no upper age limit, from April 2011.

Many high to very high earners who have saved consistently into a private pension during working life are likely to have pension pots large enough to enter Capped Drawdown in future. The flexibility that Capped Drawdown offers is likely to make it an attractive option for many people with larger pension pots when they come to make decisions regarding how to access their private pension savings.

Capped Drawdown offers the advantages of allowing people to take an income from their savings while continuing to potentially grow their funds and being able to conserve a portion of their fund to leave as an inheritance. Capped Drawdown also allows people to vary their level of withdrawal to meet income needs that change during retirement. However drawdown does not offer the security that annuities do and individuals invested in drawdown run the risk of their fund being depleted by withdrawals, market fluctuations or poor investment

[119] These contributions represent the higher end of DC pension contributions in the private sector with only 10% of employees and employers contributing more than these levels, ONS (2009) table 3.6 and 3.7
[120] PPI Individual Model

strategies. Individuals invested in drawdown also run the risk of living longer than they planned for and, as a result, depleting their fund before the end of their retirement.

Box 9: A high-earning woman aged 60 in 2010

- She starts working full time from age 20 in 1970
- During her 40 years of work she earns at high-earnings (70th percentile) for a woman.
- Between the ages of 20 and 60 she and her employer contribute to a DC pension scheme at 15% of total salary.[121]
- She dies at age 89 (average life expectancy).
- Under a low life expectancy variant she lives until 76.
- Under a high life expectancy variant she lives until 101.
- Her pension pot size at SPA, after taking a 25% tax-free lump sum is: £123,500
- In 2010 her total state pension entitlement (BSP and additional state pension) is £200pw

In order to illustrate the range of potential investment returns an individual might receive if they are invested in drawdown, the following analysis assumes that the high earning woman:

- Invests her entire pension pot into a drawdown arrangement at SPA and remains invested in it until her death.
- Withdraws income from her drawdown at 50% and 100% of what she would receive from an equivalent annuity, reflecting the half and full amounts of withdrawal allowed in Capped Drawdown.

The investment returns are modelled stochastically, (using 10,000 runs) and represent the range of possible outcomes of investment return from an income drawdown account.[122]

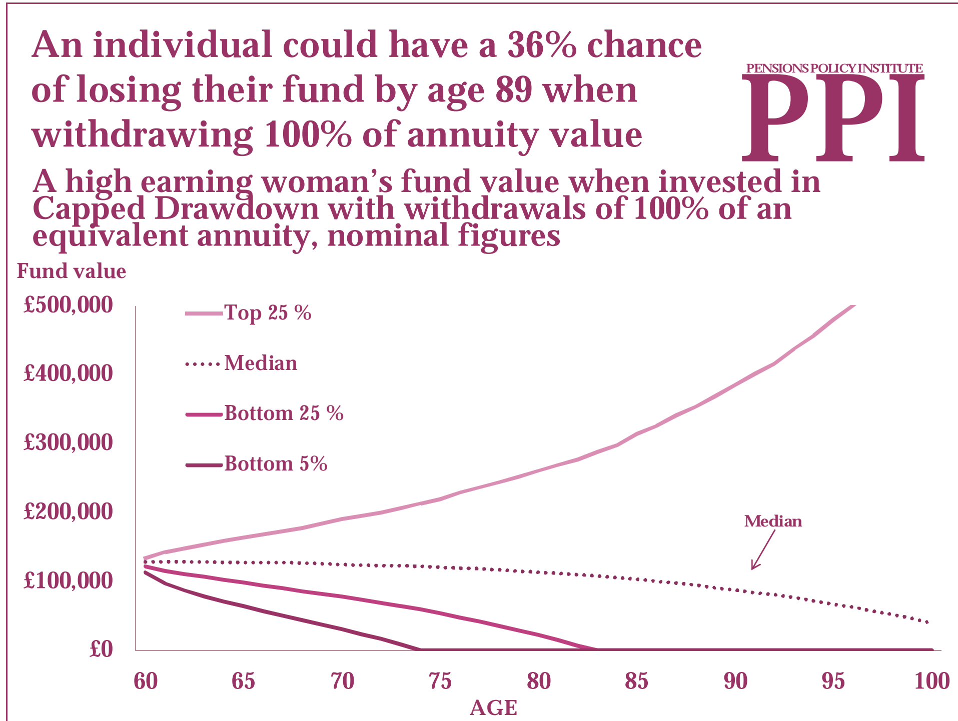
The following analysis (Chart 14) intentionally avoids comparisons between the income she receives from drawdown and the income she would receive from an annuity. The income streams cannot be valued in the same way because of the way the different products operate. The way that income from drawdown is valued will be different from valuations of annuity income because drawdown allows people to accrue investments and preserve funds after death, while annuities do not. The value of annuity income is also affected by the security it provides and will differ between annuities depending on the level of inflation risk they protect against, for example, level annuities versus escalating annuities.

[121] These contributions represent the higher end of DC pension contributions in the private sector with only 10% of employees and employers contributing more than these levels, ONS (2009) table 3.6 and 3.7

[122] Stochastic investment returns based on Barclays Capital Equity Gilt Study (2011), see modelling appendix

The fund value is presented in nominal terms and does not account for the relative value of the fund which will be impacted by inflation.

Chart 14[123]



Withdrawing at the maximum level could result in depleting the fund
Withdrawing at the maximum allowed level could result in depleting the drawdown fund if investment returns are low.

- The individual in Chart 14 has a 36% chance of losing her fund completely before her death if she lives for average life expectancy, until age 89.
- In a longer life scenario, where she lives until age 101, she has a 48% chance of losing her fund completely before her death.
- She also has a 33% chance of doubling her fund in nominal terms if she lives for average life expectancy, until age 89.

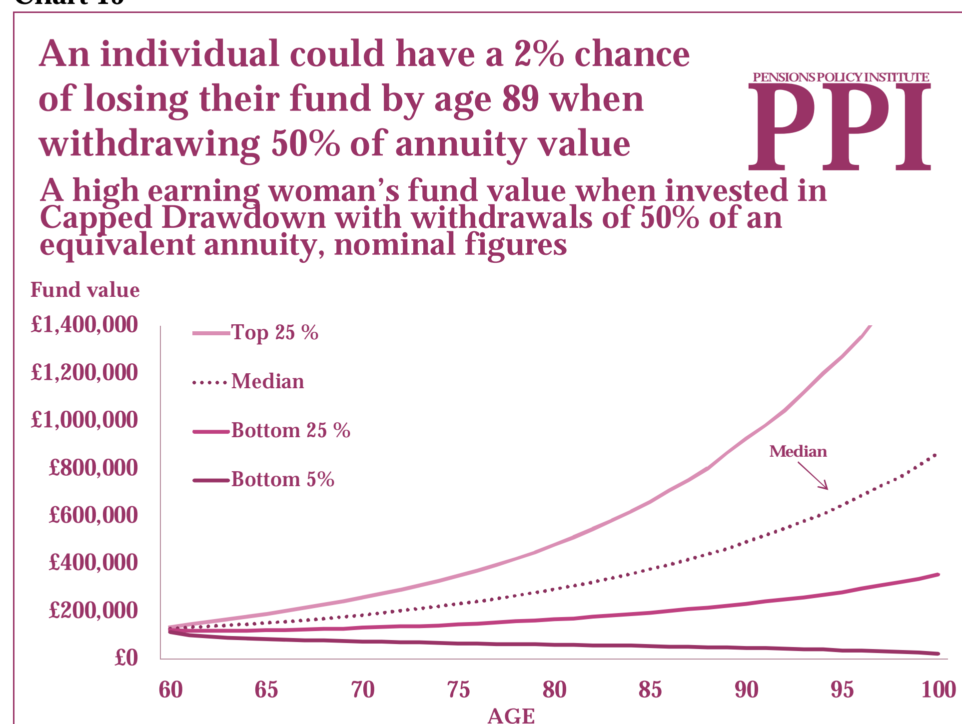
However, this analysis assumes consistent withdrawals at 100% of an equivalent annuity and a consistent mix of investments. People using Capped Drawdown will be required to undergo investment reviews every 3 years, if they are under the age of 75, and annually over the age of 75. It is very likely that if an individual's investments are not faring well in drawdown, they will be advised to change investment strategy and/or withdraw at lower levels than 100% of an equivalent annuity. In some cases, people may be advised to leave drawdown and purchase an annuity, or to purchase an annuity with some of their fund in order to provide themselves with some secure income.

[123] PPI stochastic modelling, based on Barclays Capital Equity Gilt Study (2011)

People can reduce the risks of drawdown by withdrawing at lower than maximum levels

Withdrawing at less than 100% of the maximum allowed level (Chart 15) is one way to help insure against the risk of running out of funds before death, though the particular level of withdrawal that would be right for an individual's fund and income needs will vary. Individuals may need financial advice to determine the level of withdrawal that is best for them. The next chart explores how outcomes might differ if the individual withdraws at 50% of an equivalent annuity.

Chart 15[124]



When the individual withdraws at 50% of an equivalent annuity she is more likely to grow her fund, and less likely to deplete her fund before her death.

- When the high earning woman withdraws at 50% of an equivalent annuity she has only 2% chance of depleting her fund entirely before her death, if she lives until age 89.
- In a long life scenario, where she lives until age 101, she has a 4% chance of depleting her fund before her death.
- In the median outcome, she increases her fund in nominal terms gradually throughout her retirement, leaving more than the initial investment remaining in her fund at her death.

[124] PPI Modelling

Individuals could make substantial returns on their drawdown if their investments do well

People who remain invested in drawdown for their entire retirement have the opportunity to increase the size of their fund and preserve a proportion to use in later life or leave as an inheritance, especially if they withdraw at less than the maximum allowed. For people who are not dependent on the income they receive from their private pension savings, the potential benefits might outweigh the risks involved in capped drawdown. The high earning woman risks depleting her fund but she could also achieve substantial gains from drawdown.

- Under the 100% withdrawal scenario she has 33% chance of doubling her fund in nominal terms by her death at age 89.
- Under the 50% withdrawal scenario she has a 72% chance of doubling her fund in nominal terms by her death at age 89.
- An increase in nominal terms won't necessarily mean that her fund has maintained value in terms of prices or earnings.

Any funds left in Capped Drawdown at death will be taxed at 55% before they can be passed on as a bequest. The tax recovery change will have implications for the level of fund that people are able to leave as bequest and should be taken into account when individuals calculate how much income to withdraw. Withdrawals from Capped Drawdown will be taxed at an individual's marginal tax rate.

Capped Drawdown allows individuals much more flexibility than purchasing an annuity does, however there is a trade-off as people in a Capped Drawdown account run more risk of running out of 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. 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. Frequent investment reviews in Capped Drawdown should help people to mitigate risks by changing investment strategy or lowering withdrawal rates if their investments are not faring well.

People who enter Capped Drawdown should be advised appropriately and fully understand that they are taking the risk of depleting funds or receiving a lower income in retirement than they would have done if they had bought an annuity.

Simple, fixed withdrawals from Capped Drawdown are more likely to pose risks to individuals

Simple fixed withdrawals based on a percentage of an equivalent annuity may not provide as much insurance against longevity and investment risk as more flexible approaches to drawing down income. Using a limit of a fixed percentage of the fund size, for example, hedges more longevity risk than using a fixed percentage of the equivalent available annuity rate.[125] However this approach can often involve small and fluctuating levels of fund capital withdrawal.

People who earned at very high earnings and saved consistently into a private pension during working life might be able to secure enough income to meet the MIR and access their remaining private pension savings flexibly in future

The Government intends to set the MIR at a yearly income of £20,000 in 2011. In order for income to qualify for the MIR, it must be guaranteed for life, however it is not required that the income be inflation proofed, meaning the level of secure income will be permitted to remain at £20,000 (or whatever the current MIR level is at the time it is met) in nominal terms for the duration of the individual's life.

If an individual had no other pension income from state or private pensions he could purchase an annuity which would provide an income of £20,000 per year, from 2010, with around £300,000. However it is very unlikely that people with private pension savings would reach retirement with no state pension entitlement (as accrual is linked to earnings).

If we assume that a man earns at very high earnings throughout his life, for example, in the top 10% of the earnings range in the UK, then he would reach retirement with a final salary of around £54,000pa.[126] This man would be able to meet the MIR with a combination of his state pension entitlement and income from an annuity if he contributed to his pension fund at around 6% of his salary throughout his 40 years of working life. His MIR would be secured in 2010 with income from:

- Basic State Pension – £97.65
- SERPS/S2P - £162.87
- Level annuity - £124.09

However, one advantage of securing the MIR is that it allows one to freely access any remaining DC pension savings. In order to be able to access a portion of pension savings with total flexibility an individual would need private pension savings over and above the level required to meet the MIR. If we assume that the same very high earning man:

- Saves throughout his life into a private pension and,

[125] IMA (2008)
[126] PPI Individual model

- Reaches retirement with a further £100,000 remaining in his savings over and above the amount required to meet the MIR, then,
- He will need to have contributed to his private pension at around 12% of his salary throughout his 40 years of working life.

While the very high earner above finds it easy to meet the MIR with contributions of at least 6% of salary, the above calculations assume that he earns consistently in the top 10% of the earnings range in the UK throughout his working life and that he makes consistent contributions to his private pension throughout his working life. Very high earners who have had periods of lower earnings, or who do not contribute consistently to their pension fund may need to contribute at higher levels than in the above example to have a pot large enough to meet the MIR at retirement.

However, this calculation does indicate that people who earn at very high earnings might have a reasonable chance of meeting the MIR if they save consistently into a private pension.

The introduction of Capped and Flexible Drawdown has implications for how couples might access pension savings in future

The introduction of Capped and Flexible Drawdown may provide motivation for some couples to accrue their entire pension saving in one partners name in order to maximise their chance of being able to use Capped or Flexible Drawdown. It will be important that couples who use this strategy are enabled to factor joint life expectancy into their financial decisions on accessing pension savings. For example, when designing the level of income to take from Capped Drawdown, couples may want to consider the level of fund that might be required to support one of the individuals on the death of the other, and, if relevant, the potential impact of the 55% tax that will be applied to the Drawdown fund on the fund holder's death. If one individual in the couple purchases an annuity to satisfy the MIR, they may want to consider whether a joint life annuity is the most appropriate option.

The introduction of Capped Drawdown might have implications for the way that eligibility for state funding is calculated in future

Care funding is currently provided by the state on a means-tested basis. Income from an annuity is classed as income when making assessments for eligibility for care; however it is not clear whether savings in Capped or Flexible Drawdown account will be considered as an asset in future.

Conclusions

People who earned at high or very high earnings during working life are more likely to reach retirement with a pot large enough to open an income drawdown account or, in some cases, secure enough income to meet the MIR and flexibly access their remaining savings.

A very high earner, who earned consistently in the top 10% of the earnings range during his life, might be able to meet the MIR, with £100,000 left over to withdraw flexibly, if he contributed for 40 years to a pension fund at around 12% of his salary. Very high earners who have had periods of lower earnings, or who do not contribute consistently to their pension fund may need to contribute at higher levels than in the above example to have a pot large enough to meet the MIR and withdraw some pension saving flexibly at retirement.

Many high to very high earners who save consistently into a private pension during working life are likely to have pension pots large enough to enter Capped Drawdown in future.

- Withdrawing from Capped Drawdown at the maximum allowed level could result in depleting the fund if investment returns are low. A 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.
- 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 woman investing in Capped Drawdown 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.
- People who remain invested in drawdown for their entire retirement have the opportunity to increase the size of their fund and preserve a proportion to use in later life or leave as an inheritance. Under the 100% withdrawal scenario a woman investing in Capped Drawdown at SPA in 2010 has a 33% chance of doubling her fund in nominal terms by age 89. Under the 50% withdrawal scenario she has 72% chance of doubling her fund in nominal terms by her death.

Capped Drawdown allows individuals much more flexibility than purchasing an annuity does, however there is a trade-off as people in Capped Drawdown run more risk of depleting 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. 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. Frequent investment reviews in Capped Drawdown should help people to mitigate risks by changing investment strategy or lowering withdrawal rates if their investments are not faring well.

Chapter 7: how could an early access policy interact with a more flexible approach to accessing private pension savings?

This chapter explores how a more flexible approach to accessing private pension savings could interact with policies that allow early access to pension savings.

Introduction

Before the election, the Conservatives and the Liberal Democrats both pledged to explore the potential to give individuals greater flexibility in accessing part of their pension savings before age 55 (early access). The Coalition Government has issued a call for evidence on early access to pension savings[127] and is currently reviewing the responses.

This chapter explores how early access policies might interact with the removal of the requirement to annuitise by age 75.

What is an early access policy?

An early access policy is a policy which allows people to access some or all of their pension savings before minimum allowed age of access (55 in the UK). There are a variety of possible ways to structure an early access policy. For example, early access policies may allow people to withdraw all of their pension savings, a certain percentage of their savings, or in some cases certain elements of their savings (such as an individual's own contributions but not contributions from their employer or the Government). Some early access policies might allow people to take 'loans' from their pension savings which must then be paid back.

There are several different possible models of early access

There are different international models of early access:

- Early access policies in the USA (401k plans) and New Zealand (KiwiSaver), allow people to permanently withdraw money in times of financial hardship, for home purchase or, in the USA, for education.
- 401k plans in the US allow people to take loans from their pension savings, which must be repaid with interest.

Proposals for potential policies in the UK have included:

- A 'Lifetime Savings Account', in which people would not benefit from tax relief on their contributions but would, however, receive 'matching contributions' from the Government (up to a fixed limit).[128] Savers would be allowed to access their own contributions at any time, but incentives would be in place to encourage repayment.

[127] www.hm-treasury.gov.uk/consult_early_access_pension_savings.htm
[128] Norman, J. Clark, G. (2004)

- A 'feeder fund' in which contributions would go into both an inaccessible pension fund and an accessible, liquid savings account.[129]
- Allowing people to access a portion of their 25% tax free lump sum before the age of 55.[130]

Allowing early access could incur risks for people, but could also encourage more saving

If people access their pension savings early, they run the risk of receiving a lower pension income in retirement. Under some scenarios, accessing pensions early could result in individuals reaching retirement with pension pots reduced by 15% to 50%, depending on the type of early access policy used and the behaviour of the individual.[131]If people withdraw savings under an early access policy and do not pay it back with interest then they can miss out on the income they would have received from those savings, and/or any investment returns they would have potentially earned.

However, early access policies have also been shown to help increase participation in pension savings and increase the level of contributions people make. Under some scenarios, introducing early access policies could ***increase*** the pension savings people reach retirement with by up to 10% when accompanied by increased contributions from the individual.[132]

Removing the requirement to annuitise could incur risks for some people

As has been highlighted in this report, alternatives to annuitisation can also bring risks. For example, people who remain in Capped Drawdown for the duration of their retirement will incur more longevity risk and the investment risk of capital loss than those who purchase an annuity.

Allowing early access alongside a more flexible approach to accessing pension savings could prevent people from flexibly accessing pension savings in retirement or could increase the risks some people face when accessing pension saving

Under a system which allowed both early access before age 55 and a more flexible approach to accessing pension savings after age 55, people may be less likely to reach their State Pension Age (SPA) with a pension pot of sufficient size to enable them to use Capped or Flexible Drawdown.

Equally, if someone reduces their pension pot through early access but is still able to use a more flexible method of accessing their savings, such as Capped Drawdown they may be more vulnerable to market fluctuations

[129] PPI (2008)
[130] Baroness Hollis, House of Lords, 23 June 2008, Hansard, Column 1272, Webb, S. Holland, J. (2009)
[131] PPI (2008)
[132] PPI (2008), p.30, Table 4, 'Tony' takes and repays a loan to his fund and contributes 1% more of his salary to his pension fund than he would have without an early access option

than they would have been with a larger pension pot. They may also have to withdraw at lower levels (than if they had not accessed early) in order to ensure that their savings last for the duration of her retirement.

Early access policies are, in theory, aimed at those with lower incomes
It could be argued that, as the two policies are aimed at different income groups, the likelihood of people taking advantage of both policies is low. In reality, it is possible that, were both policies to be introduced, low and high income individuals would wish to take advantage of both policies.

Many of the arguments for introducing early access focus on their potential to increase the participation rates (in pension saving) of groups who do not save enough for retirement, in particular: women, people on low incomes and young people.[133]

- There is some evidence that early access does increase participation rates: allowing early access to pension funds in the USA increased participation rates in those schemes by between 3% to 6%.
- There is also evidence that early access appeals to people with low incomes: people who take advantage of early access features in the US are more likely to be on low incomes.[134]

Alternatives to annuitisation are, in theory, aimed at those with higher incomes
It is likely that the new alternatives to annuitisation, Capped and Flexible Drawdown, will only be accessible to wealthy people with high levels of savings and assets who can either afford to secure an Minimum Income Requirement (MIR) or have pension pots high enough to bear the risks associated with Drawdown. The Government envisages that only a few people will take advantage of the new alternatives to annuitisation and intends for the majority of people to continue to purchase annuities even after the new legislation is introduced.[135]

Early access policies and alternatives to annuitisation policies are in theory aimed at different income groups but, in practice, there may be crossovers
While early access policies might be introduced in order to encourage people with lower incomes to save more, early access policies are also likely to appeal to people with higher incomes as they offer a low tax way to save. While tax avoidance can be partly mitigated with taxation policies and other restrictions, it might not be easy or equitable to design an early access policy which can only be accessed by people with low incomes.

[133] PPI (2008)
[134] PPI (2008)
[135] HMT (2010a)

Therefore it is possible that both low and high income groups will access these policies (if they are both available.) For some people, especially those on low income, this could lead to an intensification of risk.

Early access, combined with more flexibility in retirement could make DB schemes seem relatively inflexible

Neither early access policies nor alternatives to annuitisation are likely to be accessible to DB scheme members due to the structure of scheme funding.[136] Therefore, if both policies are introduced, there will be far more flexibility available to DC scheme members in accessing pension savings before and during retirement, than there will be for DB scheme members. Consumer attitude surveys consistently report that flexibility in accessing retirement income is highly valued by many of today's savers[137] and there is already some concern that introducing alternatives to annuitisation will make DB schemes seem less attractive than more flexible DC schemes.[138]

Early access and more flexibility could encourage more saving

While this chapter has focussed mainly on the risks of introducing early access alongside alternatives to annuitisation, there is a potential benefit to individuals and the state. Allowing early access has been shown in the US to increase participation rates and to increase contribution levels in schemes by between 1% to 3%.[139] However it is not known whether those who would access some portion of their savings early under a policy which allowed this would also be the people who would contribute more in response to the policy.

Allowing both policies could make pension saving seem more attractive to many people who are reluctant to save either because their savings are locked away until age 55 or because they desire more flexibility in accessing savings in retirement. It is possible that a properly designed early access policy that mitigated against risk (for example, by restricting access only to those who can prove financial hardship) coupled with allowing alternatives to annuitisation, could increase the attractiveness of pension saving, could result in increased participation in pension saving and could help increase individual pot sizes at retirement and the aggregate size of pension funds in the UK. However, early access policies could also pose risks to individual retirement income levels.

[136] DB scheme members would not be able to use early access because they do not have disaggregated pension funds which withdrawals or loans could easily be taken from

[137] ABI (2005), ABI (2008)

[138] Prudential and PPI responses to Government's consultation on removing the requirement to annuitise by age 75

[139] PPI (2008)

Conclusions

Introducing an early access policy alongside alternatives to annuitisation could increase risks to people's retirement income:

- **Under a system that allowed both early access before age 55 and a more flexible approach to accessing pension savings after age 55, people may be less likely to reach their SPA with a pension pot of sufficient size to enable them to use Capped or Flexible Drawdown. If, for example, a person decreases the size of their pension pot by accessing early they may find it harder to use a method of flexible access.**
- **Equally, if someone reduces their pension pot through early access but is still able to use a more flexible method of accessing their savings, such as Capped Drawdown they may be more vulnerable to market fluctuations than they would have been with a larger pot. They may also have to withdraw at lower levels (than if they had not accessed early) in order to ensure that their savings last for the duration of her retirement.**
- **It could be argued that, as the two policies are aimed at different income groups, the likelihood of people taking advantage of both policies and exacerbating their risk is low. In reality, it is possible that, were both policies to be introduced, low and high income individuals would wish to take advantage of both policies.**
- **A possible effect of introducing both early access policies and alternatives to annuitisation may be an increase in the perceived inflexibility of DB pensions.**
- **It is also possible that a properly designed early access policy that mitigated against risk (for example, by restricting access only to those who can prove financial hardship) coupled with allowing alternatives to annuitisation, could increase the attractiveness of pension saving and result in increased participation in pension saving, could help increase individual pot sizes at retirement and the aggregate size of pension funds in the UK. However, early access policies could also pose risks to individual retirement income levels.**

Appendix: modelling methods and assumptions

This appendix describes the assumptions and methodology for the modelling in this report. The modelling uses the PPI's Individual Model that was developed with a grant from the Nuffield foundation and further models developed specifically for this report.

Individual modelling

The PPI's individual model uses individual characteristics and working patterns to project income retirement from private pensions, state pensions and other benefits for hypothetical individuals.[140]

Assumptions

Detailed assumptions have been made about the individuals' working and saving behaviours and these are described in the boxes below. Unless otherwise stated, the modelling assumes:

- Long-term increases in the retail prices index (RPI) of 2.87%.
- Long-term increases in the consumer prices index (CPI) of 2%.
- Future annual earnings growth of 4.5%, in nominal terms.
- Expected investment returns of 3.0% in excess of prices, before charges, corresponding to a mixed equity/bond fund.
- Annual management charges of 0.5% of assets under management.
- GDP increases at 4.93% a year, in nominal terms.

These assumptions are the result of consultation between the PPI and their modelling review board. The modelling review board consists of a number of experts in the field of financial modelling.

Individuals modelled

The project explores the potential impact of the different policies on three individuals who earned at median and high earnings during their working life and who reach retirement with different baskets of savings and assets.

[140] For more information on the Individual Model, see PPI (2003) ***The Under-pensioned***

Box 1: a low-earning man, aged 65 in 2010

- He starts working full-time from age 16 in 1961.
- During his 49 years of full-time work he earns at low age-specific (30th percentile) earnings for a man.
- Between the ages of 25 and 65, he and his employer contribute to a DC occupational pension scheme at 9% of total salary (employer 6.4%, employee 3%).
- He retires at age 65 in 2010
- He dies at age 86 (average life expectancy).[141]
- Under a low life expectancy variant he lives until 74.
- Under a high life expectancy variant he lives until 97.
- His pension pot size at retirement, after taking a 25% tax-free lump sum is: £58,000

Box 2: a median-earning man, aged 65 in 2010

- He starts working full-time from age 18 in 1963.
- During his 47 years of full-time work he earns at median age-specific (50th percentile) earnings for a man.
- Between the ages of 25 and 65, he and his employer contribute to a DC occupational pension scheme at 9% of total salary.
- He dies at age 86 (average life expectancy).[142]
- He retires at age 65 in 2010
- His pension pot size at retirement, after taking a 25% tax-free lump sum is: £75,000

Box 3: A high-earning woman, aged 60 in 2010

- She starts working full time from age 20 in 1970
- During her 40 years of work she earns at high-earnings (70th percentile) for a woman.
- Between the ages of 20 and 60 she and her employer contribute to a DC pension scheme at 15% of total salary.[143]
- He retires at age 60 in 2010
- She dies at age 89 (average life expectancy).
- Under a low life expectancy variant she lives until 76.
- Under a high life expectancy variant she lives until 101.
- Her pension pot size at retirement, after taking a 25% tax-free lump sum is: £123,000

[141] Average cohort life expectancy based on GAD life expectancy tables 2008 – based on principal projections
[142] Average cohort life expectancy based on GAD life expectancy tables 2008 – based on principal projections
[143] These contributions represent the higher end of DC pension contributions in the private sector with only 10% of employees and employers contributing more than these levels, ONS (2008) Occupational Pension Schemes Annual Report 2008, table 3.6 and 3.7

Analysis of the English Longitudinal Study of Ageing
The English Longitudinal Study of Ageing (ELSA) is an ongoing study of various social indicators of people aged over 50 in England. The analysis in this report draws on data relating to current and expected future pension income from the ELSA Wave 3 dataset 2006, uprated to 2010 prices. Proportions from ELSA are then applied to 2008-based population projections for the UK. Although ELSA only covers England, it has been assumed that the survey is broadly representative of the UK as a whole. In addition to these assumptions, the specific analysis undertaken requires a number of other assumptions to be made, which are detailed below. The results are therefore only broad estimates.

Satisfying the Minimum Income Requirement
The ELSA data has been used to estimate the number of individuals between ages 55 and 75 that might be able to satisfy the minimum income requirement of £20,000 a year using eligible sources of income. These include Basic State and Additional Pension, private pensions already in payment and any other sources of guaranteed pension income. Values were taken as recorded in ELSA, apart from the following:

- Private pensions already in payment are reported on the Benefit Unit level, whereas assessment of the MIR must be done on an individual level, meaning that for couples this figure must be split. Tests were repeated assigning 100% of this income to the male or split 50:50 between partners.

In addition to this, individuals with uncrystallised DC savings were assumed to purchase a level lifetime annuity providing income up to the MIR, with any remainder left unconverted.

Although accumulated fund values on current DC savings are available in ELSA, data on retained benefits from earlier periods of employment are not. In order to estimate this, broad assumptions on average contribution levels, investment returns and accrual rates were used in conjunction with available ELSA data on pension type, dates of scheme membership and current gross salary. Where scheme membership and salary data were unavailable, this was randomly assigned using a 'hot-decking' procedure based on the financial wealth quintile of the individual. This method is similar to that used by the IFS in their paper ***Estimating Pension Wealth of ELSA Respondents*** (2005).

Further analysis considered those in the age range 55 to SPA, who currently cannot meet the MIR but may be able to by the time they reach SPA. Here, where available, ELSA data relating to expected future State Pension entitlement, DB entitlement and DC savings were used to estimate future income levels of individuals. Where unavailable, these were estimated using a number of broad assumptions:

- State Pension entitlement was taken to be full BSP, so any Additional Pension entitlement has been ignored for these individuals, potentially underestimating income levels.
- Future DB entitlement has been estimated based upon current gross salary uprated in line with earnings to SPA.
- Retained DB benefits were estimated based upon ELSA scheme membership data and current gross salary, deflated by earnings and uprated to SPA in line with RPI. Where scheme membership data was unavailable, the same 'hot-decking' procedure was used.
- Current DC savings were accrued in line with an assumed real investment return of 3% and average contributions based upon respondents' current gross salary, uprated in line with earnings until SPA. Retained benefits from DC savings were accrued in-line with the assumed investment return.

When estimating future DC savings and DB entitlements, the individuals have been assumed to continue working and saving until SPA. The results are therefore at the upper end of what is likely.

Additionally, tests were repeated using a range of assumptions for the following:

- The uprating of private pensions already in payment; firstly keeping it level and secondly in-line with RPI capped at 2.5% to reflect level annuities and DB pensions in payment respectively.
- For individuals with entitlement to DB benefits given as an unspecified percentage of final salary, values of 0% and 45% (the average) were substituted.

The use of alternative assumptions on split of private pensions in payment to couples, uprating of private pensions in payment and the level of unspecified DB benefits mean that estimates are presented as a range.

Capped drawdown

ELSA data was also used to estimate the number of individuals between ages 55 and 75 that might be able to enter capped drawdown. This was taken to be any individual with DC savings greater than £100,000, after taking a tax-free lump sum of 25% of the total fund plus those people already in income drawdown.

The ELSA 2006 based estimate of the number of people currently in income drawdown was found to be lower than more recent estimates[144], which may be a result of an increase in the number of income drawdown products sold since 2006. Because of this, a range of estimates has been presented. The lower of these represents the number of ELSA

[144] HMT (2010c), estimate of current people in drawdown and ABI stats on current number of drawdown contracts outstanding

respondents either currently in income drawdown or having a DC fund over £100,000. The upper range includes the number of ELSA respondents with a DC fund over £100,000 plus the number of income drawdown contracts in force 2009 according to ABI statistics.

Again, this was then extended to test individuals in the age range 55 to SPA that do not currently satisfy this requirement, but could by the time they reach SPA. In addition to this, individuals with DC savings that could satisfy the MIR were tested as to whether they could:

- Enter into capped drawdown, that is assumed to have a fund of £100,000 or more (either instead of or as well as satisfying the MIR).
- Satisfy the MIR and have £50,000 DC savings remaining for flexible drawdown.

Assumptions about DC savings, both at present and at SPA were the same as in the previous section.

Stochastic modelling of outcomes

This paper also uses stochastic modelling to illustrate the outcomes for individuals who may choose to use drawdown products. A range of possible outcomes is projected for each possible drawdown product considered. Performing a large number of runs allows a probability distribution of the individual's outcome to be estimated.

The stochastic model uses the pension pots at retirement as a starting point. These are calculated in the individual model and set out in Boxes 2 and 3 above. The individuals are then assumed enter into drawdown arrangements that are invested in funds backed by a combination of equities, bonds and cash. The model uses Monte Carlo simulation to run 10,000 possible scenarios allowing annual investment returns on the fund to fluctuate each year.

Annual investment returns are assumed to be Normally distributed with the following parameters:

Asset Class	Proportion of fund	Mean Return	Standard Deviation	Correlations
Equity	60%	11.1%	21.9%	Eq/Bnd 0.51
Bonds	20%	5.7%	11.9%	Bnd/Csh 0.16
Cash	20%	5.0%	3.8%	Csh/Eq 0.29

These parameters are based on historical data from the Barclays Capital Equity Gilt Study from 1899 to 2010.

Limitations of the stochastic modelling

Monte Carlo simulation can be a powerful tool when trying to gain an understanding of the distribution of possible future outcomes. However, in common with other projection techniques, it is highly dependent on the assumptions made about the future. In this case, the choice of distribution and parameters of the underlying variables, the investment returns of Equities, Bonds and Cash are important to the results.

The assumption that annual investment returns are Normally distributed is used commonly in financial analysis,[145] however it has been argued that a Normal distribution does not adequately describe the occurrences of extreme events such as market crashes.

Historical data of market returns are available in the Barclays Capital Equity Gilt Study for the period from 1899 to 2010. There is a trade-off between using a long period of data to ensure there is enough data to estimate the parameters of future asset returns and using only recent data to ensure current relevance. It was decided to use the full dataset in order to have a large pool of data encompassing important events such as the 1927 market crash.

[145] For example IMA (2008)

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