Pensions Policy Institute

PPI

How will future pensioners use guaranteed income products?

Registered Company Number: 04145584. Charity Number: 1087856 (England & Wales)

About the Pensions Policy Institute

We have been at the forefront of shaping evidence-based pensions policy for 20 years.

The Pensions Policy Institute (PPI), established in 2001, is a not-for-profit educational research organisation. **We are devoted to improving retirement outcomes.** We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. Each research report combines experience with INDEPENDENCE to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our INDEPENDENCE sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

Our Vision

Better informed policies and decisions that improve later life outcomes.

We believe that better information and understanding will help lead to better policy framework and a better provision of retirement for all.

Our Mission

To promote, evidence-based policies and decisions for financial provision in later life through independent research and analysis.

We aim to be the authoritative voice on policy on pensions and the financial and economic provision in later life.

Est. 2001

By supporting the PPI, you are aligning yourself with our vision to **drive better-informed policies and decisions that improve later-life outcomes,** and strengthening your commitment to better outcomes for all.

As we look forward now to the next 20 years, we will continue to be the trusted source of information, analysis, and impartial feedback to those with an interest in later life issues. The scale and scope of policy change creates even more need for objective and evidence-based analysis. There is still much to do, and we look forward to meeting the challenge head on.

FOR FURTHER INFORMATION ON SUPPORTING THE PPI

PLEASE VISIT OUR WEBSITE:

www.pensionspolicyinstitute.org.uk

OR CONTACT:

Danielle Baker

Head of Membership & External Engagement

danielle@pensionspolicyinstitute.org.uk

This report has been authored by…

A Research Report by Daniela Silcock, Mark Baker, John Adams

Daniela Silcock
Head of Policy Research

Daniela originally joined the Pensions Policy Institute (PPI) in 2008 as a Researcher. She took a short break in 2012 to work as a Committee Specialist for the Work and Pensions Select Committee and returned to the PPI in 2014.

In 2015, Daniela became Head of Policy Research where she now leads the PPI Policy Research Team and oversees the research conducted by the team. She has a wealth of experience in conducting quantitative and qualitative research into all aspects of State and private pensions policy.

Daniela has written many articles which have appeared in both the national and trade press, as well as presented to a variety of domestic and international audiences, including radio and television appearances. She is often requested to provide comment from the PPI's independent perspective on a variety of topics relating to the provision of finances in later life.

Prior to working in research and policy, Daniela was a social worker with vulnerable adults and children. Daniela has an MSc in Social Policy and Planning from the London School of Economics. In her free time, she enjoys reading, gardening and knitting.

Mark Baker
Senior Policy Researcher

Mark joined the Pensions Policy Institute (PPI) team in October 2018. Since his time at the PPI Mark has authored a number of reports and Briefing Notes covering varied topic areas across the pensions landscape. Currently, Mark is focussing upon research concerning annuities and charging structures.

Prior to working at the PPI Mark earned a PhD in Sociology from the University of Exeter before working for RNIB and RNID in senior research and policy roles where he authored a number of influential research reports as well as chairing the Disability Benefits Consortium and ACEVO's welfare to work special interest group.

In his own time Mark likes to read, walk and go to the opera.

John Adams
Senior Policy Analyst

John has been with the Pensions Policy Institute (PPI) since 2008 and has worked in a lead role in the modelling of a wide range of projects including public sector pensions and pension related tax-relief.

John is also responsible for the PPI's Pension Facts and oversees the annual publication of the PPI's Pensions Primer: a guide to the UK pensions system. He has authored Briefing Notes and reports on subjects such as how housing wealth can support retirement, tax policy on pension schemes, harnessing pension savings for debt alleviation and public sector pension reforms.

Before working for the PPI, John worked for Hewitt Associates where he worked primarily on modelling of standard and non-standard Defined Benefit pension scheme calculations for the consultants to present to the clients.

Prior to joining Hewitt, John worked for the Government Actuary's Department for 8 years in the Occupational Pensions directorate, during which time he calculated public sector pension scheme valuations, bulk transfer values, and designed models for the use of other Government departments.

John has a BSc in Actuarial Mathematics and Statistics from Heriot Watt and a Post Graduate Diploma in Actuarial Management from Cass Business School.

In his spare time John is an avid baker and often shares the products of his baking with the rest of the PPI team.

This report has been kindly sponsored by B&CE, providers of The People's Pension, Hymans Robertson, Retirement Line, Standard Life, part of Phoenix Group and State Street Global Advisors. Sponsorship has been given to help fund the research, and does not necessarily imply agreement with, or support for, the analysis or findings from the project.

A Pensions Policy Institute report

PENSIONS POLICY INSTITUTE

PPI

Kindly sponsored by…

HYMANS # ROBERTSON

Retirement Line

Standard Life
Part of Phoenix Group

STATE STREET GLOBAL ADVISORS

Published by the Pensions Policy Institute

978-1-914468-07-0

© September 2022

www.pensionspolicyinstitute.org.uk

info@pensionspolicyinstitute.org.uk

Contents

	Page
Executive Summary	1
Introduction	3
Chapter One – How might the role of guaranteed income change in the future?	4
Chapter Two – How might those who need or desire a guaranteed income approach retirement income strategies?	11
Chapter Three – How might those with increased spending needs pre and early in retirement approach retirement income?	19
Chapter Four – What strategies might suit those who want to maintain liquid savings throughout retirement?	26
Appendix	30
References	31
Acknowledgement and Contact Details	32

Executive Summary

This report explores the role that guaranteed retirement income products may play in the future
This summary covers the main points of the report and acts as the conclusion.

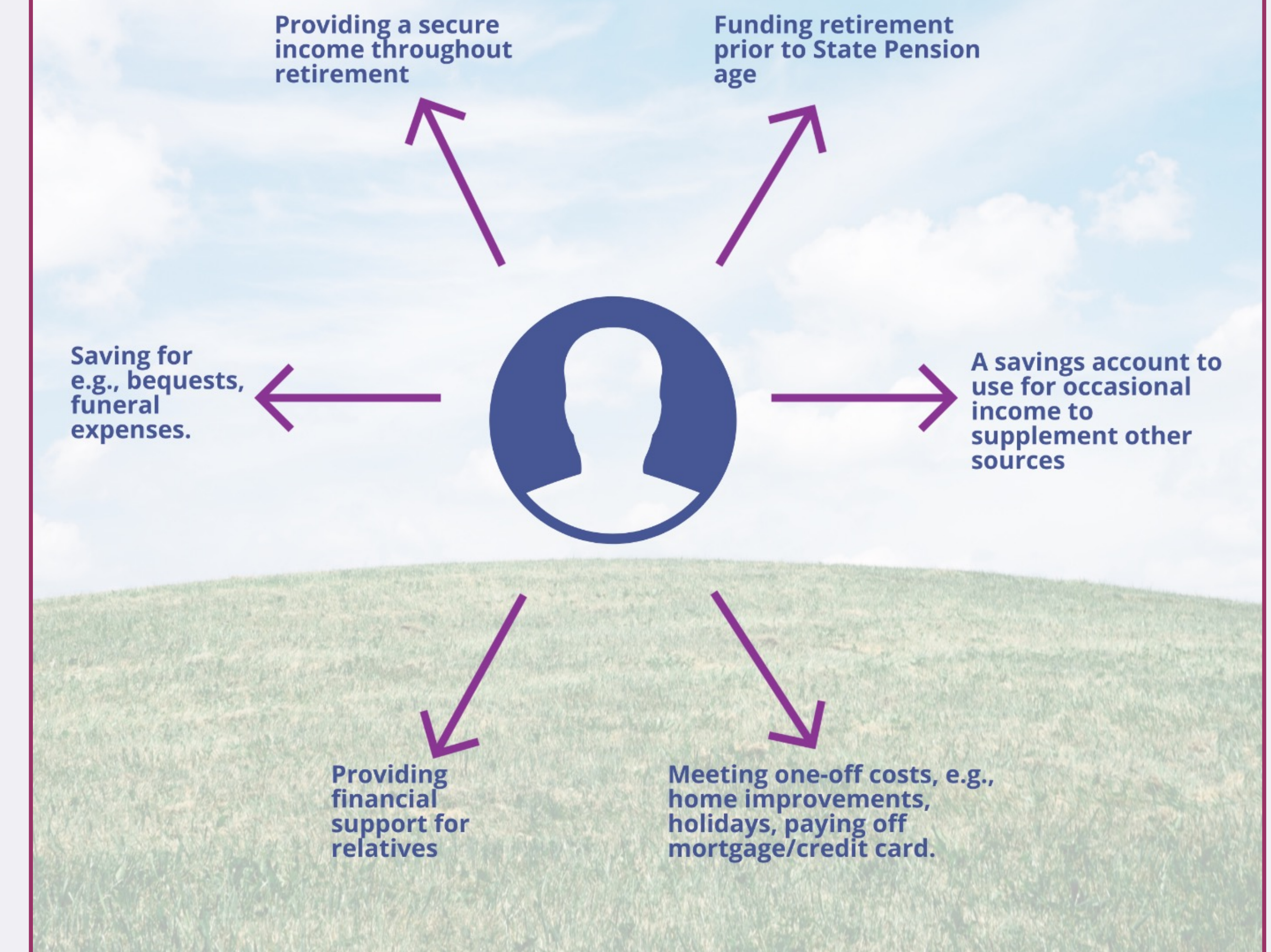
This report uses the term "annuity" to refer to a specific retirement-income product (or products) and the term "guaranteed income" when discussing how a specific type of income stream could be theoretically used to support retirement. This is because, in future, guaranteed income products may not always carry the annuity label, and this report wishes to explore the role that guaranteed income may play in the retirement portfolios of future pensioners.

Future pensioners will have different savings portfolios, needs and characteristics than current pensioners

- Future pensioners will be more dependent on their Defined Contribution (DC) savings, as they will be less likely to have a Defined Benefit (DB) safety net to fall back on. Decisions about how to access DC will more significantly impact retirement experiences and running out of DC savings too early in retirement could cause serious financial difficulties.
- Pensioners will face increased levels of financial risk, which extend from at-retirement decision making into mid and late retirement, and many will not have the financial capability to make informed decisions without support.
- People are less likely to reach retirement with sufficient savings to maintain their working-life standards of living in retirement, as DC contribution levels are far lower than those in DB and many workers will spend some time outside of pension saving. This will make choosing a retirement income strategy more complex.
- Both working and retiring has become more flexible. Working lives are becoming increasingly heterogeneous as levels of casual and self-employment increase, and people move in and out of the labour market more frequently.
- Alongside changes in working patterns, retirement is also changing as people find they need to work longer to provide for themselves and/or prefer a more gradual move into retirement through part-time/flexible working than a cliff edge. This means that income will need to be taken in increasingly flexible ways, to help people both through retirement transitions and into retirement.

◄ Prev Next ►

While at-retirement behaviour varies between people, there are archetypes of retirement needs and desires, based on qualitative evidence of behaviour and attitudes, which can be used to help illustrate the best retirement income strategies. These include, and may be a combination of the below (Ex.1).



Most archetypes will benefit from a combination of access to flexible withdrawals and guaranteed income

There are retirement income strategies, often using an annuity, drawdown or a combination of these, which can be used to meet the above needs. However, many people will base their at-retirement behaviour on expectations about their own longevity, health and household circumstances, which can change during retirement. In particular, the need to fund care costs in later life may not be anticipated. Therefore, retirement strategies require some flexibility, especially in the early years of retirement, to meet changing needs.

Timing annuity purchases with changes in need and the optimal price opportunity will require support for the majority of people. Prompts to advice and guidance during retirement will become increasingly important for future pensioners, especially as people may not always understand the importance of inflation-linked income. Many pensioners are struggling today due to the lack of an income which rises with inflation.

There will also be individuals who may benefit from an earlier guaranteed income due to health needs, low financial capability, or an aversion to making complex financial decisions during retirement. It will be important to ensure that those who would benefit from a guaranteed income purchase are not prevented from taking this step due to attitudinal/behavioural barriers.

The majority of people will benefit for at least a portion of their retirement from using drawdown or a combination of drawdown and a guaranteed income, especially those who know they have needs that are likely to change, for example, people supporting other family members.

This report uses hypothetical scenario modelling of three individuals with different characteristics to explore the impact of retirement income strategies on different people. The below summarises the main messages arising from the modelling.

While the modelling assumes that some people purchase an annuity at older ages, e.g., 80, at the moment, it is unlikely that many people would consider this option.

Those who need or desire a guaranteed income at some point during their retirement

- If an individual is likely to be using all of their income to meet their needs and/or is more likely to have variable needs in later retirement, they are more likely to benefit from purchasing an escalating annuity in early retirement or waiting to purchase a level annuity until mid retirement. These variable needs include renting, being financially dependent on another household member, and having no plans with regards to funding care. Individuals may also benefit from purchasing an annuity with an enhanced rate if and when health problems manifest, as the need for a secure and reliable income may be more pressing when managing health needs. Receiving an enhanced rate is now more straightforward, as all providers take health problems into account at the point of purchase, rather than requiring the individual to be aware that they are eligible.
- If an individual does not need to take income from their DC savings during early retirement, then they could benefit from taking a guaranteed income in mid or late retirement, as long as their investment returns make up for forgone mortality-cross-subsidie.

Those with increased spending needs pre and early in retirement, for example, those who need to fund retirement prior to State Pension age (SPa), those providing financial support for relatives, and those meeting one-off costs in early retirement

- Those required by circumstances to withdraw DC savings early will benefit from conserving the maximum amount of savings to use during later retirement.
- The way money is accessed prior to securing a guaranteed income will have an impact on tax, income and fund size, and people may need support to find the best way of accessing their savings for their own characteristics.
- Those who need to withdraw in high amounts from income drawdown will need to aim to convert to a guaranteed income in early to mid retirement if they wish to have a living standard closer to adequacy levels.
- If an individual reaches retirement with mortgage or credit card debt that they wish to pay off, but are unlikely to face any other significant one-off costs in retirement, they could achieve a higher standard of living from using all of their remaining pot to purchase a guaranteed income during early retirement.
- Future pensioners are likely to have larger DC pots and face both greater choice and greater potential risk to retirement income when making choices about how to access their savings.

Those who want to maintain liquid savings throughout retirement, for example, those who want to use DC savings as an account they can dip into, and those who wish to preserve their savings to leave as a bequest or for funeral expenses

- Waiting till mid to late retirement to buy an annuity with 100% of a fund will yield higher annual and lifetime income than purchasing during early retirement with 50% of a fund.
- Those wishing to preserve pension savings will need to weigh up their potential need for security against their desire to maximise their fund growth.

A lack of appetite for annuities means that hybrid products which offer both flexible withdrawals and guaranteed income may appeal more to consumers in future

One way in which the market is adjusting to the new landscape, where people have freedom to withdraw DC savings as they please but could still benefit from a guaranteed income element, is the development of products which offer flexible drawdown with an embedded guaranteed income element. There are currently two of these on the market.

There are also other product designs, not currently available in the UK, which could help meet the need for a guaranteed income while providing some flexibility and the opportunity to continue benefiting from investment returns, such as variable, deferred, fixed-term and built-in annuities.

As future pensioners will have complex retirements with changing needs, similar systems of support as exist for those pre and at retirement may need to be built up in order to ensure that there is guidance for those who want it, defaults and soft-defaults for the unengaged, and safety nets for those who may be making poor decisions. These supports will need to be designed to take into account changing retirement circumstances and facilitate people to use a combination of guaranteed income and flexible withdrawals in a way which meets their shifting needs.

Soft defaults which are tailored for different retirement need/desire archetypes could help people to better manage their retirement income

Alongside drawdown investment pathways, further pathways could be developed which allow for those with varying needs and circumstances to tailor their retirement income strategy; for example, these could allow for:

- People to remain in Uncrystallised funds pension lump sums (UFPLS) or enter drawdown and then secure a guaranteed income with a portion of their fund at a pre-specified age. In this scenario, the portion and the age would be agreed on by the individual and adviser/product manager.
- People to buy annuities in portions as they age.
- Management of withdrawal rates over time in order to preserve capital or ensure funds don't run out, which could include partial-annuitisation.

These strategies are likely to require further product development and potential reviews by the Pensions Regulator (TPR) to ensure the current regulatory system does not hinder more flexible approaches.

In addition to the above, a mid-retirement financial MOT, similar to the current mid-life financial MOT could be helpful, potentially around the age of 75 when cognitive decline may start setting in, consumption needs might start to smooth out, and insuring against running out of funds before death (longevity insurance) becomes more important.

Pensioners would also benefit from ongoing, free offers of pensions guidance, like that offered by Pension Wise, which can be called on at any age. This guidance will need to focus on the ongoing implications of financial decisions, while also helping people to better understand the implications of longevity and the financial benefit of cross-subsidisation in annuities.

Further work also needs to be done to ensure that take up of support options increases before, during and after retirement if people are to be helped to make optimal decisions in the future.

Introduction

The introduction of pensions flexibilities in 2015 led to a downturn in the number of annuities being purchased in the UK. While annuities and guaranteed income products still have an important role to play in the retirement landscape, they now coexist with a variety of other means of accessing pension savings, such as pensions drawdown and lump sum withdrawal.

The rise of workplace Defined Contribution (DC) pensions has seen the potential market for annuities increasing, as more people are in a position where they can self-select a guaranteed income product, and more people are purchasing annuities later in their retirement.

This report explores how guaranteed income products can provide people with income security in retirement, alongside other ways of accessing their pension pots. It will focus on how different personal circumstances and characteristics might affect people's retirement outcomes.

Chapter One – How might the role of guaranteed income change in the future?

Sets the scene for how future pensioners may use retirement income and the role that guaranteed income may play in these strategies.

Chapter Two – how might those who need or desire a guaranteed income approach retirement income strategies?

Introduces the PPI modelling, explores how different retirement income strategies may suit people who need or desire a secure, guaranteed income throughout retirement, and looks at variations of guaranteed income products which could be used in the future.

Chapter Three – How might those with increased spending needs pre and early in retirement approach retirement income?

This chapter explores retirement income options for those with early spending needs and considers policy options for helping people to manage complex retirement income strategies.

Chapter Four – What strategies might suit those who want to maintain liquid savings throughout retirement?

Explores retirement income strategies for those wishing to maintain liquid savings throughout retirement.

CHAPTER ONE:

HOW MIGHT THE ROLE OF GUARANTEED INCOME CHANGE IN THE FUTURE?

This chapter sets the scene for how future pensioners may use retirement income and the role that guaranteed income may play in these strategies

This report uses the term "annuity" to refer to a specific retirement-income product (or products) and the term "guaranteed income" when discussing how a specific type of income stream could be theoretically used to support retirement. This is because, in future, guaranteed income products may not always carry the annuity label, and this report wishes to explore the role that guaranteed income may play in the retirement portfolios of future pensioners.

PPI's 2022 Briefing Note, **Set for Life? Guaranteed incomes in retirement**, explored the ways in which people use guaranteed retirement income products today, and where there are barriers to people achieving an optimal retirement outcome. The Briefing Note concluded that:

- Guaranteed income products are likely to still form an important part of people's retirement incomes, alongside other products, but fewer are purchasing them than did before
- Those who do purchase annuities generally have larger pot sizes, and more people are purchasing in later retirement
- The potential market for annuities is growing with the increase in Defined Contribution (DC) savers
- Attitudinal barriers to purchasing annuities may prevent some people from achieving optimal outcomes in retirement

This report looks forward to the next few generations of pensioners and asks what role guaranteed retirement income products may play in the way people manage retirement finances in future. This chapter covers:

- How future pensioners' needs and characteristics may differ from those of today's
- How needs can change during retirement and what this may mean for future pensioners
- What archetypes of retirement needs/circumstances may look like
- What support future pensioners may need during retirement (advice, guidance, defaults)

Future pensioners will be more dependent on their DC savings and are likely to have consumption needs which vary during retirement

Future pensioners will have more complex retirement finances to manage as declining Defined Benefit (DB) provision means that dependence on DC savings, which requires more active management and carries more risk, will grow. Alongside this, economic and demographic changes have resulted in greater intergenerational sharing and caring responsibilities for older people. Policy changes, resulting in rises to State Pension age (SPa), have also led to more complex financial situations for those who are unable to work up until entitlement to State Pension and may have to fill the gap with income from their private pension savings.

Future pensioners will depend more on their DC savings

Economic difficulties, policy changes and increases in longevity have all combined to make hosting DB pension schemes more economically difficult for employers.[1] As a result, people saving in the private sector are much more likely to be offered access to a DC scheme by their employer. Automatic enrolment has contributed significantly to the rise in DC savings as it has brought over ten million people into pension saving, 98% of whom have been enrolled into DC schemes.[2]

These changes will take a couple of decades to play out; current pensioners still receive a significant proportion of income from DB pension schemes. In 2020/21, pensioner household units received an average of 33% of income from DB pensions, compared to around 3% from DC savings.[3] However, over the next few decades, people reaching retirement will have decreasing eligibility for DB pensions and increasing levels of DC savings. The Department for Work and Pensions (DWP) projects that, between 2014 and 2060, the average amount of income pensioners receive from DC pensions will increase by 220%, and the average amount received from DB pensions will decrease by 65%.[4]

This change in the retirement saving portfolios of future pensioners will impact their needs in several ways:

- Future pensioners will be more dependent on their DC savings, as they will be less likely to have a DB safety net to fall back on. Therefore, decisions about how to access DC savings will more significantly impact retirement experiences, and running out of them too early in retirement could cause serious financial difficulties.
- Pensioners will face increased levels of financial risk which extend from at-retirement decision-making into mid and late retirement.
- People are less likely to reach retirement with sufficient savings to maintain their working-life standards of living in retirement, as DC contribution levels are far lower than those in DB and many workers will spend some time outside of pension saving. This will make choosing a retirement income strategy more difficult for people.

Changes to working and retirement patterns mean that retirement income needs will vary more widely between people and during retirement in the future

The structure and format of retirement needs is changing as society changes. People are less likely to stay in one job and retire with an employer pension or annuity. Instead, both working and retiring has become more flexible. Working lives are becoming increasingly heterogeneous as levels of casual and self-employment increase and people move in and out of the labour market more frequently:

- Between 2001 and 2017, the proportion of those in work who were self-employed grew from 12% to 15%,
- Between 2000 and 2020, the proportion of the workforce on a zero-hour contract rose from 0.8% to 3%,
- The average number of jobs people have in their lifetime, around six in 2017, is likely to grow to around 12.5 for millennials.[5]

[1] Wilkinson et. al. (PPI) (2021)
[2] Wilkinson et. al. (PPI) (2021)
[3] DWP (2022a), Table 2.1
[4] DWP, GSR (2015)
[5] ONS (2018a); ONS (2021a); www.recruitment-international.co.uk/blog/2017/11/millennials-likely-to-have-12-jobs-intheir-working-lives-research-finds

Alongside changes in working patterns, retirement is also changing as people find they need to work longer to provide for themselves and/or prefer a more gradual move into retirement through part-time/flexible working than a cliff edge:

- In 1995, 13% of those aged 60 to 64 and 4% of those aged 65 and over worked part-time, compared to 22% and 6% in 2020.[6]
- Increases in part-time working at older ages were accompanied by increases in employment: in 1992, 57% of those aged 50 to 64 and 6% of those aged 65 and over were in work, compared to 71% and 11% in 2021.[7]
- In 2020, the average age of labour market exit for men was 65 and 64 for women, up from age 63 for men in 1996 and 60 for women in 1986.[8]

Much of this rise in older working has been driven by increases to SPa, from age 60 for women and age 65 for men in 2010, to age 66 for both in 2020. SPa will continue increasing to age 67 for both men and women by 2028.

These changes to working and retiring patterns affect financial needs as some people will require less pension income during early retirement if they have earnings income from part-time jobs. Others may require more income than before in older ages prior to SPa, in order to start their own business or learn new skills. Some people may access DC savings prior to leaving work in order to fund these new ventures. There will also be people who are unable to work up until SPa as a result of developing health problems, needing to provide care or being unable to find employment. These people may also need to access DC savings early, reducing the amount that can be potentially used to fund retirement.

Increases in intergenerational sharing may affect how future pensioners use income

The prevalence of adult children living with their parents and older people supporting younger family members is increasing. COVID-19 is likely to have exacerbated this trend. In 2020, 28% of people aged between 20 and 35 lived with their parents, up from around 25% in 2019. However, the trend for adult children to live at home has been on the rise since 1999. [9] Some of the support provided to adult children comes from pension savings, accessed by those over age 55; 31% of people whose adult children lived with them were withdrawing an average of £414pcm from their pension per child in 2020,and 28% were taking money from their savings.[10] In 2020/2021, around 19% of people who took their pension as a cash lump sum used some portion of it to support family members.[11] Those supporting family in pre and early retirement might need to carefully manage their savings in order to ensure they don't deplete them too early.

Higher rates of caring among older people could affect the way people access retirement income

Caring at older ages, especially in the years leading up to retirement, is associated with low employment and low incomes, and can disrupt retirement plans. Around 20% of carers give up employment to fulfil caring responsibilities. The employment rate for carers is below the national average, at 67%, with more than half of those not working saying they would like to do so. 53% of carers have borrowed money as a result of their caring role, and 60% have used all of their savings to cover the costs of caring.[12]

The proportion of older carers is likely to increase over the next few decades; in 2015, 28% of people over age 65 had difficulties with essential daily activities. This is projected to increase to 67% by 2040. Between 2018 and 2030, the number of carers in the UK is expected to increase from 7 million to 10.4 million.[13] The need to care for older parents or partners could increase consumption needs prior to retirement, if people need to support themselves before they can access their State Pension, and during retirement, as providing informal care is associated with extra expenses such as travel, heating and food.[14] These trends are more likely to affect women's ability to support themselves during older ages, as women are more likely to provide care than men; in 2018, 42% of carers were men and 58% were women.[15]

There are several archetypes of needs/desires which future retirement income strategies can be built on

While needs and desires will vary widely between people and change pre, during and post retirement, there are six useful need/desire archetypes, based on qualitative evidence on behaviour and attitudes, which can be used to summarise what future approaches to retirement income might look like. People may experience several of these during retirement, or may start retirement with a combination:

- **Providing a secure income throughout retirement:** this archetype will suit people with low engagement or financial capability who do not wish to make active decisions, at different stages during retirement. This archetype will also suit those with health problems, those with cognitive decline, and those worried about managing and maintaining income throughout retirement.
- **Funding retirement prior to SPa:** this archetype will suit those who can't work up to SPa because they either develop their own health problems, need to care for others with health problems or because they can't find employment.
- **Providing financial support for relatives:** this archetype is likely to suit those who have ongoing costs, because they are caring or providing support to children or grandchildren who are, for example, attending University, buying a house or temporarily unemployed/short of funds.
- **Meeting one-off costs, for example, home improvements, holidays, paying off mortgages/credit cards:** This archetype might suit those who either have sufficient income from other sources, and/or those with low levels of saving in DC which they feel would not be enough to add substantially to standards of living.
- **Saving, for example, for bequests or funeral expenses:** this archetype is likely to suit those who have sufficient income from other sources to achieve an adequate income, or who might wish to spend the minimum necessary from their DC savings and save the rest to leave behind them. Some of these people may also be saving for care costs.
- **A savings account to use for occasional income to supplement other sources:** this archetype is likely to suit those who have income from other sources, but not enough for significant discretionary spending and who wish to preserve some savings for changes in need, or for occasional extra spending on birthday presents/holidays etc. (Figure 1.1).

[6]ONS (2020)
[7]ONS (2021b)
[8]ONS (2020)
[9]ONS Dataset: Young adults living with their parents, Young adults aged 15-34 living with their parents by age and sex, UK, 2020; ONS (2019)
[10]www.thisismoney.co.uk/money/pensions/article7478231/One-three-parents-stay-home-adultchildren-tapping-pension-pots.html
[11]DWP (2022b)
[12]ONS (2018b)
[13]https://carers.org/key-facts-about-carers-andpeople-they-care
[14]Beesley, L. (2006)
[15]NAO (2018)

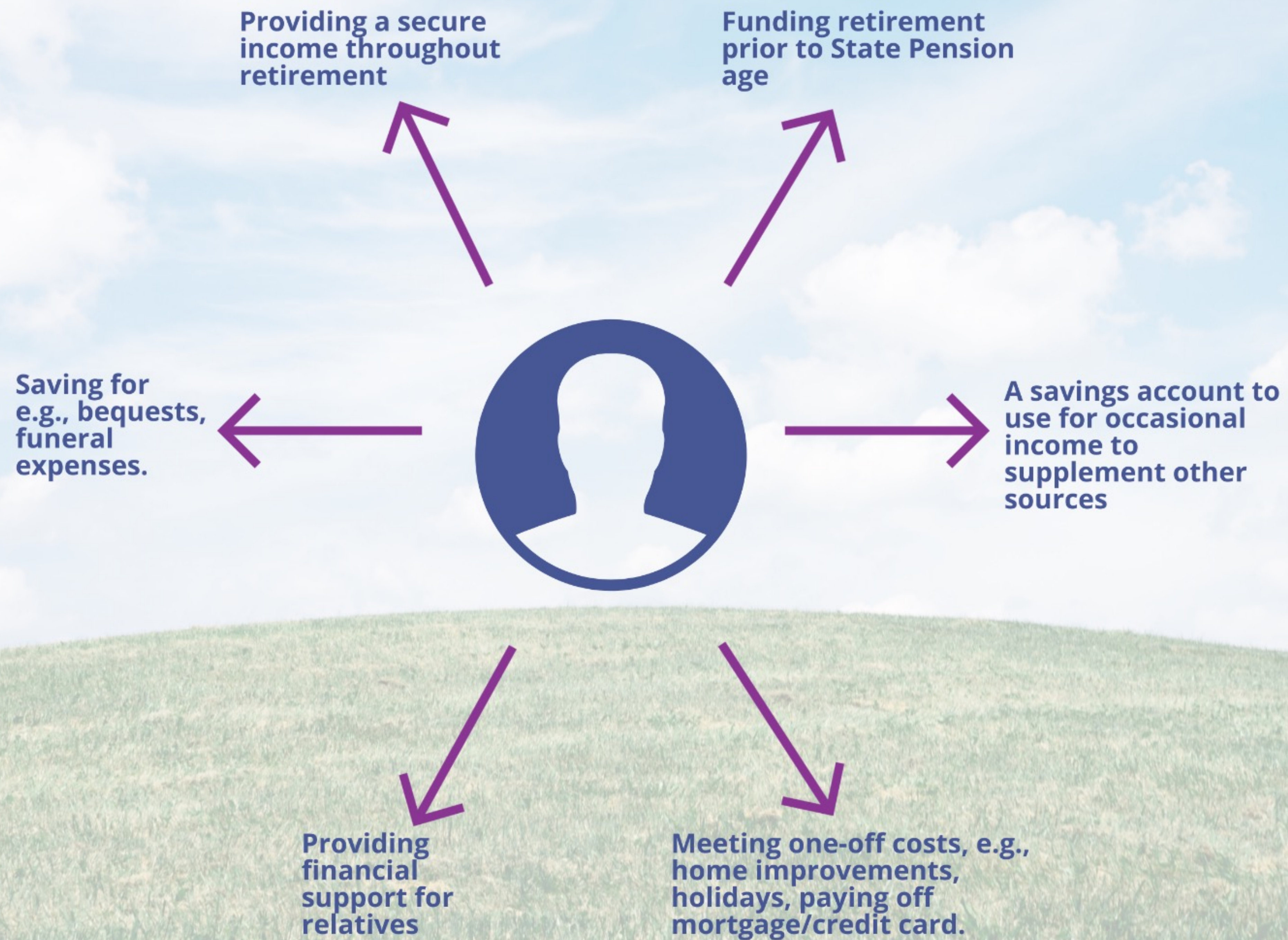


Figure 1.1: Retirement need/desire archetypes
Providing a secure income throughout retirement
Funding retirement prior to State Pension age
Saving for e.g., bequests, funeral expenses.
A savings account to use for occasional income to supplement other sources
Providing financial support for relatives
Meeting one-off costs, e.g., home improvements, holidays, paying off mortgage/credit card.

Current retirement choices are geared toward people committing to a retirement income strategy at the beginning of retirement; going forward, more flexibility will be needed as circumstances may change as people age

Different archetypes will be associated with different retirement income strategies. However, for people who might identify with several archetypes, who have needs that change during retirement, or who might have miscalculated what they might need or want, flexibility and support during retirement will be key.

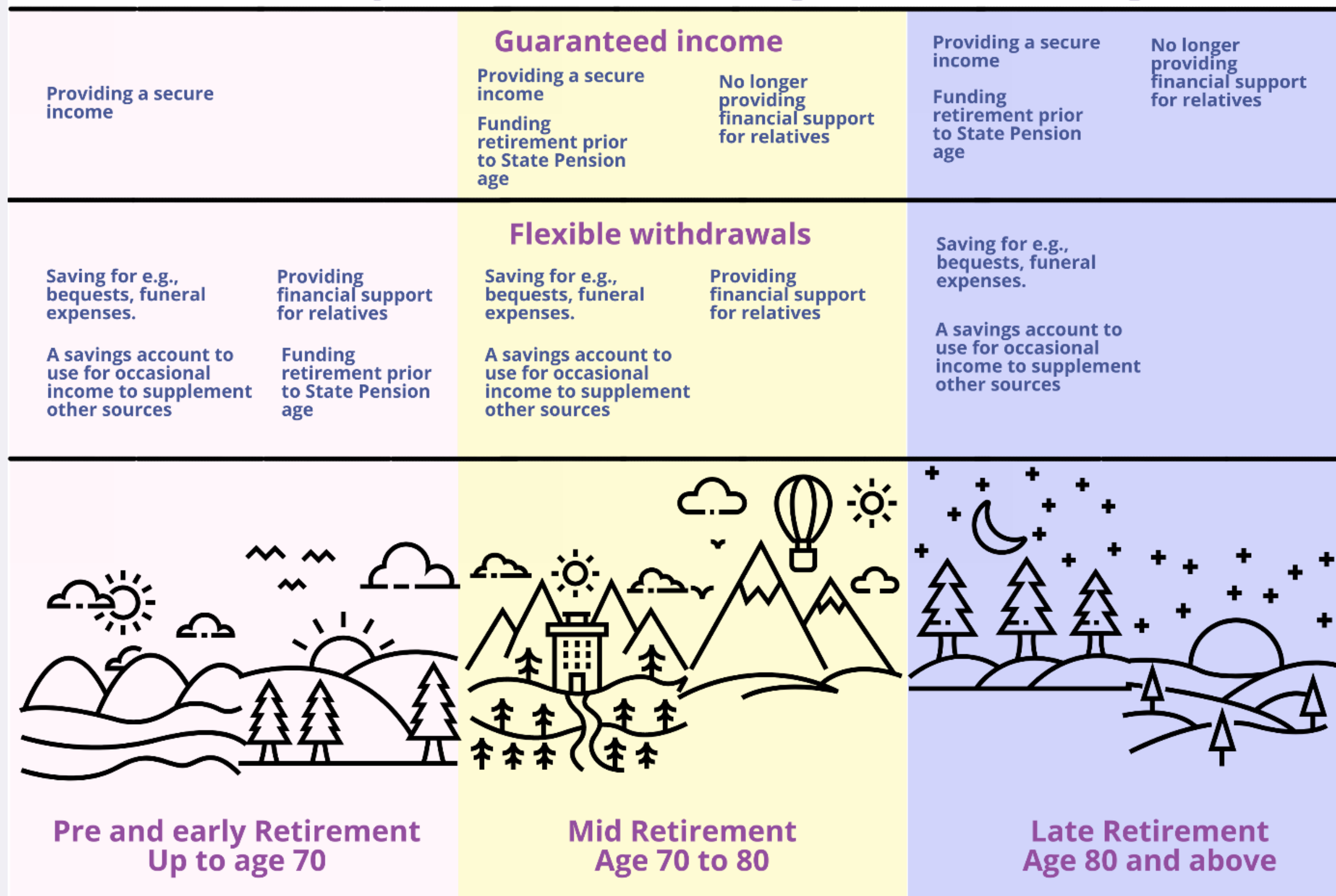
Most archetypes will benefit from a combination of access to flexible withdrawals and guaranteed income

Each archetype or combination of archetypes can be roughly associated with one or both of flexible withdrawals and guaranteed income. For example:

- While someone who only wants a secure income throughout retirement might wish to purchase an annuity for their whole retirement, someone who needs to fund themselves up until SPa might wish to use drawdown until retirement and then buy an annuity.
- An individual who needs to support family members might benefit from using drawdown until they no longer need to make payments, and then convert to an annuity.
- Someone who wishes to have occasional income to call on as well as a secure source of income might want to take both drawdown and an annuity throughout their retirement.
- Many people will benefit from moving most or all of their income into an annuity as they age due to cognitive decline and the need for longevity protection (Figure 1.2).

Figure 1.2: Need archetypes may be associated with taking income in different ways throughout retirement

illustration of how those with different retirement need/desires may take income during retirement stages



People have varying ideas about what an optimal retirement income looks like

People have different approaches and attitudes to how they want their retirement income to look and these change as people age.

While there is little data on attitudes within the UK regarding the importance of different retirement income products, Australian attitudinal data can help shed some light on how people approach retirement

Research on Australian DC savers found that while appetites for drawdown style products are in theory quite low among people and reduce during retirement, drawdown is popular in practice.

Only around 6% of Australians under the age of 55 find the idea of "a product that may go up or down with the market and can run out over time" very appealing. This rises to 7% by 10 years to retirement, but then drops to 5% for those transitioning to retirement and 4% for those in retirement.[16]

However, 68% of those under age 55 find the idea of "a guaranteed income for life" very appealing.[17] This drops to 67% for those approaching retirement, 63% for those transitioning into retirement and 54% of retired people. Considering that very few people, around 6%, annuitise in Australia, people's ideas about what they want do not necessarily translate into action.[18]

It is also interesting that the appetite for both annuities and drawdown falls during and into retirement. This could be related to negative experiences with financial services or disengagement arising from confusion about how best to proceed.

Intentions within the UK are somewhat more balanced. The retirement options people favour are related to how clear they are about their retirement plans, which may, in turn, be related to financial capability. For example, among DC savers who have a clear plan, 23% intend to take an annuity, compared to 46% of those who don't have a clear plan (Figure 1.3).

Figure 1.3: retirement access plans among DC savers in 2020/21[19]

Plan	Has a clear plan for how will take pension	Does not have a clear plan for how will take pension	Total
Take an annuity	23%	46%	39%
Purchase an income drawdown product	40%	35%	37%
Take partial lump sum	20%	23%	22%
Take all pension as lump sum	57%	70%	66%
None of the above	6%	3%	4%

As in Australia, attitudes in the UK do not always correlate with behaviour either. Here, 39% of people plan to take an annuity, but in 2020/21, only 13% of those accessing their DC pots for the first time purchased an annuity.[20]

While there is little data, and more is needed, on the underlying attitudes in the UK which lead to the choices of retirement income strategy, there is some correlative data; for example, those with small pots (around £17,000) are more likely to take their entire savings as a lump sum, and those with DB savings tend to access their DC pots at older ages.[21]

However, a worrying trend among those with DC savings is a lack of clear plan, or understanding of options. In 2020/21:

- 16% of people with DC savings did not know that they would need to make a choice about how to access their pension
- 60% knew they would have to make a choice, but did not have a clear plan for how to do so
- 23% had a clear plan for how to take their DC savings.[22]

One of the main retirement interventions is the "wake-up" pack sent to DC savers from age 50, and every five years after that. These packs detail the options available to DC savers, the available retirement-income products and contain referrals to those who can provide support.

33% of recipients do not recall receiving their pack, however, those who do recall them are more likely to have a clear retirement plan (45% compared with 12%). Special attention may need to be given to those who do not recall receiving their pack, as vulnerable customers (with low incomes and/or low financial capability) are more likely to be within this group. In particular, women who tend to have less understanding of pension issues and who are less likely to know how much they might need to live off in retirement,[23] might benefit from intervention pre-retirement.

[16] Challenger data, Australia
[17] Challenger data, Australia
[18] Commonwealth of Australia (2020)
[19] DWP (2022b)
[20] https://www.fca.org.uk/data/retirement-income-market-data-2020-21
[21] DWP (2022b)
[22] DWP (2022b)
[23] DWP (2022b)

Conclusion

Future pensioners will be more dependent on their DC savings and are likely to have consumption needs which vary during retirement

- Future pensioners will be more dependent on their DC savings, as they will be less likely to have a DB safety net to fall back on. Decisions about how to access DC will more significantly impact retirement experiences and running out of DC savings too early in retirement could cause serious financial difficulties.
- Pensioners will face increased levels of financial risk which extend from at-retirement decision-making into mid and late retirement.
- People are less likely to reach retirement with sufficient savings to maintain their working-life standards of living in retirement, as DC contribution levels are far lower than those in DB and many workers will spend some time outside of pension saving. This will make choosing a retirement income strategy more difficult for people.

While at-retirement behaviour varies between people, there are archetypes of retirement needs and desires which can be used to help determine the best retirement income strategies. These include, and may be a combination of, the below:

- Providing a secure income throughout retirement;
- Funding retirement prior to SPa;
- Providing financial support for relatives;
- Meeting one-off costs, for example home improvements, holidays, paying off mortgages/credit cards;
- Saving, for example, for bequests or funeral expenses; and
- A savings account to use for occasional income to supplement other sources.

Most archetypes will benefit from a combination of access to flexible withdrawals and guaranteed income

People have varying ideas about what an optimal retirement income looks like.

CHAPTER TWO:

HOW MIGHT THOSE WHO NEED OR DESIRE A GUARANTEED INCOME APPROACH RETIREMENT INCOME STRATEGIES?

This chapter introduces the modelling, explores how different retirement income strategies may suit people who need or desire a secure, guaranteed income throughout retirement, and looks at variations of guaranteed income products which could be used in the future.

The rest of this report deploys scenario modelling in order to illustrate how people with different characteristics might best use guaranteed income, in combination with other products, to fit their needs and circumstances as they change during retirement. This chapter covers:

- Hypothetical individuals modelled in this report and modelling assumptions;
- How those who need or desire a secure guaranteed income in retirement might approach retirement income strategies;
- How the current annuities market is developing to meet emerging needs for flexibility; and
- Other guaranteed income products which could be used in the UK to meet the need for both a guaranteed income and some flexibility.

Key chapter findings:

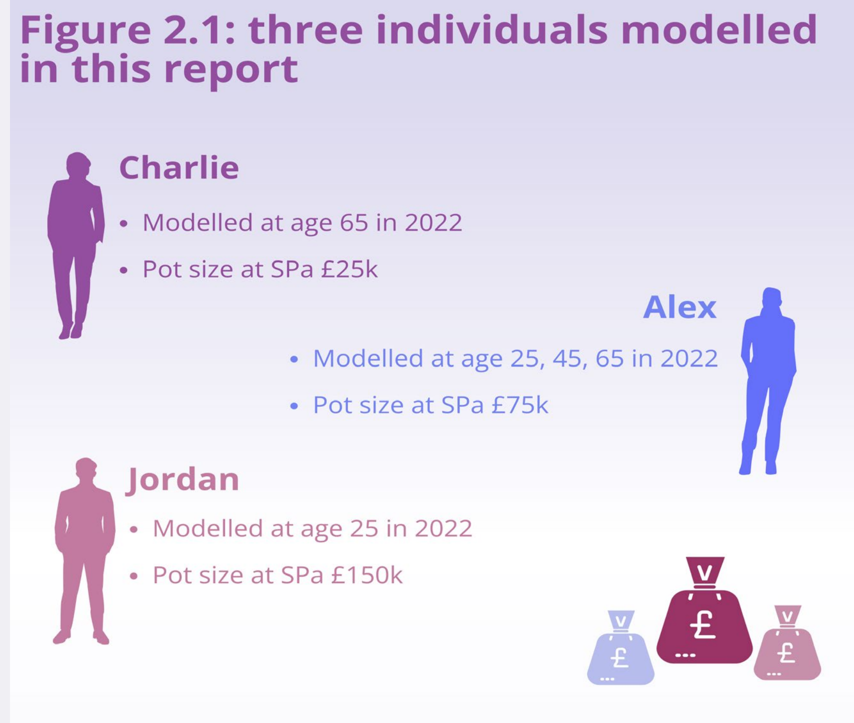
- The timing of an annuity purchase affects the price.
- Those with supplementary income can benefit more from taking a guaranteed income in mid to late retirement.
- If an individual is likely to have higher income needs in later life, or is using all of their income to meet their needs in early retirement, they will benefit more from waiting to purchase an annuity.
- If the example individual 'Alex' does not need to take income from Defined Contribution (DC) savings during early retirement, then they will benefit from taking an annuity in mid or late retirement, as long as their investment returns make up for forgone mortality-cross-subsidies.
- Waiting to purchase an annuity and/or purchasing an escalating annuity, results in higher annual income during retirement.
- A lack of appetite for annuities means that hybrid products which offer both flexible withdrawals and guaranteed income may appeal more to consumers in future.
- Alternative annuity products could also be used to appeal to people's appetites for flexibility.

This report explores hypothetical outcomes for three individuals

This report uses hypothetical scenario modelling to explore how three individuals with different pot sizes at State Pension age (SPa) and retirement ages are affected by different retirement income scenarios (Figure 2.1).

For more information on the individuals and modelling, please read the Appendix.

Figure 2.1: three individuals modelled in this report



The three individuals take their retirement income in different ways in order to illustrate how alternative strategies may suit different need/desire archetypes. Strategies are measured against the level of annual and lifetime income they provide, how well they help individuals to meet adequacy income targets, and how well they suit the needs of different archetypes. There are several key assumptions underlying the modelling (Figure 2.2).

Figure 2.2: key modelling assumptions

Pot at retirement

- Investment returns after retirement are based on two notional funds, a low-risk fund and a high-risk fund. The target returns of these funds are as follows:
  - Low-risk fund: Consumer Prices Index (CPI) over expenses
  - High-risk fund: earnings growth plus 1.5% over expenses
- The future rates of return are assumed to be in line with the targets.
- Pots are de-risked, at time of access they have a pot invested 60% in the low-risk fund, and 40% in the high-risk fund.
- All pot sizes are what remains after 25% tax-free lump sum has been taken.

Annuity rates

- Annuity rates are based on a blend of male and female mortality rates reflecting the unisex requirement of annuities sold in the UK.
- The discount rate is based on the Office for Budget Responsibility's (OBR) projected annual gilt returns, with an adjustment factor.
- Mortality proportions and the gilt rate adjustment remain constant over time; future annuities are modelled using these parameters and based on the Office for National Statistics' (ONS) projections of mortality and gilt returns (see modelling appendix for more detail).

Drawdown

- Drawdown investments are based on an asset allocation of: 60% in the low-risk fund, and 40% in the high-risk fund.
- Individuals draw 3.5% of the initial drawdown purchase, uprated in line with growth in CPI every year. This is in accordance with a strategy designed to maintain a steady income throughout retirement while having a high probability of not completely depleting the fund. This has been a common assumption in PPI reports modelling a "sensible" drawdown approach.
- As part of sensitivity analysis, some runs assume withdrawal of 8% of the initial fund, not increasing each year; 43% of regular withdrawals were withdrawn at an annual rate of 8% or more of the pot value.[24]
- Returns are net of charges (based on benchmark net returns).

All income shown is total from State and private pensions in 2022 earnings terms.

Adequacy targets

- Income received is measured against three different adequacy targets:

1. A working-life income "target replacement rate", which allows a median earner to achieve the same standard of living they had in working life during retirement: **£20,100pa**[25]
2. A "minimum" Retirement Living Standard, based on qualitative research of what people in similar circumstances think is required to achieve a minimally acceptable standard of living: **£10,900pa**[26]
3. A "Moderate" Retirement Living Standard which allows for a basic standard of living with some luxuries: **£20,800**[27]

[24] 43% of regular withdrawals were withdrawn at an annual rate of 8% or more of the pot value. FCA (2022) Retirement income market data 2020/21
[25] PPI calculations, based on Pension Commission's targets of working-life replacement rates required to replicate working-life living standards in retirement
[26] Based on Joseph Rowntree's Minimum Income Standard and Pension and Lifetime Savings Association's Minimum Retirement Living Standard
[27] Pension and Lifetime Savings Association's Moderate Retirement Living Standard

The rest of this report considers each archetype in turn, and how people with different characteristics might access retirement income. While the modelling assumes that some people purchase an annuity at older ages, e.g., 80, at the moment, it is unlikely that many people would consider this option.

Meeting one-off costs, e.g., home improvements, holidays, paying off mortgage/credit card.

Providing financial support for relatives

A savings account to use for occasional income to supplement other sources

Saving for e.g., bequests, funeral expenses.

Funding retirement prior to State Pension age

This archetype will suit people with low engagement or financial capability who do not wish to make active decisions, at different stages during retirement.

This archetype will also suit those with health problems, those with cognitive decline, and those worried about managing and maintaining income throughout retirement.

Providing a secure income throughout retirement

At some point during most people's retirements, they are likely to need a secure, guaranteed income, which lasts throughout the rest of their life. Those who have little variation in need during early retirement could benefit from securing a guaranteed income with some or all of their savings soon after they leave work. Others may see the need for guaranteed income grow as they reach older ages and expenditure levels out, cognitive decline sets in and insuring against running out of funds before death (longevity insurance) becomes a key concern.

The timing of an annuity purchase affects the price

A key factor in determining outcomes from buying an annuity is the timing of the purchase. There are three main timing issues to consider:

- **Market effects on price:** At times of economic downturn, annuity rates are lower (i.e., annuities are more expensive) because the provider anticipates receiving a lower return on the annuity purchase price, once invested. Sometimes delaying for a few months or a year can mean a substantial difference in rate; however, delay is not an option for everyone. At the point of writing this report, August 2022, annuity rates have risen as a result of increases in general interest rates.[28] This means that those purchasing an annuity today will get a better rate than someone purchasing one a few months ago.
- **The effect of age:** The later someone purchases an annuity, the higher the rate of income they will receive. For example, based on current mortality rates and market returns an individual at age 65 would be offered a single-life, level annuity rate of around 5.9%, compared to around 7.3% for a 70-year-old, and around 9.3% for a 75-year-old. These rates are based on reduced expectation of life expectancy. However, to take advantage of these higher rates one must either forgo taking any income from their DC savings until older ages, or spend down their savings, thereby reducing the total amount used to purchase the annuity. Waiting longer to purchase an annuity also increases the likelihood of receiving a higher rate due to health problems.
- **Mortality drag:** annuities, like DB schemes and the State Pension operate using a mortality cross-subsidy.

[28] https://www.thisismoney.co.uk/money/pensions/article-11039971/Annuity-rates-better-value-recent-rate-rises.html

Those in an annuity pool who die young subsidise those who live for the average amount of time or longer than expected. This is known as a mortality cross-subsidy.

People who purchase an annuity in later years miss out on some of the cross subsidy from those who die at earlier ages, because the average life expectancy increases in the pool the older an individual is by the time they purchase an annuity. The only way to avoid losing out through mortality drag is to ensure that the rate of return on investments is equal to or higher than the amount of mortality cross-subsidy forgone. Some people may be put off from purchasing an annuity if they believe they will die early, as they do not want their savings to be used to subsidise other people.

Other market changes will also affect the price of annuities over time. If more people with longer life expectancies purchase annuities, for example, the rate of pay out will decrease.

The most important considerations for those purchasing annuities, outside of timing and cost, are:

- How much income do they want/need and whether needs might change,
- Whether they would like inflation protection, and
- The level of cover they would like for dependents.

Those with supplementary income can benefit more from taking a guaranteed income in mid to late retirement

Alex is age 65 in 2022 and reaches their SPa with a £75,000 pot. Alex would like a guaranteed income in retirement because they are worried about managing their money and want to make sure they have an income for life. They could access a guaranteed income at several different times, with varying results. If Alex has no supplementary income, then they are likely to benefit from taking a guaranteed income in early retirement, as they will gain more from the mortality cross-subsidy. The following illustration is based on the assumptions that at their SPa of 66 in 2023:

- *Alex takes their 25% tax free lump sum;*
- *uses the rest of the fund to take a drawdown account withdrawing at 3.5% of original fund + a CPI uplift; and then*
- *uses the entire fund to purchase an annuity at age 70, 75 and 80 (Figure 2.3).*

Figure 2.3[29]

Those without supplementary income and needs unlikely to change in later life are likely to benefit more from taking an annuity with all savings early on in retirement

Total State and private pension income for a person currently aged 65 with a pension pot of £75k at SPa drawing down at 3.5% with CPI uprating, then annuitising at various ages (2022 earnings terms)

Alex's total income over retirement increases the earlier they take their annuity. Assuming Alex lives to median life expectancy, their total income during retirement would be:

- Around £295,000 if they annuitise at age 70
- Around £294,000 if they annuitise at age 75
- Around £287,000 if they annuitise at age 80

The differences in total income arise from Alex missing out on mortality cross-subsidies that give them a higher rate from their annuity than they replicated using their drawdown investments. Therefore, the longer they wait and the more they deplete their DC savings through drawdown, the lower their lifetime income. However, the same level of annual income will become cheaper to purchase, the older Alex gets.

If Alex is likely to have higher income needs in later life, or is using all of their income to meet their needs in early retirement, they will benefit more from waiting to purchase an annuity

Under the above scenario, Alex has purchased a level annuity. This means that their income reduces in earnings and prices terms during their retirement because of inflation. If Alex is unlikely to have variable needs in later retirement because they own their property outright; are already single or financially independent of their partner; have already made arrangements for funding later life care needs; and, do not require their total monthly income in early retirement to meet their needs, then an income that declines will be less difficult to manage on than for those whose needs are likely to go up. Alex can then optimise total retirement income by purchasing a level annuity in early retirement.

However, if Alex is using all of their income to meet their needs in early retirement, then a level annuity will make it harder to meet those needs over time, indicated by Alex's income reducing relative to the moderate Retirement Living Standard and the median working-life replacement rate during their retirement.

[29] PPI Modelling

If Alex is likely to be using all of their income to meet their needs and/or is more likely to have variable needs in later retirement because they are renting; are financially dependent on another household member; and, have no plans with regards to funding care, they are more likely to benefit from:

- purchasing an escalating annuity in early retirement,
- waiting to purchase a level annuity until mid retirement, or,
- purchasing an annuity with an enhanced rate if and when health problems manifest, as the need for a secure and reliable income may be more pressing when managing health needs.

If Alex does not need to take income from DC savings during early retirement, then they will benefit from taking an annuity in mid or late retirement, as long as their investment returns make up for forgone mortality-cross-subsidies

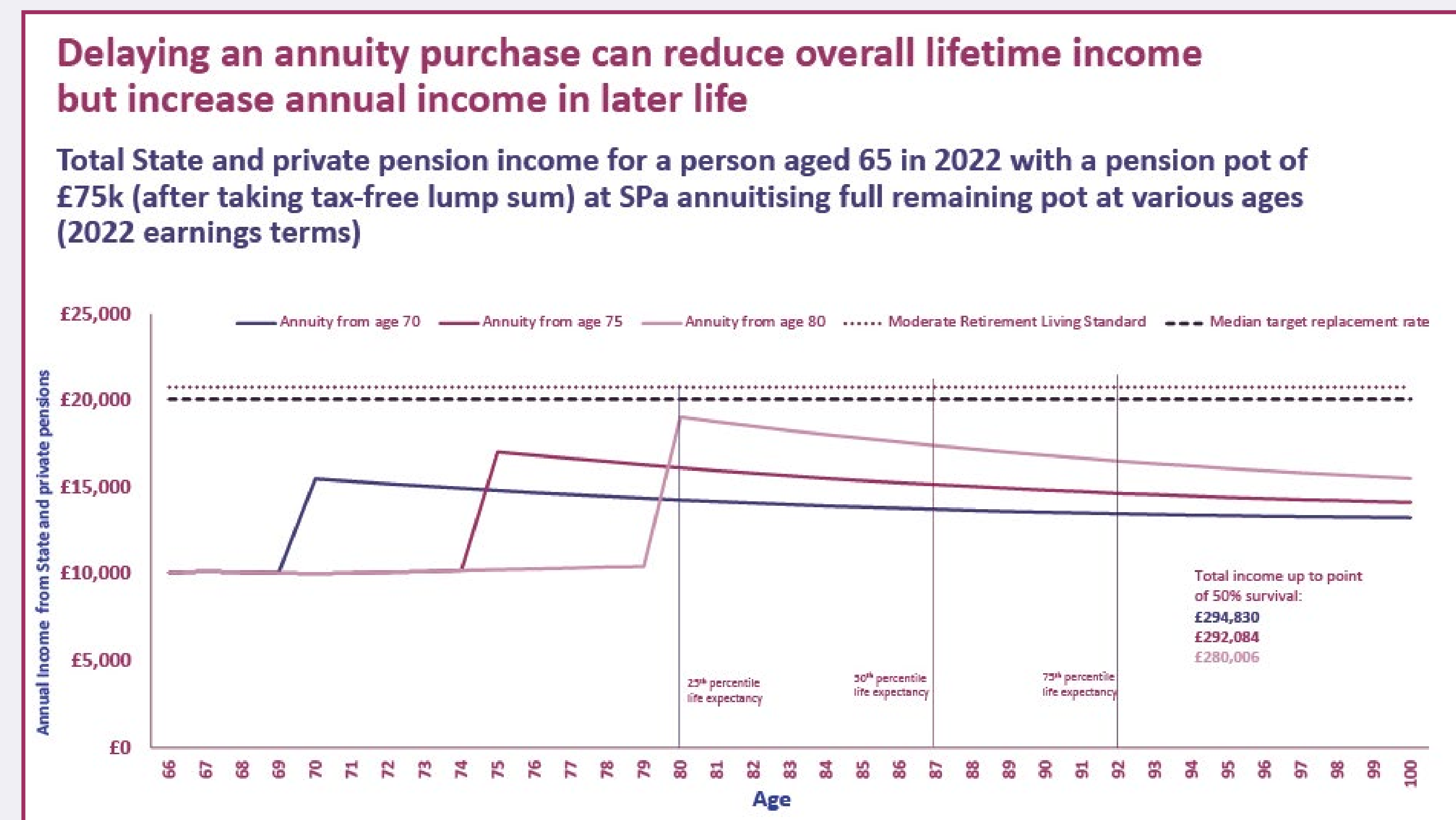
If Alex has income from other sources, for example, earnings, a partner's income, or Defined Benefit (DB) pension income, and therefore does not need to withdraw from a drawdown account prior to purchasing an annuity, they could benefit from waiting to purchase a guaranteed income until mid or late retirement. By doing so, they would receive a higher rate, as well as increasing the potential for an enhanced rate resulting from developing health problems. It has recently become easier to access an enhanced rate, as, since 2019, all annuity providers are required to ask prospective annuitants about their health and lifestyle characteristics, and take these into account when calculating life expectancy and the corresponding annuity rate. Therefore, those eligible for an enhanced rate should automatically receive one.[30] This process is known as "underwriting an annuity".

In order to optimise their income, they will want to ensure that the returns they receive from their DC savings (which could remain with their pension fund or be transferred to a drawdown account) are at, or above, the level they would have received through mortality cross-subsidies in an annuity pool.

If Alex *waits to purchase an annuity until age 70, without spending any of their savings through drawdown,* they could increase their annual income to within 23% of a median working-life replacement rate and within 25% of a moderate living standard at the point of annuitisation. If they wait until age 80 to annuitise, their income would be within 5% of a median working-life replacement rate and within 8% of a moderate living standard at the point of annuitisation, as their annuity rate will be higher the longer they wait to purchase.

However, the loss of mortality cross-subsidy results in a lower lifetime income (Figure 2.4).[31]

Figure 2.4[32]



[30] Financial Conduct Authority, Conduct of Business Sourcebook 19.9, PS 19/1
[31] If Alex lives to median life expectancy, total retirement income from their annuity and State Pension would be: £294,830 if annuitising at age 70; £292,084 if annuitising at age 75; £280,006 if annuitising at age 80
[32] PPI Modelling

Waiting to purchase an annuity and/or purchasing an escalating annuity, results in higher annual income during retirement

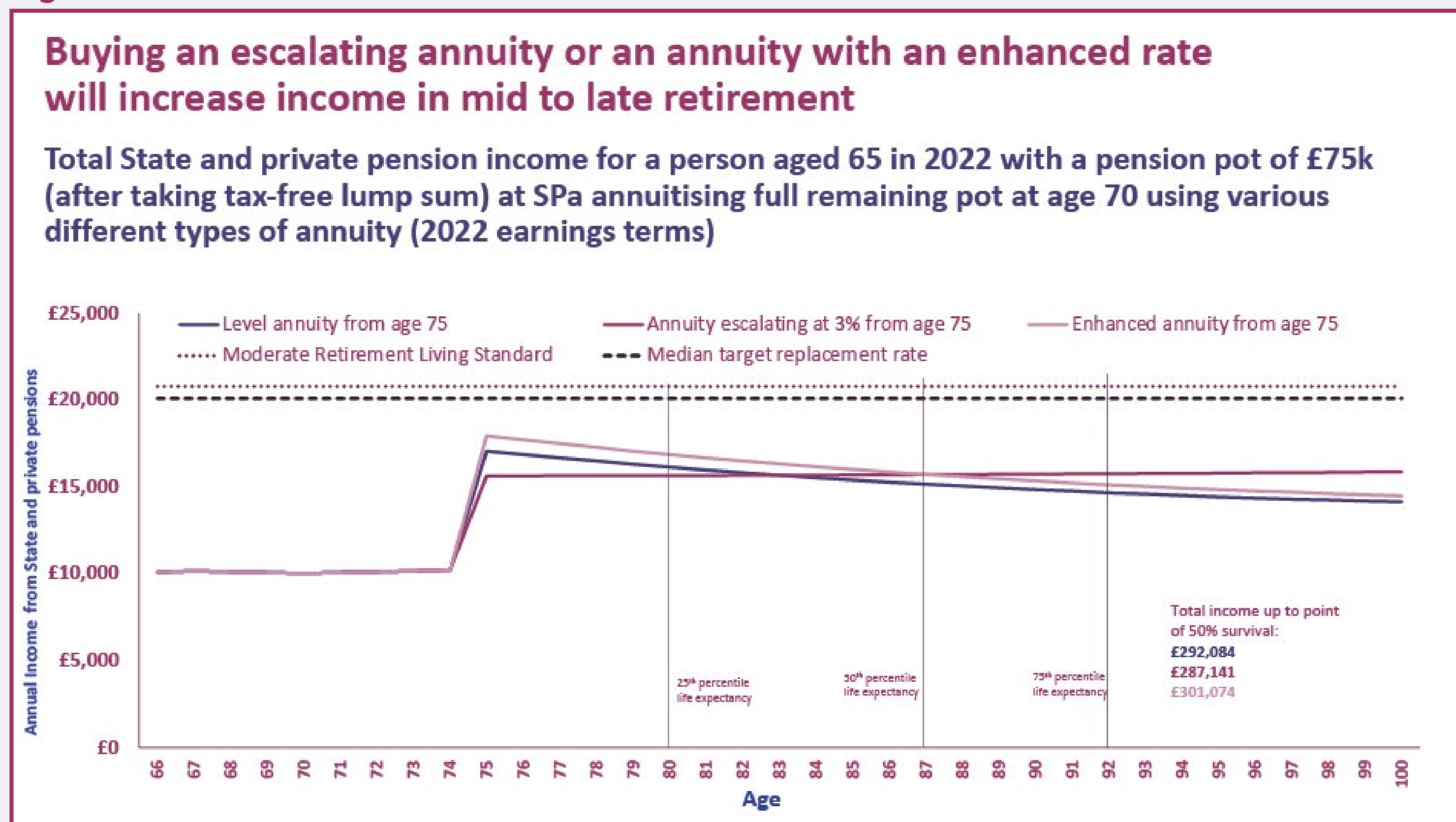
In the above examples, Alex has purchased level annuities and their income has declined during retirement. Most people will find it easier to maintain their living standard if their income increases each year, as costs of goods and services rise. Though annuities which increase with inflation are available, people are less likely to purchase these because they offer a lower starting rate, and people tend to underestimate their own longevity and thereby undervalue inflation protection.[33]

Alex is more likely to be eligible in later life for an enhanced annuity rate as a result of medical conditions or lifestyle factors. By the age of 75, more than half of people in England have a serious health condition.[34] The average uplift in rate for a health condition or lifestyle factor is around 13%, but they will each be associated with an actuarial calculation of life expectancy that will affect the rate. For example, someone who smokes or has diabetes may be eligible for a rate of around 5% higher than the standard, while someone who has a heart condition may receive a high uplift of around 21% above the standard rate.[35]

Under a scenario in which *Alex decides to purchase an escalating annuity at age 75 without taking any income through drawdown first*, their initial rate will be 8% lower than if they had bought a level annuity. However, by the time they reach age 84 their income is higher under an escalating annuity and remains within around 22% of a median target working-life replacement rate throughout their entire retirement.

Under a scenario in which *Alex purchases an annuity when they have health problems at age 75 without taking any income through drawdown prior to that age*, they could receive a rate around 13% above what they would have received if they had bought an annuity before developing health problems. However, those with an enhanced rate are generally expected to live for less than average life expectancy, so may not receive a significant increase in lifetime income (Figure 2.5).

Figure 2.5[36]



A lack of appetite for annuities means that hybrid products which offer both flexible withdrawals and guaranteed income may appeal more to consumers in future

This chapter has discussed the ways in which guaranteed income can help support people in retirement. However, there are behavioural barriers to purchasing annuities which result in many people favouring flexible withdrawals, despite the risks and potential loss of annual and lifetime income which arise from not sharing in a mortality pool.[37]

One way in which the market is adjusting to the new landscape, where people have freedom to withdraw DC savings as they please but could still benefit from a guaranteed income element, is the development of products which offer flexible drawdown with an embedded guaranteed income element. Two products currently available in the market are detailed below:

- **JUST's Secure Lifetime Income (SLI):** The SLI is a drawdown product with a guaranteed income element embedded within. An individual with an SLI will work out with their adviser or provider how much they would like to receive as a guaranteed element and use the amount required from their savings to secure this income for life. This income is then paid directly to the account owner who can use it for living costs or reinvest it in their drawdown if they wish. Those whose circumstances change within a pre-set period after the initial decision can cash in the value of the guaranteed income.[38]
- **Canada Life's Retirement Account:** The Retirement Account converts from a pensions savings account when people retire and allows people to choose between drawdown, guaranteed income or both. People can also purchase a guaranteed income in stages, as needs change during retirement. As with the SLI, people using the Retirement Account are encouraged to take financial advice.[39]

As demand grows for these types of products, further development by other providers is likely to take place. It is worth looking at how other countries approach hybrid products in order to inform innovation in the UK (Figures 2.6 and 2.7).

Figure 2.6[40]

All Australian providers are required to offer products which allow for both flexible withdrawals and guaranteed income

Australia is currently implementing its "Retirement Income Covenant", which requires all providers to prepare a retirement income strategy for all their members, including the possibility of different strategies for different cohorts of members. Alongside this, providers are required to offer a "MyRetirement" product which allows people to take a guaranteed income alongside the opportunity to keep some funds invested and take flexible withdrawals. One example of this product is the Mercer LifetimePlus.

The LifetimePlus product is essentially drawdown with an embedded guarantee income element, but instead of simply paying an income for life it is structured more like a with-profits annuity, allows opt out before death and pays out in three ways:

- Investment earnings (paid quarterly): Returns on a conservative investment aimed at cash + 0.6% p.a., net of fees, accrued daily and paid quarterly.
- Living bonus (paid half-yearly): These payments are distributed from the living bonus pool, a mortality pool calculated based on age, sex, amount and length of time invested. Older and longer invested members receive higher payments
- Capital return (paid half-yearly): Capital repayments equal to 2.5% p.a. of initial invested capital, paid to those who have been invested 15 years and are over age 75. The capital return is paid for up to 20 years.

The Australian approach is interesting in that it allows people to opt out of the guaranteed income element, but also contains financial incentives for people to stay. The Australian product is likely to appeal to those who are keen to ensure all of their savings continues to generate investment returns.

[33] Sturrock, D. (2019)
[34] Public Health England (2017)
[35] Discussion with annuity providers
[36] PPI Modelling
[37] Baker, M. (PPI) (2022)
[38] https://www.justadviser.com/products/guaranteed-income-solutions/secure-lifetime-income/
[39] https://www.canadalife.co.uk/retirement/the-retirement-account/
[40] https://www.mercer.com.tw/content/dam/mercer/adviser-portal/mercer-lifetime-plus-product-booklet.pdf

Figure 2.7[41]

Singapore's central provident fund requires people to use a certain amount of savings to purchase a guaranteed income

Singaporeans all belong to a mandatory saving scheme called the Central Provident Fund (CPF) into which they, their employer and the Government contribute. The CPF includes saving for property purchases, medical expenses and retirement. On reaching age 55, a Retirement Account (RA) is opened for each individual within their CPF account. They must transfer a minimum amount of the money remaining in their non-medical savings accounts into the RA at age 55 which will fund a guaranteed income from age 65, with the option to delay until age 70. Those who have not saved the minimum amount must transfer what they have and can also make top ups to raise the amount. Those who have exceeded the minimum amount can decide whether to put extra into their RA or make flexible withdrawals from the remainder. Singapore is also considering introducing a requirement for those reaching age 55 to purchase longevity insurance (a deferred annuity) that will come into payment at age 85.

The Singaporean approach depends on the compulsion of saving and taking a guaranteed income. As the UK currently allows flexible withdrawals, people are less likely to accept being told they cannot withdraw as they like until they have saved a specific sum. However, the Singaporean Government does set three levels for the guaranteed income, called the Basic, Full and Enhanced retirement sums. Each of these are associated with level of monthly income, which people can aim for when saving. A similar system could be built into savings products in the UK, whereby people aim to save a certain amount of money to meet a basic income (potentially using the PLSA Retirement Living Standards) and see any additional savings above this amount as set aside for flexible withdrawals.

Alternative annuity products could also be used to appeal to people's appetites for flexibility

There are other product designs which could help meet the need for a guaranteed income, while providing some flexibility and the opportunity to continue benefiting from investment returns.

"Variable" or "value" annuities: Variable annuities operate on a mortality pool in the same way that standard annuities do, but there are some key differences:

- Instead of the annuity provider bearing the risk of life expectancy increasing more quickly than expected, the members do. If life expectancy does increase more quickly than expected, member benefits can go down, however, in the case that life expectancy increases more slowly, member benefits can increase.
- The funds in the pool are invested, with some proportion in growth seeking assets. If investments perform well, members receive an increased rate. If they perform poorly, members' rates will go down for a period of time.
- Some variable annuities are cohort-pooled, and include people with similar life expectancies. This can reduce the risk of subsidising members who live for longer, but also reduces potential benefits from the cross-subsidisation of others. However, cohort-pooling could address the fears of some of those who do not like the idea of potentially subsidising those with longer lives.

Sweden and Singapore both use a variable/value annuity approach as part of their mandatory private pension systems. The Swedish system allows people to choose between different funds with variable risk profiles.[42]

The benefit of variable annuities is that they allow people to take a guaranteed income and benefit from a mortality pool, without giving up the opportunity of receiving investment returns on savings. The potential downside is the increased risk taken on by members and higher charges arising from active investment management. However, as the member bears the risk, general pay outs can be higher than from a standard annuity, as the provider no longer has to take out insurance to cover the risk of longer than expected life expectancies or poor investment returns.[43]

Deferred annuities: Deferred annuities, available in other countries such as the USA, do not pay out immediately on purchase and are set to start paying out at a set time after the initial purchase, for example, 5, 10 or 15 years. Purchasing a deferred annuity allows people to lock in a minimum annuity rate when they are relatively young, that will kick in when they are older and more likely to need support with financial decisions. It also provides longevity insurance without requiring people to lock away significant funds during early retirement. Deferred annuities can also appeal to those interested in growing their funds, which can continue to accrue investment returns, until the payments start. An individual interested in withdrawing flexibly in early retirement who is concerned about longevity and the possibility of cognitive decline, could purchase a deferred annuity and then know exactly how long their remaining savings will need to last them, which they can then spend down or save according to their needs and desires.

Fixed-term annuities: Some providers in the UK and overseas offer "fixed-term" annuities. These annuities pay out for a fixed period of time, between one and 25 years, and offer a lump sum at the end of the period of a guaranteed minimum amount. Those who desire security but are unwilling to lock their savings away for their entire retirement, could benefit from using a fixed annuity. One potential benefit of these, is that when the fixed payment period is over, and the annuitant is given their lump sum, annuity rates may have become more favourable than at the original purchase date.

Built-in annuities (Collective Defined Contribution (CDC)): Royal Mail is currently setting up a CDC scheme for its employees. CDC schemes are like personal DC schemes, in that people contribute into funds which are invested and determine the final income. However, CDC schemes do not separate out individual pension pots. Instead, working members all contribute into the same funds, which are invested with the aim of providing a certain level of income to retired members. These benefits are annuity-like in that they are paid out to members for their life and are inflation linked. However, benefits can be raised or decreased depending on market performance. If other employers start offering them, or the future regulations facilitate CDC Master Trusts, then more people will receive a guaranteed income element from their private DC pensions, which could help with longevity protection for future pensioners.

[41] https://www.cpf.gov.sg/member/infohub/educational-resources/cpf-retirement-sum-for-young-singaporeans
https://www.pensionfundsonline.co.uk/content/country-profiles/singapore/101
[42] Price et. al. (2021)
[43] Price, W. et. al. (2021)

Conclusion

For those who need or desire a guaranteed income:

- The timing of an annuity purchase affects the price.
- Those with supplementary income can benefit more from taking a guaranteed income in mid to late retirement.
- If an individual is likely to be using all of their income to meet their needs, and/or is more likely to have variable needs in later retirement because they are renting, are financially dependent on another household member, and have no plans with regards to funding care, they are more likely to benefit from purchasing an escalating annuity in early retirement or waiting to purchase a level annuity until mid retirement. Individuals may benefit from purchasing an annuity with an enhanced rate if and when health problems manifest, as the need for a secure and reliable income may be more pressing when managing health needs.
- If an individual does not need to take income from their DC savings during early retirement, then they could benefit from taking an annuity in mid or late retirement, as long as their investment returns make up for forgone mortality-cross-subsidies.
- One way in which the market is adjusting to the new landscape, where people have freedom to withdraw DC savings as they please but could still benefit from a guaranteed income element, is the development of products which offer flexible drawdown with an embedded guaranteed income element.
- There are also other product designs, not currently available in the UK, which could help meet the need for a guaranteed income while providing some flexibility and the opportunity to continue benefiting from investment returns - such as variable, deferred, fixed and built-in annuities.

Pensions Policy Institute
PPI

CHAPTER THREE:

HOW MIGHT THOSE WITH INCREASED SPENDING NEEDS PRE AND EARLY IN RETIREMENT APPROACH RETIREMENT INCOME?

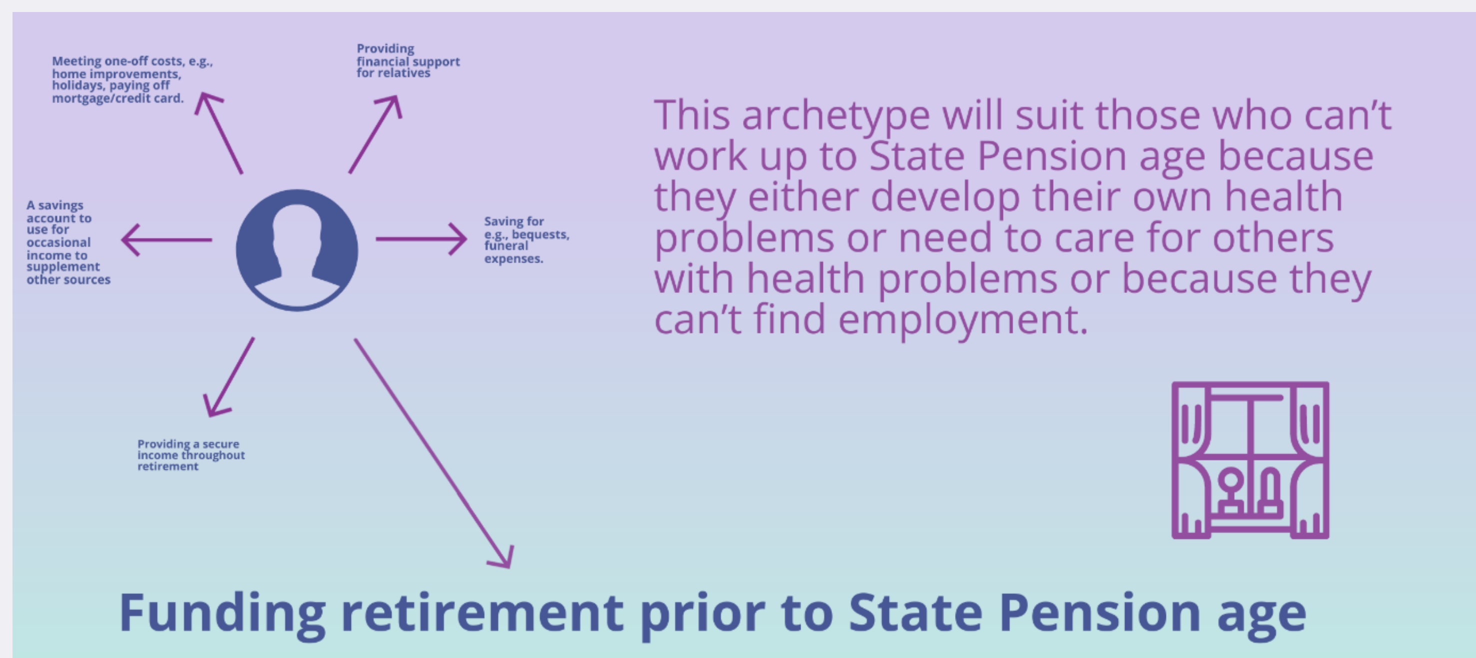
This chapter explores retirement income options for those with early spending needs and considers policy options for helping people to manage complex retirement income strategies.

This chapter covers:

- How those who need to fund retirement prior to State Pension age (Spa) could use Defined Contribution (DC) savings.
- How those providing support for relatives in early retirement could approach retirement income strategies.
- How policy could help support people making more complex decisions and facilitate people to use a combination of guaranteed income and flexible withdrawals in a way which meets their shifting needs.

Key chapter findings:

- Those required by circumstances to withdraw DC savings early will benefit from conserving the maximum amount of savings to use during later retirement.
- Those who need to withdraw in high amounts from income drawdown will need to aim to convert to a guaranteed income in early to mid retirement if they wish to have a living standard closer to adequacy levels.
- The longer that someone spends withdrawing at higher levels from drawdown, the smaller the amount they have remaining to provide a retirement income.
- If an individual reaches retirement with mortgage or credit card debt that they wish to pay off, but are unlikely to face any other significant one-off costs in retirement, they could achieve a higher standard of living from using all of their remaining pot to purchase an annuity during early retirement.
- Future pensioners are likely to have larger DC pots and face both greater choice and greater potential risk to retirement income when making choices about how to access their savings
- More resources will need to be geared towards in-retirement needs for pensioners to be supported to make optimal decisions.
- Soft defaults, which are tailored for different retirement need/desire archetypes, could help people to better manage their retirement income.
- Further work needs to be done to ensure that take up of support options increase before, during and after retirement.



SPa has increased to age 66 from age 60 for women and age 65 for men since 2010. It will increase again to age 67 by 2028. Increases in SPa mean that people who care or develop health problems are more likely to have to leave work before accessing their State Pension in future. Those made redundant at older ages may also spend more time out of work before receiving their State Pension.

Leaving work prior to SPa can result in financial difficulties, as working-age benefits are means-tested and generally pay out at a lower level than State Pension and Pensioner benefits; for example, in 2022/23 the basic monthly allowance for a couple receiving Pension Credit is around £1,115, compared to £526 under Universal Credit.[44] The average pensioner couple requires around £1,283 per month (in 2021) in order to achieve a minimally acceptable standard of living (as defined by their peers).[45]

People who need to leave work prior to SPa and who do not have alternative sources of income, may feel that they need to access their DC savings early in order to fund their retirement up until SPa. In 2017, 72% of pots were first accessed by people under SPa,[46] (though not necessarily fully drawn down) which can be problematic for several reasons:

- **Accessing early often means benefits are "crystallised":** One of the complications associated with withdrawing DC savings is the associated tax bill; DC withdrawals are taxed at an individual's marginal rate with 25% tax free. People do have the option to take the 25% tax free amount all at once, as a lump sum, in order to boost their income without paying an initial tax bill. Those who choose this option are required to move the remainder of their DC savings to another retirement income product (if they do not wish to pay tax on the remaining 75%). Many people choose a drawdown account at this time. [47] Taking one's savings out in this way is considered a crystallising event, as the full pot amount is essentially crystallised at that moment and will not grow or reduce within the pension scheme after this date. Crystallising and taking drawdown can be problematic, as drawdown accounts may not be invested in the same way as pensions and may have higher charges. Those who take drawdown during unemployment and return to work will not be able to continue contributing into the same pension account they owned previously.
- **Early access results in pot depletion:** Accessing pots early reduces both the amount saved and the amount of time the remaining savings will be required to support – resulting in a lower standard of living than would have been possible if the pot was accessed later on.

Those required by circumstances to withdraw DC savings early will benefit from conserving the maximum amount of savings to use during later retirement

People who have significant amounts of Defined Benefit (DB) entitlement that will start to pay out at or around SPa, or other income, savings or assets, may not be as affected by these early decisions about DC savings, but the way in which those who will have only DC savings and State Pension access prior to SPa will be especially significant.

Alex is age 45 in 2022. They find that they need to leave work at age 57 in order to provide care for their parents who both have debilitating health conditions. Alex's partner does not make enough income to support them both up until they can claim their State Pension, so Alex decides to access their private pension savings. Alex considers two options:

- They could take their 25% tax free lump sum and use that to supplement their income until SPa. In this eventuality, they would transfer their remaining funds to a drawdown account which they would leave invested until they decided how to access them.
- They could withdraw around 25% of their pension pot in Uncrystallised Funds Pension Lump Sum (UFPLS) withdrawals,[48] with 25% of each withdrawal tax free, allowing the remaining fund to continue growing while they consider how best to access it.

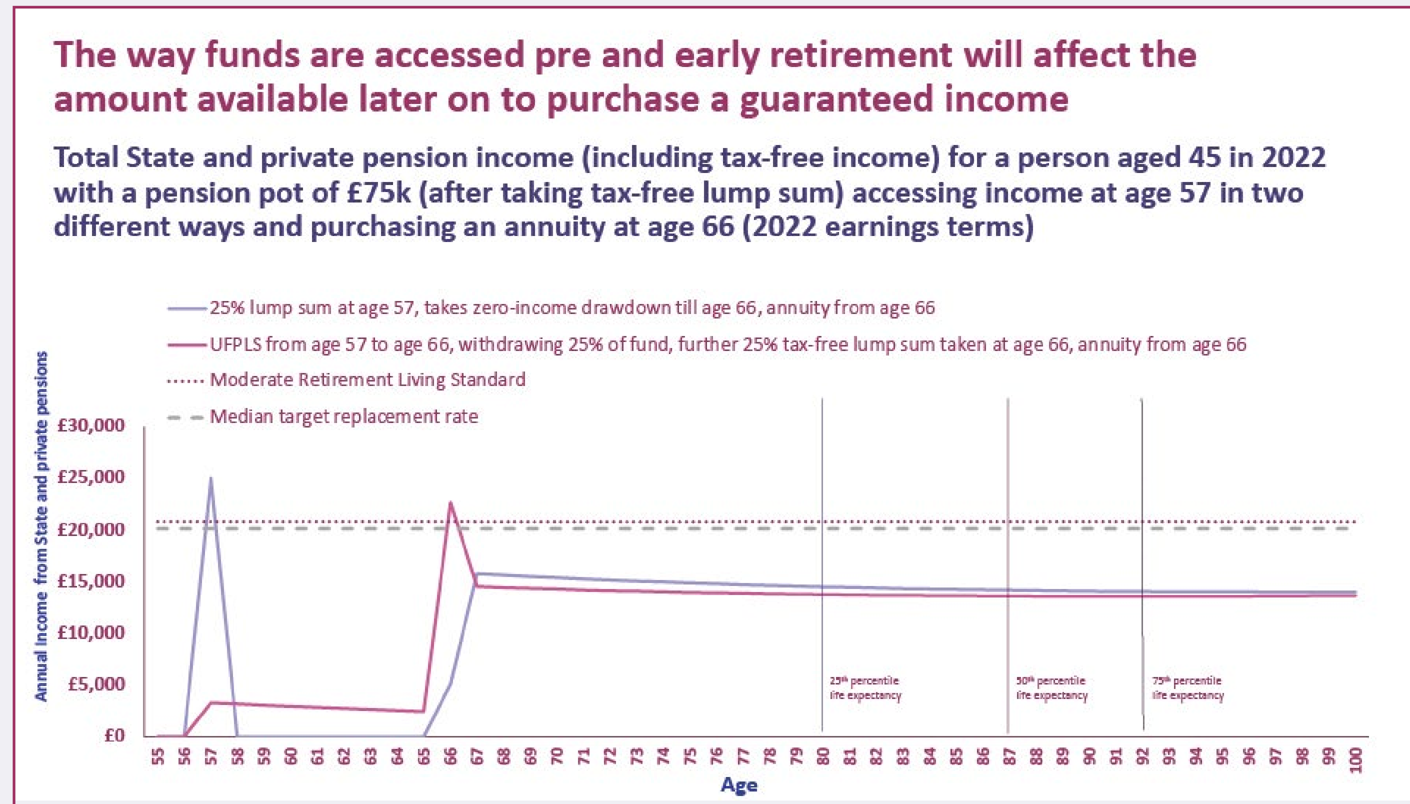
[44] GOV.UK
[45] Davis et. al (2021)
[46] FCA (2017)
[47] FCA (2017)
[48] Withdrawing directly from a pension pot, with 25% of each withdrawal tax free

At age 66, Alex decides to purchase an annuity with their remaining funds.

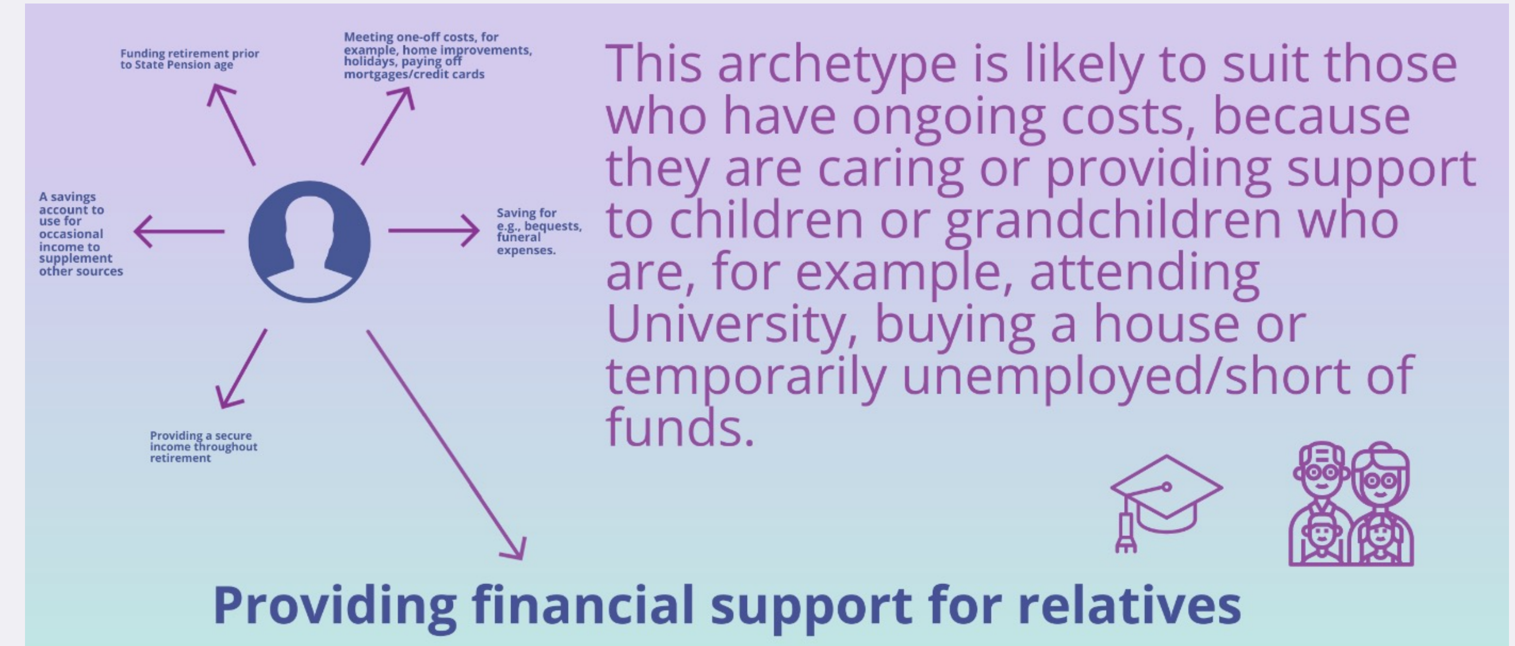
If Alex had decided to take 25% tax free and put the rest of their funds into drawdown, they would have a larger pot to purchase their annuity with than they would if they used UFPLS and then purchased an annuity. This is because if they used UFPLS, and only took 25% of each withdrawal tax free, they would still be able to take a 25% tax-free lump sum from their remaining pot, prior to purchasing their annuity at age 66. In essence, under UFPLS they would take more income prior to annuitising when you include the additional 25% tax-free lump sum at the point of annuitisation, but reduce the amount available to use to purchase an annuity:

- Under a scenario in which Alex *takes their 25% tax-free lump sum at age 57, invests the remaining fund into drawdown, and buys an annuity at age 66*, their remaining fund is around £75,300 and their retirement income is around £15,700 at age 67 (once they start receiving their State Pension).
- Under a scenario in which Alex *uses UFPLS and takes a further 25% tax-free lump sum at the point of annuity purchase*, their remaining fund is around £56,500 and their retirement income at age 67 is around £14,500, 8% lower than under the previous scenario. However, under this scenario, Alex receives an additional cash injection of around £18,800 at age 66 from their tax-free lump sum, which may be useful for any one-off costs they wish to meet prior to taking their remaining savings in an income stream (Figure 3.1).

Figure 3.1[49]



These scenarios assume that Alex takes all of the tax-free cash available, as this accords with known behaviour. These scenarios demonstrate that the way money is accessed prior to securing a guaranteed income will have an impact on tax, income and fund size, and that people may need support to find the best way of accessing their savings for their own characteristics.



Those providing financial support for family early on in retirement or prior to reaching SPa might have to make complex decisions about how to meet financial needs that will change during retirement. As illustrated above, withdrawing from DC savings early on can result in lower levels of income later in retirement. It might also be difficult to know when one's financial commitment may end, which makes longer-term planning problematic.

Those who need to withdraw in high amounts from income drawdown will need to aim to convert to a guaranteed income in early to mid retirement if they wish to have a living standard closer to adequacy levels

Jordan is aged 25 in 2022. When they reach SPa, they have a pot of £150,000. Jordan's grandchild is attending University and Jordan is paying their living expenses. Jordan has promised to support their grandchild through University and finding their first job, so Jordan does not know in advance when these expenses are likely to end.

The longer that Jordan spends withdrawing at higher levels from drawdown, the smaller the amount they have remaining to provide a retirement income

If Jordan *takes a high rate of drawdown, around 8%, and uses their remaining fund to purchase an annuity in mid retirement* (age 70 or 75) they will be able to maintain a moderate standard of living, or replicate working-life living standards for a median earner longer than if they annuitise later.

If Jordan ceases to support their grandchild at age 70 and *uses 100% of their remaining fund to purchase an annuity*, they will have an annual income of around 15% below a median target replacement rate and around 17% below a moderate retirement living standard by the age of 92 (median life expectancy for someone aged 22 in 2022).

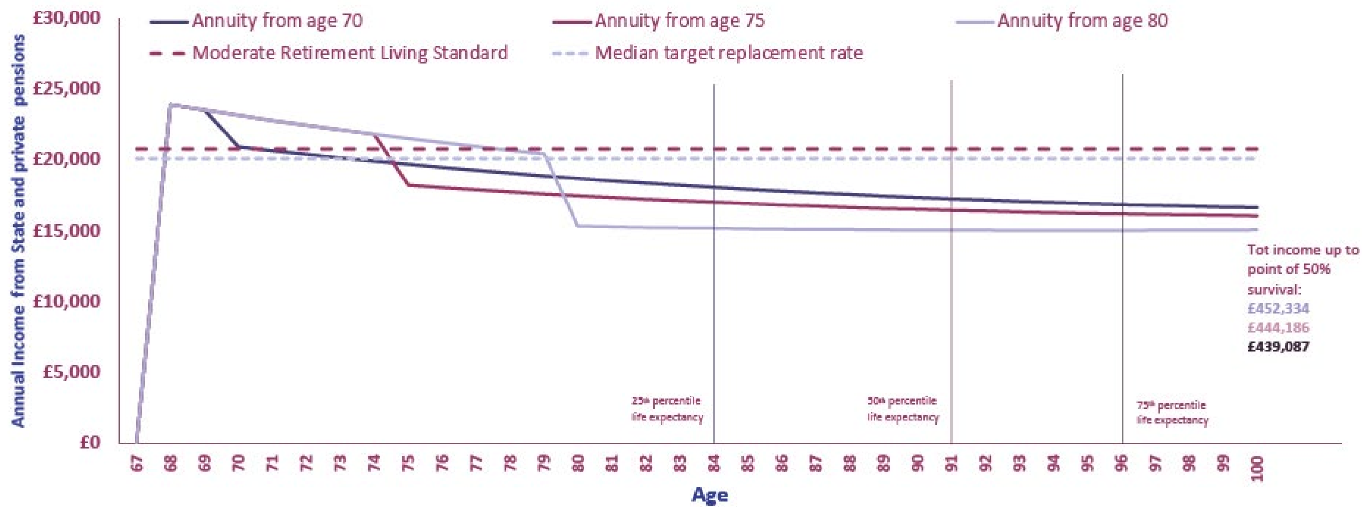
However, if they *take an annuity later, at age 80*, their annual income will be further below these adequacy targets at around 25% below a median target replacement rate and around 28% below a moderate retirement living standard by the age of 92 (Figure 3.2).

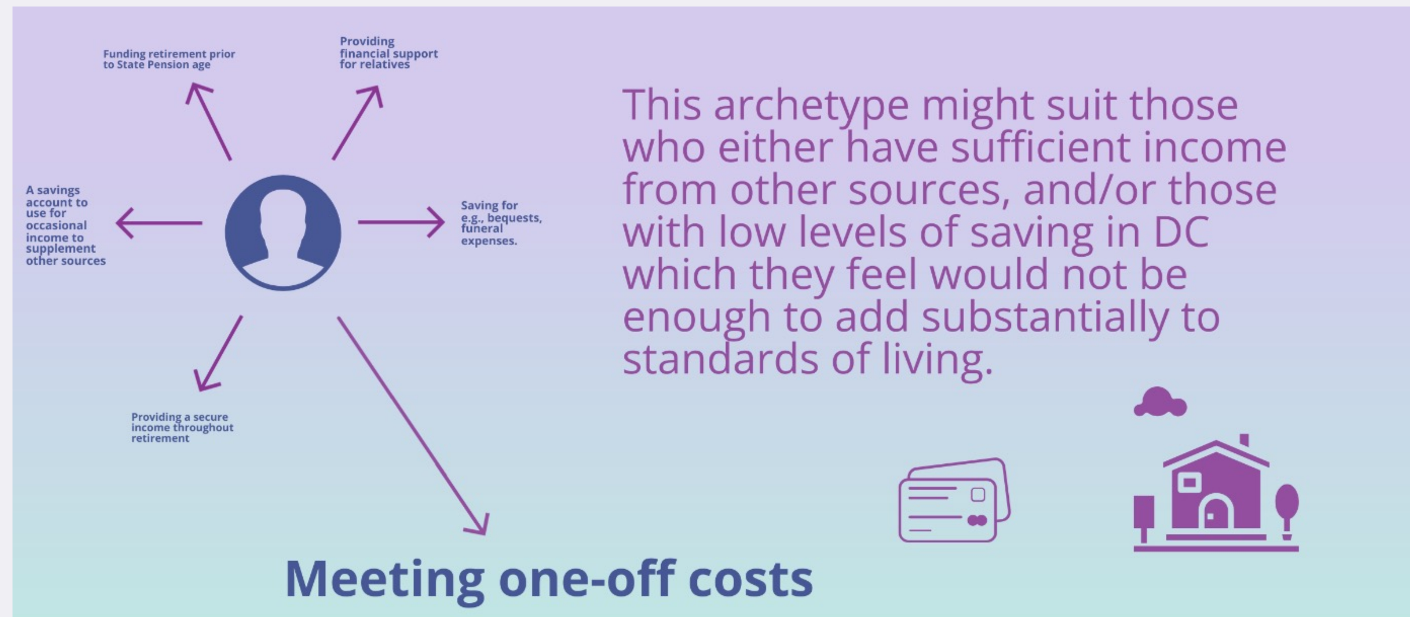
[49] PPI Modelling

Figure 3.2[50]

Those with high expenses in early retirement should aim to annuitise as early as possible in order to maintain living standards

Total State and private pension income for a person currently aged 25 with a pension pot of £150k at SPa (after taking 25% tax-free lump sum) drawing down at 8% of initial fund, then annuitising at various ages (2022 earnings terms)





Those meeting one-off costs are likely to be most tempted to take their 25% tax-free lump sum to pay off debts or meet sudden spikes in need. If they do not require an income immediately after meeting this one-off cost, or they only need a small income, they could benefit from remaining in drawdown for longer, in order to attempt to grow their fund before purchasing an annuity. In order to benefit financially from staying in drawdown, their fund will need to deliver a rate of return equal to or higher than any income missed out on from forgoing cross-subsidisation from those who die early. If they want some guaranteed income, but also want liquid savings to purchase further one-off costs during retirement, they could choose to use only 50% of their remaining drawdown fund to purchase an annuity.

If an individual reaches retirement with mortgage or credit card debt that they wish to pay off, but are unlikely to face any other significant one-off costs in retirement, they could achieve a higher standard of living from using all of their remaining pot to purchase an annuity during early retirement

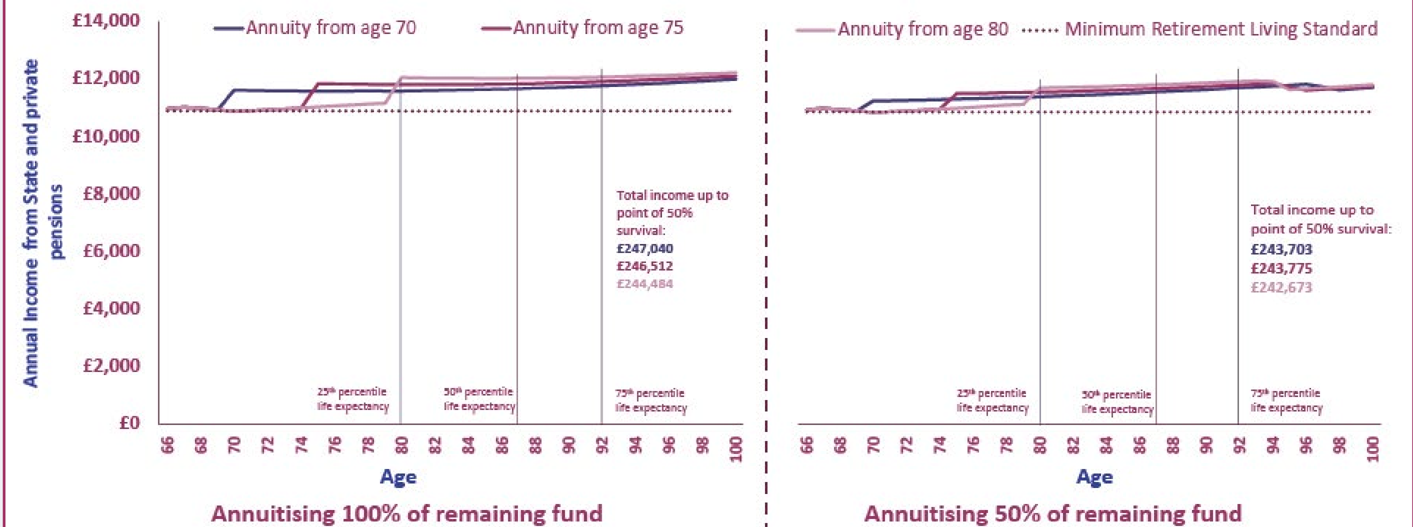
If we assume that Charlie, age 65 in 2022, reaches SPa with a £25,000 pot and has one-off costs to pay, they could choose several different routes. They could **take their entire pot as a lump sum (paying tax on 75% of their pot at their marginal rate) or a series of lump sums; they could take 25% tax free as a lump sum and invest the rest in drawdown; purchase an annuity;** or do a combination of both/all three.

If the initial one-off cost to pay is unlikely to reoccur (for example, paying one-off debts) and Charlie wishes to use the rest of their fund to secure a guaranteed income for life, they could use 100% of their remaining fund to purchase an annuity and achieve a higher standard of living during retirement. However, if Charlie anticipates that there may be other one-off costs to pay during retirement, they could annuitise 50% of their pot while retaining the rest in drawdown to grow and use as liquid savings (Figure 3.3).

Figure 3.3[51]

Those with one off costs early in retirement can achieve a higher standard of living afterwards through annuitising all of their pension pot

Total State and private pension income for a person aged 65 in 2022 with a pension pot of £25k at SPa (after taking 25% tax-free lump sum) drawing down at 3.5% with CPI uprating, then annuitising at various ages (2022 earnings terms)



Under a scenario of using 100% of their pension pot to take an annuity at age 70, 75 or 80, Charlie has higher annual and lifetime income than under a scenario in which they only use 50% of their remaining fund to buy an annuity. If Charlie requires a continuing source of liquid income, they can put 50% of their remaining fund into an annuity, but will receive a lower annual and lifetime income in return.

As Charlie's fund is relatively small, they are less likely to purchase an annuity and may feel that doing so will not sufficiently affect their retirement income. However, purchasing an annuity could increase their annual income because of the mortality cross subsidy. The more Charlie puts into an annuity, the more benefit they see:

[50] PPI Modelling
[51] PPI Modelling

- Purchasing an annuity with 100% of the fund at age 70 results in an income of around 1.4% (£3,000) more during retirement than purchasing with 50% of their fund.
- Purchasing an annuity with 100% of the fund at age 80 instead of 50% results in an annual income of around 2.5% more at the point of annuitisation, and almost 4% by the time the drawdown income would have run out at age 95.

Future pensioners are likely to have larger DC pots and face both greater choice and greater potential risk to retirement income when making choices about how to access their savings

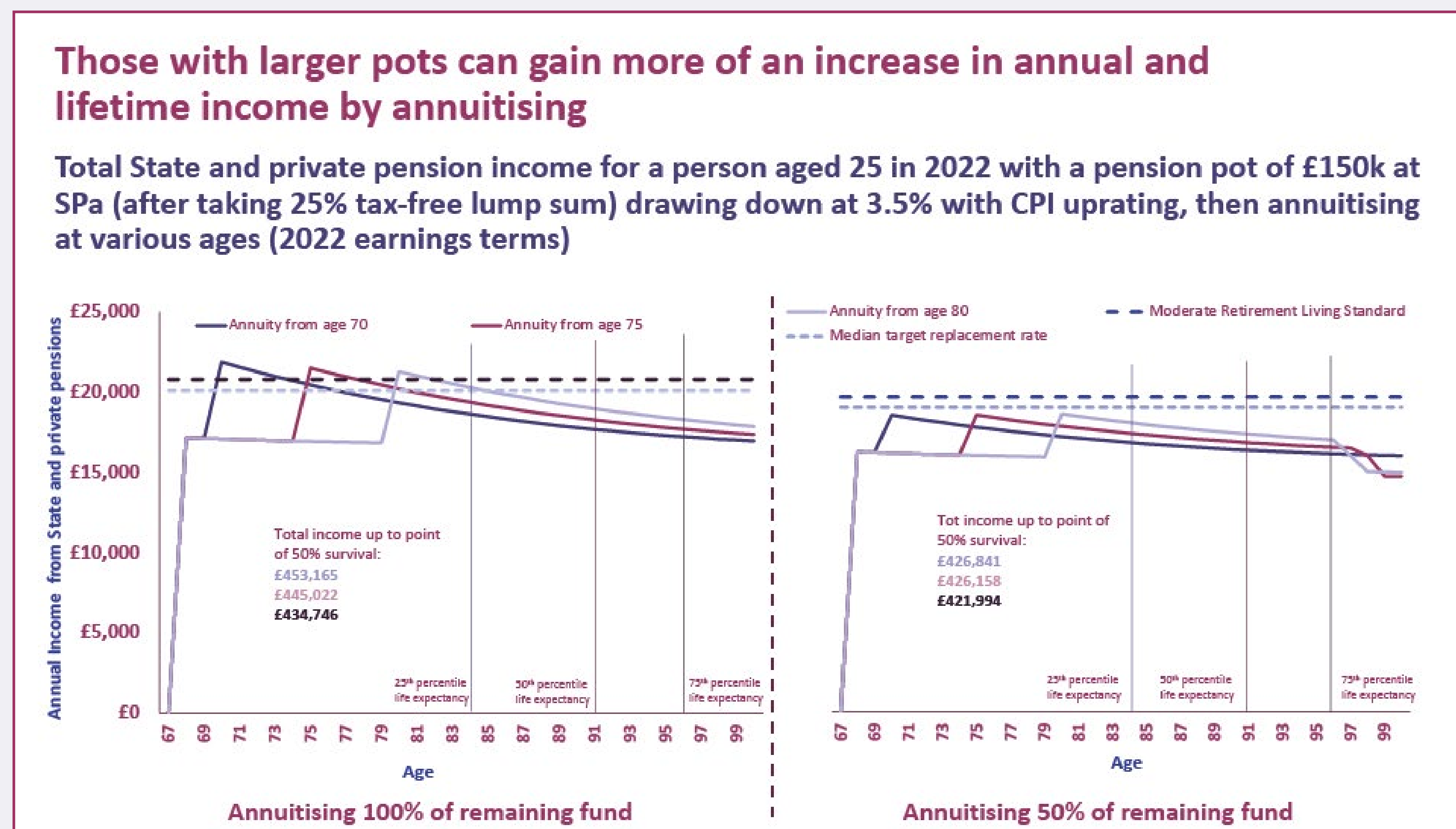
Jordan is aged 25 in 2022 and, after spending a lifetime automatically enrolled, they have accrued a DC savings pot of £150,000 at SPa after taking their 25% tax free lump sum. The decisions which Jordan makes about their DC pot will affect their standard of living more than those Charlie makes, with their pot of £25,000.

If Jordan with their larger pot has one-off costs in retirement which they use their 25% tax-free lump sum to meet, and purchases an annuity with 100% of their remaining fund at age 70, they could receive a total retirement income around 6% higher than they would receive if they purchased an annuity with 50% of their remaining fund.

Purchasing with 100% of their fund earlier in retirement, age 70, would increase total lifetime income to 7%. If Jordan purchases their annuity at age 80 with 100% of the remaining fund, their annual income would be around 8.3% higher at the point of annuitisation than if they purchase their annuity with 50% of their remaining fund and continue to draw income down.

The difference in annual income received between purchasing an annuity at age 70 and age 80 rises to around 14% by the time the drawdown fund is depleted at age 98 (Figure 3.4).

Figure 3.4[52]



More resources will need to be geared towards in-retirement needs for pensioners to be supported to make optimal decisions

The pre- and at-retirement systems are currently supported by a set of policies and interventions including:

- **Defaults** – automatic enrolment, contributions, default investment strategies
- **Soft defaults** – drawdown investment pathways
- **Prompts** – guidance prompts when transferring pensions or reaching specific ages, wake up letters
- **Guidance and education** – financial education through school/work, mid-life financial M.O.T.s

During retirement there are fewer interventions, though pensioners using drawdown can benefit from drawdown investment pathways and cash warnings, which are sent to people invested in cash drawdown who can be getting better returns with a different asset allocation.

As future pensioners will have complex retirements with changing needs, similar systems of support may need to be built up in order to ensure that there is guidance for those who want it, defaults and soft-defaults for the unengaged, and safety nets, like cash warnings, for those who may be making poor decisions. These supports will need to be designed to take into account changing retirement circumstances and facilitate people to use a combination of guaranteed income and flexible withdrawals in a way which meets their shifting needs.

Soft defaults which are tailored for different retirement need/desire archetypes could help people to better manage their retirement income

Alongside drawdown investment pathways, further pathways could be developed which allow for those with varying needs and circumstances to tailor their retirement income strategy; for example, these could allow for:

- People to remain in UFPLS or enter drawdown and then secure a guaranteed income with a portion of their fund at a pre-specified age. In this scenario the portion and the age would be discussed, and the most appropriate agreed on by the individual and adviser/product manager.
- People to buy annuities in portions as they age.
- Management of withdrawal rates over time in order to preserve capital or ensure funds don't run out, which could include partial annuitisation.

These strategies are likely to require further product development.

In addition to the above, a mid-retirement financial MOT, similar to the current mid-life financial MOT, could be helpful, potentially around the age of 75 when cognitive decline may start setting in, consumption needs might start to smooth out and insuring against running out of funds before death (longevity insurance) becomes more important.

Pensioners would also benefit from ongoing, free offers of pensions guidance, like that offered by Pension Wise, which can be called on at any age. This guidance will need to focus on the ongoing implications of financial decisions, while also helping people to better understand the implications of longevity and the financial benefit of cross-subsidisation in annuities, although sensitivity will be an important factor when discussing mortality with individuals.

[52] PPI Modelling

Further work needs to be done to ensure that take up of support options increase both before, during and after retirement

While there are a variety of support options available to people pre and during retirement, take up of some is quite low:

- Pension Wise, the guidance and information service for people aged 50 and over with DC savings, reports positive feedback and action from those who have used their services. However, only 14% of people accessing a DC pot for the first time used Pension Wise.[53]
- Fewer people are using advice when purchasing annuities and drawdown; in 2014 29% of annuity purchases and 91% of drawdown purchases were made using independent or restricted advice. These levels dropped to 20% and 64% in 2020.[54]
- Only half (51%) of people entering drawdown used the investment pathways in the first quarter of 2022.[55]
- The number of cash warnings issued to people in all-cash drawdown has increased from 3,790 in the first quarter of 2021 to 12,625 in the first quarter of 2022.[56]
- 40% of companies do not offer financial education in the workplace.[57]

This lack of take-up or engagement with existing supports indicates that more needs to be done to ensure those who would benefit from soft defaults, prompts and safeguards access these, and that if new supports are put into place, work is done to ensure that these are also used by the people who would benefit from them.

[53] https://blog.thepensionsregulator.gov.uk/2022/01/13/why-its-time-for-trustees-to-pension-wise-up/
[54] ABI data
[55] ABI data
[56] ABI data
[57] https://www.hrmagazine.co.uk/content/news/financial-education-is-now-a-necessity#:~:text=Financial%20education%20has%20become%20a,education%20classes%20to%20their%20employees.

Conclusion

Those with increased spending needs pre and early in retirement

- Those required by circumstances to withdraw DC savings early will benefit from conserving the maximum amount of savings to use during later retirement.
- The way money is accessed prior to securing a guaranteed income will have an impact on tax, income and fund size, and people may need support to find the best way of accessing their savings for their own characteristics.
- Those who need to withdraw in high amounts from income drawdown will need to aim to convert to a guaranteed income in early to mid retirement if they wish to have a living standard closer to adequacy levels.
- If an individual reaches retirement with mortgage or credit card debt that they wish to pay off, but are unlikely to face any other significant one-off costs in retirement, they could achieve a higher standard of living from using all of their remaining pot to purchase an annuity during early retirement.
- Future pensioners are likely to have larger DC pots and face both greater choice and greater potential risk to retirement income when making choices about how to access their savings.

Alongside drawdown investment pathways, further pathways could be developed which allow for those with varying needs and circumstances to tailor their retirement income strategy. For example, these could allow for:

- people to remain in UFPLS or enter drawdown and then secure a guaranteed income with a portion of their fund at a pre-specified age. In this scenario, the portion and the age would be discussed and the most appropriate agreed on by the individual and adviser/product manager.
- people to buy annuities in portions as they age.
- management of withdrawal rates over time in order to preserve capital or ensure funds don't run out, which could include partial annuitisation.

However, further work needs to be done to ensure that take up of support options increase before, during and after retirement if people are to be helped to make optimal decisions in the future.

Pensions Policy Institute
PPI

CHAPTER FOUR:

WHAT STRATEGIES MIGHT SUIT THOSE WHO WANT TO MAINTAIN LIQUID SAVINGS THROUGHOUT RETIREMENT?

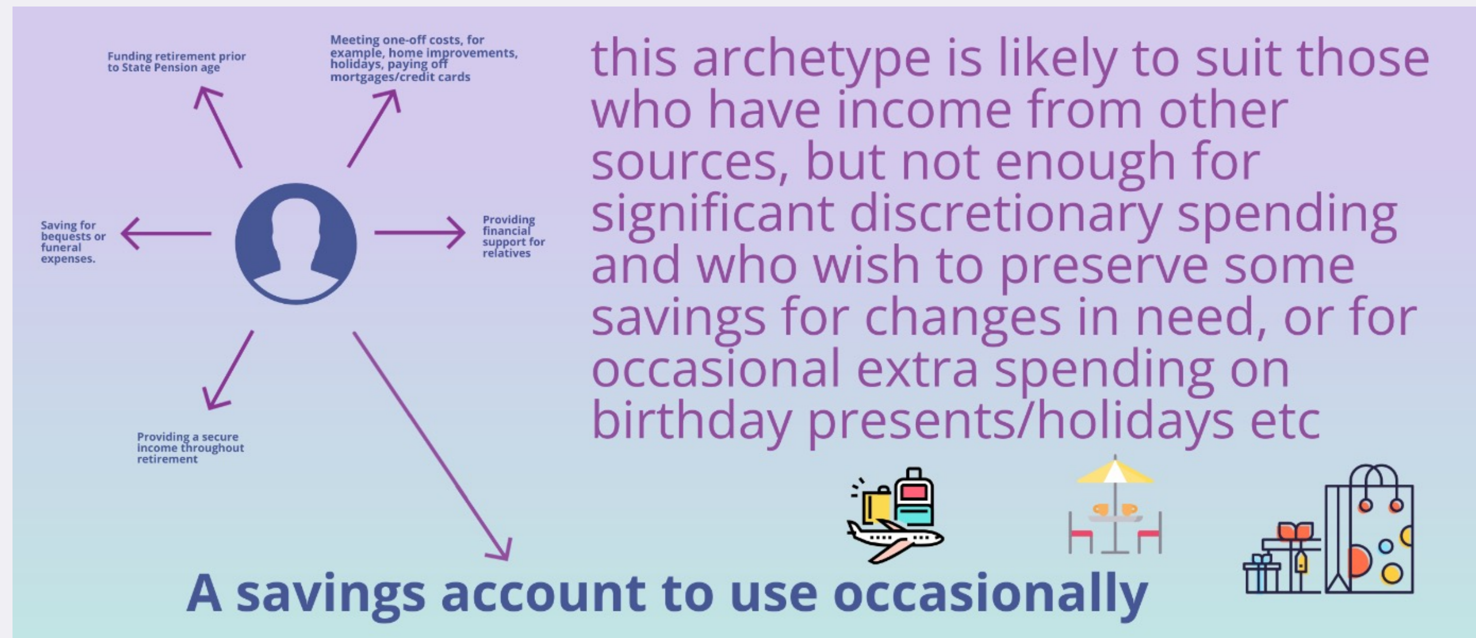
This chapter explores retirement income strategies for those wishing to maintain liquid savings throughout retirement.

This chapter covers:

- How those who wish to preserve savings to use as an occasional top up for income, or to leave behind them could approach retirement income strategies

Key chapter findings:

- Waiting till mid to late retirement to buy an annuity with 100% of a fund will yield higher annual and lifetime income than buying during early retirement with 50% of a fund.
- Those wishing to preserve pension savings will need to weigh up their potential need for security against their desire to maximise their fund growth.



There will likely be two main types of people who prioritise maintaining liquid savings during retirement, beyond those who feel their pot is not sufficiently large to bother annuitising:

- **Those who have supplementary income from other sources, particularly guaranteed income from Defined Benefit (DB) pensions, or other income, savings and assets**: People who fit into this first category may not be significantly affected by choosing not to take a guaranteed income during retirement, even if that means that run out of Defined Contribution (DC) savings before they die. Though, if the other income sources are not certain to remain throughout retirement, preserving some DC savings as an income through a guaranteed income product is likely to be beneficial.
- **Those who do not trust annuities, and/or do not like the idea of having their savings locked away:** People in this category are likely to be more vulnerable to scams and poor decision-making. Those more likely to have low levels of trust in mainstream financial services include people on low incomes, people with low levels of financial capability, people from some ethnic minority groups, and women.[58] Some of the people in this group may also wish to maintain their liquid savings out of a fear of spending their pension and running out.

Government, industry and support bodies may wish to focus particularly on people in the second category, who are most in danger of making decisions which lead to sub-optimal financial outcomes in retirement or becoming victims of scams.

Those who do not take an income stream are also at risk of over-conserving income, and potentially experiencing a lower standard of living than necessary, as a result of fear of running out of funds.

Waiting till mid to late retirement to buy an annuity with 100% of a fund will yield higher annual and lifetime income than buying during early retirement with 50% of a fund

Alex is 45 in 2022 and will have a pension pot of £75,000 when they reach their State Pension age (SPa), and after they have taken a 25% tax-free lump sum. Alex does not feel comfortable annuitising and would like to keep their DC savings in a drawdown account, and take income occasionally to supplement their State Pension income and their income from their partner's pension.

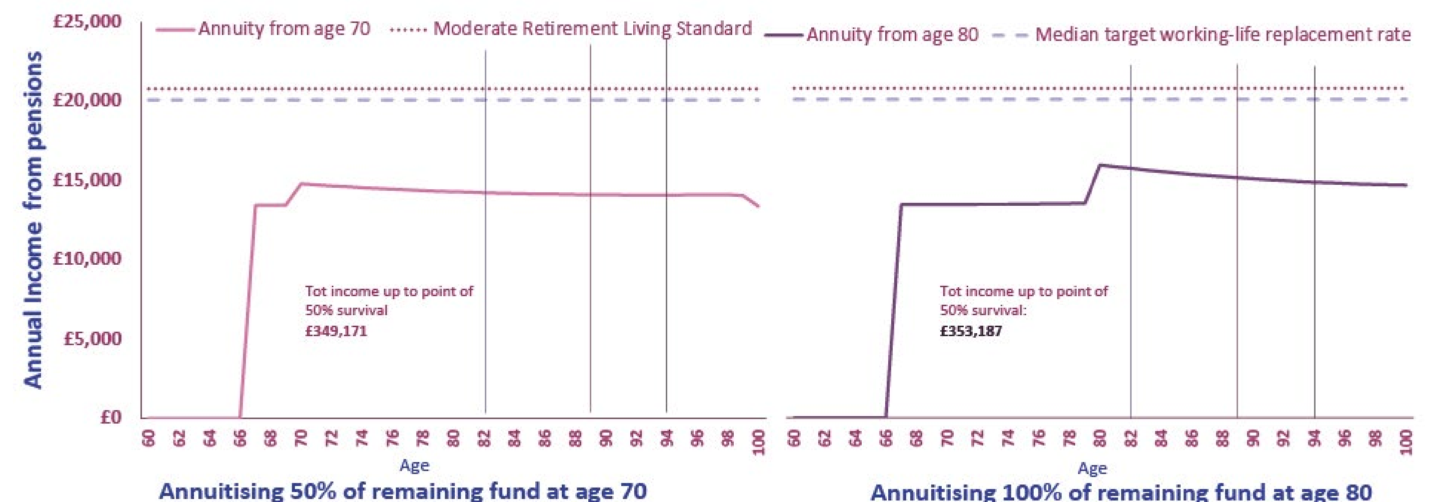
However, as Alex ages they begin to worry about what might happen if they spend all of their savings before they die or if they lose access to their partner's pension income. Alex considers two potential options:

- They could *annuitise 50% of their remaining drawdown fund* to use as security against a loss of other income or living longer than expected, while maintaining flexibility with the remainder of their drawdown.
- Alternatively, Alex could wait until older ages in order to extend the time in which they have full flexibility, but use 100% of their fund to purchase a secure income when they feel security will be more important than flexibility.

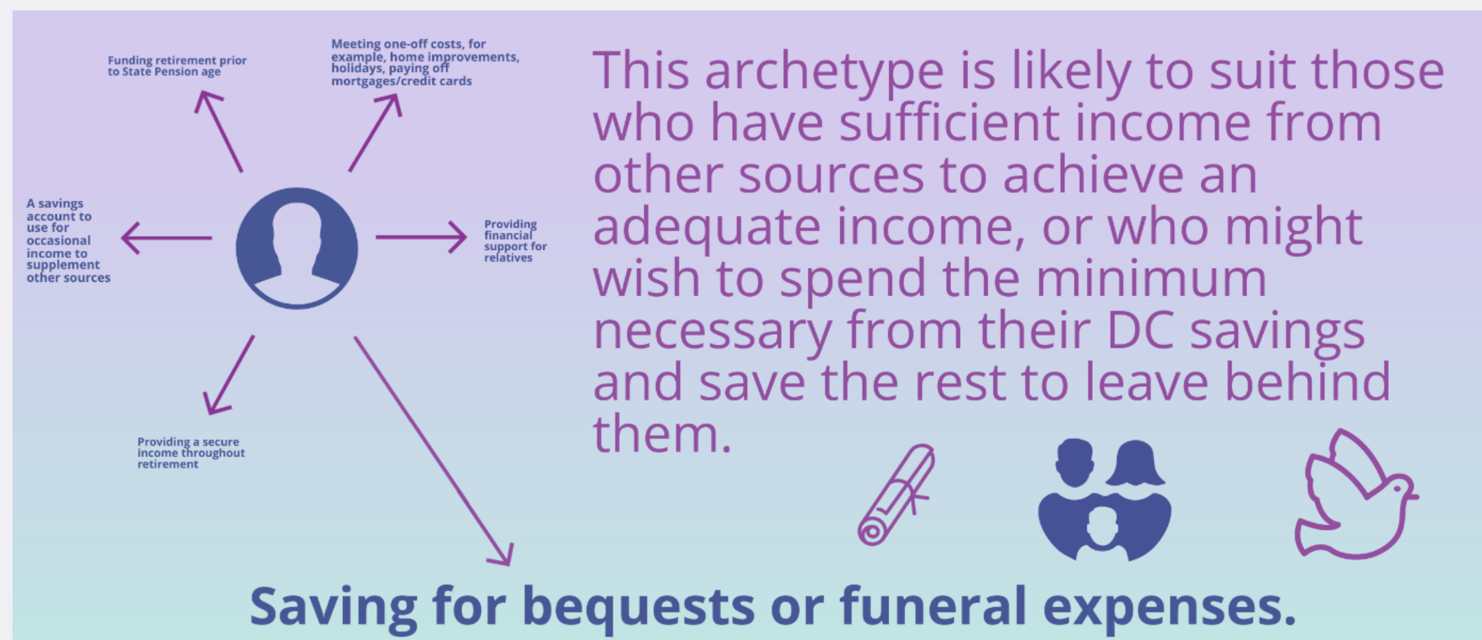
If Alex waits until they are age 80 to purchase an annuity with the remainder of their drawdown fund, and does not significantly alter their withdrawal patterns, they will have a higher lifetime income and a higher annual income at older ages, but lower annual income during mid-retirement:

- If Alex *purchases their annuity at age 80 with 100% of their fund*, they will receive a lifetime income from State and private pensions of around £353,000, compared to around £349,000 (around 1% lower) if they purchase it with half of their fund at age 70.
- Income from State and private pensions will be between 5% - 9% lower during mid retirement if Alex waits to purchase their annuity and does not significantly alter their withdrawal patterns. But after age 80, income will be 7% - 10% higher (until their average life expectancy of age 88) if they annuitise 100% of their remaining fund (Figure 4.1).

Figure 4.1[59]



[58] FCA (2021)
[59] PPI Modelling



Those whose sole aim with their DC savings is to leave as much as possible as a bequest are likely to have, or believe that they have, adequate additional sources of income to support themselves throughout retirement. Others may plan to take some savings as a form of income, but save and grow the rest to leave as a bequest. These people will wish to consider the following:

- **The best way of continuing to grow their savings:** Those mainly focused on leaving a sum of money behind them for inheritance, or to help with funeral costs and other family expenses, will be motivated to ensure they grow their money as much as possible during retirement. Some people may leave their savings in their pension fund in order to do this, while others may wish to take their 25% tax-free lump sum and invest the remainder through a drawdown account. Some engagement with their providers available investment strategies may be necessary. A different strategy will be appropriate for a fund which is solely destined for growth than one which people intend to draw an income from.
- **Costs:** Retirement income products are not subject to the same regulations on charging as workplace pension schemes and may therefore vary more widely. Drawdown providers tend to charge members higher percentages if they have smaller pots. It can be difficult to compare drawdown costs as providers can charge several different types of fees, for example set-up fees, administration charges, platform charges, dealing commission, and charges for trading funds and shares. These charges can range from flat fees to percentage charges and can, altogether, total several percent of fund size every year. Choosing a high charging product could result in fund erosion over time.
- **The reliability of alternative income sources:** If people are depending on other income sources to support them, it is worth considering how reliable they are. For example, if they are a spouse's income through an annuity or DB pension, the level of dependent cover involved will need to be considered. If alternative sources are not 100% reliable, people may wish to consider the safety net of a guaranteed income product.
- **Cognitive decline:** While at age 65 people might feel confident in maintaining a drawdown account and ensuring their money is invested properly, around people's mid to late 70s cognitive decline is more likely to set in.[60] People often do not realise they are experiencing decline and may therefore not realise that they need help. People in this situation will be more vulnerable to scams or mismanagement of their funds and may not be able to leave the bequest they are aiming for. Industry and Government may wish to focus special attention on people in this group by building in safety nets for those around age 75 in income drawdown.
- **Longevity insurance:** Most people underestimate their own longevity (at ages under 80) and are therefore less likely to see the value of insuring against running out of funds before death.[61] This underestimation of longevity also goes some way to explaining why annuities are not more popular. The fact that people think they will live for less time than their prospective provider means that annuity quotes seem like a poorer deal than they actually are.[62] As people will generally live for longer than they expect and are likely to start experiencing cognitive decline at some point in later retirement, guaranteed income can provide an important insurance against poor decision making or outliving other income sources. Those attempting to preserve savings may wish to use a portion to purchase a guaranteed income during the later stages of retirement.

Those wishing to preserve pension savings will need to weigh up their potential need for security against their desire to maximise their fund growth

Jordan is age 25 in 2022. At their SPa they have sufficient income from other sources to meet their needs and they decide to save their DC savings to leave as an inheritance. They transfer their remaining DC savings (after taking a 25% tax-free lump sum) of £150,000 to a drawdown account and decide to grow it there in order to leave as an inheritance.

Jordan's other income comes from a combination of rent from a second home, a DB pension, and their partner's income. During retirement they start to worry about how they will manage in later retirement if they lose access to their partner's income. They also find that managing a rental property is becoming too stressful, so they sell the property and give the money to their child in order to help them buy a house. Jordan decides to secure a small portion of extra income by purchasing an annuity with 25% of their remaining fund at age 80, with the remainder reserved for bequest.

Through purchasing an annuity, Jordan is able to ensure some security against their other income declining. By using only a small portion of their funds to purchase an annuity, they also are able to preserve the majority of their funds to leave as an inheritance.

If Jordan *purchases an annuity with 25% of their pot at age 80,* they could have a fund worth around £1,582,000 by age 91 (median life expectancy), and if they don't purchase an annuity their pot could be worth around £1,187,000 by age 91. The amount that someone with extra income who wishes to preserve their funds might wish to put into an annuity will depend on how they weigh security against maximising pot amount. Projections of potential final fund sizes under different annuitisation scenarios may help people in this position to make informed decisions.

[60] Public health England (2017)
[61] O'Dea, Sturrock (2020)
[62] O'Dea, Sturrock (2020)

Conclusion

Those who want to maintain liquid savings throughout retirement

- Waiting till mid to late retirement to buy an annuity with 100% of a fund will yield higher annual and lifetime income than purchasing during early retirement with 50% of a fund.
- Those wishing to preserve pension savings will need to weigh up their potential need for security against their desire to maximise their fund growth.

Pensions Policy Institute
PPI

Appendix

This appendix sets out the individuals, scenarios, assumptions and approach used in the modelling of annuities and drawdown products in the Guaranteed Retirement Income project.

Individuals modelled

The modelling for the report is intended to show various scenarios exploring the range of outcomes for individuals taking an annuity at different stages of their retirement journey.

The aim is to show clearly when (if at all) it might be optimal for individuals to purchase an annuity to ensure an adequate income in retirement. To achieve this, the modelling should be easy to communicate and understand.

Three individuals were modelled; these were

- Individual 1: Charlie – Low earner, pot size £25k (age 65 in 2022)
- Individual 2: Alex - Median earner, pot size £75k (age 25, 45, 65 in 2022)
- Individual 3: Jordan - High earner, pot size £150k (age 25 in 2022)

All pot sizes are after lump sum withdrawal.

Scenarios

- An individual takes drawdown at State Pension age (SPa) and then purchases an annuity with 50% of remainder at ages 60, 65, 70, 75, 80.
- Individual takes drawdown at SPa and uses 100% of remainder at to purchase an annuity at ages 60, 65, 70, 75, 80. Model the comparison with buying a deferred annuity bought 10 years prior, assuming no income taken from pot over that time.
- Individuals modelled purchasing level, enhanced and escalating annuities at each age level. Does not access pension pot until the purchase of the annuity, then uses 100% of pot to make the purchase.
- An individual takes a 25% tax free lump sum at age 57, then stays in drawdown till age 66 before taking an annuity, to compare with uncrystallised funds pension lump sum (UFPLS) withdrawals from age 57 to 66 up to the same amount as the 25% tax free lump sum and then taking an annuity at age 66.
- An individual enters into drawdown at SPa to release their lump sum but does not withdraw anything and does not annuitise, compared with a scenario where the individual enters drawdown, does not withdraw anything but takes an annuity with 25% of pot at age 80.
- An individual takes an annuity at age 65, with 50% of their pension pot, and then uses the remaining fund to enter drawdown with no withdrawals.

Assumptions:

As with all PPI modelling, the economic determinants assumptions are in line with assumptions made by the Office for Budget Responsibility (OBR), published in their Long-Term Economic Determinants spreadsheet.

Annuity rates

Annuity rates are needed both for current retirees and those in the future. The approach taken is designed be reflective of the current market rates of annuities and be calculated with reference to a discount rate that can be determined from the OBR's projected assumptions. Annuities are calculated based on a blend of male and female mortality rates reflecting the unisex requirement of annuities sold in the UK.

Approach taken

- Obtain current mortality rate projections from the Office for National Statistics (ONS).
- Create a unisex mortality rate by combining the male and female mortality rates, with an adjustable proportion.
- Base the discount rate on OBR projected annual gilt returns with an adjustment factor.
- Annuity calculations set up for single life, reversionary, escalating.
- Compared the resulting annuities to current market rates for different ages and different types of annuity contract.
- Used the results of the comparison to calibrate the model using the adjustable proportion and the gilt rate adjustment factor to replicate the market rates as close as possible.

It is assumed that the mortality proportion and the gilt rate adjustment remain constant over time, so future annuities are modelled using these parameters and based on the ONS's projections of mortality and the OBR's projections of gilt returns.

Pot at retirement - investment returns

Investment returns after retirement are based on two notional funds, a low-risk fund and a high-risk fund. The target returns of these funds are as follows:

- Low-risk fund: Consumer Prices Index (CPI) over expenses
- High-risk fund: earnings growth plus 1.5% over expenses

The future rates of return are assumed to be in line with the targets. It is assumed that both drawdown and money remaining in the pension fund are invested the same way after retirement. We assume that before retirement the individual significantly de-risked their pot, so that at the time they retire they have a pot invested 60% in the low-risk fund, and 40% in the high-risk fund.

Behaviour

On taking drawdown

When taking drawdown from the pension pot, it is assumed that the individual draws an income each year. The amount of the income, unless otherwise stated, is 3.5% of the initial drawdown purchase uprated in line with growth in CPI every year.[63] As part of sensitivity analysis, this will also be run assuming an annual withdrawal of 8% of the initial fund,[64] not increasing each year.

On buying an annuity

When buying an annuity, it is generally assumed to be a single-life level annuity unless otherwise stated.[65] It is assumed that the annuity can be purchased from funds remaining in either the pension pot or the drawdown fund.

If the annuity is purchased from the drawdown fund, it is assumed that they will reduce the amount drawn down to allow for the lower level of assets remaining in the drawdown fund. This is done in essentially a reversal of taking drawdown. The amount being drawn down is reduced by 3.5% of the amount removed from the fund to purchase the annuity.

[63] In accordance with a strategy designed to maintain a steady income throughout retirement while having a high probability of not completely depleting the fund. This has been a common assumption in PPI reports modelling a "sensible" drawdown approach.
[64] 43% of regular withdrawals were withdrawn at an annual rate of 8% or more of the pot value. FCA (2022) Retirement income market data 2020/21
[65] 74% of annuities purchased between Oct 2020 and March 2021 were single life annuities, and 84% of annuities purchased were level only. FCA (2022) Retirement income market data 2020/21

References

Baker, M. (PPI) (2022) *Briefing Note Number 130: Set for life? – Guaranteed incomes* in retirement, London, Pensions Policy Institute

Beesley, L. (2006) *Informal Care in England*, King's Fund

Commonwealth of Australia (2020) *Retirement Income Review; Final Report* Australian Capital Territory: The Treasury

Davis, A. et. al. (2021) *A Minimum Income Standard for the United Kingdom in 2021,* York: Joseph Rowntree Foundation

Department for Work and Pensions, Government Social Research (2015) *Pensioner Income Projections,* London: DWP

Department for Work and Pensions (2022a) *Pensioner Income Series*, London: DWP

Department for Work and Pensions (2022b) *Planning and Preparing for Later Life: Findings from the 2020/21 survey*, London: DWP

Financial Conduct Authority (2017) *Retirement Outcomes Review - at a glance,* 2017, London: FCA

Financial Conduct Authority (2021) *Financial Lives 2020 survey: the impact of coronavirus Key findings from the FCA's Financial Lives 2020 survey and October 2020 Covid-19 panel survey*, London, FCA

National Audit Office (2018) *Adult social care at a glance*, NAO

O'Dea, C. Sturrock, D. (2020) *Survival pessimism and the demand for annuities; Working Paper 19/02*, London, Institute for Fiscal Studies

Office for National Statistics (2018a) *Trends in self-employment in the UK*, Newport, ONS

Office for National Statistics (2018b) *Provision of unpaid care by age group, UK, 2015 to 2017, Figure 1*, ONS

Office for National Statistics (2019) *Families and households in the UK*: 2019, ONS

Office for National Statistics (2020) *Economic labour market status of individuals aged 50 and over, trends over time*: September 2020, ONS

Office for National Statistics (2021a) *Dataset:EMP17: People in employment on zero hours contracts*, ONS

Office for National Statistics (2021b) *A05 SA: Employment, unemployment and economic inactivity by age group (seasonally adjusted),* ONS

Price, W. Inglis, E. Ryder, D. (2021) *Variable Uninsured (Value) Life Annuities - Theory, Practice and Country Cases*, Illinois, USA, Society of Actuaries Research Institute

Public Health England (2017) Health Profile for England 2017 - Chapter 3: trends in morbidity and behavioural risk factors, GOV.UK

Sturrock, D. (2019) *The role of pessimism about survival in explaining the 'annuity puzzle'*, London, Institute for Fiscal Studies

Wilkinson, L., Adams, J. and Silcock, D. (PPI) (2021) *The DC Future Book: in association with Columbia Threadneedle Investments*, London, Pensions Policy Institute

Acknowledgement & Contact Details

The Pensions Policy Institute is grateful for input from many people in support of this paper, including:

Claire Altman
Danielle Baker
Darren Baillie
Philip Brown
Alistair Byrne
Sangita Chawla
Peter Cowell
Chris Curry
Kathryn Fleming
Christine Harris
Janine Harrison
Olivia Kennedy
Tarryn Kleinschmidt
Robert Laslett
Maritha Lightbourne
Sarah Luheshi
Mark Ormstron
Adam Sewell
Lynda Whitney
Lauren Wilkinson

Editing decisions remained with the author who takes responsibility for any remaining errors or omissions.

© Pensions Policy Institute, 2022

Contact: Chris Curry, Director
Telephone: 020 7848 3744
Email: info@pensionspolicyinstitute.org.uk

Pensions Policy Institute
King's College London
Virginia Woolf Building
1st Floor, 22 Kingsway
London WC2B 6LE

PENSIONS POLICY INSTITUTE
PPI

SPONSORING PPI RESEARCH

The PPI gives you the power to shape the cutting-edge of policy making. Each research report combines experience with independence to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

We lead the debate and contribute fact-based analysis and commentary to the policymaking process. Our reports are well respected by Government and organisations alike, and frequently used to inform policy changes.

We've been at the forefront of shaping evidence-based pensions policy for 20 years – our analysis informs decision making.

Our Independence sets us apart – we do not lobby for any particular cause or political party. We just focus on the facts.

If you would be interested in discussing sponsoring future reports, please contact Sarah Luheshi, Deputy Director – **sarah@pensionspolicyinstitute.org.uk**

The PPI is grateful to our Supporters for their continuing support:

Platinum

BlackRock.

JUST.

Gold

AXA Investment Managers

B&CE, Providers of The People's Pension

Capita

Cardano Group
(Cardano, Lincoln Pension & Now: Pensions)

Department for Worj & Pensions

Legal & General Investment Managers

MFS Investment Management

Nest

Phoenix Group

Railpen

Scottish Widows

Silver

AON

Association of British Insurers

Barnett Waddingham

BP Pensions Trustees Ltd

Chartered Insurance Institute

Exxon Mobil

LCP

MNOPF

PLSA

Quilter

Royal London

Sackers

Shell

USS

Which?

PENSIONS POLICY INSTITUTE

PPI

All enquiries regarding the Pensions Policy Institute's activities should be addressed to Chris Curry, Director at:
Pensions Policy Institute, King's College London, Virginia Woolf Building,
1st floor 22 Kingsway, London WC2B 6LE

t: 020 7848 3744
e: info@pensionspolicyinstitute.org.uk
w: www.pensionspolicyinstitute.org.uk

ISBN: 978-1-914468-07-0

Registered Company Number: 04145584. Charity Number: 1087856 (England & Wales)