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The financial resilience of the recently retired

This report is a report for Age UK's Financial Services Commission and was initially presented at a summit event that took place on 6 February, before the 2014 Budget announcement regarding the removal of restrictions on accessing Defined Contribution savings. For this reason the report does not take account of these proposed changes.

The financial resilience of the recently retired

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Published by the Pensions Policy Institute
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Summary

This briefing paper has been prepared for Age UK's second summit meeting of the Financial Services Commission and is on the topic of the 'recently retired' and their financial resilience. The note explains what we mean by the 'recently retired'; explores their financial resilience to economic, health and lifestyle shocks during early retirement; and highlights some key considerations for the industry when exploring how to improve financial resilience. This was prepared in advance of the Budget 2014 proposals and therefore does not take into account the impact of the removal of any limits on the amounts that individuals can draw down from their pensions.

Three shocks during the early years of retirement are considered in terms of their impact on retirement incomes and spending needs: a period of unexpectedly high inflation; the onset of a moderate severity disability or health issue; and the early death of a partner. Headline findings are that:

- For those individuals and couples reliant on the state pension, the triple-lock guards them well against the risks of inflation throughout retirement.
- Those more reliant on private pension income, and in particular DC pension income, could see a significant fall in their actual income against their income requirement (for our DC retiree here (Table 2), a fall from receiving 95% of required income in 2012 to 76% of required income in 2022).
- A return to the earnings-link for the state pension from 2016 would exacerbate this (a fall to 72% by 2022).
- The onset of a moderate severity disability or health issue is associated with a significant increase in spending needs, and hence required income, when the condition begins.
- Even those with a DB private pension find their income is no longer sufficient to meet their income requirements *and* cover the additional spending needs of their disability (for our DB retiree here (Table 4), a fall from receiving 114% of required income in 2012 to 92% of required income in 2022).
- The early death of a partner is also associated with falling actual income against income requirements. Whilst couples are generally more financially resilient, in the example considered here (Tables 5 and 6), actual income against income requirements would fall from 156% to 138% between 2012 and 2022 were the partner with the lower DC annuity income (single life) to die first 5 years into retirement, and from 156% to 116% were the partner with the higher DB income (including a 50% spouse benefit) to die first 5 years into retirement.

The risks to financial resilience from early death of a partner are likely to be greater in future years as more households are reliant on DC pensions for their incomes and where these may not provide any protection for spouses depending on whether a single or joint life annuity is selected. Once decisions

about the age of retirement and the choice of retirement income product have been made there is limited scope for individuals and couples to increase their financial resilience. Potential issues for the industry to address include:

- Ensuring that before making final decisions individuals are aware of the potential improvement to their retirement incomes and financial resilience from working an extra year or two beyond SPA (previous PPI research has shown that working and saving for an extra two years can increase retirement income by 20%).
    - **Should illustrations be included in pre-retirement packs as standard information to break the default of an assumed retirement age and a conventional annuity?**

- Ensuring that safety checks are in place (to clarify that individuals are aware of the inflation risks of taking a level annuity, and the financial risks to their partner of taking a single-life annuity) before allowing individuals to lock into a retirement income product.
    - **Should clear warnings be sent to those who already have a single-life annuity to ensure they and their partner understand the implications?**

- Ensuring that individuals are aware of the full range of their retirement income options and that they do not necessarily have to lock into an irreversible decision at the start of retirement (raising awareness of fixed-term annuities and income drawdown as alternatives, where appropriate).
    - **Can clearer guidance and tools be developed to indicate when these products *might* be suitable without individuals needing to take full financial advice to understand the implications?**

- Generating financial planning tools that allow individuals to consider the likelihood and risks of unexpected events that could knock their financial plans of course, including the risks of health and disability issues and the risk of losing a partner.
    - **Do existing financial planning tools allow 'what-if' scenarios to be considered that model the impact of these lifestyle shocks over the course of retirement?**

This note has not addressed the use of wider assets, including housing wealth and other financial assets, to supplement retirement income but for some individuals these may provide a credible 'Plan B' option. The strong correlation between private pension savings and other assets, however, means this is unlikely to help the groups with the lowest financial resilience.

Who are the recently retired?

While retirement is often considered as a single event taking place around State Pension Age, research highlights that for many the reality is far more blurred. People under State Pension Age (SPA) may view themselves as already retired. In addition, leaving full time work and starting to draw down private pension income may take place at different stages of later life, and either before or after reaching SPA.

Data from the English Longitudinal Study of Ageing (ELSA) highlights that, for most people, starting to receive private pension income and leaving paid employment do not happen simultaneously. For instance, while around two thirds of people were in work immediately prior to starting to draw their private pension income, only 45% of this group left work when they first started to draw their pension with the remainder staying in work.[1]

Underlying these complex transitions into retirement, there are also positive trends in the numbers of people staying in work at older ages. Between 2004 and 2010, the average age at which people left the labour market increased from 63.8 years to 64.6 years for men and from 61.2 years to 62.3 years for women.[2] This is likely to be an on-going trend. Around two-thirds of workers over SPA are currently in part-time employment while around a third are self-employed, highlighting the importance of the availability of flexible working arrangements for older workers to remain in the labour market.[3]

When discussing the 'recently retired' this briefing note will typically focus on those groups within 10 years of reaching SPA (currently 61 and over for women, and 65 and over for men), and those groups under the age of 75. There are approximately 6 million people in the UK within this group.[4]

Annex A provides an overview of the characteristics and circumstances of the recently retired/pensioners under the age of 75 and demonstrates that individuals approaching SPA will experience a diverse range of circumstances across a range of areas including wealth, income, employment, family circumstances and housing tenure. These factors will all interact to influence individuals' decisions around retirement.

[1] IFS (2012)
[2] ONS (2012)
[3] ONS (2012)
[4] ONS population projects

Financial resilience to economic, health and lifestyle shocks during early retirement

It is difficult for people to make accurate predictions about their future circumstances and income requirements; however there are some particular 'shocks' that may happen in retirement and have implications for retirement incomes and living standards. This paper uses four hypothetical individual pensioners, who reached SPA in April 2012 and started receiving their pension income from then onwards, to examine how the following events would affect their incomes:

- **A period of unexpectedly high inflation** from 5 years into their retirement, where inflation (Consumer Price Index) runs at 7.5% per annum for 5 years;
- The onset of medium severity disability[5] 5 years into retirement that significantly increases living costs.

The paper then goes on to assume that two of these hypothetical individuals are in a couple and examines how **each partner dying unexpectedly early (5 years into retirement)** would affect the other partners income and spending needs.

Each hypothetical individual is assumed to start out at retirement (SPA) with different incomes and assets. The hypothetical individuals and couples are intended to illustrate some of the possible variations that people may have to enable us to examine the magnitude of impact of the above events on each of these pensioners. They are not intended to be representative of the average pensioner. The figures in table 1 are for their income before housing costs and it is assumed that, with the exception of the partner described above, each individual lives until the age of 82.

[5] See table A1

Table 1:[6] Hypothetical individuals experiencing life course scenarios, weekly income[7] in 2012 at SPA 61 (F), 65[8] (M)

Individual	Total state pension (SP)[9] income and state benefit income at SPA	Private or occupational pension income	Tenancy – weekly rent or house value in 2008
Keisha: a 61- year-old low-earning woman	£158 (SP) £4 other benefits £69 (HB) £15 (CTB)	None	£70pw Rent
Amit: a 65 year-old median-earning man	£210(SP) £4 other benefits	£95 level annuity (from DC pension)	Owner occupier with housing assets worth £200,000
Grace: a 61-year-old high-earning woman	£259(SP) £4 other benefits	£349 index linked (from DB pension)	Owner occupier with housing assets worth £250,000
William: a 65 year old man on disability benefits	£134 (SP) £13(GC) £11 (SC)[10] £69 (HB) £15 (CTB) £51 (AA)[11] £4 other benefits	None	£70pw Rent
Mark (65) and Evie (61) Ellis	Mark £210(SP) £4 other benefits Evie £259(SP) £4 other benefits	Mark £95 level annuity (from DC pension) Evie £349 index linked (from DB pension)	Owner occupiers with housing assets worth £250,000

Each individual's income over the course of their retirement is compared to the desired replacement rates suggested by the Pension Commission (their 'required income' in the examples below), updated overtime to reflect earnings growth.[12]

[6] Figures in table rounded to nearest pound, for further details on each individual see Appendix 3
[7] In 2013 earnings terms
[8] These individuals are aged 65 and 61 in 2013 as they retired at State Pension Age in 2012
[9] Including Graduated Retirement Benefit, SERPS and S2P income
[10] Pension Credit: Guarantee Credit and Savings Credit
[11] Attendance Allowance
[12] Pensions Commission (2004)

Period of high inflation

For each individual table 2 compares the income required with the income that they would receive in the baseline scenario and where there is an economic shock – that inflation is running at 7.5% from 5 years into their retirement.

Table 2: Comparison of required weekly income and actual weekly income (£) for selected years under the baseline scenario[13] and with inflation at 7.5% from 2017 for 5 years – if the triple-lock[14] is in place

	Required income		Actual income		Proportion of required income met by actual income	
	Baseline	**7.5% inflation**	**Baseline**	**7.5% inflation**	**Baseline**	**7.5% Inflation**
Keisha						
2012	£204	£204	£246	£246	120%	120%
2017	£206	£218	£258	£259	125%	119%
2022	£201	£260	£255	£258	127%	99%
2027	£191	£247	£252	£255	132%	103%
2032	£181	£234	£250	£253	138%	108%
Amit						
2012	£306	£306	£293	£293	96%	95%
2017	£310	£327	£280	£287	90%	88%
2022	£302	£391	£260	£295	86%	76%
2027	£286	£370	£244	£277	85%	75%
Grace						
2012	£469	£469	£535	£535	114%	114%
2017	£475	£500	£543	£565	114%	113%
2022	£461	£598	£526	£653	114%	109%
2027	£438	£567	£501	£621	115%	109%
2032	£415	£538	£479	£592	115%	110%
William						
2012	£134	£134	£298	£298	222%	222%
2017	£136	£143	£301	£304	221%	212%
2022	£132	£171	£298	£306	225%	179%
2027	£125	£163	£296	£305	236%	188%

In order to show the extent to which their income meets their needs the table includes the proportion of their required income that is met by their actual income. **Where the figure is less than 100% it is suggested that this income would not meet their retirement expectations whereas figures over 100%**

[13] Using the Office for Budget Responsibility projected levels for CPI
[14] The triple lock guarantees that the basic state pension is uprated in line with whichever is the highest of: the annual rise in prices (as measured by the Consumer Price Index - CPI), average earnings, or 2.5 per cent.

indicate that they would receive more income than their retirement expectations.

While the triple-lock is in place, all of the hypothetical individuals receive some protection from the impact of high inflation through the uprating of the Basic State Pension.

In particular, as Grace receives an index-linked DB pension and she receives a relatively large State Pension high inflation would have a limited impact on the adequacy of her income overall. Even in the high inflation scenario she receives approximately 110% of her required income throughout her retirement.

William's receipt of the State Pension and benefits that increase in line with earnings, along with his relatively low requirements, mean that while he would be affected by a period of high inflation, he would continue to receive income well in excess of his required income. Similarly, Keisha's receipt of the State Pension and benefits that increase in line with earnings provide some protection from the impact of a period of high inflation.

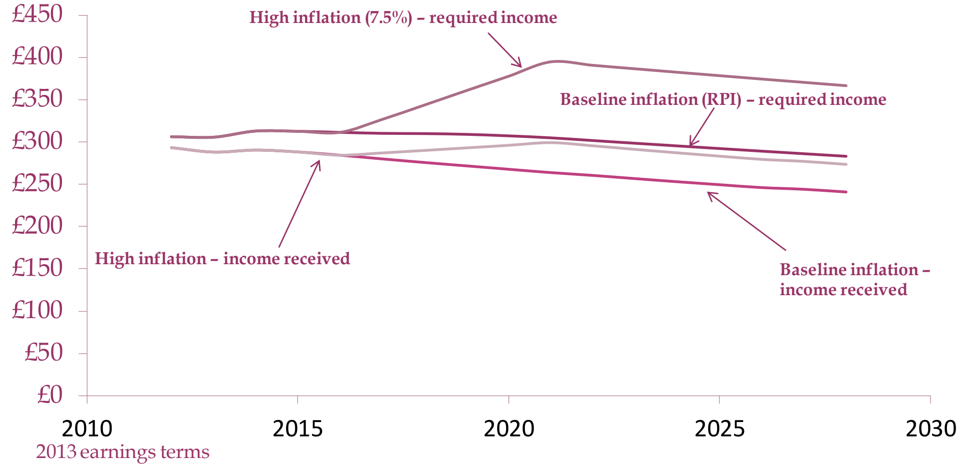
In contrast, the fact that Amit receives a level (non-indexed) annuity means that, even without a period of high inflation, his income would fall relative to his income requirements. A period of high inflation would further reduce his income relative to his income needs so that by 2022 his actual income would be only three quarters of his required income, compared to the baseline scenario where his actual income would be 86% of his required income in 2022.

Chart 1 shows how, with a period of high inflation from 2017 to 2022, Amit's required income would increase until 2022 and subsequently level out while the income received by him would, for the most part, remain level. This would leave him with a greater shortfall.

Chart 1

A period of high inflation can make it more difficult to meet replacement rates – with the triple lock

Comparison of Amit's required weekly income and weekly income received by year with baseline inflation (RPI) and high inflation (7.5%)



For each individual table 3 compares the income required with the income that they would receive in the baseline scenario and where inflation is at 7.5% from 5 years into their retirement. **While table 2 assumes that the Basic State Pension is uprated by the triple-lock, table 3 assumes that it is uprated by earnings from 2016.**

Table 3: Comparison of required weekly income and actual weekly income (£) for selected years under the baseline scenario and with inflation at 7.5% from 2017 for 5 years – if the Basic State Pension is uprated by earnings.

	Required income		Actual income		Proportion of required income met by actual income	
	Baseline	**7.5% inflation**	**Baseline**	**7.5% inflation**	**Baseline**	**7.5% Inflation**
Keisha						
2012	£204	£204	£246	£246	120%	120%
2017	£206	£218	£258	£258	125%	119%
2022	£201	£260	£255	£256	127%	98%
2027	£191	£247	£251	£252	132%	102%
2032	£181	£234	£249	£251	138%	107%
Amit						
2012	£306	£306	£293	£293	96%	95%
2017	£310	£327	£280	£284	90%	87%
2022	£302	£391	£260	£280	86%	72%
2027	£286	£370	£242	£260	84%	70%
Grace						
2012	£468	£468	£535	£535	114%	114%
2017	£475	£500	£543	£563	114%	113%
2022	£461	£598	£525	£637	114%	107%
2027	£438	£567	£499	£693	114%	106%
2032	£415	£538	£476	£573	115%	107%
William						
2012	£134	£134	£298	£298	222%	222%
2017	£136	£143	£301	£301	221%	210%
2022	£132	£171	£297	£297	225%	173%
2027	£125	£163	£294	£294	234%	181%

While Grace's income relative to her requirements would be lower where the Basic State Pension is uprated by earnings rather than the triple-lock, the fact that her index-linked DB pension accounts for a large part of her income means that the impact would be lower and her income would always be higher than her required income.

William's relatively low requirements mean that while his income relative to his requirements would be lower, he would continue to receive income well in excess of his required income. Similarly, for most years Keisha's income would cover her required income.

However, Amit receives a level (non-indexed) annuity – and as the Basic State Pension would now be linked to earnings (rather than the higher of earnings, inflation and 2.5%) this means that both his private pension income and

income from his Basic State Pension would fall relative to his income requirements under a high-inflation scenario. By 2027 his actual income would be only 70% of his required income, compared to the baseline scenario where his actual income would be 84% of his required income by 2027.

Onset of moderate severity disability

For each individual table 4 compares the income required with the income that they would receive in the baseline scenario and where they acquire a moderate severity disability 5 years into their retirement. A moderate severity disability is defined as difficulties with memory, comprehension and ability.[15] Again, in order to show the extent to which their income meets their needs the table includes the proportion of their required income that is met by their actual income. The costs of disability used in this paper were calculated using percentages of mean income as the costs of disability as detailed in previous research. We have assumed that to maintain their standard of living relative to working age they would require them to still achieve their replacement rate *plus* enough to cover the additional costs of disability.[16]

Table 4: Comparison of required weekly income and actual weekly income (£) for selected years under the baseline scenario and with the onset of a moderate severity disability from 5 years into retirement

	Required income		Actual income		Proportion of required income met by actual income	
	Baseline	**Disability onset**	**Baseline**	**Disability onset**	**Baseline**	**Disability onset**
Keisha						
2012	£204	£204	£246	£246	120%	120%
2017	£206	£375	£258	£309	125%	82%
2022	£201	£370	£255	£306	127%	83%
2027	£191	£359	£251	£303	132%	84%
2032	£181	£340	£250	£301	138%	86%
Amit						
2012	£306	£306	£293	£293	96%	95%
2017	£310	£479	£280	£331	90%	69%
2022	£302	£470	£260	£312	86%	66%
2027	£286	£455	£244	£295	85%	65%
Grace						
2012	£468	£468	£535	£535	114%	114%
2017	£475	£643	£543	£594	114%	92%
2022	£461	£630	£526	£577	114%	92%
2027	£438	£606	£501	£552	115%	91%
2032	£415	£584	£479	£584	115%	91%

[15] For more information on OPCS severity scores see Martin, Meltzer and Elliot (1988), pp. 13 – 15 and on the associated costs Zaidi & Burchardt (2005) p. 32

[16] Zaidi and Burchardt (2005)

For all individuals their increase in costs due to their disability means that they will no longer receive sufficient income to cover their replacement rate of income and their additional costs of disability. While they would receive Attendance Allowance[17], for these individuals, this would not be sufficient to cover the additional costs of disability.

For Amit, a moderate severity disability would further reduce his income relative to his income needs so that by 2027 his actual income would be only 65% of his required income, compared to the baseline scenario where his actual income would be 85% of his required income in 2027.

Chart 2 shows that, under the baseline scenario, Amit's required income is higher than the income he would receive. With a moderate level disability, Amit's required income would increase sharply at the onset of his disability. His income would also increase, but not to the same extent, widening the disparity between his required income and the income that he would receive.

Chart 2

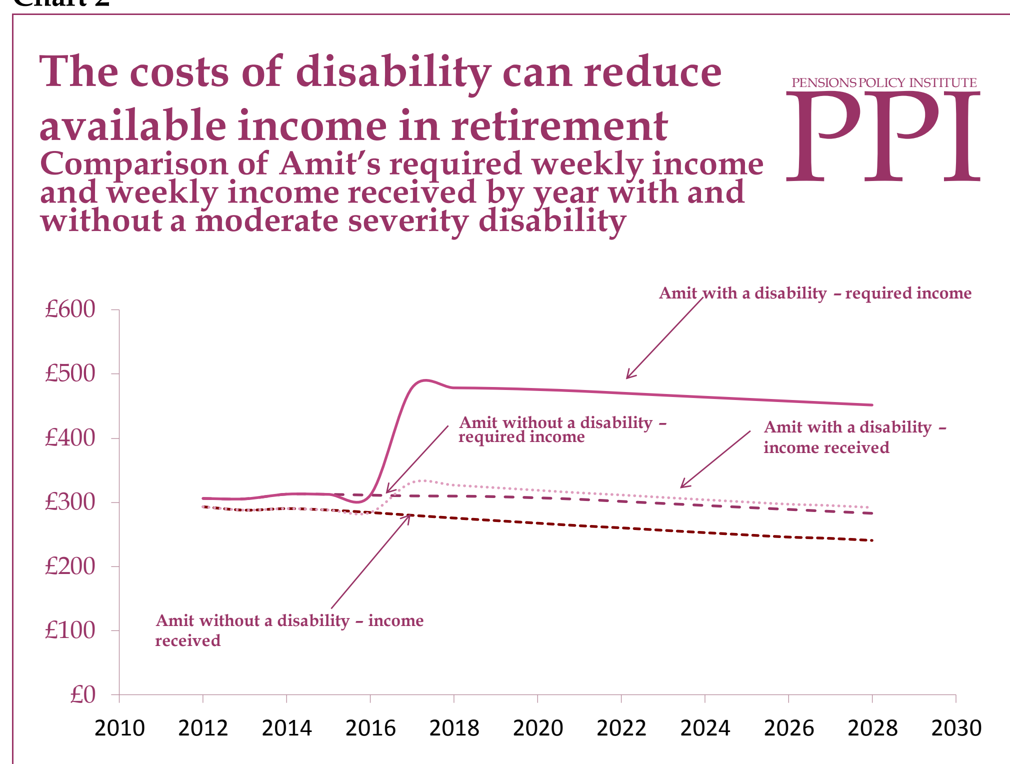


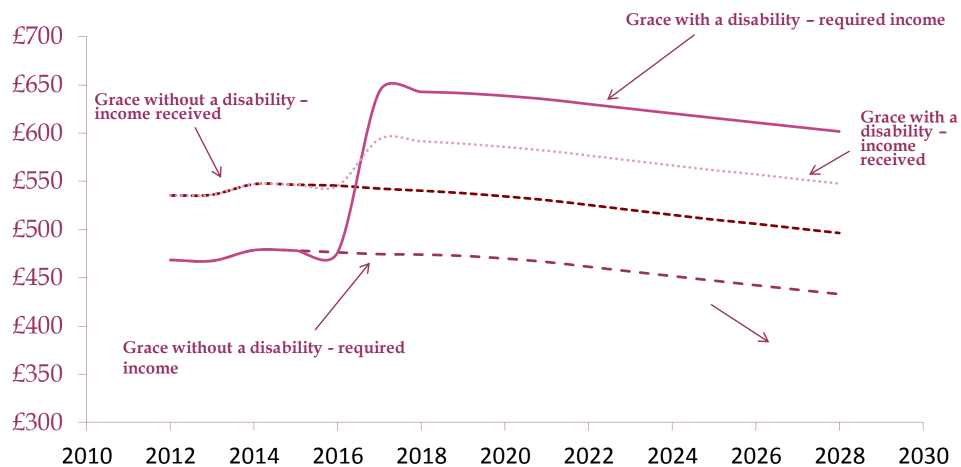
Chart 3 shows that, under the baseline scenario, the income that Grace would receive is consistently higher than her required income. With a moderate level disability, Grace's required income would increase sharply at the onset of her disability. Her income would also increase, but not to the same extent, meaning that her income would no longer meet her requirements.

[17] Attendance Allowance is designed to help people look after themselves because they have a disability or illness, the lower rate for 2013/14 is £53

Chart 3

The costs of disability can mean that an individual's retirement income no longer meets their needs

Comparison of Grace's required weekly income and weekly income received by year with and without a moderate severity disability



Partner dies just 5 years into their retirement

While the scenarios described above have considered income at the individual level, many couples pool their resources and, for their circumstances, it is more realistic to consider the adequacy of their joint incomes. The interdependence, in financial terms, means that a change in one partner's circumstances, such as worsening health or the onset of disability, can have implications for the adequacy of the other's partner's income.

The most extreme scenario, in this respect, is where one partner in the couple dies. This scenario considers what might happen where one partner dies 5 years into retirement. We assume that the couple pool their income and that, regardless of any difference in income levels between the partners during their working lives, each surviving partner would require the standard of living experienced by the couple in their early retirement. Table 5 compares the income required with the income that Mark Ellis (who has the same characteristics as Amit) would receive in the baseline scenario (as part of a couple) and where Evie Ellis (who has the same characteristics as Grace), his partner, dies 5 years into retirement. In order to show the extent to which their income meets their needs the table includes the proportion of his required income that is met by his actual income.

Table 5: Comparison of Mark Ellis' required income and actual income (£) for selected years under the baseline scenario[18] and where his partner, Evie Ellis, dies 5 years into her requirement

	Required income		Actual income		Proportion of required income met by actual income	
	Baseline	**Partner's early death**	**Baseline**	**Partner's early death**	**Baseline**	**Partner's early death**
2012	516	516	808	808	156%	156%
2017	523	392	803	472	154%	120%
2022	508	381	766	443	151%	116%
2027	483	362	727	415	151%	115%

If Evie dies 5 years into retirement, Mark's income would fall relative to his required income. This would reduce his income relative to his income needs so that by 2022 his actual income would be 116% of his required income, compared to the baseline scenario where the couple's actual income would be 151% of their required income in 2022. This is because Mark would only be entitled to 50% of Evie's DB pension on her death but would face relatively higher living costs.

Table 6 compares the income required with the income that Evie Ellis would receive in the baseline scenario (as part of a couple) and where Mark Ellis, her partner, dies 5 years into retirement. In order to show the extent to which their income meets their needs the table includes the proportion of her required income that is met by her actual income.

Table 6: **Comparison of Evie Ellis' required income and actual income (£) for selected years under the baseline scenario[19] and where her partner, Mark Ellis, dies 5 years into her requirement**

	Required income		Actual income		Proportion of required income met by actual income	
	Baseline	**Partner's early death**	**Baseline**	**Partner's early death**	**Baseline**	**Partner's early death**
2012	516	516	808	808	156%	156%
2017	523	392	803	547	154%	139%
2022	508	381	766	526	151%	138%
2027	483	362	727	501	151%	138%

[18] Assuming that the couple's income is pooled
[19] Assuming that the couple's income is pooled

If Mark dies 5 years into retirement, Evie's income would fall relative to her required income. This would reduce her income relative to her income needs so that by 2022 her actual income would be 138% of her required income, compared to the baseline scenario where the couple's actual income would be 151% of their required income in 2022. However, her income would fall to lesser extent than Mark's would if she died. This is because a greater proportion of the couple's retirement income comes from Evie's income, in particular, her private pension. She would continue to receive this if Mark died.

Other options

In one of the scenarios described above Amit has taken a level, single-life, conventional annuity at the point of retirement. In this way, his income is effectively fixed (in nominal terms) from the age of retirement while the income that he needs, in order to maintain a similar standard of living, could increase as a result of high inflation, the onset of disability or the early death of a partner.

However, individuals in the same position at retirement may be able to use annuity products more flexibly or, since the ending of the requirement to annuitise by age 75, may be able to use income drawdown arrangements to meet changing needs or to vary their income over the course of their retirement.

Some of the options are as follows[20]:

Capped or Flexible Drawdown

Under 'Capped Drawdown' individuals invest their pension savings in an income drawdown arrangement with no upper age limit and a withdrawal cap of 100% of what they would have received from an equivalent annuity. Under 'Flexible Drawdown' (for those with a secure pension income of over £20,000 a year from state pension, DB pension and other annuity income) there is no cap on withdrawals. This allows them to vary the level of income that they withdraw year on year to meet income needs that change during retirement and, unlike a conventional annuity, allows them to carry some investment risk (and hence potential investment growth) in their pension pot.

Delaying purchasing a lifetime annuity by purchasing a shorter fixed term annuity

People may wish to delay the purchase, or purchase an annuity using only some of their pension pot. For instance, they may purchase a 5-year fixed term annuity, whereby the capital is returned to them at the end of the term, and then subsequently purchase a lifetime annuity. This could prove advantageous for those who find their health deteriorates in early retirement who can then secure a higher enhanced or impaired annuity rate later on in retirement.

[20] Quoted from PPI (2011)

Purchase a flexible/investment linked annuity
When an individual purchases a flexible annuity their fund is invested and may accrue investment returns, while they are allowed to receive regular income up to 120% of what they would receive with a level annuity. Every 3 years, the amount of income an individual could receive from a level annuity purchased with the fund is reassessed – this in turn influences the amount that they can receive every year. Income can go down as well as up, down to a Minimum Income Guarantee of 50% of a level annuity. Table 7 summarises the pros and cons of each option:

Table 7:[21] Pros and cons of other options for withdrawing income from a pension fund

	Pros	Cons
Capped or Flexible Drawdown	Enables people to vary their income over retirement in line with their needs Fund remains invested so may continue to grow Individuals are able to reserve a portion of the fund as an inheritance	Risk of overall retirement income being lower than an annuity due to poor investment performance, the costs of advice and charges, and longevity. Previous PPI research showed a 1 in 3 chance of individuals exhausting their fund by 89 when drawing 100% of the cap.
Delay purchasing a lifetime annuity by purchasing a 5-year fixed annuity	Enables people to vary their income in retirement May enable them to maximise income though difficult to predict in advance – for instance, if they qualify for an enhanced annuity[22] at the end of the fixed term Pension pot may benefit from investment returns	Individual may see a drop in income at the end of the fixed term if annuity rates have fallen (e.g. due to falling gilt yields) or if the investment fund has not grown fast enough to offset mortality drag (the expected reduction in cross-subsidy with later annuitisation from losing the early deaths).
Purchase a flexible annuity	Enables people to vary their income over retirement in line with their needs Fund remains invested so may continue to grow	Risk of overall retirement income being lower than an annuity due to poor investment performance .

[21] PPI (2011)
[22] An annuity paid to people with life limiting illnesses, disabilities or lifestyle characteristics

All of the options described above are arguably more risky for the individual than a lifetime annuity; however, they allow the individual to vary their income in line with their needs and also offer scope for investment growth.

Many IFAs recommend that Capped or Flexible Drawdown is only suitable for individuals with a pension pot of at least £100,000. Of the individuals considered in this paper Grace's level of pension income suggests that Capped Drawdown might be suitable for her. However, her income is from a DB pension and therefore this income cannot be withdrawn in this way. When considering Evie and Mark as a couple, they may be willing to bear more risk in Mark's DC pension given that Evie has a secure DB pension income.

The other options may be suitable for Amit. However, these options are likely to be particularly beneficial where an individual is able to withdraw income of less than 100% of the level annuity that they would receive in the early years of retirement – reducing the risk of exhausting the funds later in life whilst also achieving greater investment returns. As, even under the baseline scenario, Amit does not receive sufficient income to meet his requirements he is unlikely to be in a position to withdraw less than 100% of the level annuity that he would have received. He may also not be comfortable with giving up the protection against living longer than expected that would be provided by a conventional annuity. However, this could be a more attractive option if, for example, a fixed-term annuity or flexible annuity was combined with Amit working part-time to supplement income in early retirement.

A further option, includes individuals boosting their retirement income by working longer. Further research could be carried out on the impact of defaults in pensions communications and expectations on actual retirement behaviour, e.g., even after the removal of a default retirement age, do pension communications still imply the employer has a default retirement age and a default retirement income product to individuals? What is the impact of this?

Improving the financial resilience of the recently retired

This paper considers the impact of particular 'shocks' on retirement income for some hypothetical case studies in order to explore what might have a negative impact on individual's and couple's 'financial resilience' in the early and middle years of their retirement.

The state plays an important role in protecting individual's and couples against shocks to their income during retirement. As we have shown, if the Basic State Pension continues to be uprated by the triple-lock rather than earnings this would afford a degree of protection to the impact of a period of high inflation. However, those people dependent on income from level annuities bought with DC pensions would be at greater risk of high inflation eroding the buying power of their pension. In contrast the triple-lock would give those people for whom the Basic State Pension forms a large proportion of their income a higher degree of protection from the impact of high inflation.

If the Basic State Pension is uprated by earnings rather than the triple-lock a period of high inflation would affect all individuals in receipt of the Basic State Pension to a greater extent. In practice, it is uncommon to have a period of time where CPI is very much higher than earnings inflation – therefore, while this set of circumstances might cause problems there is a relatively low probability that this would happen.

There is a relatively high probability of one partner in a couple suffering ill health or acquiring a disability in retirement and this can significantly increase households' spending needs and income requirements. Whilst many may prefer not to address this risk, it is important that pensioners do understand the risk of this happening to them and/or their partner and the potential magnitude of additional costs associated with disability.

There is a moderate probably of one partner dying early in retirement. Again, couples may prefer not to address this risk, but depending on each partners' own income sources and the level of dependency between partners this may leave one partner at risk. Financial resilience will be lowest where the partner who died early has received private pension income from an annuity and has been defaulted into a single-life annuity or not selected a joint-life annuity (safety checks carried out by advisers have reportedly shown that many choose a single-life annuity without fully appreciating that their partner will be left with nothing).

Some specific issues for the industry to address for groups approaching retirement or the recently retired include:

- Ensuring that before making final decisions individuals are aware of the potential improvement to their retirement incomes and financial resilience from working an extra year or two beyond SPA (previous PPI research has shown that working and saving for an extra two years can increase private pension income by 20%).

  Q. Should illustrations be included in pre-retirement packs as standard information to break the default of an assumed retirement age and taking a conventional annuity at that age?

- Ensuring that safety checks are in place (to clarify that individuals are aware of the inflation risks of taking a level annuity, and the financial risks to their partner of taking a single-life annuity) before allowing individuals to lock into a retirement income product.

  Q. Should clear warnings be sent to those who already have a single-life annuity to ensure both they and their partner understand the implications and have a 'Plan B' where appropriate?

- Ensuring that individuals are aware of the full range of their retirement income options and that they do not necessarily have to lock into an irreversible decision at the start of retirement (raising awareness of fixed-term and flexible annuities and income-drawdown as alternatives, where appropriate).

  Q. Can clearer guidance and tools be developed to indicate when these products *might* be suitable without individuals needing to take full financial advice to begin to understand the implications? Are the current rules of thumb around these options appropriate or too simplistic?

- Generating financial planning tools that allow individuals to consider the likelihood and risks of unexpected events that could knock their financial plans off course, including the risks of health and disability issues and the risk of losing a partner.

  Q. Do existing financial planning tools allow 'what-if' scenarios to be considered that illustrate the impact of these lifestyle shocks over the course of retirement? Should pensioners be encouraged to have a retirement 'MOP test' and 'Plan B' in place for dealing with shocks?

Annex A

Characteristics and circumstances of the recently retired/pensioners under 75

State Pension Entitlement

- This group will not receive the single-tier pension and most will be unaffected by the introduction of automatic enrolment.

- These individuals will receive some or all of the current Basic State Pension (BSP) with many women, in particular, not having a full BSP record. Many people under 75 will also receive benefit from the SERPS and S2P elements of the State Second Pension.[23]

- There is a disparity between men and women in this age group in terms of the Basic State Pension and the State Second Pension, with women receiving lower amounts.[24]

- As a result, larger numbers of women are in receipt of Guarantee Credit.[25]

Spending Needs

- Pensioners tend to spend a large proportion of income on leisure and recreation in the early years of retirement (ages 65 to early 70s) while spending decreases during the middle years of retirement (around ages 75 to 85) as a result of losses in mobility.

- Health-related expenditure means that spending increases in later retirement.[26] As people age they are more likely to acquire a disability – while this may mean decreased expenditure on areas such as leisure, the acquisition of a disability usually leads to increased costs, such as personal care costs or housing adaptations. The additional costs associated with a disability depend on the type and level of severity.

- As people age, their income tends to decrease from all sources except their benefit income, meaning that any reduction in spending observed could be a result of a fall in income as well as being due to changes in requirements as people age.[27]

[23] Both of these looked to provide pension income in a way that was more linked to earnings than the Basic State Pension; SERPS was in place from 1978 to 2002, and S2P was in place from 2002 onwards.
[24] Men typically receive more income from the State Second Pension than women as they have typically worked with fewer career breaks and higher salaries In addition, State Second Pension credits were only given for caring responsibilities from 2002 onwards so many women may have gaps in their contribution record.
[25] Guarantee Credit is effectively the name used for income support for people over State Pension Age (currently 61 for women and 65 for men) and is, therefore, paid to those with low state and private pension incomes. It guarantees a minimum of £145.40 per week for single pensioners and a minimum of £222.05 per week for couples.
[26] PPI (2009)
[27] PPI (2009)

Incomes of the recently retired

Table 1 below shows the average weekly income of pensioners by the age of the head of household.

Table 1: Average weekly gross income[28]

	Pensioner couples	Single pensioners
Recently retired[29]	£665	£341
Where the head is under 75	£659	£315
Where head is over 75	£549	£285

- Those individuals in households where the head of household has recently retired[30] have the highest weekly income while the households where the head is aged 75 or over have the lowest income. This is likely to include a cohort effect where people who are now recently retired have a greater income at retirement than those people who were recently retired ten years ago.

- While single pensioners have approximately half of the income of pensioner couples in each age group, the costs per head of running a one-person household are generally higher than for a two-person household. Therefore, single pensioners often have a lower standard of living than pension couples.

- Male single pensioners receive a higher income than female pensioners – on average a male pensioner receives income of £346 per week while a female pensioner receives £282 per week. Differences in the income received from occupational pensions account for much of this disparity.

Other assets

- Of those households where the head of household was aged over 65, 64% owned their house outright while 5% owned it with a mortgage, 19% were in social rented housing and 5% were in private rented housing.[31]

- There exists a correlation between overall levels of wealth and housing tenure for people aged 50 and over (from the early 2000s, so the same

[28] The Pensioners' Income Series – 2011/12
[29] Where the head is aged less than 5 years over State Pension
[30] Where the head is aged less than 5 years over State Pension
[31] FRS (2011/12)

group that is now aged 60 and over). The average net financial[32] and physical wealth[33] held by owner occupiers was £100,000 compared to £12,000 for renters or people who live rent-free.

- The above demonstrates the level of disparity in terms of sources of wealth and suggests that, where an individual has high levels of one type of wealth, such as housing wealth, they are more likely to have higher levels of other types of wealth, such as savings and investments.

Changes in early retirement

- Pensioners face particular risks to their income levels and spending needs in retirement, the risk of which increases as people age. Despite this, some patterns endure – people who were part of a couple at retirement tend to have higher incomes than single pensioners in similar circumstances, regardless of further developments during their retirement.

- Health and social care needs, along with the potential acquisition of a disability, could have an impact on both income levels and spending needs in retirement.

- Changes in the household structure during retirement, such as losing a partner, may lead to loss of income. However, pensioners who have lost a partner are still likely to have a higher income than pensioners who were never partnered but have the same income and earnings history. This is due to their receiving some inherited entitlement from their partner's state pension and possibly their private pension.[34]

- The indexation arrangements from pensions in payment and annuities may have an impact on relative value of pension income relative to the incomes of the working age population and earnings. Pension income from DB pensions is generally indexed in line with prices, though there will often be an upper limit (LPI) on any price indexation, whilst income from a DC pension taken through an annuity is generally bought as a level annuity with no increases built in for inflation during retirement.

- Earnings generally increase slightly faster than prices; therefore as pensioners get older, their incomes are likely to be lower relative to younger pensioners and people of working age.[35] Those dependent on a DC pension (and to some extent those with a DB pension) for their retirement income are likely to be at particular risk from bouts of high inflation.

[32] Net financial wealth includes all assets held in bank accounts, premium bonds, ISAs, TESSAs, PEPs, stocks and shares, bonds and gilts and unit or investment trusts, less the value of any debts such as personal loans, credit card and store card debt, hire purchase agreements and money owed to other individuals.
[33] Net physical wealth includes the value of farm or business properties and second homes or holiday homes, less the value of any loans secured on these properties. Net physical wealth also includes the value trusts, covenants, collectives, antiques and jewellery.
[34] PPI (2009)
[35] PPI (2009)

- A further change that might affect people in retirement and that is difficult to predict is the receipt of an inheritance. Again, the chances of inheriting are higher for people in traditionally higher income groups and those people who have greater wealth. Senior professionals say they are 70% likely to receive some inheritance during their lifetime, whereas clerical workers are 57% likely and casual workers/unemployed people are around 30% likely.[36]

Changing landscape for households approaching retirement

- As active membership in DB pension schemes has declined, the type of pension provision recently retired households have is also expected to shift dramatically over the next 10-15 years. [37]

- This means that an increasing number of pensioners and future pensioners will receive their private pension income from DC pension schemes. As both equity returns and bond yields have been volatile since 2008, this has resulted in growing uncertainty for individuals around their retirement income and some individuals have reached retirement whilst annuity rates have been historically very low.

- From April 2011, the Government ended the effective requirement to use DC pension savings to purchase an annuity, allowing individuals from the age of 55 to access their private pension savings through one or a combination of methods:
    - Capped Drawdown, whereby individuals invest their pension savings in an income drawdown arrangement with a withdrawal cap of 100% of what they would have received from an equivalent annuity. There is no restriction on the size of pension pot a person needs to enter this type of income drawdown.
    - Flexible Drawdown where an individual can withdraw unlimited amounts from their Defined Contribution savings, provided they can demonstrate that they have a secure income of at least £20,000 per year.

- The PPI previously estimated that 5%[38] of people aged between 55 and 75 in 2010 could potentially make use of capped drawdown while around 2% could have sufficient pension income to use flexible drawdown.

- Recent research conducted with income drawdown providers found that the total number of customers for the 59 providers that responded was 243,439 while the drawdown assets averaged at £160,000 per client.[39] This is a large amount relative to most private pension pots and suggests that income drawdown is still not readily available or considered appropriate for the majority of those retiring with a DC pension.

[36] Rowlingson, McKay (2005)
[37] PPI (2009)
[38] This is based on the assumption that people with pension pots of £100,00 or more would be in a position to purchase an income drawdown product
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