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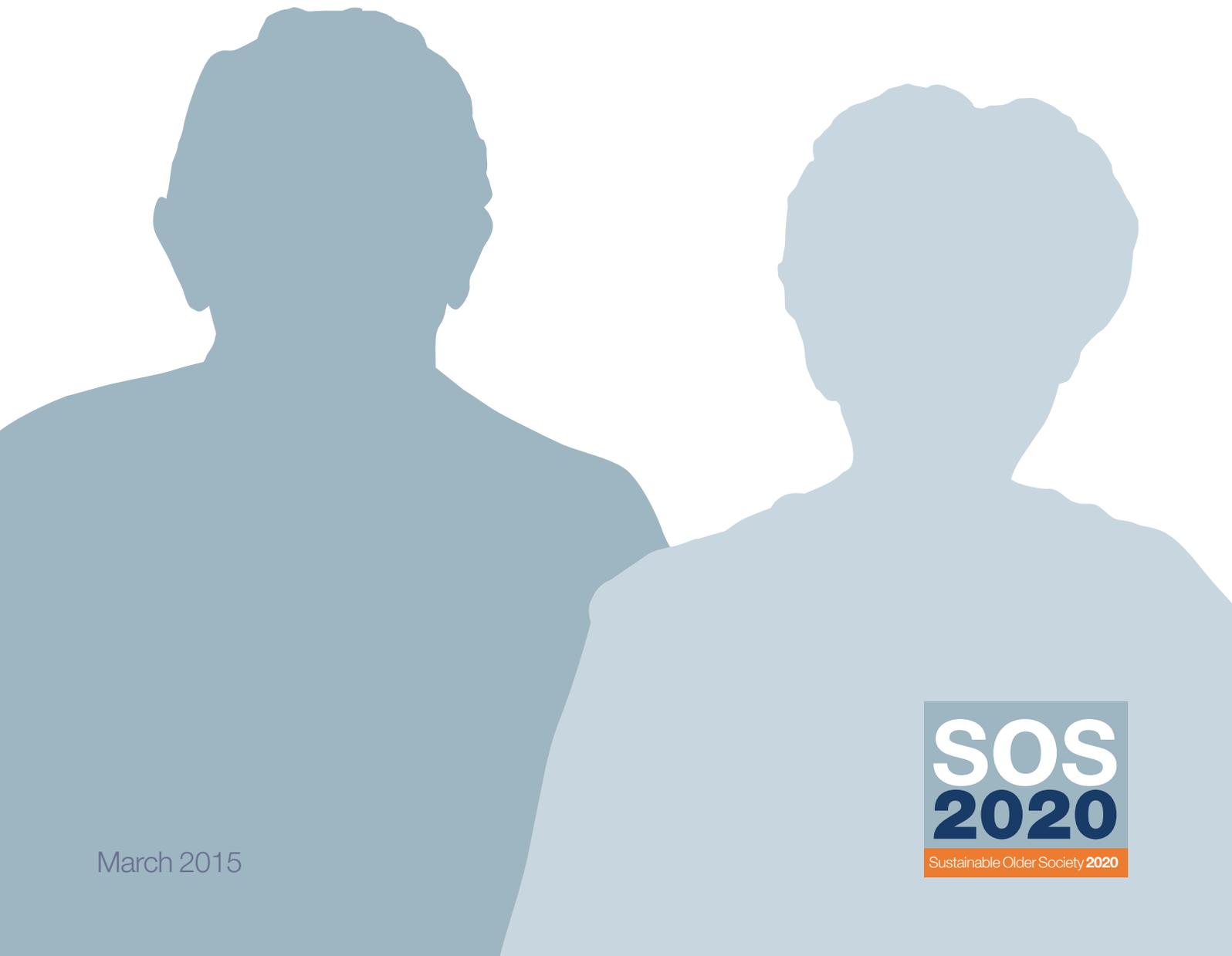


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Here today, gone tomorrow

How today's retirement choices could affect financial resilience over the long term

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Sustainable Older Society 2020

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Foreword from Baroness Sally Greengross, Chief Executive of the ILC-UK

Ensuring adequate retirement incomes for all generations is one of the biggest long term economic challenges facing the UK. Rising life expectancy means that people will need to save more for the future as well as work for longer, all the while choosing the right combination of financial products and services to meet their changing spending needs. The ILC-UK is at the forefront of this debate, seeking to deliver a robust and impartial evidence base about what needs to happen to deliver a sustainable older society, including the delivery of sustainable pensions and healthcare systems. This is why we have embarked on a programme of work under the banner of Sustainable Older Society 2020 to take a long term view.

In this context, this report is the first in a series. In the wake of the new pension freedoms outlined in the 2014 Budget, it looks at how the choices made at the point of retirement today, could impact on retirement incomes over the long term. This is a policy area of huge importance and despite measures taken by the government to introduce Guidance for all those who can access their pots, and by the financial services regulator to increase consumer protection, we are entering the unknown. Evidence from abroad suggests that consumers in countries that have liberalised retirement income markets often squander their hard earned savings, favouring consumption today rather than smoothing it over their lifetime. And while recent UK consumer research has shown that those approaching retirement would favour a guaranteed income for life, many consumers are confused about what their options are and have low levels of financial capability. The potential for a mismatch between what people might want and the products and services they ultimately access with their money is high.

But what is the potential scale of long-term consumer harm stemming from these reforms and which consumer segments are most at risk? This report utilises detailed analysis of longitudinal data in order to answer these all important questions. I think there are two particularly striking findings:

First, even if we assume that people who are at the point of retirement make decisions as they have in the past and annuitise, 1.1 million people with some defined contribution wealth in England will not be able to secure an adequate retirement income unless they receive additional pensioner benefits or use their non-pension assets. But things are even worse if everyone was to use their DC pots on items that do not generate a retirement income. In this instance, the numbers facing an inadequate income could rise to over 1.4 million.

Second, there is a sizable population of some 850,000 people in England who are high risk – with a large concentration of their wealth in defined contribution savings and a significant proportion with low financial capability. For these individuals, the choices that they make could make a huge difference to the level of income they receive in retirement. We must ensure that there are appropriate measures in place to support these individuals in the short, medium and long-term, and I hope that this report can play an important role in making this happen.

Acknowledgements

In order to help inform this report, we brought together an advisory group of experts in the field (see Appendix A for all of the group members). The ILC-UK is extremely grateful for the comments that we received which have helped to shape our thinking, but the approach, contents and findings of the final report are solely the responsibility of the authors. We would also like to thank Aviva for making this report possible and to Clive Bolton, John Lawson and Katy Litt in particular.

Approach

While the new pension freedoms have been a source of much debate and speculation since they were announced in the Budget of 2014, there has been little or no quantitative research into the long-term impact on retirees' finances. This report is the first detailed exploration of what certain choices made today could mean for overall levels of retirement income adequacy over the next 30 years. Using in-depth analysis of the largest representative survey of people over 50 in England (the English Longitudinal Study of Ageing), it quantifies the potential level of financial detriment associated with particular choices and outlines which consumer segments are most at risk of facing income shortfalls if they make certain decisions. We do this by exploring four stylised yet plausible scenarios around future choices and applying these to the overall population as well as to specific consumer segments. It is therefore a must read for industry, regulators, policymakers and consumer bodies.

Summary of findings from scenario modelling

...the new pension freedoms will not solve the endemic problem of undersaving

The new pension freedoms will allow people aged 55 and over to use their defined contribution (DC) savings as they wish. Across England, there are approximately 2 million people aged over 55 who have yet to retire and who have a DC pension pot. Only half of them have accumulated more than £37,000 within their DC pots. We calculate, that even if these individuals were to annuitise their DC pots as they would have done in the past, over half (1.1 million people) will not be able to secure an adequate income in retirement unless they use non-pension assets or receive additional benefits on top of the State Pension.

...blowing the pot leads to substantial falls in retirement income

The new freedoms allow people to use their pension pots to purchase big-ticket items (such as a car or holiday) which will not deliver an income stream in retirement. We estimate that in a scenario where the DC pot is used in this way, an additional 350,000 people (1.4 million people in total) will not be able to secure an adequate income in retirement. At an aggregate level, if everyone was to blow their pot, it could result in £7.4bn less income per annum in retirement or up to £184bn less over the duration of retirement.

For certain consumer segments, blowing the pot results in particularly disastrous outcomes. Our calculations indicate that most people with relatively large DC pots have no savings in defined benefit (DB) pension schemes and are therefore highly reliant on their DC pensions to deliver an income in retirement. Therefore, for some 850,000 individuals, blowing the pot would lead to a substantial fall in average projected replacement rates during retirement, from a replacement rate averaging almost 70% if they annuitise, to less than 40% if they blow the pot. Our research suggests that a significant proportion of this group also have relatively low levels of financial capability making them particularly susceptible to poor decisions.

...underestimating life expectancy can be fatal

Annuitising or blowing the pot will not be the only choices in the new world of pension freedoms. We also model two other potentially common scenarios - one where people put all their DC wealth into a low interest savings account, and another where they leave it invested in the pension fund and draw an income from it. Consistent with past evidence, in both scenarios we assume that people underestimate their life expectancy by 4 years and therefore spread their savings over too short a time period.

Before an individual's money in a savings account runs out, just over half of the sample are able to secure an adequate retirement income (similar to the scenario where people annuitise), but once they have used all their savings (4 years before death), only 3 in 10 will be able to secure an adequate income for the remainder of their lifetime. As a result, average replacement rates fall from 66%

when they have some savings to 49% when they do not. Such an income fall coming at the end of someone's life could have disastrous implications, resulting in them cutting back on expenditure just at a time when they may need it most – i.e. to maintain basic living standards as well as paying for additional costs such as long-term care.

Once again, it is the sizable consumer segment who have a significant proportion of their wealth locked up in DC schemes (approx. 850,000 people) who will suffer the largest income falls if they spend their money too early. If this group chooses to draw an income from a savings account and underestimates their life expectancy, they could see their average replacement rate fall from over 60% when they have some savings to less than 40% when they do not. The below table provides a breakdown by scenario and consumer segment.

Table 1. **Average replacement rates across scenarios and consumer segments**

Consumer segments	Annuity	Blow the Pot	Savings Account		Income drawdown	
			Before Savings Runs Out	After savings Out	Before Fund Runs Out	After Fund Runs Out
1. Small DC, High SA, No DB	49.2%	46.1%	48.7%	46.1%	49.9%	46.1%
2. Small DC, Low SA, No DB	51.5%	48.4%	50.9%	48.4%	52.1%	48.4%
3. Large DC, High SA, No DB	69.6%	33.4%	64.0%	33.4%	77.8%	33.4%
4. Large DC, Low SA, No DB	66.1%	39.8%	61.6%	39.8%	71.9%	39.8%
5. Any DC, Low SA, Medium DB	94.0%	68.5%	89.1%	68.5%	99.5%	68.5%
6. Any DC, High SA, High DB	85.0%	81.5%	84.4%	81.5%	85.8%	81.5%
Total	69.4%	49.1%	66.0%	49.1%	74.0%	49.1%

Note: calculations are before tax and do not include additional pensioner benefits

...beware of volatility from income drawdown

While drawing an income directly from the pension fund (income drawdown) allows people to benefit from higher returns by keeping the fund invested, underestimating life expectancy results in the same outcome – incomes fall towards the end of life as people spend their money too early. We calculate that average replacement rates for income drawdown are initially higher than in any other scenario but the subsequent drop in income is also greater – resulting in the average replacement rate falling from 74% when people still have money to draw from the fund to 49% when they do not.

Despite drawdown offering the prospect of higher returns and therefore potentially higher average replacement rates up until the fund runs out, reporting the average for the initial period masks substantial volatility. We calculate that in a “balanced” fund composed of 60% bonds and 40% equities, average annual income in retirement could vary between £18,000 and £12,000 due to yearly fluctuations in asset prices. If individuals are unprepared for such volatility, it would be akin to significant year on year income shocks which could adversely impact living standards if people decide to cut back on essential expenditures during years when returns are lower.

Figure 1: **Annuity vs. Income drawdown**



Source: own elaborations based on ELSA data and FTSE100 historical data.

Main considerations for each consumer segment

Large DC, low savings, No DB (450,000 people)

Those who have a high concentration of DC wealth and little else are clearly most at risk of harm if they blow their DC savings, and regulators and policymakers should look at ways to better protect this group from decisions that could lead to substantial income shortfalls. This group not only needs to generate an income from their DC pots but also needs some flexibility of income as they do not have much by way of liquid savings. A blended solution may therefore be best for some of these individuals – with part of the DC money used to buy an annuity and some being held in other more flexible savings vehicles.

Large DC, high savings but no DB (400,000 people)

For those with high DC and high savings but no DB their savings may already be sufficient to provide the flexibility that they need and so using their DC pot to buy an annuity is likely to make most sense, protecting them against longevity risk as well as possible one-off costs during retirement.

Some DC, low savings and medium DB (260,000 people)

It is more complicated for those with some DC savings, low levels of liquid savings and medium DB. For this segment it will be vital to understand what configuration of private pension wealth and financial assets gets them towards an adequate level of retirement income as well as some flexibility. However, it will still be critical to emphasise the point that blowing the pot will leave them significantly worse off.

High DB, high savings and some DC (190,000 people)

Those with high DB accrual, high savings and some DC, are the lowest risk segment – even if they blow their pot it does not really affect the proportion of people meeting their replacement rates and able to have some flexibility. These individuals are better placed to take some financial market risk – perhaps some form of income drawdown though they must, of course, be aware of potential losses in the value of the fund and whether this would impact on their specific retirement plans.

Small DC, high/low savings, no DB (685,000 people)

For many however, their total pension accrual (DB+DC+State) as well as their liquid financial assets

will not be sufficient for an adequate retirement income even if they do annuitise all their DC wealth. There may be a temptation for those who are facing significant retirement income shortfalls to invest in high risk assets or scams to try and “make up” for lost ground. For this reason, those with low levels of DC pension wealth should be made aware of the harsh reality – many may have to consider working longer or unlocking some of their housing wealth to fund retirement as well as using any remaining liquid savings. And the regulator should remain on the lookout for scams affecting this group.

Recommendations

Short term

1. Annuities must play key role in any future default strategy

In the face of complexity, many individuals are likely to do nothing which means that their retirement incomes will be dependent on whatever happens to the fund. We would argue that for a significant number of people, and especially for those who have high DC wealth concentrations, buying an annuity is still the right option and should form the backbone of any default strategy. However, annuitising is likely to remain an irreversible decision so individuals need to be given appropriate warning that they will have part of their fund annuitised (perhaps 75% of the fund so as to retain some flexibility) if they do nothing. For this reason, consumers must be given a year’s warning, and the default must not kick in before they reach their respective State Pension Age. Up until this age, the pension fund should be invested in a balanced portfolio of safe and risky assets to allow for continual growth in the fund.

2. Annuities must be rebranded

The framing of annuities is extremely important in determining consumer demand. While some consumers see annuities as “risky” because they “could die early”, they must instead be framed by the industry as safe guaranteed income for life. Critically, providers must focus on the opportunity cost of not taking out an annuity – i.e. the likelihood of falling back on non-pension assets such as the home, or other family members – if they do not annuitise. Annuity rates have fallen in recent years predominantly due to rising longevity and falling yields on Government bonds. But other asset classes have also seen lower returns stemming from the protracted economic recovery, and so it is time to do away with the misnomer that annuities are, as a general rule, bad value for money. For many consumers they are still likely to form a key part of their retirement strategy.

Longer term

3. Free Financial Guidance for those in advance of reaching retirement

Over the longer term, it is vital that people are engaged before they reach retirement and not just at the point of retirement. While the stakes are already high for those on the verge of retiring today, they will be even higher tomorrow when the numbers of people with high concentrations of DC wealth will be far higher. From age 50, anyone with a DC pension pot should be able to access the free Financial Guidance. This offering should be widely promoted by the Pension Wise service as well as by pensions providers and employers.

4. Independent Pensions Commission needed to tackle inadequacy

As the modelling in this report shows, for many of those with DC pots, even if they do annuitise they will not be able to secure an adequate income in retirement. With the death of final salary schemes, this is perhaps a taste of things to come. Modelling from the Pensions Policy Institute has shown that based on minimum contribution rates through autoenrolment, less than half of people with median incomes will have an adequate income in retirement. We believe that a Pensions Commission is urgently needed to bring back coherence in pensions policy and to tackle the challenge of income adequacy in a holistic way.

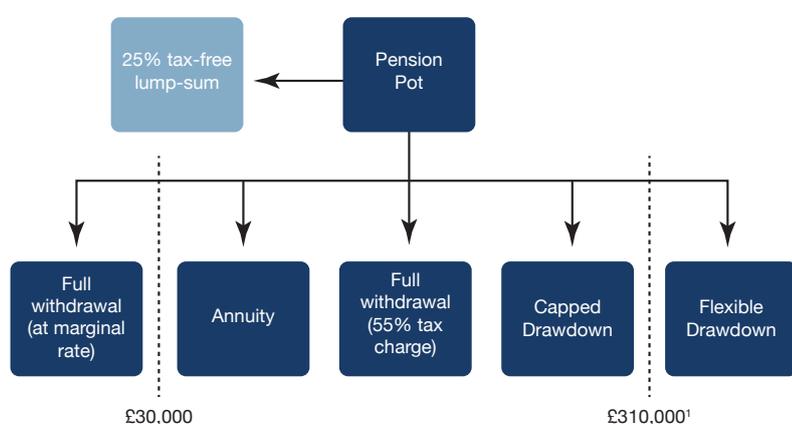
Introduction

Policy context

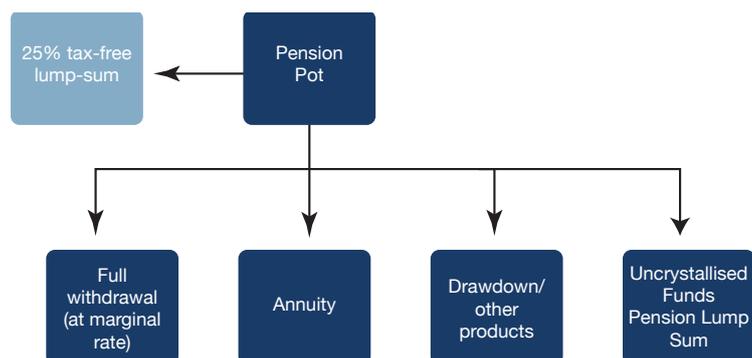
In his Budget 2014 speech to Parliament, Chancellor George Osborne announced sweeping reforms for accessing defined contribution pensions at retirement. By April 2015, the tax penalties for individuals taking all their money out in cash will be significantly reduced. Today, individuals can take 25% of their pot as a lump sum, but if they pull the rest out it will be subject to a 55% tax charge. By contrast, under the proposed reforms, while the first 25% remains tax free, the remainder can be withdrawn at the individual's marginal rate of tax. See below chart for an illustration of the changes. Many have referred to the reforms as “the new freedoms” for accessing DC pension pots, and it has led to much speculation about exactly how individuals will use their pension pot under the new tax framework.

Figure 2. **Graphical illustration of changes proposed in the 2014 Budget**

Under the current system, people's choices are constrained by the size of their defined contributions pensions pot. There is some flexibility for those with small and very large pension pots, but around three-quarters of those retaining each purchase an annuity.



¹This is a stylised assumption based on a individual with a full basic pension of £5,744 per year, who takes the maximum tax free lump sum (25%) from their defined contribution pension pot and purchases a single life, level no guarantee annuity worth £14,256 per year (an annuity rate of 6.1%) at age 65. This will enable them to meet the minimum income requirement of £20,000 per year for entering flexible drawdown.



Under the new system, regardless of the size of their defined contribution pension pot, everyone will be able to choose any of the options in the above diagram. This will mean that everyone has access to full withdrawal, an annuity or drawdown, and potentially other products created by providers.

Source: Author's adaptation of HM Treasury diagram from March 2014

Since the initial announcement, the draft legislation has also introduced a third facility alongside annuities and drawdown called ‘uncrystallised funds pension lump sum’ (UFPLS). A UFPLS can be taken from uncrystallised funds with 25% of the lump being tax-free, with the remainder being taxed at the individual's marginal tax rate. This measure will therefore allow people to draw a lump sum from their pension without having to crystallise the whole pension pot.

Alongside these changes, the Government has given a guarantee that all those at the point of retirement will have access to **free and impartial guidance**. The Government has ruled that the guidance offered must be:

- impartial and be considered of good quality;
- covers the individual's range of options to help them make sound decisions to equip them to take action, whether that is seeking further advice or purchasing a product;
- free to the consumer (at point of use); and
- offered face-to-face.

Under current plans, the reforms will be implemented in **April 2015**¹ with Citizens Advice Bureau offering face to face guidance and The Pensions Advisory Service providing online and telephone guidance. In addition, the Government has rolled out its Pension Wise service – providing online information about the choices facing individuals. By any criterion this is a very tight timeframe for relevant parties to consult, design and deliver the requirements that need to be embedded in these reforms. Indeed, there remain considerable fears that many people will lose out to financial scams operating outside the regulatory perimeter in the new world. Research by insurance provider Phoenix Group found that 45% of pension savers have been approached to see if they wanted to review their pension or release some of it as cash. Such scams can seriously erode savings as the following example of a typical scam demonstrates:

*"If you had a £10,000 pot and wanted to 'liberate' £3,000 of that, you would receive a lump sum of £3,000. However, the pension 'liberation' companies typically charge a 30% fee, so the fee could be as much as £3,300. You would expect the remaining £3,700 to be invested to give you an income when you retire - but there is a real risk that the money will not be there when you expect it"*².

In response to such fears, the Financial Conduct Authority (FCA) has made new rules requiring pension providers to question those who are about to take money from their pensions about their personal circumstances and issue risk warnings before releasing the consumer's funds in order to avoid the worst decisions. The FCA's suggested question areas are focused on a number of themes including: the individual's health, whether the consumer has any dependents, whether the consumer has shopped around, tax implications, investment scams and charges amongst a number of other areas³. While this is likely to be a step forward in terms of consumer protection, it raises the prospect of confusion once the new freedoms are in place. Consumers are likely to think that they can gain access to their pension pots straight away only to find additional barriers in place. It also poses an implementation risk as providers will need to set up systems and controls to raise the appropriate questions and issue the necessary warnings within a very short timeframe.

The role and structure of this report

Given the constantly evolving policy backdrop, there are clearly a number of big unanswered questions. Perhaps the biggest of all, is what different choices at the point of retirement will mean for future retirement income – both at the aggregate level (i.e. for the whole population) as well as for different consumer segments. While the new pension freedoms have been a source of much debate and speculation since their announcement, there has been little or no quantitative research into how different choices could impact retirees' finances over the long term. This report seeks to fill this significant gap in the debate, analysing the costs of certain decisions for different consumer segments as well as for the population as a whole which can provide the basis for useful guidance and advice going forwards. In this regard, this report is structured in seven parts:

¹ For more details see the Government's consultation paper, Freedom and Choice in Pensions (2014). <https://www.gov.uk/government/consultations/freedom-and-choice-in-pensions>

² Phoenix Group (2015) *Three-fold increase in pensions scams since announcement of budget pension reforms* <http://www.thephoenixgroup.com/~media/Files/P/Phoenix-Group-V2/Attachments/pdf/pension-scams-26-01-15.pdf>

³ For a full list of question areas see: FCA (2015) Retirement reforms and the guidance guarantee: retirement risk warnings, Policy Statement PS15/4: <http://www.fca.org.uk/static/documents/policy-statements/ps15-04.pdf>

Section one examines how consumers might respond to the reforms based on evidence from past literature.

Section two outlines the basis of the four stylised scenarios that we will ultimately model.

Section three identifies the population of UK consumers that we are most interested in and reports the results of statistical analysis which segments the older population into different groups based on wealth.

Section four explicitly sets out the assumptions underpinning all of the modelled scenarios and the results that we derive from those scenarios.

Section five discusses some high level guidance about what each of the different consumer segments might do in response to the freedoms.

Section six briefly assesses overall levels of financial capability amongst the different consumer segments and the implications.

Section seven concludes the report and outlines recommendations for future action.

1. How consumers might respond to the reforms: evidence from past literature

Since the publication of Yaari's (1965) seminal paper⁴, economists have long argued that risk averse retirees should convert a high proportion of their retirement wealth to an annuity at retirement. Annuities have the potential to solve some complex problems individuals struggle with, and, because they continue making payments until death, they provide retirees with the insurance against the risk of outliving their accumulated financial assets. Annuities in the private market are also able to offer higher rates of return than other risk-free investments, because they transfer assets from those who die to those who survive: the "mortality premium."

Until the recent pension reforms, individuals in the UK were incentivised to purchase an annuity or income drawdown plan that capped the amount of withdrawals that could be taken from the pension fund. Prior to announcement of the reforms it has been estimated that approximately 75% of individuals with DC pensions annuitised⁵. As of April 2015 however, individuals will have much greater freedom with regards to how they choose to use their pot. In some countries where similar freedoms are already in place, the level of annuitisation is much lower. For example, the USA has a voluntary annuitisation rate of just 2% and Australia's is 2%-10%⁶.

While an annuity may not suit everyone, there is evidence of under-annuitisation in countries such as Australia and the USA, where individuals are exposing themselves to running out of money before they die. The Pensions Policy Institute reported that in the USA, 'half of those in or close to retirement in 2010 were in danger of exhausting their private pension savings before their death'⁷.

By providing a stable retirement income, annuitisation has clear benefits, so the very low levels of voluntary annuitisation in certain countries has become known as the "Annuity Puzzle". Much of the discussion since the UK's new pension freedoms were first proposed has focussed on this issue and its potential ramifications for UK consumers. So why do some people fail to annuitise and what might be the implications?

Why do people decide against annuitising?

There is a wide body of research which attributes low voluntary annuitisation rates to behavioural biases as well as a lack of understanding, among retirees.

People may not annuitise their pension pots because they gain a feeling of security from having liquid savings in the bank. The Strategic Society Centre has described this as a 'psychological dividend'⁸ and argues that savings could boost people's confidence and expectations. Annuitising a pension pot would result in the loss of this dividend, even if it would provide security in other ways, and so people may choose not to.

Hu and Scott (2007) argue 'mental accounting and loss aversion can explain the unpopularity of annuities by framing them as risky gambles where potential losses loom larger than potential gains'⁹. Individuals face a potential loss as there is a probability they will die before they get as much out of an annuity as they initially put in. They are loss averse and therefore over weigh the likelihood of this, and choose not to purchase an annuity. Framing an annuity as a risky investment, rather than as guaranteed consumption, can therefore have a big effect on the take up of the product¹⁰.

Brown et al (2013) suggest that complexity may act as a barrier to the annuitisation of pension pots. Using experimental evidence they show that 'individuals have difficulty valuing annuities, and this

⁴ Yaari, M. (1965). *Uncertainty Lifetime, Life Insurance and the Theory of the Consumer*, Review of Economics Studies, 32, 137-150.

⁵ Pensions Policy Institute (2014) *Freedom and Choice in Pensions: comparing international retirement systems and the role of annuitisation*. PPI Briefing Note Number 66.

⁶ Ibid.

⁷ Ibid.

⁸ Lloyd (2014), *New Annuity Era – Understanding retirement choices and the annuity puzzle*, Report for the Strategic Society Centre

⁹ Hu W and Scott J (2007) "Behavioural Obstacles in the Annuity Market" in *Financial Analysts Journal*, Vol. 63, No. 6 Centre

¹⁰ Lloyd (2014), *New Annuity Era – Understanding retirement choices and the annuity puzzle*, Report for the Strategic Society Centre

difficulty – rather than a preference for lump sums – can help explain observed low levels of annuity purchases¹¹. When people retire and face the annuitisation decision, they are making a choice they have no prior experience of. Brown et al use their research to argue that in the face of this, individuals resort to ‘rule-of-thumb behaviors’. In an experiment where they presented individuals with hypothetical choices, they found ‘a large divergence between the price at which individuals are willing to buy an annuity and the price at which they are willing to sell an annuity’. This implies people were using ‘a simple “buy low, sell high” heuristic’ rather than fully understanding the decisions they were making.

In a similar vein, the Strategic Society Centre suggest that when people choose not to annuitise they are ‘simply displaying inertia in the face of a complex decision’¹². Instead of trying to understand the complexities of various annuity options, individuals may choose to put their money in to ‘easy access liquid savings accounts which do not commit individuals to any course of action’.

An alternative explanation for low annuitisation may be that people do not accurately predict how long they are going to live for. If people think they are only going to live for a short period after retirement they may not think that an annuity is the best option. Research by the IFS found that ‘over half (58.5%) of individuals aged 50–64 (who are not yet retired) have never thought how many years of retirement they will have to fund’ and that ‘this figure is higher among members of DC pension schemes than among members of DB schemes’¹³. People who have considered their life expectancy in retirement do not expect to live as long as they might, ‘only 9% of men and 10% of women expect to live until at least age 90, when in fact the official estimates are that 18% of men and 29% of women will do so.’ The IFS go on to argue ‘...to the extent that DC scheme members underestimate their true life expectancy, they will see annuity rates as offering poor value for money’.

UK consumer preferences for using DC pensions

While there is a wide behavioural economics literature on the preferences of those saving for retirement and on the “annuity puzzle”, its empirical evidence is often grounded on findings from other countries which have similar freedoms in place. Until recently there has been much less research based on directly asking UK consumers to state their views and preferences. Since financial preferences surrounding risk, savings and income are likely to be underpinned by social and cultural norms, which may in turn, be region or country specific, the need for good quality UK-specific evidence is high.

Most of the UK consumer surveys that have been undertaken since the new freedoms were announced have sought to assess 1) what people want their pension pots to achieve for them during retirement and 2) what decision they will actually make regarding their pots. While both issues are related, the latter is arguably harder to test with any accuracy at this point because people are so unsure of the options facing them and what they will mean. A recent report from the International Longevity Centre-UK, focused on the first aspect – namely, identifying what consumers want their pension pot to deliver – and surveyed a representative sample of people aged 55-74 who were yet to retire or draw on their private pension wealth¹⁴. At the time of writing, to the best of our knowledge, this is the largest survey of the “at retirement” group that has been conducted exploring consumer views in light of the reforms.

Nearly 70% of respondents said that delivering a secure guaranteed income to pay regular bills in retirement was the most important thing, while just 8% said supporting the needs of family members was most important and 7% said paying for big ticket items such as a holiday, car or housing repairs. It should be noted that the question specifically asked people to state the “most important” thing. When they did not have to stipulate the most important element, but were just asked what they wanted their pension to deliver, the proportion who said they wanted their pension to deliver a

¹¹ Brown J et al. (2013) *Complexity as a Barrier to Annuitization: Do Consumers Know How to Value Annuities?* Pension Research Council Working Paper, University of Pennsylvania

¹² Lloyd (2014), *New Annuity Era – Understanding retirement choices and the annuity puzzle*, Report for the Strategic Society Centre

¹³ Crawford R and Tetlow G (2012) *Expectations and experience of retirement in Defined Contribution pensions: a study of older people in England*, Institute for Fiscal Studies, London

¹⁴ Franklin and Creighton (2015) *Making the System fit for purpose*, Report for the ILC-UK Centre

big ticket item rose to just under half the sample, though a guaranteed income to pay regular bills remained top. The difference in the results across the two questions, suggests that people will want their pension pot to achieve multiple things, but that delivering an income in retirement remains the most important element for the vast majority.

While people may want a guaranteed income in retirement, the ILC-UK's research suggested that there is likely to be significant confusion about how to achieve this. Only half of people surveyed with a defined contribution pension said they understood what an annuity was quite or very well. Only 20% said they understood what an enhanced annuity was quite or very well with nearly half saying they had no understanding of this product. And just 35% of people said they understood what income drawdown was. This compared to 9 out of 10 people who said they understood what a savings account was quite or very well. The overall level of consumer confusion, compounded by a lack of retirement planning, means that there may be a mismatch between what individual's underlying preferences might be for using their pension pot, and the products and solutions they ultimately fall back to get there.

2. Towards four stylised scenarios

Based on the background literature regarding how consumers have responded to liberalised retirement income markets in other countries, combined with evidence from consumer surveys in the UK, it is possible to speculate about the choices consumers will make in the new world of pension freedoms. These choices form the building blocks for four broad scenarios. Each is necessarily stylised and assume that people make one major decision with their pension pot and stick with it throughout retirement. In reality, of course, people could choose to do a number of things with their pot at different points in time, but we think that these stylised scenarios act as a useful point of departure when trying to quantify the opportunity costs of certain likely courses of action in the new world.

1. Annuitise

While there has been much speculation about the end of annuitisation, many people are still likely to purchase annuities going forward. Surveys of UK consumers such as the one referred to above have shown that people value certainty of income during retirement and so will still opt for the one product that can deliver this. But the overall level of demand will depend on raising the public's understanding of annuities and how they sit amongst the suit of options that are open to them. In the meantime, the current level of uncertainty regarding the future options facing consumers is not conducive to making an irreversible decision. Indeed, analysis by IRESS of data from over 150,000 advised annuity cases has found that sales of single life annuity products via financial advisers fell by 30.1% in 2014 compared to 2013¹⁵ as people digest what the reforms mean. Nevertheless, in the new world we still think many will choose to annuitise at least part of their pot to benefit from the insurance against longevity risk.

Opportunities and risks from annuitising.

Opportunities:

Consumption smoothing: As part of standard retirement planning, annuities are the best way to smooth consumption and keep a stable level of income before and after retirement.

Protection from Longevity risk: since annuities are paid till the time of death, consumers are fully protected from the risk of outliving their assets.

Risks:

Decreased flexibility/lower control: if all wealth is annuitised, people's ability to face unforeseen financial shocks is reduced, and it greatly depends on how much they have in savings/other financial assets.

Macro-economic risks: if consumers buy level annuities (not linked to inflation), they may attain a low real rate of return in the long-run and thus see the value of their income stream diminish. In addition, since DC schemes are fully based on individual contributions, there are risks related to future earnings trajectories, which in turn depend on the general health of the economy .

Financial market risk: risks associated with varying real rates of return to pension assets, and the future pricing of annuities. Consumers should be aware about buying annuities when rates are low, since their choice is irreversible.

2. Blow the pot

While the likelihood of everyone blowing their hard earned pension savings has arguably been overstated, there remains a real possibility that some people at least will decide to consume all of their pension savings in the initial years of retirement. Immediate rewards are often hard to resist. Within the behavioural economics literature, it is often observed that people tend to consider events as less important if they occur in the distant future, rather than in the near future – known as temporal

¹⁵ IRESS (2015) At retirement report, Edition Three: http://cdn2.hubspot.net/hub/194991/file-2441872322-pdf/docs/IRESS_At_Retirement_Report_January_2015.pdf?&__hssc=&__hstc&hsCtaTracking=6617cb18-7e71-4252-9a14-4da8fcbdb16a%7C64b3cfbb-d5d9-4539-a2c5-7f9bfe-7bee5b

discounting. This tendency can result in individuals choosing smaller immediate rewards over a larger delayed reward.¹⁶ For this reason, we think that some people will choose to spend everything and live for today, foregoing an income stream for the duration of retirement.

Opportunities and costs arising from spending the pot

Opportunities:

By taking out a big lump sum, consumers can spend it all on consumption, for example a holiday, or paying off existing debts, helping out children or renovating the family home. A recent report from the Centre for the Modern Family revealed that, according to 27% of Britons, the new pension freedoms will put pressure on retirees to use pension savings to help struggling family members, and the risk is especially high for those who have adult children living at home.¹⁷

Risks:

The main risk from failing to annuitise comes from the strong possibility of inadequate retirement income. The cost is higher for consumers who cannot count on any other sources of retirement income, e.g. DB entitlement, and have no liquid savings. In the worst case scenario, with particularly low retirement incomes, many would have to access the equity locked in their homes – providing that they own their home and that it is worth enough to be eligible for an equity release product.

Another risk is the lack of flexibility and irreversibility of the choice: once the lump sum is spent, there is no going back.

3. Put all the money into a savings account

People understand savings accounts and like the flexibility that they provide, which will allow both regular withdrawals to help fund living costs in retirement and the freedom to release cash if it is needed for exceptional costs. But people typically underestimate their life expectancy which will make it hard for them to sustain a regular income from these savings over their remaining lifetime. According to ILC-UK calculations, women aged 55-74 typically underestimate life expectancy by between 5.6 and 6.3 years, while men underestimate their life expectancy by between 4.2 and 5.5 years.¹⁸ For this reason, we think it is reasonable to assume that some people will take all their money out of their DC pot, put it into their savings account to provide them with an income and will spend it all before the end of their life because they draw on it too quickly.

Opportunities and costs of putting everything in a savings account

Opportunities:

Consumption smoothing: by progressively drawing on their savings, consumers can actively choose to smooth consumption over their retirement until their money runs out.

Flexibility: since the money is held in a savings account, it can still be used to face unexpected expenditures. Furthermore, consumers have more freedom since they can, potentially, withdraw as much or as little as they want.

Risks:

Shift of Longevity risk onto the individual: because the funds are held in a savings account, consumers are not protected from longevity risk and could outlive their savings.

Increased responsibility: by buying an annuity, consumers can secure a constant stream of income without having to calculate the optimum amount to withdraw each year, while with a savings account they have to know how much to withdraw every year in order to make the fund last as long as possible.

Erosion of value from inflation: There is also the risk that interest rates on savings accounts will not keep up with inflation.

¹⁶ Magen et al (2008) The Hidden-Zero Effect Representing a Single Choice as an Extended Sequence Reduces Impulsive Choice. Association for Psychological Science. <http://www.stanford.edu/dept/psychology/cgi-bin/drupal/system/files/The%20hidden%20zero%20effect.pdf>

¹⁷ Centre for Modern Family (2015) Forever young: The new landscape of later-life planning.

¹⁸ Franklin and Creighton (2015) Making the system fit for purpose, report for the ILC-UK

4. Draw an income from your pension investments

The general consensus is that income drawdown is set to become more popular and there is already evidence of increased take up. According to the Financial Conduct Authority drawdown sales are likely to continue growing if annuity rates remain at current levels and consumers take a more risk-tolerant approach to their pensions once the new freedoms are in place¹⁹. As a result, a fourth scenario that we consider, is for people to leave their money invested in the pension. Arguably, two groups of individuals are most likely to end up in drawdown arrangements; 1) those who actively want to keep the fund invested to benefit from potentially higher returns and the flexibility that drawdown offers 2) inert consumers who do not make a decision because they are confused by the complex choices they face and so remain invested by default. Again, because both sets of individuals may underestimate their life expectancy, they draw on their fund too quickly and run out of money before they die.

Opportunities and risks of income drawdown

Opportunities:

Possibility to benefit from growth in the fund: The main opportunity from income drawdown is to earn a higher return by investing in higher risk assets though of course this is not guaranteed.

Flexibility: At the same time, there is some flexibility, since there are no minimum limits to the amount drawn each year.

Risks:

Volatility: There are high risks associated with stock market volatility; therefore the composition of the DC portfolio is of paramount importance.

Outliving your savings: Keeping the fund invested also leaves the individual exposed to longevity risk – if they spend too much of the fund too early this could result in them running out of money before they die.

These four stylised scenarios form the context for our subsequent analysis, which attempts to model what these different choices would mean for an individual's income over the duration of retirement. But before we can quantify the opportunity cost of different decisions, we must better understand the population of interest – the wealth and assets of people who will be eligible to decumulate from their pension pot under the new freedoms.

¹⁹ FCA (2014) Retirement income market study: Interim Report <http://www.fca.org.uk/static/documents/market-studies/ms14-03-2.pdf>

3. Defining the population of interest

In order to assess the potential impact of the reform, we use data drawn from the English Longitudinal Study of Ageing (ELSA)²⁰, a longitudinal study representative of the English population aged 50 and over, which is conducted every two years.

For the present analyses, we use only data from 2010 and keep in our estimation sample all core members aged between 55 and 74 as in Crawford and Tetlow (2012).²¹ Furthermore, as the increased flexibility granted by the reform will only affect those who have a Defined Contribution (DC) pot, we exclude from our analysis all people who do not have any DC savings. Total pension wealth (state and private) is a derived variable estimated by the Institute for Fiscal Studies (for the methodology used to estimate pension wealth in the ELSA see Banks et al).²²

In 2010, roughly 56% of the population aged between 55 and 74 (approximately 5.9 million people) had not yet entered retirement²³, nearly all of the non-retirees, 99.8%, have accumulated at least some State Pension (SP) entitlement, with average values approximating £140,000. Only 10% were contributing to a DC scheme, but at least **one in three** (nearly **2 million people**) had a DC pot²⁴, with an average pot size of £103,000. However, while the amount of state pension wealth did not vary dramatically among the non-retirees, DC pots show considerable disparities, with a median value of approximately £37,000, the bottom 25% holding less than £12,000 and the top 25% more than £107,000. If we divide our sample by gender, we see that women are not only less likely to have a DC pot, but they also tend to have much smaller pots, generally about half the size of men's.

It is also worth mentioning that because of automatic enrolment in an occupational pension scheme, the number of people with DC savings is rising.

What people decide to do with their DC savings will have a different impact on their future financial resilience according to whether or not they have access to other forms of pension wealth, such as Defined Benefit (DB) schemes, and other liquid savings^{25,26}.

While membership of a DB scheme will generate a retirement income, liquid savings are vital to soften the impact of financial shocks, such as unexpected health and care expenditures. However, DB schemes are deemed no longer sustainable, and many are now closed to new subscribers²⁷, therefore their importance is limited to the older cohorts of future pensioners.

Roughly 25.5% of our sample currently contributes or has retained rights to a DB scheme, with average wealth approximating £290,000. In total, roughly 50% of the sample of non-retired (2.9 million people) have either a DC pot or some DB entitlement or both.

Nearly 90% have access to liquid savings, but the level of savings is quite low, which means that as many as 1.5 million people have access to no or very little amounts (up to £4,400) and over 2.9 million people have access to £15,000 or less.

²⁰ Data from the English Longitudinal Study of Ageing (ELSA) were made available by the ESRC Data Archive.

²¹ Crawford and Tetlow (2012): Crawford, R. Tetlow, G. (2012). Expectations and experiences of retirement in defined contribution pensions: a study of older people in England, IFS report (R73)

²² Banks, J. Emmerson, C. Tetlow, G. (2005). Estimating Pension Wealth of ELSA Respondents, IFS Working Paper 05/09

²³ This means that they define themselves as either employed/self-employed/seeking work/sick and not seeking/ or unoccupied.

²⁴ For all DC schemes ELSA respondents are asked to give the current value of their fund. This measure includes wealth from personal pensions, stakeholder pensions, S226 plans and additional voluntary contributions (AVCs) and freestanding additional voluntary contributions (FSAVCs) to DB schemes.

²⁵ Liquid assets include: savings in current accounts, cash ISAs, TESSAs, plus interest from all of the above.

²⁶ Unlike information on pension wealth, information on savings is collected at the benefit unit level, since it is meant to give an idea of people's access to wealth, rather than asset ownership.

²⁷ Silcock, D., Adams, J., Duffield, M. (2014). Transition to Retirement - How complex are the decisions that pension savers need to make at retirement? Pension Policy Institute, Research Report

Defining specific consumer segments

We now focus on people who have a DC pot, and we define six main consumer segments in terms of the amount held in each pot as well as combinations between DC, DB and liquid savings. We identified these groups by running a cluster analysis which evenly partitions the population depending on underlying assets.

It is important to bear in mind that there is a trade-off between DC and DB savings, so that individuals who contribute (or have done so in the past) to a DB scheme are less likely to also contribute to a DC scheme. To be more precise, we would have 35% fewer individuals with a DB plan among DC contributors²⁸ than among the rest of the population. Only individuals with higher incomes and higher educational attainment tend to have both.

Conversely, we found no trade-off between having access to liquid savings and having a DC pot, with savers substantially more likely to have a DC pot. This is an important issue not just for the present but also for the future, since, arguably, automatic enrolment in occupational pension schemes will not have a negative impact on other types of savings.

Consumer segments defined on the basis of their DC pots, DB entitlement and liquid savings²⁹:

Consumer Segment 1: Small DC pot (<£28,000), High savings(>£13,800) and no DB entitlement (roughly 15.1% of the sample = 302,000 people).

Consumer Segment 2: Small DC pot (<£28,000), Low savings (<£13,800) and no DB entitlement (roughly 19.2% of the sample = 383,000 people)

Consumer Segment 3: Large DC pot (>£28,000), High savings (>£13,800) and no DB entitlement (roughly 22.7% of the sample = 453,000 people)

Consumer Segment 4: Large DC pot (>£28,000), Low savings (<£13,800) and no DB entitlement (roughly 20.1% of the sample = 402,000 people)

Consumer Segment 5: Any DC, medium DB, Low savings (roughly 13.2% of the sample = 264,000 people)

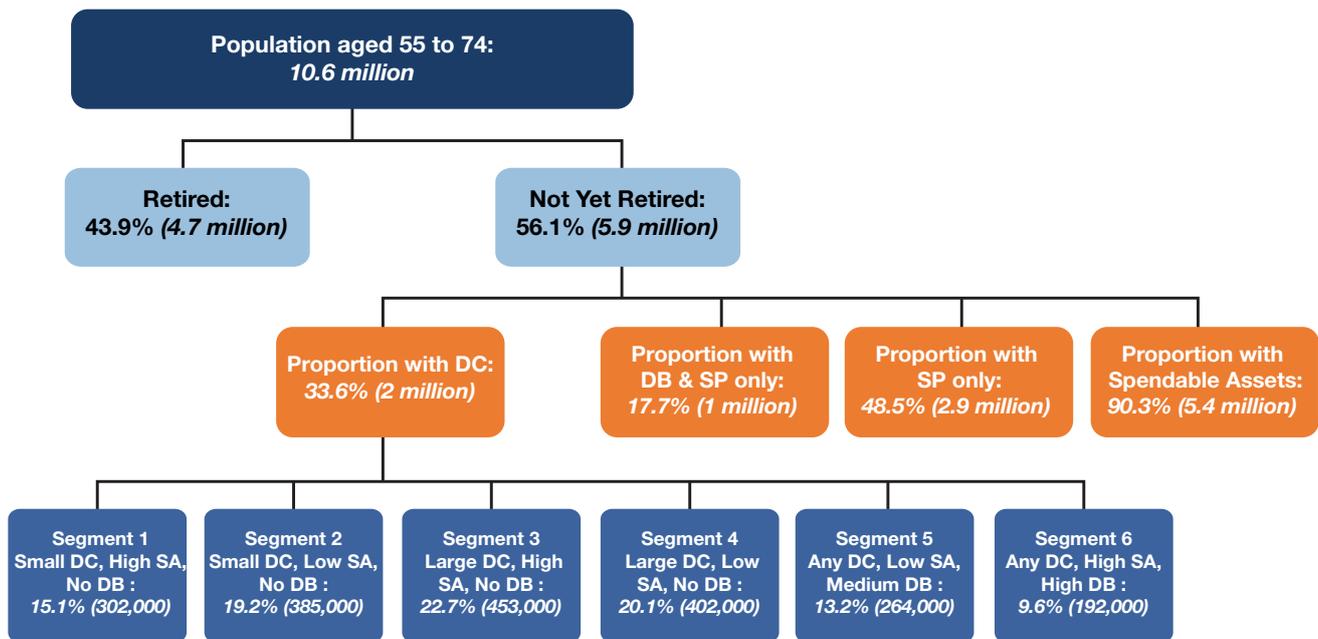
Consumer Segment 6: Any DC, high DB, High savings (roughly 9.6% of the sample = 192,000 people)

Note: to calculate percentiles of DC savings we include both current and retained DC savings; we include only positive values because of our focus on the new pension freedoms. Conversely, when calculating DB wealth and financial assets, we also include zero values.

²⁸ Results from marginal effects after probit regression, with membership in a DC scheme as dependent variable and controlling for several socio-demographic factors, such as gender, age, health status, educational level and income quartile.

²⁹ We run a cluster analysis and identified six non-overlapping segments as shown in the box.

Figure 3. Pension wealth details of population aged 55 to 74



Financial indicators for each consumer segment

Consumer segments differ from each other in many ways. Segments 1 and 2 are almost identical in terms of accumulated state pension wealth (about £150,442 and £151,266 respectively) and DC pot sizes (roughly £12,809 and £11,703 respectively), but differ substantially in terms of total pension wealth and liquid savings, with people in segment 1 much better off.

Consumer segments 3 and 5 have the highest total pension wealth, but might face very different issues at retirement, since one (segment 3) has most of its wealth in liquid savings and DC savings, while the other (segment 5) appears to have a more balanced combination, with relatively high liquid savings (above £30,000), high DC pot (over £150,000) and substantial DB (nearly £170,000).

We should also notice that state pension wealth for all segments is higher than in the average population of non-retirees, since presumably consumers who have a DC pot have also worked (or earned) more.

Table 2. Financial indicators, by consumer segment

	Segment 1	Segment 2	Segment 3	Segment 4	Segment 5	Segment 6
	<i>Small DC, High SA, No DB</i>	<i>Small DC, Low SA, No DB</i>	<i>Large DC, High SA, No DB</i>	<i>Large DC, Low SA, No DB</i>	<i>Any DC, Low SA, Medium DB</i>	<i>Any DC, High SA, High DB</i>
Average liquid savings before retirement	£60,673	£4,212	£74,065	£4,207	£31,591	£61,995
Average Total Pension Wealth before retirement	£216,469	£182,664	£445,392	£331,016	£514,745	£382,917
Average State pension wealth before retirement	£150,442	£151,266	£163,502	£164,669	£162,641	£147,371
Average DC pot before retirement	£12,809	£11,703	£226,361	£142,268	£163,370	£20,315
Average DB before retirement	£0	£0	£0	£0	£176,264	£211,864

Source: own elaborations from ELSA wave 5 Data weighted using sampling weights.

4. Modelling the different scenarios

Defining the outcome of interest: Retirement income adequacy

A standard indicator of income adequacy in old age is given by the replacement rate – i.e. income in retirement expressed as a percentage of income before retirement - for each segment. Replacement rates capture whether pensioners' income allows them to keep their working life living standards. Ensuring that individuals' income in retirement is at least a certain proportion of the income they enjoyed while working is a basic tenet of any social security system. Replacement rates also happen to be relatively easy to measure, yet can be flexible enough to take account of differences across groups making them the ideal indicator to focus our modelling efforts around.

In this instance, we use the UK Department for Work and Pensions target replacement rates by income group³⁰, so we can highlight which consumer segments are more likely to endure inadequate retirement incomes due to the choices they make at the point of retirement as well as what the average replacement rates are across the different groups.

Target replacement rates set by the Department for Work and Pensions (2012)

- Lowest income bracket (under £12,000): target replacement rate = 80%;
- Between £12,000-£22,100: target replacement rate = 70%;
- Between £22,100-£31,600: target replacement rate = 67%;
- Between £31,600 and £50,000: target replacement rate = 60%
- Over £50,000 target replacement rate = 50%.

Core assumptions underpinning all scenarios

To understand what level of income people are able to achieve in retirement and subsequently to calculate their replacement rates we make a number of simplifying assumptions. First, all pre-retirement incomes are calculated by taking the average income from employment, self-employment, and benefits over the years during which the individuals are present in the ELSA survey³¹. Second, we use IFS estimates on total accrued pension wealth - State pension, DC and defined benefit entitlement (see box below). Then to calculate retirement incomes we apply a standard annuity formula (see technical appendix for more details). Methods for calculating the DC income streams in retirement depend on the specific scenarios being modelled which we discuss in more detail in the next section.

For simplicity there are a number of elements that we exclude from our modelling.

First, we do not include liquid savings when calculating income in retirement. This is because we want to see the extent to which income derived from accrued pension wealth is adequate on its own and therefore how different choices made regarding DC pensions shape the income stream in retirement. In actual fact, when looking at the data, it is fair to say that for a large proportion of people in this age group, liquid savings amount to very little and will not shift replacement rates by that much. According to our calculations, over 27.8% of our sample do not have enough savings for an emergency i.e. between three and six months living expenses, and approximately 5.4% have no savings at all.

Second, aside from the State Pension, we exclude pensioner benefits from our modelling. Trying to model likely pensioner benefits at an individual level over the entire duration of retirement is beyond the scope and scale of this exercise. In any case, we think that the level of those benefits are liable to change quite considerably over a 20 to 30 year period making any assumptions pretty heroic. But the exclusion of benefits will nevertheless result in artificially smaller replacement rates for those at

³⁰ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223015/inadequate_retirement_incomes_july2012.pdf

³¹ Because the distribution of pre-retirement income is quite skewed, we trim the tails by eliminating top and bottom 1%.

the lower end of the income spectrum. Finally, we exclude taxation from our analysis of retirement income, so that the reported incomes are on a gross basis rather than net. This underlines the complex interactions between pensions, benefits and tax, so even people with modest savings will need to think about the trade-offs between each of these elements which can be very complicated.

Despite these exclusions, we believe that, at the very least, our modelling pin points those consumer segments who are liable to face significant retirement income shortfalls due to their decisions made at retirement unless they receive additional pensioner benefits on top of the State Pension, or tap into their non-pension assets. Also, and perhaps most critically, the modelling approach will still allow us to show differences in pension income adequacy achieved across the scenarios – which is perhaps the most important feature of this research.

Please see below for a table outlining the definitions of the main economic variables used to model the scenarios.

Definition of Main Economic Variables used for the scenarios	
Retired	Self-defined by ELSA respondents, as opposed to employed, self-employed, seeking work, sick and not seeking, unoccupied.
Liquid savings	Value given by ELSA respondents, including savings in current accounts, cash ISAs, TESSAs, plus interest from all of the above.
DC pot	Value given by ELSA respondents, including wealth from personal pensions, stakeholder pensions, S226 plans and additional voluntary contributions (AVCs) and freestanding additional voluntary contributions (FSAVCs) to DB schemes.
DB entitlement	IFS derived variable, calculated multiplying the number of years in the scheme by an accrual rate and a measure of final salary.
State Pension Wealth	IFS derived variable, equal to the discounted present value of the stream of income that an individual will receive from their pensions between starting to draw these pensions and death. If the individual is aged under SPA, we used the discounted present value of the stream of income up to SPA, while if the individual was above SPA we used the discounted present value of the stream of income assuming that he/she would retire in 2010.
Pre-retirement income	Income from employment or self-employment and benefits.
Life Expectancy	Individual LE taken from ONS.gov “Historic and projected expectations of life (ex) from the 2012-based life tables”
Real annual returns	Bonds: Annual returns based on historic movements in average yield from British Government Securities, 10 year Nominal Par Yield for Bank of England adjusted for inflation. Equities: Annual returns on the fund are equal to FTSE100 stock market returns over the last 25 years adjusted for inflation.
Inflation	MM23 Consumer Price Indices, CPI All Items (ONS)

Results from the modelled scenarios

Scenario 1: Annuitise

A life annuity converts a stock of wealth at retirement into an income stream payable to a beneficiary until death³². In this scenario, consumers make similar choices as they have in the past, taking 25% of their DC pot as a tax free lump sum, which is spent entirely, and the rest as an annuity. We calculate the total value of their retirement income to be the sum of: 1) State Pension entitlement, 2) DB entitlement (if any) and 3) annuity from their DC pot.

Assumptions in Scenario 1:

- Retirement age: assume people retire at their current age (average age = 59).
- 25% of accumulated DC wealth taken as tax free lump sum.
- Any DB and State Pension wealth taken as pension income.
- Rest of DC savings annuitised immediately at the point of retirement. The annuity rate is an average of the best and worst indicative inflation adjusted rates derived from the ABI (2.1%).
- Individuals live to their average cohort life expectancy.

Results:

In the first scenario, we calculate that the average person would receive a tax free lump sum of £26,000, and an average retirement income of approximately £12,600 a year. While the average replacement rate across the entire sample of 69.4% is close to what might be defined as “adequate”, approximately half our population of interest - 54% or 1.1 million people – still miss their specific replacement rates as defined by the DWP.

We also modelled incomes and replacement rates for all the consumer segments identified in the previous section. Perhaps predictably, consumers who also have some DB entitlement (in segments 5 and 6) have the highest replacement rates, receiving between one to two thirds additional retirement income compared to the average population, and nearly three times the income of consumer segments 1 and 2 who have little DC or DB savings and therefore have the lowest overall replacement rates. Consumers in segment 2 (approx. 385,000 people) are the most vulnerable since not only does the great majority of this group (70.7%) miss their target replacement rate, but also, unlike consumers in segment 1, they do not have any liquid savings to fall back on.

Consumers in segment 4 - approx. 400,000 people who have their financial wealth concentrated in DC pensions are also at risk of missing their target replacement rates and therefore facing inadequate incomes in retirement – our projections suggest that more than half of this group will fall short unless they use non-pension assets or fall back on the State.

Perhaps surprisingly, even amongst those in the top two consumer segments for pre-retirement wealth accrual, we find a proportion of people who miss their target replacement rates: roughly 28.4% of consumers with some DC, high savings and medium DB, and approximately 37.4% of consumers with some DC, low savings and high DB will not be able to secure an adequate income in retirement. See below chart for a full breakdown of the results.

³² The formula used to calculate the annuity is in the appendix.

Table 3: **Replacement rates from annuitising DC wealth at the point of retirement**

Consumer segments	Pre-retirement Income per Annum ^(a)	Est. Retirement Income per Annum	Average Replacement Rate	Proportion Missing the Target
1. Small DC, High SA, No DB	£15,044	£7,409	49.2%	70.7%
2. Small DC, Low SA, No DB	£13,768	£7,085	51.5%	70.7%
3. Large DC, High SA, No DB	£22,297	£15,519	69.6%	51.3%
4. Large DC, Low SA, No DB	£18,401	£12,155	66.1%	55.6%
5. Any DC, Low SA, Medium DB	£21,243	£19,975	94.0%	28.4%
6. Any DC, High SA, High DB	£19,304	£16,416	85.0%	37.4%
Total	£18,206	£12,637	69.4%	54.0%

(a) Note: the ELSA provides weekly figures, which we multiplied by 52 assuming that everyone worked for a full year.
Source: Our elaborations from ELSA wave 5. Data weighted using sampling weights.

Scenario 2: Blow the Pot

Individuals take full advantage of the flexibility granted by the reform and spend their entire DC pot on one-off big ticket items that do not generate an income stream (alternatively they may use it to pay off their debts, help their children etc.). We calculate the total value of their retirement income to be the sum of: 1) State Pension entitlement and 2) DB entitlement (if any).

Assumptions in Scenario 2:

- Retirement age: assume people retire at their current age (average age = 59)
- All accumulated DC wealth taken as tax free lump sum and spent in one go on one-off big ticket items that do not generate an income stream.
- Any DB and State Pension wealth taken as pension income.³³
- Individuals live for their average cohort life expectancy after retirement (average LE=28.6).

Results:

After blowing the entire pension pot, we calculate that the average retirement income approximates £9,000 a year, corresponding to a weekly income of £170. Compared to the first scenario where people annuitise, we see an average income loss of roughly £3,700 a year (or about 30%). Once again, consumer segments 5 and 6 are better off than all the others, since they can count on some DB entitlement and typically have accrued less DC wealth before retirement. However, all segments do, on average, experience significantly lower incomes compared with the previous scenario where they annuitise. The most severe losses occur in segments 3, 4 and 5 which have relatively high concentrations of wealth in DC schemes and so see their average annual incomes fall by 52%, 40% and 27% respectively when compared to their incomes if they annuitise.

When we turn to retirement income adequacy, the potential damage is high, with an average replacement rate of 50% across the entire sample compared with 69.4% if everyone were to annuitise. And we calculate that the number of additional people who are set to miss their target replacement rates as a result of blowing the pot approximates **350,000** (see column 5 of Table 4), which means that in total 1.4 million people will have inadequate incomes if everyone blows their DC pension wealth by comparison to 1.1 million if they annuitise.

Only segments 5 and 6 who have relatively high levels of DB wealth manage to reach the target replacement rates on average, however even in these two groups a very large proportion (47.9% in segment 5 and 44.5% in segment 6) will still have inadequate retirement incomes. Segment 3 would have the lowest replacement rate, therefore its members would have to use up their non-pension assets to boost retirement income.

³³ To calculate DB and State pension income we use the values and guidelines provided by the IFS. To model state pension income, we apply a standard annuity formula and assume 1.5% interest rate; modelling DB entitlement can be difficult, therefore we simplify it by modelling it as an annuity as well, only with a different rate (2.1 %).

Table 4: **Replacement rates in scenario 2**

Consumer segments	Est. Retirement Income Per annum	Average Replacement Rate	Proportion Missing the Target	Additional people missing their target replacement rate compared with scenario 1
1. Small DC, High SA, No DB	£6,940	46.1%	71.3%	1,667
2. Small DC, Low SA, No DB	£6,664	48.4%	74.8%	15,998
3. Large DC, High SA, No DB	£7,445	33.4%	85.7%	155,617
4. Large DC, Low SA, No DB	£7,329	39.8%	80.1%	98,087
5. Any DC, Low SA, Medium DB	£14,557	68.5%	47.9%	51,283
6. Any DC, High SA, High DB	£15,730	81.5%	44.5%	13,685
Total	£8,945	49.1%	71.4%	347,802

Source: Our elaborations from ELSA wave 5. Data weighted using sampling weights.

Scenario 3: Savings Account

In this scenario, consumers take the money out of their DC pot and put it in a low risk, low return savings account. They make regular withdrawals to supplement their pension income, but underestimate their life expectancy by 4 years, as found in the literature, and therefore run out of money from their DC savings before they die.

Assumptions in Scenario 3:

- All DC wealth is moved into a savings account yielding a real interest rate of -0.5% per annum. This is consistent with real interest rates on savings accounts over the past 5 years.
- The amount of money in the account is recalculated year on year, and the individual draws an income each year consistent with smoothing consumption over the length of time the individual expects to live for.
- Consumers expect to die four years before their average cohort life expectancy, and therefore run out of savings four years before death.
- Retirement income consists of Basic State Pension, DB pension and regularly drawing from their DC savings until it runs out of money; state pension and DB pension afterwards.

Results:

When modelling future income streams for this scenario, we calculated average incomes before and after the savings account runs out of money. According to our calculations, before running out of money, consumer's average retirement income amounts to about £12,000 a year which is around £600 less than in the annuities scenario. However, because people spend their money too soon, we estimate that after people spend all of their savings, average annual income will fall from £12,000 to £9,000 for their rest of their life.

Table 5 shows the estimated retirement income and replacement rates before and after the fund runs out, i.e. at least 4 years before predicted end of life by cohort. Once again, income falls are sharpest for the consumer segments with the highest concentration of wealth in defined contribution pots with those in consumer segment 3 (about 450,000 people) seeing their incomes effectively halved as a consequence of running out of savings stemming from their DC wealth.

Table 5: **Replacement rates in scenario 3**

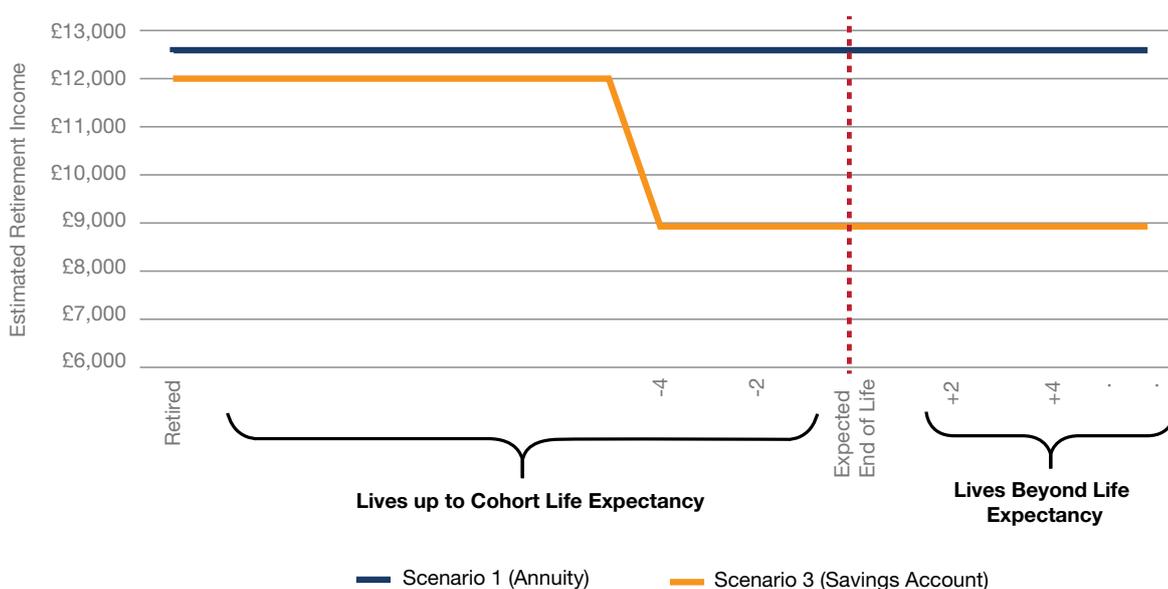
Consumer segments	Est. Retirement Income per annum		Average Replacement Rate	
	Before savings Run Out	After savings Run Out	Before savings Run Out	After saving Run Out
1. Small DC, High SA, No DB	£7,328	£6,940	48.7%	46.1%
2. Small DC, Low SA, No DB	£7,009	£6,664	50.9%	48.4%
3. Large DC, High SA, No DB	£14,278	£7,445	64.0%	33.4%
4. Large DC, Low SA, No DB	£11,342	£7,329	61.6%	39.8%
5. Any DC, Low SA, Medium DB	£18,929	£14,557	89.1%	68.5%
6. Any DC, High SA, High DB	£16,283	£15,730	84.4%	81.5%
Total	£12,012	£8,945	66.0%	49.1%

Source: Our elaborations from ELSA wave 5. Data weighted using sampling weights.

When looking specifically at retirement income adequacy, we again need to differentiate between income adequacy before and after savings run out. In this regard, our modelling suggests that just over half of the sample may experience an inadequate retirement income before they run out of money, rising to 7 in 10 once they have run out of money four years before their average cohort life expectancy. ONS statistics suggest that many are already living beyond their life expectancy. In 2011-2013, more than a third of male deaths and more than half of female deaths occurred at ages 85 or above³⁴. For many in our sample then, there is a risk that their income will suffer from a significant fall a number of years before they die, leaving them in poverty for significantly longer than the four years which their cohort life expectancy would imply.

In Figure 2 we provide a graphical illustration to clarify the dynamics of this scenario. It shows the difference between the income stream derived from an annuity as per scenario 1 and that derived from a savings account which is spent too quickly by the average retiree. For a number of years the income stream looks similar, albeit slightly lower for those in the savings account scenario, but then there is a substantial fall in income as those who put all their DC money into savings run out of cash. Such an income fall coming at the end of someone’s life could have disastrous implications, resulting in them cutting back on expenditure just at a time when they may need it most – i.e. to maintain basic standards of living as well as paying for additional costs such as long-term care.

Figure 2: **Comparing income streams in retirement: annuity versus low interest savings account**



Source: Our elaborations from ELSA wave 5. Data weighted using sampling weights.

³⁴ ONS, Number of survivors in the life table

Scenario 4: Keeping the fund invested

In this scenario, individuals put their money into an income drawdown arrangement and withdraw money from the fund to smooth consumption over the length of time that they expect to live for.

We assume that individuals invest in a “balanced” fund consisting of bonds and equities. As with the savings account scenario, we also assume that consumers underestimate their life expectancy by 4 years and therefore only aim to draw on their funds for this period of time thereby risking running out of money.

Assumptions in Scenario 4:

- All DC pot is kept invested. The portfolio composition is 60% bonds³⁵ and 40% equities^{36,37}. For simplicity no dividend payments are assumed and returns on equities are calculated based on historic movements in the FTSE100 index³⁸. Returns on gilts also based on historic yields. Both adjusted for inflation.
- The fund value is recalculated year on year, and the individual draws an income each year consistent with smoothing consumption over the length of time the individual expects to live for.
- Consumers expect to die four years before their average cohort life expectancy, and therefore run out of savings four years before death.
- Retirement income consists of Basic State Pension, DB pension and regular drawdown from income drawdown fund until it runs out; state pension and DB afterwards.

Results:

Given that income drawdown will not provide a guaranteed income for life and therefore risks individuals running out of money, we again report incomes and replacement rates before and after retirees run out of money. Our projections suggest that average retirement incomes in this scenario are, initially at least, higher for those in income drawdown than in any other scenario as consumers benefit from higher investment returns. Average incomes before the fund runs out amount to £13,500 by comparison to £12,600 for those who annuitise. The average replacement rate across the sample is also higher at 74% - 5 percentage points greater than if people were to annuitise. Yet this higher income is only relevant in the initial years in retirement. After the fund runs out – four years before the individual’s cohort life expectancy - average incomes fall to £9,000 and the average replacement rate falls to 49%.

Looking across the consumer segments, some stand to face substantial income falls as a result of the fund running dry or in the face of investment volatility. Consumer segment 3 which has relatively large DC savings, high liquid savings and no DB stand to face an income fall of nearly 60% from over £17,000 per annum before the fund runs out to less than £8,000 when it does. This income fall has a significant impact on average replacement rates for this consumer group – falling from 78% to 33%. As with the savings account scenario, such a significant fall in income coming towards the end of someone’s life could have dramatic implications for their standard of living especially if such income falls come unexpectedly. Individuals could find themselves scrambling for extra money from non-pension assets including property (which is illiquid) and from support from the State.

Unsurprisingly, those with DB savings who are less reliant on DC do not face such significant falls in income if the fund runs out before they die. Even after the fund runs out, consumer segments 5 and 6 still have average replacement rates of 69% and 82% respectively.

³⁵ Annual average yield from British Government Securities, 10 year Nominal Par Yield for Bank of England.

³⁶ Annual returns on the fund are equal to FTSE100 stock market returns over the last 25 years.

³⁷ Inflation is calculated using MM23 Consumer Price Indices, CPI All Items.

³⁸ Historic FTSE100 taken from Yahoo Finance: <https://uk.finance.yahoo.com/q/hp?s=%5EFTSE&a=00&b=3&c=1984&d=01&e=2&f=2015&g=m&z=66&y=66>.

Table 6: **Replacement rates in scenario 4**

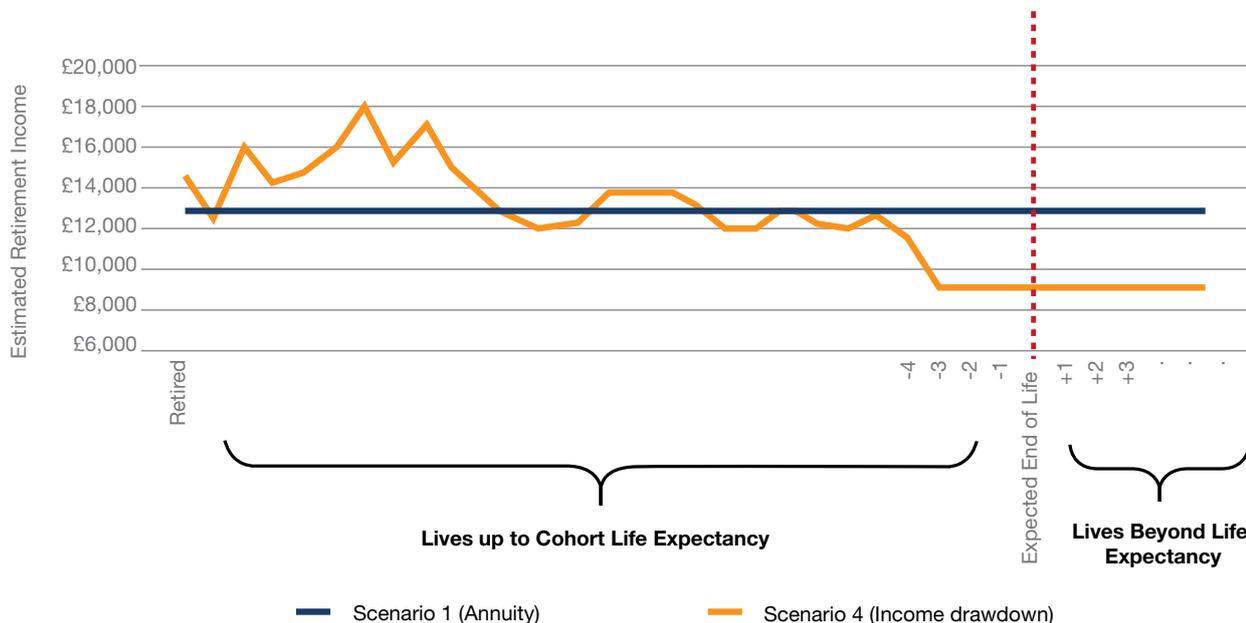
Consumer segments	Est. Retirement Income per annum		Average Replacement Rate	
	Before Fund Runs Out	After Fund Runs Out	Before Fund Runs Out	After Fund Runs Out
1. Small DC, High SA, No DB	£7,513	£6,940	49.9%	46.1%
2. Small DC, Low SA, No DB	£7,177	£6,664	52.1%	48.4%
3. Large DC, High SA, No DB	£17,348	£7,445	77.8%	33.4%
4. Large DC, Low SA, No DB	£13,231	£7,329	71.9%	39.8%
5. Any DC, Low SA, Medium DB	£21,139	£14,557	99.5%	68.5%
6. Any DC, High SA, High DB	£16,564	£15,730	85.8%	81.5%
Total	£13,464	£8,945	74.0%	49.1%

Source: Our elaborations from ELSA wave 5. Data weighted using sampling weights.

Despite drawdown offering the prospect of higher returns and therefore potentially higher average replacement rates up until the fund runs out, reporting the average for the initial period masks substantial volatility. We calculate that in this “balanced” fund, average annual income in retirement could vary between £18,000 and £12,000 due to yearly fluctuations in asset prices.

Below we plot the potential income from an income drawdown plan (orange line) against the retirement income the same person who would have received an annuity in scenario 1 (blue line) to illustrate these fluctuations more clearly, as well as the sharp fall once the fund runs out. If individuals are unprepared for such volatility, it could be akin to significant year on year income shocks which could adversely impact living standards if people then decide to cut back on essential expenditures during years when returns are lower. Individuals therefore need to ensure that they will have enough income to live off in bad years for investment returns as well as in good years.

Figure 3: **Annuity vs. Income drawdown**



Source: own elaborations based on ELSA data and FTSE100 historical data.

The long-term costs of retirement decisions

On the basis of the results from our scenarios, it is possible to estimate aggregate levels of potential consumer harm associated with different decisions as well as to identify which consumer groups could lose out the most.

What could happen at the aggregate level?

Across England, there are approximately 2 million people aged over 55 who have yet to retire but who have a DC pension pot. According to our calculations even if all these individuals were to annuitise their DC pots as they would have done in the past, over half (1.1 million people) will not be able to secure an adequate income in retirement unless they use non-pension assets or receive additional benefits on top of the State Pension.

But in a situation where everyone blows their pot, we estimate that an additional 350,000 people will not be able to secure an adequate income in retirement (1.4 million in total). At an aggregate level, if everyone was to blow their pot, it could result in £7.4bn less income per annum in retirement or up to £184bn less over the duration of retirement.

Of course not everyone is likely to pull all of their money out of the pot and spend it too quickly. In the Treasury's analysis of the costs associated with the reforms, they estimate that around 30% of people in defined contribution schemes will decide to draw on their pension faster than they would if they bought an annuity³⁹. Previous ILC-UK analysis suggests that around 10% of people with DC pots think paying for big ticket items is the most important thing for their pension to deliver⁴⁰. Both therefore imply that a high proportion will use their pension to draw an income rather than spend it all at once. But even if we assume that just 1 in 10 people blow their entire DC pots in the new world, this would still reduce incomes in retirement by £740 million per annum or up to £20bn cumulatively over the duration of retirement. In addition, this is likely to be a conservative estimate, as we have not modelled the aggregate impact of people who put their money into a savings account or income drawdown plan and then draw on it too quickly.

What could happen to our different consumer segments?

Retirement decisions affect our consumer segments in very different ways. For instance, even though in the "Blow the pot" scenario replacement rates are lower for all segments compared to the annuitise scenario, more than half the people in segment 6, who have, on average, some DC wealth and high DB, are likely to secure an adequate retirement income because they can fall back on their DB entitlement.

Conversely, segment 3, which is also the largest (over 450,000 people) would be severely harmed by blowing the pension pot, with an average replacement rate of 33%, resulting in 85% of people failing to secure an adequate retirement income unless they use non-pension assets or receive help from the State. For this segment, annuitising the entire DC pot results in the highest income for the duration of retirement – assuming of course, that individuals live to, or beyond, their cohort life expectancy. If they die four years or more before their life expectancy, then income drawdown would deliver the highest average income in retirement, albeit with substantial year on year volatility which could put at risk living standards during the years when underlying investments perform poorly.

Consumer segment 4 would face the largest income shortfalls if they spend all their savings too early because they have no savings or DB pension wealth to fall back on once their DC pot has been used up. They will also experience the most significant degree of income volatility if they put all their money into a drawdown plan.

A large proportion of consumers in segments 5 and 6 could potentially be better off taking drawdown as they can benefit from investment returns over the course of retirement, but can rely on their DB pensions and liquid savings to fall back on in years when returns are poor.

³⁹ HM Treasury (2014) Budget 2014: Policy Costings https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/295067/PU1638_policy_costings_bud_2014_with_correction_slip.pdf

⁴⁰ ILC-UK (2015) *Making the System fit for purpose*

Table 7: **Comparing Replacement Rates in the Four Scenarios**

Consumer segments	Annuity	Blow the Pot	Savings Account		Income drawdown	
			Before Savings Runs Out	After savings Out	Before Fund Runs Out	After Fund Runs Out
1. Small DC, High SA, No DB	49.2%	46.1%	48.7%	46.1%	49.9%	46.1%
2. Small DC, Low SA, No DB	51.5%	48.4%	50.9%	48.4%	52.1%	48.4%
3. Large DC, High SA, No DB	69.6%	33.4%	64.0%	33.4%	77.8%	33.4%
4. Large DC, Low SA, No DB	66.1%	39.8%	61.6%	39.8%	71.9%	39.8%
5. Any DC, Low SA, Medium DB	94.0%	68.5%	89.1%	68.5%	99.5%	68.5%
6. Any DC, High SA, High DB	85.0%	81.5%	84.4%	81.5%	85.8%	81.5%
Total	69.4%	49.1%	66.0%	49.1%	74.0%	49.1%

Source: Our elaborations from ELSA wave 5. Data weighted using sampling weights.

5. Discussion: Main considerations for each consumer segment

In this short section we briefly discuss what sorts of approaches to retirement planning might make most sense for the different consumer segments.

Large DC, low savings, No DB (450,000 people)

Those who have a high concentration of DC wealth and little else are clearly most at risk of harm if they blow their DC savings, and regulators and policymakers should look at ways to better protect this group from decisions that could lead to substantial income shortfalls. This group not only needs to generate an income from their DC pots but also needs some flexibility of income as they do not have much by way of liquid savings. A blended solution may therefore be best for some of these individuals – with part of the DC money used to buy an annuity and some being held in other more flexible savings vehicles.

Large DC, high savings but no DB (400,000 people)

For those with high DC and high savings but no DB their savings may already be sufficient to provide the flexibility that they need and so using their DC pot to buy an annuity is likely to make most sense, protecting them against longevity risk as well as possible one-off costs during retirement.

Some DC, low savings and medium DB (260,000 people)

It is more complicated for those with some DC savings, low levels of liquid savings and medium DB. For this segment it will be vital to understand what configuration of private pension wealth and financial assets gets them towards an adequate level of retirement income as well as some flexibility. However, it will still be critical to emphasise the point that blowing the pot will leave them significantly worse off.

High DB, high savings and some DC (190,000 people)

Those with high DB accrual, high savings and some DC, are the lowest risk segment – even if they blow their pot it does not really affect the proportion of people meeting their replacement rates and able to have some flexibility. These individuals are better placed to take some financial market risk – perhaps some form of income drawdown though they must, of course, be aware of potential losses in the value of the fund and whether this would impact on their specific retirement plans.

Small DC, high/low savings, no DB (685,000 people)

For many however, their total pension accrual (DB+DC+State) as well as their liquid financial assets will not be sufficient for an adequate retirement income even if they do annuitise all their DC wealth. There may be a temptation for those who are facing significant retirement income shortfalls to invest in high risk assets or scams to try and “make up” for lost ground. For this reason, those with low levels of DC pension wealth should be made aware of the harsh reality – many may have to consider working longer or unlocking some of their housing wealth to fund retirement as well as using any remaining liquid savings. And the regulator should remain on the lookout for scams affecting this group.

6. Financial capability across the consumer segments

The scenario analysis has allowed us to identify consumer groups that are likely to face the biggest retirement income shortfalls as a result of making particular decisions at the point of retirement. What we have not yet explored is the likelihood that individuals will make poor decisions. To help shed some light on this issue, we analyse results from ELSA which collects data on aspects of individual's financial capability.

Financial capability is a broad umbrella term which stands for many different things. Most definitions are not just concerned with peoples' knowledge and skills about personal finance but also about their attitudes and motivations⁴¹. In this way, financial capability helps encapsulate some of the underlying and related reasons why people might make poor decisions with their money when purchasing financial products. Low levels of financial capability are typically reported if people do not understand financial terms, because they have no prior experience with similar issues, because they fail to plan for the future or because they are naturally risk taking despite having little by way of financial resource. In this context, we looked at three relevant measures of financial capability captured within ELSA:

- The proportion of people that answered a simple question on compound interest correctly.
- The proportion who have experience of basic banking including savings accounts and current accounts.
- The proportion who have experience with investments including share ISAs, life insurance, premium bonds and others.

In the last section, consumers in segment 4 stood to lose the most as a result of failing to annuitise. This is because they have all their pension wealth concentrated in DC pots and little by way of liquid savings or DB accrual. What is striking, is that according to our measures of financial capability, consumers in segment 4 who stand to lose the most if they fail to annuitise, also score relatively poorly against the three indicators – just under 18% correctly answered the compound interest question while only 60% had experience of investment products such as share ISAs. This compares to 20% of people with high DB pensions who answered the compound interest question correctly and nearly 90% who had experience with investment products. In fact the only consumer segment to score worse against our financial capability measures was group 2 – those with small DC pots and no liquid savings or DB entitlement. For this group only 10% answered the compound interest question correctly and less than half had experience of investment products.

Table 8. **Financial capability**

	Proportion with Correct Answer on Fin Cap question	Experience of Basic Banking	Experience with investments
1. Small DC, High SA, No DB	21.8%	100.0%	75.5%
2. Small DC, Low SA, No DB	10.0%	86.6%	47.3%
3. Large DC, High SA, No DB	31.6%	100.0%	84.4%
4. Large DC, Low SA, No DB	17.8%	89.4%	59.9%
5. Any DC, Low SA, Medium DB	20.4%	96.1%	67.4%
6. Any DC, High SA, High DB	19.8%	100.0%	87.8%

Investments include: share ISA, life insurance ISA, joint assets, premium bonds, national savings, PEP, Shares, Trusts, Bonds and Gilts, Life Insurance savings.

Implications

These findings tentatively suggest that the consumers who stand to lose most from making a poor decision, those in segment 4, may also be more liable to making a poor decision due to low levels of financial capability. This finding is broadly consistent with recent research from the Pensions Policy Institute which highlighted that the highest risk consumers generally score badly on financial

⁴¹ For more on financial capability see: Money Advice Service (2013) The financial capability of the UK [http://www.nationalnumeracy.org.uk/files/70/The%20Financial%20Capability%20of%20the%20UK%20\(2013\).pdf](http://www.nationalnumeracy.org.uk/files/70/The%20Financial%20Capability%20of%20the%20UK%20(2013).pdf)

capability, while also noting that financial advice is hardly used making them particularly susceptible to poor decisions⁴². For this group of individuals, additional protections may be needed to ensure that those who face losing the most are appropriately supported when making decisions at the point of retirement.

7. Conclusion and policy recommendations

The UK is braced for the most sweeping changes to pensions decumulation ever. While liberalisation of the retirement income market was initially welcomed by consumers, a degree of trepidation is setting in as the April 2015 deadline approaches. Many questions still remain unanswered: How easy will it be to access the Guidance service and what level of take up and effectiveness will it have? How easy will consumers find it to take advantage of the new pension freedoms and what will they do with their savings? What new financial products and services will emerge to help support the retirement needs of consumers? These are just a few of the most pertinent questions - there are many more.

While ensuring that the providers of the Guidance Guarantee, as well as the financial services firms and regulators have the necessary systems and controls up and running by the beginning of April is a massive challenge in itself, ensuring consumers are adequately protected for the new world is a whole other ball game. Evidence from abroad suggests that consumers in countries that have liberalised retirement income markets often squander their hard earned savings, favouring consumption today rather than smoothing it over their lifetime. And while recent ILC-UK consumer research has shown that those approaching retirement would favour a guaranteed income for life, many consumers are confused about their options and have low levels of financial capability.

This report adds significant weight to the debate, highlighting how choices made at the point of retirement could lead to a significant number of people experiencing inadequate incomes over the long term. Some have argued that the choices made today will not matter because the level of saving into DC schemes is so low. On the basis of our analysis we would comprehensively disagree. The research clearly shows that for the 850,000 or so people aged over 55 in England with relatively large DC pots, the choices they make over the coming years will make a significant difference to their lifetime incomes. While we do not advocate that everyone should take a particular course of action, our analysis clearly highlights the benefits of annuitising for those individuals who have a high concentration of wealth in DC savings. All other stylised choices – blowing the pot, putting DC money into a savings account or taking income drawdown from an invested pension fund risk significant falls in income during retirement. Unfortunately, however, annuities are generally misunderstood and the group who stand to lose the most from spending everything too early, also score relatively badly on financial capability, making them particularly susceptible to poor decision making. Without the appropriate support, these individuals could end up significantly worse off in retirement. Guidance alone will not be enough. So where do we go from here?

⁴² Pensions Policy Institute (2014) Transitions to Retirement – *“How complex are the decisions that pension savers need to make at retirement”*

Recommendations

Short term

1. Annuities must play key role in any future default strategy

In the face of complexity, many individuals are likely to do nothing which means that their retirement incomes will be dependent on whatever happens to the fund. We would argue that for a significant number of people, and especially for those who have high DC wealth concentrations, buying an annuity is still the right option and should form the backbone of any default strategy. However, annuitising is likely to remain an irreversible decision so individuals need to be given appropriate warning that they will have part of their fund annuitised (perhaps 75% of the fund so as to retain some flexibility) if they do nothing. For this reason, consumers must be given a year's warning, and the default must not kick in before they reach their respective State Pension Age. Up until this age, the pension fund should be invested in a balanced portfolio of safe and risky assets to allow for continual growth in the fund.

2. Annuities must be rebranded

The framing of annuities is extremely important in determining consumer demand. While some consumers see annuities as “risky” because they “could die early”, they must instead be framed by the industry as safe guaranteed income for life. Critically, providers must focus on the opportunity cost of not taking out an annuity – i.e. the likelihood of falling back on non-pension assets such as the home, or other family members – if they do not annuitise. Annuity rates have fallen in recent years predominantly due to rising longevity and falling yields on Government bonds. But other asset classes have also seen lower returns stemming from the protracted economic recovery, and so it is time to do away with the misnomer that annuities are, as a general rule, bad value for money. For many consumers they are still likely to form a key part of their retirement strategy.

Longer term

3. Free Financial Guidance for those in advance of reaching retirement

Over the longer term, it is vital that people are engaged before they reach retirement and not just at the point of retirement. While the stakes are already high for those on the verge of retiring today, they will be even higher tomorrow when the numbers of people with high concentrations of DC wealth will be far higher. From age 50, anyone with a DC pension pot should be able to access the free Financial Guidance. This offering should be widely promoted by the Pension Wise service as well as by pensions providers and employers.

4. Independent Pensions Commission needed to tackle inadequacy

As the modelling in this report has shown, for many of those with DC pots, even if they do annuitise they will not be able to secure an adequate income in retirement. With the death of final salary schemes, this is perhaps a taste of things to come. Modelling from the Pensions Policy Institute has shown that based on minimum contribution rates through autoenrolment, less than half of people with median incomes will have an adequate income in retirement. We believe that a Pensions Commission is urgently needed to bring back coherence in pensions policy and to tackle the challenge of income adequacy in a holistic way.

Appendix A: Members of the advisory group

Chris Curry

Baroness Sally Greengross

Mark Hoban MP

Michael Johnson

John Lawson

Les Mayhew

Tom McPhail

Jackie Wells

Appendix B: Technical Appendix

We calculate -retirement income (P) by adopting the following formula:

$$P = \frac{stW}{\frac{1 - \left(\frac{1}{1 + r_{st}}\right)^e}{r_{st}}} + \frac{prW}{\frac{1 - \left(\frac{1}{1 + r_{pr}}\right)^e}{r_{pr}}}$$

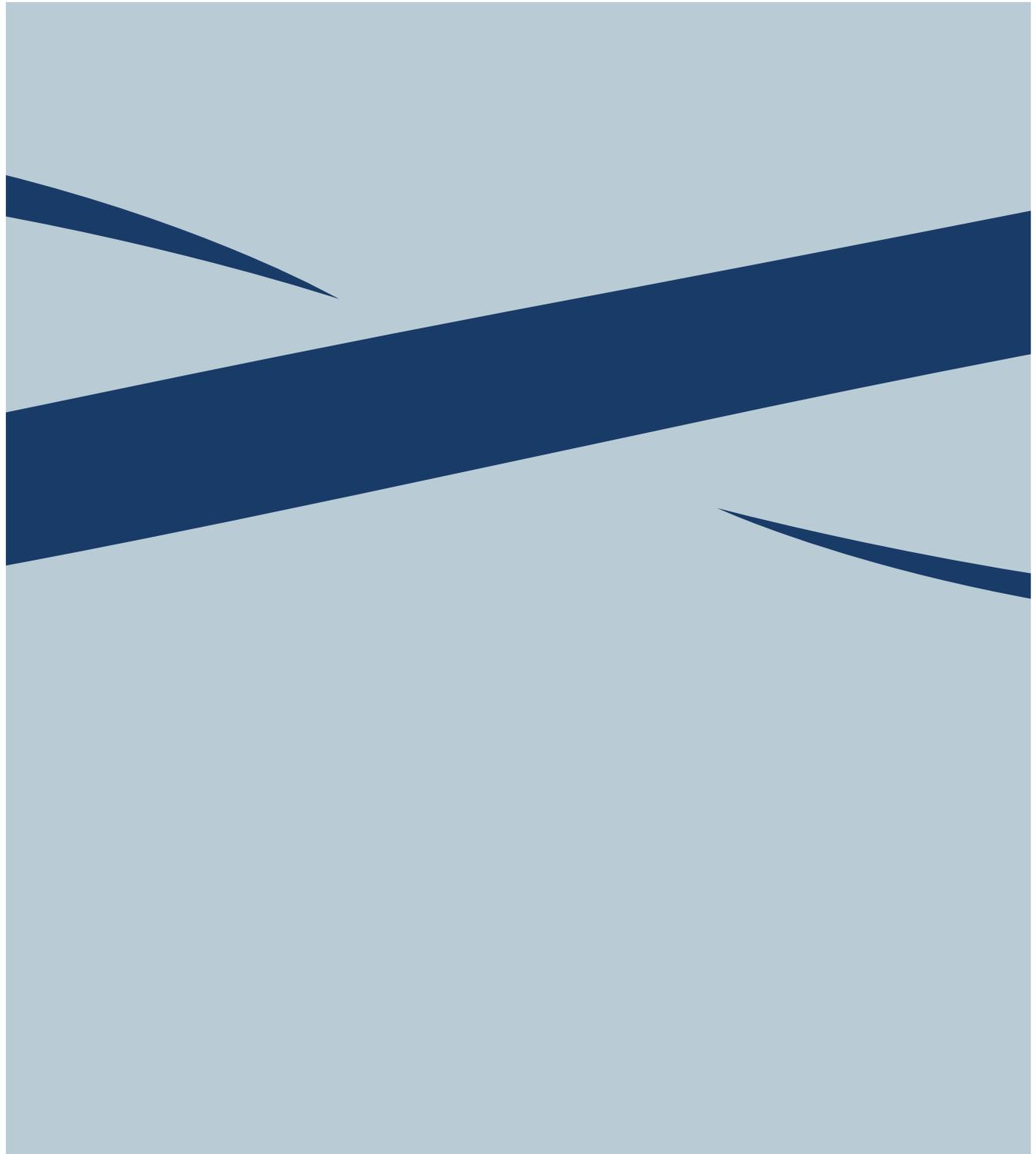
Where

stW=State pension wealth + additional pension wealth

prW= private pension wealth (DC + DB+other) minus the 25% Lump sum

R=interest rate equal to 1.5% for state pension and 2.1% for private pension

e=is the life expectancy by group and cohort (Life expectancy source: National Life Tables, England, years 2010-2012)



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