MERCER

AGE UK FINANCIAL SERVICES COMMISSION

Improving Income in Retirement for the Recently Retired

Mercer have been asked by Age UK to identify actions that can be taken by recent retirees to improve their financial resilience throughout retirement. Questions we were asked to consider are:

- What is your recipe for financial resilience for recent retirees?
- The impact of low interest rates on savings. What is the role of tax incentives?
- How should recent retirees optimize their income from pension pots and other savings?
- How can retirement products better meet the needs of the mass market?
- How can recent retirees best protect themselves throughout retirement and strike a balance between spending down and saving for the future?

Recipe for financial resilience

1. Plan for the 'U'

Generally, people tend to spend more in the early, active retirement years. Income needs then level off, only to increase again, with additional medical and care expenses. The Budget announcements in March 2014 provide great flexibility for those with defined contribution (DC) pension savings, and from April 2015 individuals will be able to do any of the following:

- Take cash immediately
- Take secured income (eg. an annuity)
- Take variable income (ie. Income drawdown)

Evidence from the US and Australia (where there has never been any requirement to purchase an annuity with pension plan savings) is that people spend too much of their savings in the early years of retirement, through a lack of appreciation of what will be required in the later years. Following the Budget announcement in March 2014, whilst the flexibility that will be available to individuals at retirement has been generally welcomed, this will now be something to consider in the UK. Whilst the State Pension provides some basic level of security, unless an individual has a defined benefit income or decides to purchase an annuity, the remainder of the pot will be at risk from ill informed spending decisions, poor investment returns and longevity.

However, we still feel that individuals need to think carefully about their retirement income needs and the risks of not achieving them. To assist individuals, the amount of income an individual needs/obtains might be defined by two tiers:

TIER 1: The minimum requirements. The level of income required to meet basic day-to-day living expenses.

TIER 2: Replacement. The level of income required to preserve broadly current living standards or higher.

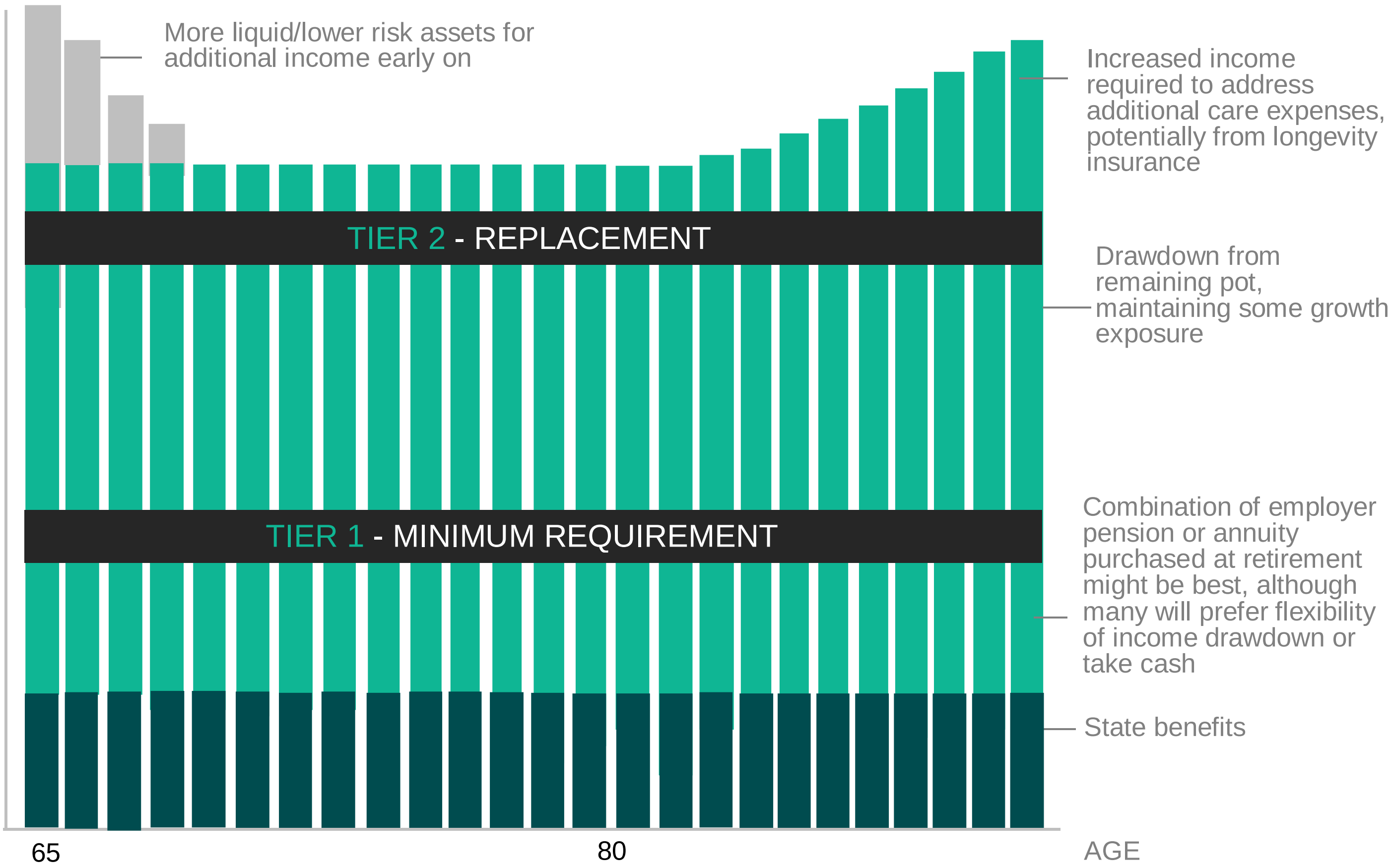
For many, attaining Tier 1 may be the extent of the opportunity available. For these individuals it might be best to have a secure income stream to secure their basic needs, although the attraction of being able to withdraw their savings at any time maybe too much to turn down for future retirees.

For those that want security of income, a solid income floor includes an element which protects against longevity risk, either through a combination of state pension, a pension from an employer sponsored defined benefit pension plan or securing an annuity with a portion of retirement savings. Whilst there is now uncertainty about the future evolution of the annuity market in a post Budget world, there is scope for more innovation in insured products in this area. For example, longevity insurance which is purchased at or close to retirement but takes effect on living past age 85 say, greater innovation in investment linked annuities e.g. with a reasonable guaranteed return plus scope for some market upside.

Whilst we believe that security of income will still be attractive to many, they may prefer to to defer annuity purchase to later in retirement when the annuity rate itself can produce a meaningful income and the individual circumstances and state of health are clearer. For these individuals, in the years directly after retirement the flexibility of drawdown will be attractive when spending requirements are higher and more varied and their longevity is less clear.

The elements of retirement income are illustrated below:

Retirement income requirements – plan for the ‘U’



2. Use your human capital!

Bluntly, the ability to continue some form of work in the early years of retirement creates an opportunity to defer accessing retirement savings and grow savings further.

This clearly requires the ability to continue to work, although research from Pru health and Mercer showed that many people in their 60s are fitter and healthier than employees in their 30s and 40s. (Britain’s Healthiest Company, 2013)

Greater education on post retirement employment options or alternatives, such as setting up your own business, would also assist for those fit enough to continue working. Re-engaging with work some years after retirement is a possibility (nessessity) for some. Career advisors could focus on this.

3. Access financial education and advice

Research shows a clear need for additional education, assistance and advice. Employers have a role to play for the near retirees, and increasingly, recent retirees. As part of the Budget, the Government announced the intention to legislate that individuals receive face to face 'guidance' at retirement. The details will be finalised after consultation but we welcome this development especially as the new flexibility makes the "at retirement" decision much more complicated. We would, however, advocate that such guidance is made several years before retirement as well as at and during retirement.

There is also a lack of trust in financial institutions and advisers that needs to be overcome. Our research shows that employees generally have high levels of trust in their employer for such guidance.

Online business models are evolving and will serve a proportion of the population but there will be a significant number of retirees that are not 'tech savvy' or who do not have the confidence or trust in online solutions. Independent Financial Advisers recognise that advice for elderly clients is best delivered through a home visits often with other family members present. Whilst this model is unlikely to work across all categories of retirees it is important that financial knowledge is delivered face to face into the community by those with access. Options (on top of the 'guidance' in the years prior to retirement) to consider include:

- Incentivising banks, independent financial advisers and not-for-profit organisations to provide walk in clinics and workshops for general financial education and awareness

- Using other community outlets including libraries, citizens' advice bureau, royal voluntary services etc. and creating an academy of non-authorised volunteer advisers.

Financial advice and education is required around investments, maximising tax opportunities, such as ISAs and decisions on annuity purchase timing and structure.

Future product development

The existing tax and legislative framework for pensions and savings could be modified to adjust to the changing demographic of the UK population and public health and welfare policy. Much of the uncertainty for retirees in the early or mid years of retirement which constrains income and investment decision making is the uncertainty of knowing how much they will be required to pay for long term care.

- A new long term care product

  Insuring the risk of requiring long term care has not been effective with premiums prohibitively expensive and an unwillingness of individuals to prioritise this risk. Establishing a product that is designed to meet the long term care needs of an ageing population would improve the levels of savings in the population. Features could include:

  - Tax incentives to save up to the care threshold of £75,000 due to take effect from 2017
  - Exemption from Inheritance Tax on the element of the fund not used to meet care costs

  Care is required to ensure that the product is not used as an additional tax privileged savings vehicle for the wealthy and would need to be targeted at lower and middle income groups.

- Auto piloting

  Managing the balance between securing a base floor level of income and investing and drawing down savings to provide additional income needs now and in the future takes time, knowledge and judgement. Consideration should be given to establish an automated product that sets the level of income and liquidity required with automated threshold triggers for rebalancing. This product would not be without risk, however it would deliver a balance between growth and income assets to provide retirees the opportunity to generate above inflation returns to optimize the value of their assets during retirement.

- Consider compulsion

  Compulsory pension provision in Australia (and very recently in the UK) is generally accepted as delivering good outcomes. Further compulsion around pension for later life e.g. long term care could be legislated.