PENSIONS POLICY INSTITUTE

PPI

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

Executive summary

The PPI is grateful for the support of the following sponsors of this project:

Sponsorship has been given to help fund the research, and does not imply agreement with, or support for, the analysis or findings from the project.

A Discussion Paper by Daniela Silcock, Daniel Redwood and John Adams

Published by the Pensions Policy Institute

ISBN 978-1-906284-17-6
www.pensionspolicyinstitute.org.uk

Summary of Conclusions

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

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

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

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

A small proportion of people might be able to use Capped or Flexible Drawdown

From April 2011, people will be permitted, from age 55, to remain in income drawdown, 'Capped Drawdown,' with no upper age limit. The Government has placed a cap on the amount of income that people can withdraw, at 100% of an equivalent annuity. There is no regulatory restriction on the size of pension pot a person needs to enter income drawdown, however many IFAs recommend people need a pension pot of a minimum of between £100,000 and £250,000 as well as other income and assets in order to ensure people can bear the investment risk and longevity risk associated with drawdown.

- If it is assumed, for illustrative purposes, that people with pots of £100,000 or more might be in a position to purchase an income drawdown product, then, based on existing market data and analysis, around 600,000 to 700,000 people aged between 55 and 75 in 2010 could potentially make use of Capped Drawdown because they are either already in income drawdown or have enough DC pension savings (which have not yet been used to purchase an annuity) to enter Capped Drawdown. This includes those already in income drawdown arrangements as well as those individuals who have more than £100,000 in uncrystallised DC pension savings, some of these people will still be working and contributing to their pensions.

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

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

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

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

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

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

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

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

The impact on low earners

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

The impact on median earners

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

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

The impact on high earners

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

Capped Drawdown allows individuals the flexibility to potentially grow their fund, vary their level of withdrawals within the limits set by Government and leave some capital as inheritance, while purchasing an annuity does not. However there is a trade-off as people in Capped Drawdown run more risk of depleting funds and may need to withdraw from their accounts at lower levels than they would receive from an annuity in order to preserve their funds. For people with high levels of income and assets, high appetite for risk and for whom conserving a portion of their fund as an inheritance is important, Capped Drawdown could be an attractive, and potentially profitable way to access private pension savings. Frequent investment reviews in Capped Drawdown should help people to mitigate risks by changing investment strategy or lowering withdrawal rates if their investments are not faring well.

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