Original Article

What are the implications of the UK Government's policy to remove the effective requirement to annuitise private pension funds by the age of 75?

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The PPI's research report, on which this article is based, can be downloaded from the PPI's website at www.pensionspolicyinstitute.org.uk.

ABSTRACT The UK Government has removed the effective requirement to purchase a lifetime annuity with private Defined Contribution (DC) pension savings by the age of 75 years. People will still be able to purchase an annuity if they wish to but will no longer be *required* to purchase an annuity with their remaining private money-purchase pension fund by the age of 75 years. People with high levels of pension savings may be able to withdraw some or all of their private DC pension savings in unlimited amounts if they can demonstrate that they can meet the Government's Minimum Income Requirement (MIR) by having a secure pension income, in payment and guaranteed for life, of at least £20000 per year (in 2011). In addition, individuals will be able to use income drawdown beyond the age of 75 years, to invest their funds and withdraw income from their private pension savings within certain limits set by the Government (Capped Drawdown.) The new rules will give private pension savers in the United Kingdom greater flexibility over how they convert their pension fund into a retirement income. However, the introduction of greater flexibility is accompanied by potential risks for individuals. In particular, individuals who invest their entire pension savings in capped drawdown and remain invested throughout their retirement run greater investment risk and longevity risk than those who use some or all of their pension savings to purchase an annuity. In 2010, the vast majority of people aged between 55 and 75 years 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 MIR. The Government will need to ensure that people have access to understandable, appropriate and accessible advice and information to ensure

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that they understand both the potential upsides, but also the inherent risks involved in accessing private DC pension savings more flexibly. This article is intended as a contribution to the policy debate about pensions and retirement provision. Individuals should not rely on it in making their own decisions about their own pension fund, as individual circumstances will vary.

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INTRODUCTION

From April 2010, the UK Government removed the effective requirement that people with private pension savings in money-purchase schemes purchase an annuity by age 75. The aim of the policy is to allow people to access their pension savings in a more flexible way. As always, there is a trade-off. An increase in flexibility in accessing pension savings is accompanied by an increase in risks for some people. This article examines the trade-off between the flexibilities and risks encompassed by the new policies and also explores what the policies might mean for how people in the United Kingdom could access their private money-purchase pension savings in future.

WHAT WERE THE RULES AROUND ACCESSING PENSION SAVINGS BEFORE THE CHANGE IN LEGISLATION?

Different types of private pension savings in the United Kingdom carry different options for access at retirement. People who have *occupational pensions* (pensions managed and administered by their employer) will often have limited options for how they can access their pension savings. Occupational pension schemes generally allow members to take 25 per cent of their savings as a tax-free lump sum, if people are aged 55 years or over, but access to the remainder of their savings is limited. Occupational pension schemes either pay a pension directly to members, or the scheme administrators purchase an annuity (or annuities) on members' behalf.

However, individuals with pension savings in money-purchase, (Defined Contribution (DC)), schemes, which are not managed by an employer, have more options when they come to convert their pension savings into an income. Before April 2011, people with private DC pension savings between the ages of 55 and 75 years were allowed to do one, or a combination, of the following:

- keep their pension in their pension fund;
- purchase one or more annuities;
- or purchase an *income drawdown* contract. Income drawdown is an investment product that allows people to invest their pension savings, and potentially grow them if market conditions are positive, while also taking an income from their savings.

People with private DC pension savings can also take 25 per cent of their savings tax-free to spend in any way they like at any point after the age of 55 years.

However, before April 2011, people with private DC pension savings were required by UK law to 'secure an income' with the remainder of their private pension fund by the age of 75 years, and this was generally done through purchasing a lifetime annuity.

WHAT DOES A REMOVAL OF THE REQUIREMENT TO ANNUITISE MEAN IN PRACTICE?

From April 2011, individuals with private DC pension savings will still be allowed to purchase an annuity at any point from age 55 years;

however, they will no longer be *required* to purchase an annuity by age 75 years.

PEOPLE CAN NOW REMAIN IN INCOME DRAWDOWN BEYOND THE AGE OF 75

Under the new regulations, people will still be allowed to invest some or all of their pension savings in an income drawdown arrangement; however, the age limit of 75 is removed, meaning that people can keep their savings in an income drawdown arrangement for as long as they wish provided that they withdraw within the limits set by the Government and have regular investment reviews of their fund. In order to ensure that there are safeguards against individuals in income drawdown depleting their funds too quickly, the Government has reduced the amount of income a person can withdraw from their pension fund through income drawdown. The limit before the new legislation was 120 per cent of what an individual would have received from an equivalent annuity, meaning 120 per cent of the rate they would have received from a single-life, level annuity purchased with their fund size. The new withdrawal limit is 100 per cent of what an individual would have received from an equivalent annuity. The Government has called this new income drawdown product '*Capped Drawdown*'.

PEOPLE WITH A SECURE MINIMUM LEVEL OF PENSION INCOME CAN WITHDRAW THE REST OF THEIR PRIVATE DC PENSION SAVINGS FLEXIBLY

The new regulations have also allowed for a third option. People who can demonstrate that they can meet the Government's Minimum Income Requirement (MIR) by demonstrating that they have a secure *pension* income, in payment and guaranteed for life, of at least £20 000 per year (in 2011), can access the rest of their private DC pension savings in any amount they wish. They can do this through a product the Government has called '*Flexible Drawdown*'. The MIR is set at a level that the Government believes is sufficient to prevent people from falling back on means-tested benefits during their retirement. The Government intends to review the level of the MIR periodically.

WHAT DOES THE NEW LEGISLATION MEAN FOR THE TRADE-OFF BETWEEN FLEXIBILITY AND RISK THAT INDIVIDUALS MUST NEGOTIATE WHEN ACCESSING THEIR PRIVATE DC PENSION SAVINGS?

The new regulations allow more flexibility in how individuals access their private DC pension savings in the United Kingdom. People have more choice over when to purchase an annuity, or annuities, as well as having the option to potentially grow some or all of their pension savings throughout their retirement. The capped and flexible drawdown options also allow people to attempt to preserve some of their savings to leave as an inheritance, although any inheritance passed on from capped drawdown will be taxed at 55 per cent (unless it is used for a dependent's pension). For those with high levels of savings, who can meet the MIR, there is the option of complete flexibility in how they access the remainder of their private DC pension savings.

INDEFINITE CAPPED DRAWDOWN CARRIES MORE RISKS FOR INDIVIDUALS THAN THE PREVIOUS SYSTEM OF COMPULSORY ANNUITY PURCHASE BY AGE 75

The capped drawdown option can bring more risks for individuals than the previous system of compulsory annuity purchase, although there are safeguards built in to the capped drawdown option; individuals in capped drawdown are required to undergo investment reviews every 3 years when they are below the age of 75 years, and every year when they are over the age of 75 years. These investment reviews are intended to ensure that people change their investment and/or withdrawal strategies if funds are underperforming or people's savings are being depleted too quickly. However, regular investment reviews cannot entirely protect individuals from the two most serious risks associated with capped drawdown: *investment risk* and *longevity risk*.

Investment risk is an umbrella term for many of the financial risks associated with investing, which range from the risk of great changes in the market causing funds to lose value quickly to the risk of funds not performing well enough to keep up with inflation.

Longevity risk is, more simply, the risk of depleting one's savings before one's death. People can deplete their savings too quickly as a result of poor financial planning; as a result of changes in the market, which mean funds dwindle too rapidly; or through underestimating one's own longevity. Many people underestimate average longevity, and may deplete their savings more quickly than is prudent as a result.

Although higher risks to individuals are associated with capped drawdown, the flexibility to potentially grow one's savings and leave an inheritance could make capped drawdown an attractive option for people with the right characteristics. People with large savings, a range of income and assets and a high appetite for risk might find that capped drawdown suits their needs and financial behaviour. PPI modelling indicates that individuals with capped drawdown accounts might need to withdraw income at lower than the maximum level (of 100 per cent of what they would have received from an equivalent annuity) in order to ensure that they do not deplete their savings before their death. Therefore, capped drawdown may not be safe or appropriate for people who are dependent on receiving the maximum possible amount from their pension savings, and who do not have other income and assets to top up their pension income or fall back on in case of poor fund performance.

Some people may wish to use capped drawdown in combination with purchasing annuities in order to benefit both from the security that annuities bring and the flexibility associated with capped drawdown.

PEOPLE WHO PURCHASE A LIFETIME ANNUITY ARE TRADING OPPORTUNITIES FOR PROTECTION AGAINST RISK, ALTHOUGH LIFETIME ANNUITIES DO POSE SOME RISKS TO INDIVIDUALS

Because lifetime annuities guarantee an income for the life of the annuitant, regardless of how long that lifetime might be, they protect individuals against both investment and longevity risk. Therefore, purchasing an annuity will remain the safest and most appropriate option for many people with small pension pots, who are dependent on the income they receive from their private DC pension savings.

People who purchase a lifetime annuity make a trade-off. They are giving up the opportunities to potentially grow their pot further, and/or potentially leave a portion of their fund as inheritance, in return for protection against the risk of outliving their retirement assets and against the risk of falls in the market. However, purchasing a lifetime annuity is not devoid of risks for individuals. People who purchase lifetime annuities run the risks of:

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

PROVIDERS OF ADVICE AND INFORMATION WILL PLAY A CRUCIAL ROLE IN DETERMINING HOW PEOPLE BEHAVE UNDER A NEW SYSTEM

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

Annuities will still be the best option for the majority of individuals with private DC pension savings who have relatively modest pension pots, and are dependent on receiving a secure income from their pension savings. Individuals with small pots are exposed to more risks in drawdown than individuals with larger pots, as small pension pots are at greater risk of depletion before death and may be less able to deal with market fluctuations. However, the negative associations many consumers have with annuities might mean that some individuals do not make the annuity choice when they come to access their pension savings.

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

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

HOW MANY PEOPLE MIGHT BE ABLE TO ACCESS THEIR PRIVATE DC PENSION SAVINGS MORE FLEXIBLY IN THE UK AS A RESULT OF THE NEW LEGISLATION?

The PPI used data on the wealth, assets and saving behaviour of people aged between 55 and 75 years in the United Kingdom in 2010 in order to make some projections about who might be able to access their private DC pension savings more flexibly as a result of the new legislation. PPI analysis found that in 2010 the vast majority of people aged between 55 and 75 years 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 MIR. Although the new legislation ostensibly extends the options of capped and flexible drawdown to all individuals with private DC pension savings, annuitising is likely to remain the safest and most appropriate option for many people when they come to access their private DC pension savings.

A SMALL PROPORTION OF PEOPLE MIGHT BE ABLE TO USE CAPPED OR FLEXIBLE DRAWDOWN

There is no regulatory restriction on the size of pot a person needs to purchase an income drawdown product, and the suitability of income drawdown may depend on a number of factors including other savings and income, and the ability to cope with the risk of loss. Many IFAs recommend that a pension savings pot of between £100 000 and £250 000 (as well as access to other income and assets) is necessary to ensure that people can bear the longevity risk and investment risk associated with drawdown.

If it is assumed, for illustrative purposes, that people with private pension pots of £100 000 or more might be in a position to purchase an income drawdown product, then the Pensions Policy Institute (PPI) estimates that around 600 000 to 700 000 people aged between 55 and 75 years in the United Kingdom in 2010 could potentially make use of capped drawdown. This includes those already in income drawdown arrangements, as well as people who have more than £100 000 in uncrystallised (not yet turned into an annuity) DC pension savings. Some of these people will still be working and contributing to their pensions.

This represents around 5 per cent of all people aged between 55 and 75 years in the United

Kingdom in 2010 and around 22 to 26 per cent of people aged between 55 and 75 years in the United Kingdom with uncrystallised DC pension savings.

A SMALL PROPORTION OF PEOPLE MIGHT HAVE ENOUGH INCOME AND SAVINGS TO MEET THE MIR, BUT RELATIVELY FEW WILL BE ABLE TO USE FLEXIBLE DRAWDOWN

The PPI estimates that around 700 000 to 1 million people between age 55 and 75 years in the United Kingdom 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 per cent of people between age 55 and 75 years in the United Kingdom in 2010.

However, the majority of people who could meet the MIR are unlikely to be able to take advantage of flexible drawdown, 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 pension and Defined Benefit (DB) pension income, which cannot be withdrawn as a fund once already in payment. 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. Choosing to transfer out of a DB fund into a DC fund could mean that individuals face greater levels of risk to their pension fund. Individuals should always seek independent financial advice before making any such decisions.

Around 200 000, out of the 700 000 to 1 million people who could meet the MIR in 2010, could have sufficient DC savings left over to access flexibly. This represents around 2 per cent of people between age 55 and 75 years in the United Kingdom in 2010 and around 7 per cent of people between age 55 and 75 years in the United Kingdom in 2010 with uncrystallised DC pension savings.

MORE PEOPLE MIGHT BE ABLE TO USE CAPPED OR FLEXIBLE DRAWDOWN IN FUTURE

Part of the explanation for why such low numbers of people between the ages of 55 and 75 years in the United Kingdom in 2010 might be able to use capped or flexible drawdown is attributable to the historically low levels of DC saving in the United Kingdom. However, the decline in DB pension provision over the last few decades has led to an increase in people saving in DC schemes, which is likely to increase further when auto-enrolment into pension savings begins in the United Kingdom in 2012. Therefore, it is likely that over the next few decades, the number of people in the UK reaching retirement with DC savings will increase and that in the future more people will have an opportunity to access capped or flexible drawdown.

REMOVING THE REQUIREMENT TO ANNUITISE COULD ENCOURAGE PEOPLE TO USE EXISTING RETIREMENT INCOME PRODUCTS MORE FLEXIBLY

The DC pension savings market is undergoing changes because of a shift from DB to DC provision and the introduction of auto-enrolment in the United Kingdom from 2012. There are likely to be far greater numbers of people reaching retirement with DC pension savings in the future. Active membership in DC schemes could reach around 15 million by 2020 and around 17 million by 2050, compared with an estimated 5 million (in 2008) (PPI Modelling). There should also, as a result of Government initiatives, be a greater number of people shopping around for the best type and rate of annuity in future. These changes, coupled with the removal of the requirement to annuitise, could encourage a more flexible approach and attitude to using existing annuity products.

It is possible to use existing annuity products in a more 'flexible' way that can help meet income needs as they change during retirement.

The annuity market offers people a range of products that can be used to

- delay or vary the income people receive in retirement, by, for example, purchasing fixed-term annuities;
- increase the income people receive in line with inflation, by, for example, purchasing index-linked annuities;
- allow people to continue to earn investment returns on their pension fund, by, for example, purchasing flexible annuities;
- provide higher levels of income to people with shortened life expectancies (for example, people with serious health problems or people who smoke), by, for example, purchasing enhanced annuities

Within the new landscape, people may start to consider ways of accessing private DC pension savings more flexibly using existing annuity products that previously they might not have considered. This may be especially relevant for median earners who may be attracted to the idea of flexibility, but may not have sufficient income and assets to use capped or flexible drawdown.

However, there are risks involved with using some 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 NEW LEGISLATION MAY IMPACT DIFFERENTLY ON PEOPLE OF DIFFERENT EARNINGS LEVELS

For the majority of low earners, who are likely to have small pension pots, purchasing an annuity is likely to provide the safest and most appropriate way to access their private pension savings. The majority of 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. Some median to high earners may start to use existing annuity products in a more flexible way. 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.

CONCLUSIONS

The effective requirement to annuitise remaining DC pension funds before the age of 75 years in the United Kingdom has been removed; however, 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 years in the United Kingdom 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 MIR.

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 years in 2010 might be able to access capped or flexible drawdown is the historically low levels of DC saving in the United Kingdom. However, the decline in DB pension provision has led to an increase in people saving in DC schemes, and the number of people saving in DC schemes is likely to increase substantially when auto-enrolment into pension savings is introduced from 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. However, the Government will need to ensure that people have access to clear, appropriate and accessible advice and information to ensure that they understand both the potential upsides but also the inherent risks involved in accessing private DC pension savings more flexibly.

The new legislation may impact differently on people of different earnings levels. For the majority of low to median earners, annuitising is likely to remain the safest and most appropriate option for accessing private pension savings. Some higher earners 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.

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