

Dashboards and jam-jars

Helping consumers with small Defined Contribution pension pots make decisions about retirement income



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Age UK discussion paper, written by Dominic Lindley, independent consultant, December 2014

Dashboards and Jam-Jars – Helping consumers with small DC pension pots make decisions about retirement income

Executive Summary

The retirement income reforms announced in the 2014 Budget are the most significant changes to the taxation of pensions for a generation. The reforms increase the complexity of retirement income decisions for individuals. Simply expanding the choices available is unlikely to result in consumers becoming more empowered. The system will still rely on consumers at retirement becoming informed, engaged and taking active decisions. Just as there has not been strong competitive pressure placed on companies to offer good value annuities, there may not be pressure to offer good value alternatives. Behavioural biases will mean that most consumers will struggle to make these decisions and there may be a strong trend towards the 'default' option, with consumers either taking what they are offered or choosing the middle of multiple options.

Despite more than 10 years of effort and rewriting the literature and documents consumers are sent when they are about to retire too many were still failing to get a good deal from the annuity market. Shopping around for an annuity is relatively simple compared to shopping around for and making decisions around income drawdown and other more complicated products. Current alternatives to annuities are not suitable for the mass market due to cost and investment risk. The Guidance Guarantee will help many understand their options and make better decisions. But some consumers with small pension pots might not access it and for others there might be a long gap between accessing the Guidance and using their pension to give them a retirement income. All these factors indicate that further changes are necessary to ensure that consumers with small pension pots are able to get the best value from their retirement income.

Small DC pension pots

Consumers with small DC pension pots face a series of complex decisions about how to access their DC pension pots to generate a retirement income. They should:

Maximise State Pensions and means-tested benefits: Maximising State Pensions is a good value way for those with small DC pension pots to gain much higher levels of secure income than through a standard annuity. Those on means-tested benefits should limit withdrawals to remain below capital limits and be aware of the impact of how they access their pension on their benefits.

Gain a full picture of all pension and other assets: Before taking any decisions, consumers should gain a full picture of all of their pensions and other assets and track down any lost pension pots.

Consider merging small pots: Consumers should merge small pots before buying an annuity or entering income drawdown unless they would lose valuable Guaranteed Annuity Rates or be subject to exit charges.

Be aware of taxation: Cashing in their entire pension in one year could result in consumers sleepwalking into a higher rate tax charge. Spreading withdrawals over a number of years could dramatically reduce the tax they pay.

Consider using DC pensions to repay expensive debt: Consumers with expensive unsecured debt could use their pensions or other assets to repay it. Whether consumers should access their pension to repay mortgage debt will depend on the interest rate charged, their attitude to risk and financial circumstances.

Maximise income from other financial assets: In addition to being wary of taxation on withdrawals from their DC pension, consumers should maximise use of ISA allowances and shop around for better savings account.

Retirement income products: Consumers will need to decide (with or without the help of a financial adviser) whether they prefer the lower secure lifetime income from an annuity or take the risk that entering an income drawdown plan could see them having to reduce their income or run out of money. For some they may want to choose a mixture of these two options or enter income drawdown with a view to buying an annuity at a later date.

Take difficult decisions about income drawdown: Consumers should try and avoid high charging income drawdown products and understand how their pension should be invested and how much they want to withdraw each year to avoid running out of money. They should think about what income they would live on if their DC pension ran out. These decisions will be difficult for them to undertake on their own.

Shop around for an annuity and declare medical details to qualify for a higher rate: Consumers should always shop around for an annuity, declare any medical details so they qualify for an enhanced rate and consider the position of their partner and whether they want a level income or one which increases over time.

Recommendations

To help those with small DC pension pots take decisions and maximise their retirement income, the Government, pensions industry and regulators should introduce the following changes:

Pensions Dashboard: Consumers should be provided with a Pensions Dashboard which should be able to gather data electronically from all their schemes. The Dashboard should display details of all of the consumer's DB and DC schemes in one place alongside their State Pension entitlement.

Pensions Jam-Jars: Pension providers should develop new tools to help people budget, control their spending and set aside money for future goals. These could also help them manage the inevitable trade-offs and conflicts which exist when taking a retirement income. These tools could help consumers decide how much money to take out of their pension each year. Once consumers have made a plan, specific alerts can be used if consumers are departing from it or at risk of running out of money or triggering a higher rate tax charge.

Integrate decisions about small DC pots with decisions about State Pensions: It is essential that decisions about how to access small DC pension pots are aligned and integrated with decisions about when to access State Pensions and whether to use some or all of their DC pot to buy Additional State Pension.

Introduce a 'Second-line of defence' requiring pension providers to ask specific questions at the time the pension is used to generate a retirement income: To help consumers make the best

decisions pension providers should be required to introduce a second line of defence, consisting of a further set of questions when consumers access their pensions. The questions would include issues around their medical circumstances, whether they had a partner, what they would live on if they exhausted their DC pension, how to avoid scams and the need to minimise taxation.

Introduce strong governance requirements around retirement income processes: It is important that those responsible for specifying retirement income processes within pension schemes have strong duties to act in the best interests of pension scheme members. This should include requirements to ensure that all annuities, income drawdown and other retirement income products available through the scheme offer value for money.

Review default investment options in DC pension schemes: The new flexibilities mean that many previous default investment options could be inappropriate and should be reviewed.

Reasonable returns for those holding cash within their pension: The industry and Government should do more to make better cash products available within pensions. One option might be to make the new Pensioner Bonds available within pensions.

Charge cap for income drawdown pensions: Understanding and comparing the total charges for an income drawdown pension is very complicated. It will be very difficult for consumers to compare the cost of different schemes, shop around and switch to better value arrangements. The extension of the charge cap to income drawdown will help prevent consumers from paying excessive charges.

Clearing house for annuity purchases and mandatory medical questions: Annuities will remain an important source of retirement income for many consumers. An annuity clearing house could help maximise value and prevent consumers being defaulted into a poor product. Pension providers would need to check their own internal rates against those which were available through the clearing house. Pension providers and intermediaries should also be required to ask specific medical questions when selling an annuity and to provide enhanced annuities to those consumers eligible for higher rates due to medical or lifestyle issues.

Pensions industry to work with regulators, the Government and the police to prevent scams: Pension providers' employees need to be trained to spot consumers who may be vulnerable to investment scams and to provide specific warnings.

Lenders to clarify how they will treat small DC pension pots when attempting to collect debts: There should be clarity about how mortgage and other lenders should treat small DC pension pots when collecting debts or starting repossession procedures.

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Section 1: Introduction

The Budget reforms

The enhanced flexibilities which will be introduced in April 2015 are the most significant reforms to the pension taxation framework since the 1986 Social Security Act. The two key changes for consumers are:

Flexibility in how they access their pension: From April 2015 consumers over the age of 55 will be able to access their Defined Contribution pension “however they want”. All limits on how consumers can access their pension will be removed. They will be able to take the entire fund as cash, buy an annuity, leave the fund invested and draw an income from it (known as income drawdown) or any combination of these approaches. Up to 25% of the pension fund will be available as a tax-free lump sum, with the remainder withdrawn incurring a tax charge payable at the consumer’s marginal rate.

Pensions Guidance: To support this increased flexibility the Government has announced a ‘Guidance Guarantee’ which will enable all consumers with a DC pension fund to access free, impartial guidance. This service will give the consumer guidance to help them make decisions about what to do with the benefits available from their pension scheme. The guidance will be delivered to standards set by the FCA.

Why are those with small pots important?

While on some measures consumers are reaching retirement with higher levels of wealth the economic environment and financial markets have meant that the rate at which that wealth can be used to generate secure income has declined. Returns on savings accounts are at record lows, and falling interest rates and increased longevity have pushed down annuity rates. This makes it more important than ever that those approaching retirement are able to access suitable and efficient products and take decisions which mean that they get the best value from their retirement income.

This research focuses on the implications of the reforms for those with average-sized pension pots. It examines their information needs and the decisions and conflicts they will face. The reforms increase the complexity of retirement income decisions for consumers. The changes will also transform the management of retirement income from a one-shot and irreversible decision into a situation where consumers (or their advisers) will need to review on a regular basis.

On its own, expanding the choices available is unlikely to result in consumers becoming more empowered. The system will still rely on consumers at retirement becoming informed, engaged and taking active decisions. Just as there has not been strong competitive pressure placed on companies to offer good value annuities, there may not be pressure to offer good value alternatives. Behavioural biases identified below will mean that most consumers will struggle to make retirement income decisions and there may be a strong trend towards the ‘default’ option, with consumers either taking what they are offered or choosing the middle of multiple options.

Despite more than 10 years of effort and the rewriting of literature and documents consumers are sent when they are about to retire too many were still failing to get a good deal from the annuity market. Shopping around for an annuity is relatively simple compared to shopping around for and making decisions around income drawdown and other more complicated retirement income products. The

Guidance Guarantee will help many understand their options and make better decisions. But some consumers with small pension pots might not access it and for others there might be a long gap between accessing the guidance and using their pension to give them a retirement income. All these factors indicate that further changes are necessary to ensure that consumers with small pension pots are able to get the best value from their retirement income.

There are several reasons why policymakers should carefully consider the needs of those with small pots. These include:

- **The majority of those approaching retirement will have small pots:** The Pensions Regulator found that the average pot size in a DC trust-based scheme at retirement is £25,000.ⁱ ABI figures indicate that the mean annuity purchase in 2013 was £35,600, but the median was £20,000 – meaning half of all consumers bought an annuity worth less than this.ⁱⁱ
 - **DC pensions wealth is a larger proportion of total assets for those with low wealth:** For the poorest 20%, DC pensions wealth makes up just under a fifth of their total wealth.ⁱⁱⁱ For the next quintile, DC pensions wealth represents 12.9% of their total wealth. The fact that for many with low wealth, the DC pension pot is a very important part of their overall assets makes it vital for them to get the best value when taking a retirement income.
 - **Automatic enrolment:** The introduction of automatic enrolment harnesses inertia to help consumers save for their retirement. When they are about to retire, the existing system relies on consumers becoming informed, engaged and taking active decisions which are difficult to make. Many older workers savings for a pension for the first time under automatic enrolment will reach retirement with small pots.
 - **People don't know that they will have to make a retirement income decision and so don't prepare for it:** Research published by the ABI showed low levels of knowledge and engagement amongst those approaching retirement with “a general assumption that money will somehow simply be ‘paid back to me by my provider’”.^{iv} This means that even a few years out from retirement many will not have made a decision. Research by the Pensions Policy Institute found that just 26% of those aged 55 to 64 “knew” how they would use their pension pot. 40% of all individuals over 40 thought that they would be “best placed” to make a decision about what to do with their pension a year or less before their retirement.
 - **Tailored Independent Financial Advice is likely to be less accessible and less affordable for those with small pots:** High quality independent financial advice will be available from both IFAs and some specialist brokers. Those with significant pensions or other financial wealth may have an existing IFA to provide advice about retirement income. But it may be difficult to access for those with small pots. Consumers may not know how to find an IFA or how to judge the quality and value of their advice. Others may not be able to afford it or may be put off by the level of fees.
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- **Lack of appropriate regulation for non-advised / execution-only services:** Instead of taking advice, those consumers with small pots may rely on non-advised services. Those providing these services can still receive commission from pension product providers for selling products.
- **Decisions are now more complex, include more options for consumers to consider and will need to be reviewed regularly:** The reforms expand the number of different options available to consumers and will require more of them to make ongoing decisions post-retirement about where their pension is invested and how much to withdraw each year.
- **Relying on written information doesn't work:** Improving the quality of the written information provided to consumers at the point of retirement has had little impact in making the retirement income market work better for consumers.
- **Those with small pension pots have less choice of annuity provider and are offered worse rates:** There is less competition in the market for small pots, with the result that annuity rates are particularly poor.
- **Current alternative retirement income products to annuities do not meet the needs of the mass market:** Research conducted by the Pensions Institute and published by Which? found that the alternative products to annuities do not meet the needs of the mass market due to costs and investment risk.^v
- **Vulnerability to scams:** Those with small pension pots will have the ability to take all of their money out at once – which could make them a target for scam artists and fraudsters.

Behavioural factors affecting retirement income decision-making

Retirement income decisions involve a number of factors that many would describe as difficult: long-term planning, complex and unfamiliar decision making, weighing up risk and making decision around what to do with a large pot of money. When considering how consumers might make these decisions it is important to take into account the behavioural factors affecting their decision. The following factors mean that consumers find it difficult to find the best value approach to their retirement income:

Inertia and procrastination – Taking a retirement income requires an active decision which is often complex and requires a sequence of choices. There will be a strong preference to put off such a complex decision, which could mean that they might not be prepared for it and may need to make a quick decision. Shopping around and switching retirement income products could be perceived (and actually is) complicated and difficult, putting consumers off. This could lead to consumers taking the default option.

Poor financial literacy and difficulty understanding the saliency of information – consumers do not understand what is required for effective retirement planning and the complexities of annuities and income drawdown.

Poor grasp of life expectancies – People underestimate their life expectancy (on average by about five years for men and three years for women) and also do not understand variability in life expectancy. This means people underestimate longevity risk and overestimate the risk of dying young. This could make them reluctant to purchase an annuity or more likely to take out more money in the early years of their retirement.

Choice overload – This applies when considered which type of annuity or retirement income product to take out, but also when looking for advice. They may not know how to access advice or how to assess its quality and value.

Lack of trust – Consumers may not trust their pension provider or the pension industry in general and may ignore or place low weight on information they are sent.

Lack of engagement and knowledge of pensions – Pensions schemes may use complex terms or jargon which can put people off engaging. Consumers may have few positive assumptions about their pension and they may be cynical that it will be worth anything. They may not understand the key terms of their pension schemes or be able to estimate how much in total they hold in their different multiple pension pots.

Fear of the unknown – Consumers might think that if they try to switch their pension pot to another provider then something might go wrong or the provider might collapse. They may feel that their current provider is the safer option.

Illusion of control – People like to feel in control of their money. Pensions may be seen as risky and subject to fluctuations due to changes in the stock market. Withdrawing all of their money from the pension and placing it in a normal cash savings account may give them a feeling of increased control. Investing in something tangible such as property that they can see may also increase their feeling of control. Buying an annuity could feel like totalling losing control of all of their money.

Overconfidence – People do not have realistic expectations of how much they will need to live on in retirement and over-estimate the amount of income which could be provided from a DC pension.

Unwillingness to contemplate unpleasant things – Issues around death are often things that people do not like thinking about or acting on. People might not want to contemplate how their partner will cope after they die.

Hyperbolic discounting – People value today over tomorrow, and value tomorrow over next week. This leads to a poor understanding of the distant future and a poor understanding of things like inflation. Options which lead to a higher retirement income in the first few years of retirement could be preferred – such as higher level annuities, rather than those which increase with inflation. Even though consumers may say they want an income which increases with inflation, they take a different choice when actually presented with the numbers. It could also lead to people preferring single life annuities over joint-life annuities.

Mental accounting – People tend to see different ‘pots’ of money as different and a more/less inclined to spend from them. Theory suggests that annuities help people with this, as people have an over propensity to spend lump sum payments as they are seen as ‘available for immediate spending’ while annuities are seen as ‘retirement income’. Mental accounting can also cause a bias against people depleting their capital.

Difficulty with self-control – Consumers self-control could be weaker if they are upset, stressed or don't have a specific plan. This could encourage people to take impulsive decisions about taking money out of their pension.

Framing effects – Consumers can be influenced by how the information is presented to them. Giving them three options could result in them choosing the middle one as this might be perceived as the safest option which most people would go for (safety in numbers). Describing things in different ways could affect the option they choose – for example, saying “You have a 20% chance of running out of money” would lead to a different choice than saying “You have an 80% chance of meeting your retirement income target”. Stressing retirement income rather than depletion of a large sum is positive for people. Conversely the conversion of a seemingly large pension pot into an apparently small annuity has the opposite effect. In experiments, listing the annuity income in a table leads to more consumers choosing level annuities over index-linked than if the data is shown on a graph.

Loss aversion – People may be more reluctant to lose their pension savings through early death than they are to benefit from potential gains through living longer than expected. Probabilities and other rational ways of evaluating risks have little effect on this.

Regret aversion – People avoid potential feelings of regret, so may feel as though they got a good deal even when they didn't. Consumers may claim that they shopped around, even when they didn't do so effectively.

Section 2: Choices and decisions faced by consumers taking a retirement income from their small DC pension pot

Consumers with small DC pension pots face a number of complex and inter-linked questions when deciding how to use their pension to generate a retirement income. These include:

- How do they gather information about their pension schemes and other assets to understand the total resources they have available to provide an income in retirement
- How do they maximise their State Pension and should they use some of their DC pension pot to help them do this?
- What implications do their DC pension choices for any means-tested benefits they receive?
- What should they do with their DB pension and how might this affect decisions about what to do with their DC pension?
- Do any of their DC pension schemes have valuable guarantees which they should take into account?
- Should they merge their multiple small DC pension pots into one place, or access them separately?
- How should they access their DC pension to minimise their tax bill and avoid paying tax at the higher rate?
- Should they use a withdrawal from their DC pension fund to pay off debt?
- How should they use their other non-pension assets to generate a retirement income? If they make a withdrawal from their DC pension, where should they save or invest it?
- What retirement income product should they buy? Do they want a secure income from an annuity or take extra risk through income drawdown in the hope of gaining a higher overall income or leaving an inheritance?
- Should they buy a single life or joint life annuity? Should they buy a level annuity or one which increases each year?
- How much should I take out of my DC pension each year and how often should I review it? How long will my pension last? How much will be left for their partner when they die? How will they and/or their partner cope if it runs out?
- What implication do their medical circumstances have for their choices?
- How can they ensure that their partner has enough income to live on after they die?

In this section of the report we examine some of the options and trade-offs associated with these decisions and how different types of consumers can maximise their retirement income.

Types of consumers with small DC pensions pots used in the report

Throughout this report we analyse and model the decisions consumers have to make by using 5 different types of consumer with average DC pensions wealth (£15,000-£45,000).

Consumer type 1 - Multiple small pots: 4 small DC pension pots of varying sizes - £3,000; £4,000; £8,000 & £14,000 totalling £29,000. Other financial assets of £15,000 cash and £15,000 investments.

Consumer type 2 - DC pension alongside DB pension: DC pensions wealth of £15,000 alongside DB pension of £7,000 a year. They have a minor health condition.

Consumer type 3 - Renter: DC pension pot of £15,000 and £5,000 cash. Entitled to Housing Benefit / Council tax benefit.

Consumer type 4 - Debt: DC pension pot of £45,000, homeowner with interest-only mortgage of £60,000 and other financial assets of £30,000.

Consumer type 5 – Serious Health condition: DC pension pot of £30,000,

Types of consumer used in the modelling in this report:

Consumer type	Pensions wealth	State pension	Homeowner	Financial wealth / Debt	Health conditions	Benefits	Marital status
Multiple small pots	4 DC pots - £29,000	Full	Yes	£15,000 – Cash £15,000 – Investment funds	None	None	Married
DC and DB	DB - £7,000 a year DC - £15,000	Full	Yes	£12,000 - Cash	Minor health condition	None	Married
Renter	DC - £15,000	Partial	No	£5,000	None	Housing / Council tax benefit & Pension Credit	Married
Debt	DC - £45,000	Full	Yes	£30,000 – Cash £60,000 – Interest-only mortgage	None	None	Single
Health condition	DC - £30,000	Full	No		Potentially serious health condition	None	Married

2A: Maximising State Pensions

State Pensions consist of the Basic State Pension and the Additional State Pension (previously known as the SERPs or the S2P). The Basic State Pension for 2014/15 is £113.10 per week for those with a full National Insurance record. Additional State Pension has undergone a variety of changes over the years but entitlement depends on earnings, the number of years in the labour market with some allowances for those out of the labour market such as people with caring responsibilities and whether the individual was 'contracted out' through an occupational or personal pension. The current Government has committed that the Basic State Pension will be increased each year by the "triple lock" (the higher of prices, earnings or 2.5% a year). The Additional State Pension is increased each year in line with prices measured by the Consumer Price Index (CPI).

State Pensions represent an important source of secure income for many pensioners although women continue to have lower levels of pension entitlement than men. There are 3 options for those with small pots to use State Pensions to gain additional secure income.

- Defer their State Pension and use some alternative form of income until they receive it
- For those with partial entitlement to the Basic State Pension, buy additional qualifying years by paying extra Class 3 National Insurance contributions
- For those who reach State Pension Age before 6th April 2016, buy Additional State Pension by making a new form of Class 3A National Insurance contributions

Deferring State Pensions

Once they reach State Pension Age (currently 65 for men and 62 for women), consumers can choose when to start claiming their State Pension. If they defer then they will receive extra State Pension or a taxable lump-sum when they begin to claim it. The current rules^{vii} surrounding the deferral of State Pensions are:

- A consumer can defer their State Pension at any point – even if they have already started claiming it.
 - The whole of the State Pension and any additional payments (such as the Additional State Pension) on top must be deferred – consumers cannot defer only part of their State Pension.
 - By deferring their State Pension the consumer will receive extra money when they start to receive their pension. They can claim this in one of two ways:
 - Taking a higher weekly State Pension for life: Under the current rules the consumer would receive an extra 1% in weekly State Pension for each 5 weeks of deferral, which amounts to 10.4% for each year (this will reduce to 5.8% for each year for those who reach State Pension age after April 2016).
 - Receiving a lump sum: If the consumer defers their State Pension for at least a year then they can receive a one-off, taxable lump-sum. This is based upon the amount of State Pension they would have received if it had not been deferred and interest at "about 2% above the Bank of England Base Rate". This option will only be available to those who retire before April 2016.
 - The amount of extra State Pension is applied to all of the consumer's State Pension payments which have been deferred, including Basic State Pension, S2P and some other additions
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- When the consumer dies part of the extra weekly State Pension or the entire lump-sum payment can be inherited by their spouse or civil partner

Table 1: Extra amounts which could be gained by deferring a full Basic State Pension assuming current rate of 10.4% increase for each year of deferral

Weekly State Pension Deferred	Number of Years	Total amount deferred	Lump-sum Payment	Extra Weekly State Pension	Extra Yearly State Pension
£113.40	1	£5,896	£5,971	£11.80	£613
	2	£11,793	£12,088	£23.60	£1,227
	3	£17,690	£18,363	£35.40	£1,840
	4	£23,587	£24,790	£47.20	£2,453
	5	£29,484	£31,400	£59.00	£3,066

One option for those with small pension pots is to defer their State Pension and rely on other sources of income before claiming it at a later date. By doing this they could benefit from a higher rate of secure income or a lump-sum payment once they begin to draw their State Pension. Other sources of income could include continuing to work – where once they reach State Pension age they will no longer pay National Insurance contributions and would therefore see a small increase in take-home pay. However, continuing to work is likely to only be an option for a minority of individuals and, despite recent improvements, just 10.1% of those aged over 65 are employed.^{viii} Therefore many with small pots would have to either rely on other financial assets during this time or use the new flexibilities to make regular withdrawals from their pension fund. Consumers using their DC pension to replace the income from the State Pension during this deferral period would have to erode the capital in their fund – an annuity would pay far too little.

To replace the income received from a Basic State Pension a consumer would need to withdraw a total of £5,897 annually from their pension. For a consumer with a £29,000 pension pot this would erode their pension pot within 5 years. When they began to draw their State Pension they would then benefit from an extra £3,066 a year, which would increase in line with CPI. By comparison if they had used their pension fund immediately to buy an annuity then this would have produced an annual income of around £1,600 a year from a level annuity or £900 from an RPI index-linked annuity. This means that compared with the cost of buying an annuity they have gained around 2-3 times as much secure income. Alternatively they could opt for a lump sum payment of £31,400. They may want to take a lump sum if they had become seriously ill since deferring their State Pension.

Topping up the Basic State Pension by buying additional qualifying years

Eligibility for the Basic State Pension depends on the number of years in which a consumer has paid National Insurance contributions. A consumer retiring between 2010 and 5th April 2016 needs 30 years of National Insurance contributions or eligible credits for the basic State Pension. After 5th April 2016 a consumer will need 35 qualifying years to qualify for the new single tier State Pension. Consumers with fewer than the required number of qualifying years will receive a partial State Pension.

To boost their number of qualifying years some consumers will be able to make voluntary National Insurance contributions. Normally consumers can only pay for gaps in their National Insurance records

in the current year and the previous six years. However, those who reach State Pension age between April 2010 and April 2015 and already have 20 qualifying years are eligible to pay up to six years covering years going back to 1975.

In 2014/15 the cost of buying extra years is £722.80 for each year purchased. For each year purchased, their Basic State Pension will increase by £3.77 a week or £196 a year.^{ix} This means that it will take just over 3.5 years for a consumer to receive their capital back and continue to benefit from a higher rate of secure income through the Basic State Pension. Even if the consumer has to pay tax to withdraw money from their pension fund to buy the extra years then the return available is more than 7 times that available from an index-linked annuity. However, those on Pension Credit or other means-tested benefits might see the increase to the State Pension offset, either totally or partly, by reductions in these other benefits.

Buying Additional State Pension

The Government will also be introducing a further scheme for those who reach State Pension Age before 6th April 2016. This will be known as “Class 3A voluntary contributions”. This will enable consumers to top-up their State Pension by between £1 and £25 a week, with the cost depending on how much extra pension they want and how old they are when they make the contribution. As currently proposed the scheme will only operate between October 2015 and April 2017. The Government expects most people who want to take up the additional entitlements under the scheme to do so in the first few months of its operation. Pricing of the scheme will be on an “actuarially fair” basis based on estimates of life expectancy provided by the ONS. The Government has indicated that the following types of people will gain from the scheme:

- Couples where only one pays tax, with women who have an average state pension of £109 a year highlighted as potential beneficiaries
- Self-employed people who generally have lower levels of State Pension but are approaching retirement with higher levels of assets
- People approaching retirement with Defined Contribution pensions who may want to supplement their income from annuities or income drawdown
- Older pensioners who may welcome a simple offer from the State to increase their income

The Additional State Pension will increase in line with prices as measured through the Consumer Price Index (CPI), rather than by the triple lock. On death, at least 50% of the additional state pension is inheritable by the consumer’s spouse. Additional State Pension can be deferred using the process described in the previous section.

Table 2: Cost of Paying Additional Class 3A NI Contributions by Age Compared to Cost of Buying Index-Linked Annuity

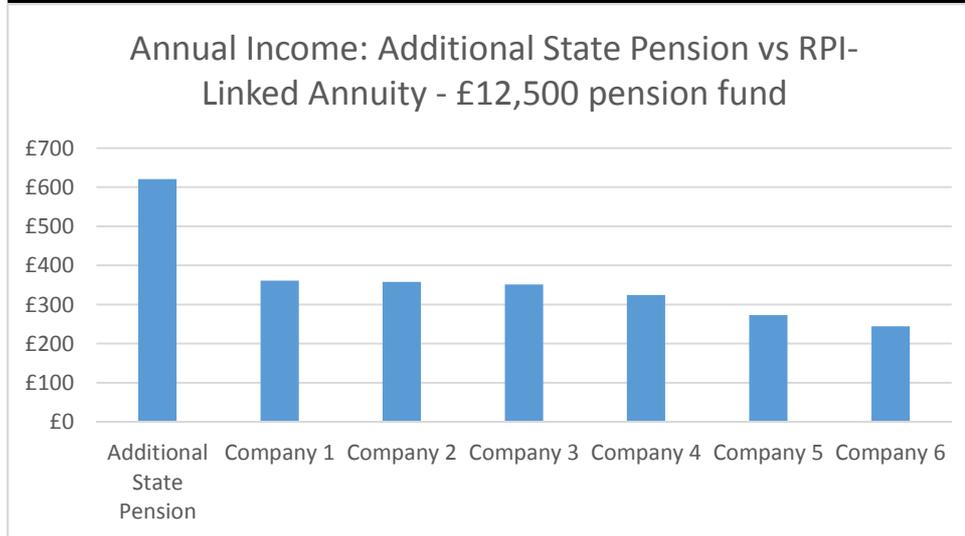
Age	Cost of buying £1 a week additional income	Cost of buying the maximum £25 a week	Cost of buying equivalent single life RPI-linked Annuity	Cost of buying equivalent joint-life RPI-linked Annuity
65	£890	£22,250	£38,000	£42,000
68	£827	£20,675	£33,000	£36,500
70	£779	£19,475	£29,500	£34,000
75	£674	£16,850	£22,500	£26,000

RPI-Linked Annuity, Living in SE13, Joint-life both aged 65 or single life aged 65, annuity increasing by RPI, Rate available on Money Advice Service Comparison Table - Accessed 24th November

The table shows that the current cost of paying additional Class 3A NI contributions to gain additional State Pension income is considerably cheaper than buying either a single-life or joint-life index-linked annuity. This is true even when adjusting for the fact that the additional state pension is uprated with CPI instead of RPI.

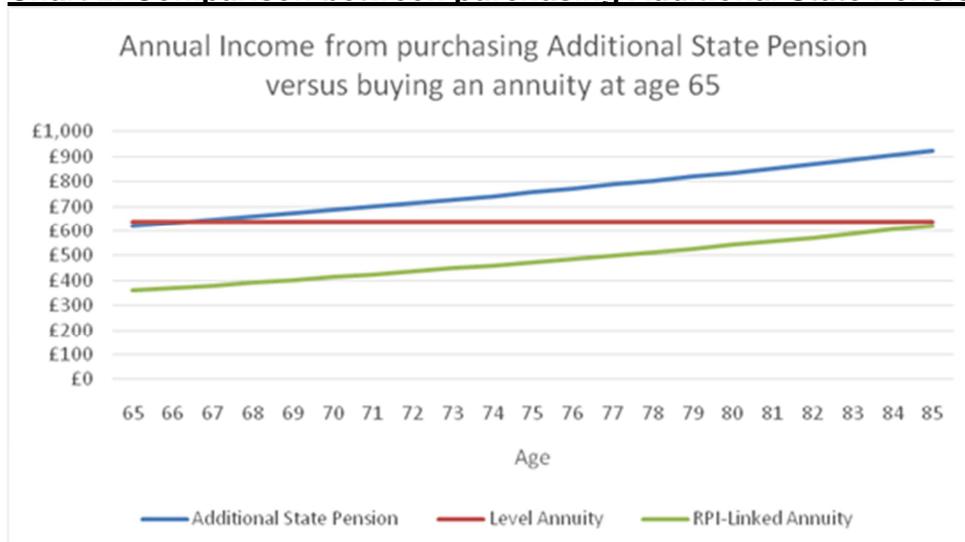
There is one additional complication which is that Class 3A NI contributions can only be paid in cash – a consumer cannot use their tax advantaged pension saving to purchase additional state pension. This means that to use their pension saving in this way consumers can use the new flexibilities to make a withdrawal from their pension and incur a tax charge on at least 75% of this amount. So, if consumer type 1 decides that they want to secure an index-linked income from £12,500 of their pension fund then they can either purchase an index-linked annuity within their pension or withdraw the money from their pension fund – incurring a tax charge of £1,875 and purchase additional state pension with the balance of £10,625. The first chart below shows that the amount of an index-linked annuity, compared to the amount which could be purchased through the additional state pension. However, the vast majority of annuities purchased are level annuities which do not increase over time. The second chart shows that the amount which can be purchased through the additional state pension will, after 3 years, surpass the return available from a level annuity.

Chart 1: Annual income from withdrawing a £12,500 pension fund and using it to purchase Additional State Pension versus using it to buy RPI index-linked annuity



Index-Linked Annuity, Living in SE13, Joint-life annuity increasing by RPI, Both aged 65 Rate available on Money Advice Service Comparison Table - Accessed 24th November

Chart 2: Comparison between purchasing Additional State Pension and an Annuity



Joint-life annuity, Living in SE13, RPI linked annuity is assumed to increase at 2.75% per year and Additional State Pension is assumed to increase at 2% a year, Both aged 65 Best rate available on Money Advice Service Comparison Table - Accessed 24th November

Conclusions

Under the current framework, deferring their State Pension or buying Additional State Pension or extra qualifying years to enhance their Basic State Pension are good value ways for those with small pension pots to secure higher levels of secure lifetime inflation-linked income for themselves and their spouses.

Maximising State Pension benefits in these ways may be particularly helpful for consumers:

- In good health

- With spouses/partners, as long as the inheritable Additional State Pension would not take their partner above the maximum amount
- With small pension pots – where annuity rates are particularly poor
- Women who retire earlier and therefore would be offered poorer annuity rates

It is likely to be less beneficial or not beneficial at all for consumers:

- In poor health
- Receiving means-tested benefits such as Pension Credit

However the following caveats should be considered:

Communications challenges: There are currently no requirements for the option to defer the State Pension or purchase Additional State Pension to be highlighted in wake-up packs and communication documents sent by occupational or personal pensions. Promoting it as £1 a week for an additional payment of £890 may suffer from the same problem as an annuity in that it sounds a very low payment in return for the lump sum.

Unexpected expenses: Eroding all of their DC pension fund and other assets might leave those consumers less able to cope with an unexpected expense in retirement. However, if a consumer who had deferred their State Pension was faced with an unexpected bill then they could take a lump-sum instead of an increase in their weekly State Pension.

Future changes will reduce the attractiveness of these options or eliminate them: The reduction in the benefit from deferring the State Pension from 10.4% to 5.8% a year and removing the ability to take a lump sum will reduce though not remove the attractiveness of this option. The Government's intention is that the ability to make Class 3A NI contributions will only be available to those reaching State Pension age before 6th April 2016 and that they will have to do so by April 2017.

Political risk: Whilst at the moment the major political parties are committed to increasing the State Pension each year this may change in the future – as it did when the uprating of the Additional State Pension was changed from RPI to CPI.

2B: Understanding the impact on means-tested benefits

The three main types of means-tested benefits available for those older than State Pension age are:

- Pension Credit: The Guarantee Credit tops up a consumer's income to £148.35 a week for individuals and the Savings Credit which can provide a further payment for those with an income of between £120.35 and £190 a week.
- Housing Benefit: Renters can receive Housing Benefit with the eligibility and amount received depending on their weekly income and rent.
- Council Tax Reduction: Those on a low income or claiming benefits can get a reduction on their Council Tax bill. What a consumer receives can depend on their circumstances and where they live as each council runs its own scheme.

Income received from the DC pensions will reduce eligibility for means-tested benefits. The Government has announced that this will be the greater of the actual income taken or 100% of the income which could be bought by a conventional annuity.^{xi} The consumer type 3 – 'renter' - currently has £15,000 in a DC pension. This means that in calculating their entitlement to means-tested benefits this would be assumed to generate an income of around £14.90 a week (£774 a year). They would be assumed to receive this income even if they did not make any withdrawals from their pension scheme. If they were to withdraw more than this amount then the additional income would further reduce their entitlement to means-tested benefits.

Also relevant for those with small pension pots receiving these benefits will be the capital limits which apply. Capital which counts towards the limits include savings in bank accounts, investments, and property. However, it excludes holdings in occupational and personal pensions.

Claimants with capital above the minimum limit will start to see a reduction in their benefits. Those which exceed the maximum limit will no longer be entitled to any of that particular type benefit. The amount of tariff income is the amount of income which it is assumed that capital above the minimum limit delivers and it is used when estimating entitlement to benefits. These are shown in the table below:

Table 3: Capital limits for means-tested benefits

Benefit	Minimum Capital Limit	Maximum Capital Limit	Tariff income
Pension Credit	£10,000	No maximum	£1 a week for every £500 of eligible capital
Housing Benefit	£6,000 for those below Pension Credit age £10,000 for those above Pension Credit age	£16,000 unless eligible for the Pension Credit Guarantee Credit in which case no maximum is applied	£1 a week for every £500 of eligible capital for those above Pension Credit age £1 a week for every £250 of eligible capital for those below Pension Credit age
Council Tax Reduction	Depends on the Council but can be between £6,000 and £10,000 and vary between those below and above Pension Credit age	Depends on the Council and age but can be between £6,000 and £16,000.	£1 a week for every £500 of eligible capital for those above certain ages £1 a week for every £250 of eligible capital for those below certain ages

The consumer type 3 'renter' currently has £5,000 held in cash savings accounts. This amount is below the minimum capital limit for all 3 types of means-tested benefits and therefore does not affect their entitlements. If they were to withdraw their entire £15,000 DC pension fund then after tax they would receive £13,850 in cash. Adding this to their existing savings would give them a total of £18,850. This means they would lose entitlement to Housing Benefit and Council Tax reduction. They would also lose some entitlement to Pension Credit as the £8,850 in capital would be assumed to generate them £930 a year in income.

Those consumers who receive means-tested benefits will need to consider how the way in which they flexibly access their pension will affect their entitlement to these benefits. There will be a greater impact on those who access their pension before State Pension Age as the capital limits are lower.

2C: Gaining a full picture of multiple pension pots

The first stage for any consumer approaching retirement will be to gain a comprehensive picture of their pension entitlements. This would need to include their State Pension and any public and private sector Defined Benefit and Defined Contribution schemes. As a starting point, when they reach their retirement, they would need to know the following information for each of their pension schemes.

State Pension: The amount of income they would receive from the State after their State Pension age.

Defined Benefit / Hybrid schemes: The amount of income payable from the scheme and the retirement age from which it becomes payable. They would also need to know whether the pension would increase post retirement and if it would provide an income for their spouse/partner.

Defined Contribution schemes: The value of the accumulated savings in the scheme, what assets it is invested in and the amount of income this might generate when they retire.

This information will be more complicated to obtain for those with multiple pension pots. At present there is no easy way for an individual to view their total aggregate amount of their DB and DC pensions in one place or to see this alongside their State Pension entitlement.

State Pension forecasts and statements can be requested from the Pension Service and are now available online – although the statement cannot be saved, only printed out. To gather information for their DC and DB pensions they would need to consult their annual statements or terms and conditions of the pension. If they were within 6 months of their scheduled retirement date then they should have received a ‘wake up’ pack which would contain this information. They would then need to add these numbers together to determine their total retirement savings.

It was estimated that between a quarter and two-fifths of DC pension holders have multiple pension pots.^{xii} These numbers are likely to have increased following the introduction of automatic enrolment, which will result in more consumers possessing a separate pension for each of their jobs. Whilst the Government is scheduled to introduce a mechanism for automatic transfers of small pension pots in the next Parliament, this will only apply to new small pots and exclude those with a value of more than £10,000.

Tracking down lost pension pots

Consumers may have lost touch with their pension savings or not kept address details up to date. Both occupational and personal pensions are supposed to make some effort to trace individuals for whom they no longer hold up to date contact details. The Pension tracing service is free and enables consumers to track down their pension schemes by entering any information they have about their employer or pension provider. Following a successful trace, the consumer would need to contact the scheme provider to find out what the scheme is worth.

Communications between pension providers and customers regarding retirement options

Between two and five years prior to their selected retirement date, a pension provider must communicate with a customer on an individual basis at least once to:

- Encourage the customer to start considering their retirement options
- Introduce the customer to the decisions they will need to make

This can be done through the annual pension statement, or alternatively through a separate customer communication.

If a provider has not already been approached by a customer about their retirement options, the provider must also:

- send out a 'wake-up' pack at least 6 months pre-Selected Retirement Date for trust-based occupational schemes and at least 4 months pre-Selected Retirement Date for contract-based schemes
- send out a 'follow-up' pack at least 10 weeks pre-Selected Retirement Date for trust-based occupational schemes and at least 6 weeks pre-Selected Retirement Date for contract-based schemes

2D: Understanding whether to merge multiple small DC pension pots

Once they have received details of their pensions, then those consumers with multiple small DC pots will need to make a decision as to whether they convert each of the individual pots into a retirement income or whether they merge them together in one place. To take this decision consumers will need the following information:

Exit charges and Market Value Reductions: The application of these charges could reduce the benefits from the scheme if the consumer transfers out, makes a withdrawal or cashes-in their pension. Explicit exit charges may be levied in the form of an explicit charge for leaving the scheme before a certain number of years have elapsed or before the stated maturity date. These exit charges are not normally present in schemes set up after 2001 and are prohibited for Stakeholder schemes. In 2013, the FSA said that it did not hold data on the prevalence or level of exit penalties within pension schemes.^{xiii} A Market Value Reduction is a deduction which can be applied to pensions held in with-profits funds when the consumer transfers out of their pension, makes a withdrawal or cashes it in. These are expressed in percentage terms – for example a 10% MVR would mean a reduction in 10% in the value of the consumer’s pension policy. The amount of an MVR is not fixed – the insurance company can change it and will levy the MVR which applies when the consumer cashes-in their pension or transfers out.

Exit charges / MVR-free windows: There may be certain times when exit charges or MVRs will not apply. For example, an exit charge/MVR might not apply if the consumer holds the pension until their stated retirement date when they joined the scheme. However, some with-profits funds only offer MVR-free windows for a period before and after the selected retirement date. If the consumer does not transfer out during that window then they can be subject to MVRs in the future when they transfer, cash-in or take a withdrawal from their pension.

Guaranteed Annuity Rates, Guaranteed Annuity Option and any other Guarantees: A Guaranteed Annuity Rate (GAR) provides a guarantee that the pension provider will use a particular minimum rate at which the consumer can use their pension saving to purchase an annuity with that provider. For example a GAR of 10% would mean that if the final value of the pension at retirement was £100,000 then the consumer could use it to purchase an annuity paying £10,000 a year. Guaranteed Annuity Rates can be very valuable as they are normally far above that which can currently be achieved by a healthy individual in the current market.

Information about charges and asset allocation: Consumers would need to understand whether they would incur any extra administration charges by merging pots. To decide which scheme to use they would have to have some way of understanding and comparing the different charges and where the schemes were invested.

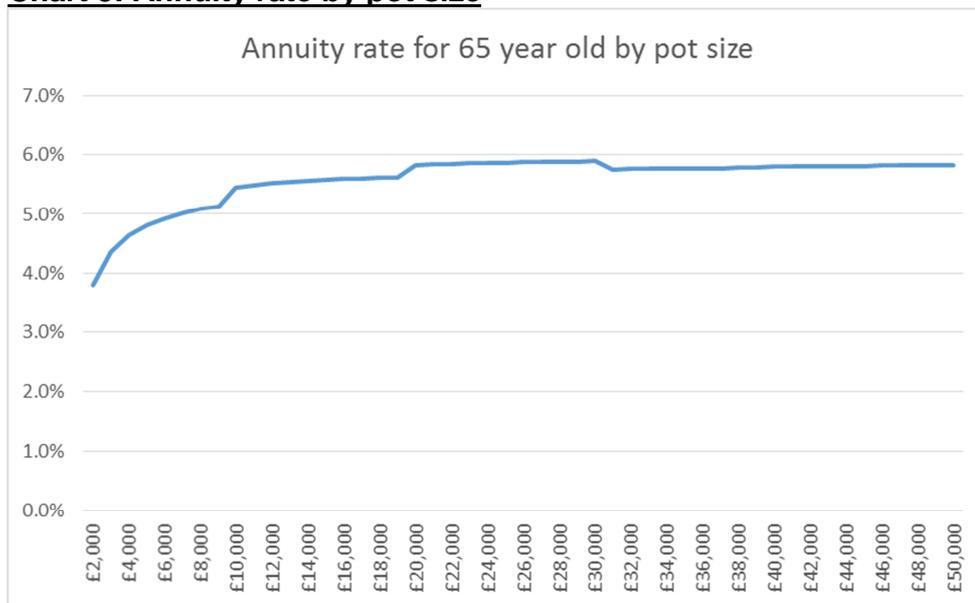
Using multiple small pots to buy annuities

Buying individual annuities across a number of small pots could also increase complexity and reduce the amount of income received by the consumer. Smaller pots receive lower annuity rates due to increased administration costs and lower levels of competition for small pots as few companies will compete on the open market for annuities below £10,000. The chart below shows the annuity rate offered by one major provider by pot size – annuity rates are lower for those consumers with pension

pots of less than £20,000 and take a further significant lurch downwards for those with less than £10,000.

If the consumer type 1 with multiple pots fails to combine their different pension pots before buying an annuity then they could lose out on valuable secure income. Buying separate single life annuities with their small pots of £3,000, £4,000, £8,000 and £14,000 would pay them an income of just over £1,500 a year. Combining these into one big £29,000 pension pot could give them around £1,700 a year.

Chart 3: Annuity rate by pot size



Single Life Annuity, Purchased at age 65 in good health, lives in SE13

Using multiple small pots for income drawdown

To manage and review a drawdown programme across multiple small pots increases complexity as the consumer will have to know the amounts remaining and investment allocation across the multiple pension pots. Managing multiple small pots could also incur greater charges if there are initial or annual fees for entering income drawdown or administration fees for changing the amounts of regular withdrawals or taking ad-hoc withdrawals. It could also increase the cost of receiving advice.

Conclusions

Consumers with exit charges should try and avoid accessing their scheme before retirement but should consider taking advantage of any penalty free window.

Schemes with GARs are likely to be a good option for those consumers who want to use their pension to gain a secure income. However, some of the GARs may come with restrictions such as not providing an income for a consumer's partner.

If there are no schemes with GARs then consumers should always aggregate their schemes when buying an annuity. Consumers should also consider merging schemes before entering income drawdown, but whether to do this and which pension scheme to use is a complicated decision for which most consumers will require financial advice.

2E: Issues for those with DB schemes alongside small DC pension pots

Defined Benefit (DB) schemes can provide consumers with a good source of secure income in retirement. 43% of individuals aged 45-54 and 30% of individuals aged 55-64 have some form of DB pension which they have not yet received a payment from.^{xiv} In addition to offering a greater level of certainty to consumers regarding the amount of their final pension, 97% of DB schemes also provide an income for the surviving spouse and 74% increase benefits in line with inflation. Issues arising for those with DB schemes include:

Lump sum or secure income: DB schemes typically offer the ability for consumers to transform or 'commute' part of their annual income into a tax-free lump sum.

Ability to transfer out: The Government decided to continue to allow transfers from private sector and funded public sector DB schemes into DC schemes. Two new safeguards will be introduced requiring consumers to take independent financial advice and new guidance for trustees to delay transfer payments and take account of funding levels when deciding on the transfer value. In a thematic review of advice concerning whether to transfer out of DB schemes the FCA found that even when advice was provided by the employer – this was 'process driven', creating a risk that not all the consumers' circumstances were considered in all cases. If consumers want to transfer out then they need to do so before they reach the retirement age for the scheme. Those receiving a pension from a DB scheme are normally banned from transferring out.

Consumer type 2 - 'Defined Benefit' - has a DB pension of £7,000 a year alongside a DC pension of £15,000. He is a smoker with raised cholesterol and would therefore qualify for an enhanced annuity paying 10% more than the standard rate. Their DB scheme has a commutation factor of 18:1 and a transfer value of £140,000. They would face the following decisions:

Whether to give up DB pension to generate a lump-sum: By giving up £1,000 of annual income the consumer would receive a lump-sum of £18,000. However, even accounting for the fact that he would qualify for a higher annuity rate due to his health it would cost at least £30,000 to replace the £1,000 of index-linked income. Those with DB schemes and with needs for lump-sums may be better off using the new flexibilities to withdraw it from their DC scheme.

Whether to transfer out: The transfer value of £140,000 is equivalent to an annual income from an index-linked annuity of £4,600 a year so would be a significant decrease to the annual income available in the DB scheme. Moving into drawdown would result in a significant increase in investment risk and the risk of running out of money. Transferring out of DB schemes is only likely to be suitable for a small minority of consumers such as those with a serious health condition. Under the new framework if the consumer died before the age of 75 any payment from a drawdown pension or joint-life annuity to their partner would be tax-free.

However, this example illustrates that even for those with relatively modest DB pensions, the transfer value is likely to vastly exceed the amount in their DC scheme. This may prove tempting to some consumers – even with the requirement to take Independent Financial Advice. It is notable that in the FCA's recent thematic review^{xv}, 59% of transfers were undertaken at the "insistence" of the member after the adviser had given them a recommendation to stay in the DB scheme. Employers seeking to reduce their deficits in final salary schemes may also encourage consumers to transfer out of DB schemes by offering some 'enhancement' to transfer values.

Section 3: Accessing Small DC pension pots

3A: Taxation: Understanding the options for making withdrawals from their pension and how this would impact on the amount of tax paid

Under the new framework consumers with small pots will have four main ways of accessing their pension with different implications for taxation. These options are:

- **Small Lump Sum (SLS):** This is available for small pots of less than £10,000 with 25% of the fund being paid tax-free and 75% being taxed at the marginal rate. In a SLS the entire pension fund is paid to the individual in one go. Taking a SLS does not trigger a reduction in the consumer's Annual Allowance for money purchase pensions to £10,000.
- **Uncrystallised Funds Pension Lump Sum (UFPLUS):** This is available for any size of fund and is a withdrawal in the form of a lump sum with 25% being paid tax-free and 75% being taxed at the marginal rate. A consumer can take multiple UFPLUSs from their fund and spread them over months or years. Taking an UFPLUS reduces the consumer's Annual Allowance for money purchase pensions to £10,000
- **Flexi Access Drawdown (FAD):** This is available for any size of fund. The consumer takes 25% of the fund immediately as a tax-free lump sum. The remainder is placed into Flexi Access Drawdown with any withdrawals through FAD being taxed at the marginal rate. Entering FAD reduces the consumer's Annual Allowance for money purchase pensions to £10,000.
- **Tax-free lump sum and annuity:** This is available for any size of fund. The consumer can take up to 25% of the fund immediately as a tax-free lump sum and use the remainder to buy an annuity or other retirement income product. Taking a Pension Commencement Lump-Sum (PCLS) and buying an annuity reduces the consumer's Annual Allowance for money purchase pensions to £10,000. The income from the annuity will be taxed at the consumer's marginal rate.

Many of the consumers with small pots who use the new rules to access their pension post retirement might be unlikely to be negatively affected by the reduced Annual Allowance. Those continuing to work will still be entitled to employer contributions into their workplace pensions and be allowed to make their own contributions to workplace or personal pensions. These would be unlikely to exceed £10,000 a year. However, those below State Pension age or those who know that they might want to make a lump-sum contribution into a pension – perhaps from an inheritance will need to be aware of the potential impact before they decide how to access their pension. If they have multiple pension pots then the best option for them would be to take one or more of those as Small Lump Sums. For those consumers who need to withdraw larger amounts there are some differences between the two ways they can access their pots flexibly, the UFPLUS and the FAD. Whether those with small pots are better off using the UFPLUS or FAD will depend on the following factors:

- FAD is more suitable for those consumers who have an immediate need for larger amounts of cash in the first year of their retirement and/or those who may have unused portions of their
-

personal allowance to use in the latter years of their retirement. In particular, using FAD allows those on moderate incomes to maximise the withdrawals from their pension and avoid paying higher rate tax.

- UFPLUSs are more suitable for those who have no immediate need for large amounts of cash in the first year of their retirement and/or those who know that their income will exceed the annual allowance in each year of their retirement. By delaying the utilisation of the tax-free element of the withdrawal consumers could gain if the size of their pension fund continues to grow post-retirement.

The rate of taxation applied to withdrawals from DC pots

With the exception of the tax-free element, the money withdrawn from pensions will be taxed at a consumer's marginal income tax rate. To determine the marginal rate it is necessary to add up all of the consumer's income from other sources including employment, profits from self-employment, State Pensions, savings, property and investments. Adding the amount of taxable withdrawal from their DC pension to this amount and applying the marginal rate from the table below will give the total tax paid by the consumer.

Table 4: Marginal Rates of Income Tax 2015-16

Amount of income	Tax-rate
£0 - £10,500	0%
£10,500 - £42,385	20%
£42,385 - £150,000	40%
Above £150,000	45%

The key objective for those consumers with small pots who want to drawdown their pensions as quickly as possible will be to minimise the amount of the withdrawals which are taxed at the 40% marginal rate. Making some assumptions about the income from employment and savings the table below shows the maximum amount the consumer type 1 with 'multiple small pots' totalling £29,000 could withdraw from their pension in the year they retire before they move into the higher rate tax band. To minimise their tax liability it is important that the consumer does not withdrawal more than these amounts. If the entire £29,000 was withdrawn immediately then given the amount of other taxable income the consumer has in the 2015/16 tax year £6,800 of the withdrawal would be taxed at the higher marginal rate of 40%. This is because the consumer has taxable income of £27,402 in 2015/16 and so can only withdraw £14,983 (£42,385 - £27,402) in a taxable withdrawal from their pension before they begin to pay tax at the higher marginal rate of 40%. This would lead to a total tax payment on the withdrawal of the pension of £5,700 (40%*£6,800 + 20%*£14,983).

Table 5: Taxable income and amounts consumer with ‘multiple small pots’ can withdraw from their pension in the first tax year of their retirement before paying higher rate tax

Consumer type 1	Year 1 (2015/16)
Total taxable income	£27,402
Total taxable withdrawal before being taxed at the higher rate	£14,983 (£42,385-£27,402)
Maximum UFPLUS which can be made before the consumer would begin to pay higher rate tax	£19,978 (75% - £14,983 would be taxed)
Maximum tax-free lump sum + withdrawal under FAD which could be made before the consumer would begin to pay higher rate tax	£22,233 (Consisting of tax-free lump-sum of £7,250 and taxable withdrawal of £14,983)

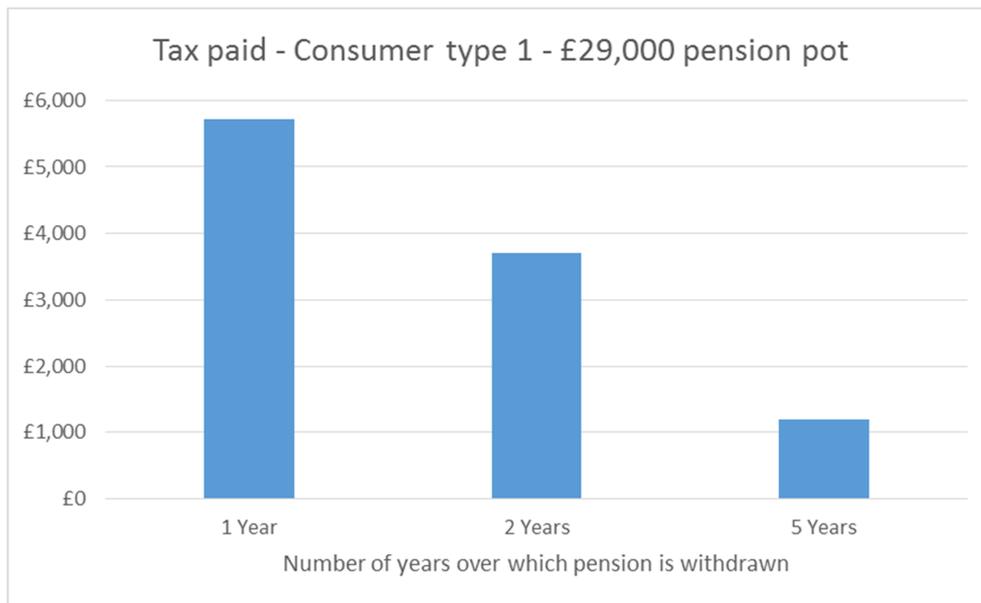
Assumptions: Consumer retires at end of December 2015 having worked up until their retirement and then immediately claims the State Pension. Makes the withdrawal through the UFPLUS or FAD in the 2015/16 tax year

Table 6: Taxable income and total tax paid on pension withdrawal by ‘multiple small pots’ consumer if withdrawals are spread over 5 years

Consumer type 1	Year 1 (2015/16)	Year 2 (2016/17)	Year 3 (2017/18)	Year 4 (2018/19)	Year 5 (2019/20)
Total taxable income from savings/investments & State Pension	£27,402	£7,798	£7,723	£7,955	£8,194
Total tax-free regular withdrawal	£0	£3,227	£3,853	£4,200	£4,569
Tax-free lump sum	£7,250				
Total withdrawal	£7,250	£5,438	£5,438	£5,438	£5,438
Total taxable pension withdrawal	£0	£2,211 (£5,438 - £3,227)	£1,585 (£5,438 - £3,853)	£1,238 (£5,438 - £4,200)	£869 (£5,438 - £4,569)
Total amount of tax paid	£0	£442 (20% * £2,211)	£317 (20% * £1,585)	£247 (20% * £1,238)	£173 (20% * £869)
After tax income from pension	£7,250	£4,996	£5,121	£5,190	£5,264

Assumptions: Consumer retires at end of December 2015 having worked up until their retirement and then immediately claims the State Pension and gradually moved their cash savings and investments into ISAs. Annual Allowance is £10,500 in 2015/16 and then increases at 5% per year. Consumer takes tax-free lump sum in 2015/16 and places the rest in Flexi-Access Drawdown and makes 4 further withdrawals of £5,438 each tax year.

Chart 4: Amount of tax paid by ‘multiple small pots’ consumer if pension withdrawn over 1 year, 2 years or 5 years



Notification requirements

When a consumer has flexibly accessed their pension saving the administrator of the pension scheme must send them a flexible access notification. This must include the following information:

- That the member has flexibly accessed their pension savings and the date of the relevant event
- If the member's total pension inputs into money purchase arrangements and certain hybrid arrangements is more than £10,000 for a tax year,
 - they will be liable to an annual allowance charge on the excess over £10,000, and
 - their annual allowance for pension inputs under other types of arrangements will be reduced by £10,000.

Following the receipt of the notification:

- the member must within 91 days, beginning with the day of receipt of the notice from the scheme administrator tell the scheme administrator of any other scheme that they are an active member of (or for any new scheme they join when they join the scheme) that they have flexibly-accessed their pension rights and the date of that they did so;
- If a consumer fails to notify other schemes within 91 days of receiving the notice then they can be liable for a penalty of £300.^{xvi}

These notification requirements will affect those consumers with small pots who continue to work into retirement after having accessed their pension flexibly through an UFPLUS or FAD. It is likely that many who continue to work will be paying into their current workplace pension as they will have been automatically enrolled before reaching State Pension Age. There will need to be clear information provided to those with small pots as to how they should find the details of their current scheme. Given that many with small pots are unlikely to exceed the £10,000 Annual Allowance placing the notification requirement on the consumer and penalising them if they fail to comply seems unnecessarily harsh.

PAYE

Pay-As-You-Earn (PAYE) is the HMRC system through which those making pension payments to individuals, both employers making occupational pension payments and registered pension providers, should deduct income tax and send it to HMRC. Those accessing a pension fund will need to supply a tax-code to their pension scheme. If they do not then on the initial withdrawal they may be taxed under an emergency code. An emergency code will normally mean that the consumer does not receive any benefit from their annual allowance, meaning that at least basic rate tax will be deducted, and the payment will be taxed as though it is a monthly payment. This could result in them paying tax at the 40% rate. To prevent this occurring consumers will need to supply their pension scheme with their P45 or their tax code.^{xvii}

If only one payment is made from a scheme during a tax year then as part of the end of tax year reconciliation under PAYE, HMRC will determine whether the consumer has paid too much tax and if so, refund them. Where more than one payment is made then provided that the member has given their tax code to their pension scheme an adjustment can be made during the year. Given that some with small pension pots may have unused personal allowances due to being on a low income it will be particularly important for them to supply their pension provider with their tax code to avoid excessive tax deductions being made.

Conclusions

There is a risk of consumers with small pots paying excessive amounts of tax when they make a withdrawal from their DC pension. By not minimising their tax liability they are reducing their potential retirement income. Consumers should be encouraged to spread their withdrawals over a number of years and to take the maximum tax-free lump sum.

To ensure right amount of tax is deducted it is important that consumers are provided with accurate tax codes and are able to communicate these to their pension schemes.

3B: Accessing the DC pension fund to repay debt and using non-pension financial assets to generate income

Consumers' ability to generate a retirement income will be influenced by the amount of debt and other financial assets they possess. 9 out of 10 retired people have other sources of income in addition to their annuity and State Pension, including savings, investments, earnings from employment or rental income from a property.^{xviii} Decisions about what to do with their DC small pot should factor in consideration of the amount and investment strategy of their other assets. Consumers will also need to make decisions about which product and which provider to save or invest any tax-free lump sum they withdraw from their pension. Others may use the new flexibilities to withdraw more money than they need from their pension pot for their day-to-day spending. They will then need to decide where to save or invest this surplus income.

Using the DC pension fund to repay debt

Research from Prudential found that 1 in 6 of those planning to retire in 2014 will have debts. The main sources of debts are credit cards (56% of those with debt) and mortgages (44%), followed by overdrafts (19%) and bank loans (14%).^{xix} Age UK has found that whilst the proportion of older people with debt had fallen between 2002 and 2010, the average size of the debt had increased.^{xx} There are also concerns that lenders may be unwilling to lend to older people and in particular to extend mortgage terms so that they are repayable after retirement.^{xxi} This could mean that more consumers have to repay debt when they reach State Pension age.

Those consumers with unsustainable levels of debt will need to be referred to independent debt advice agencies. The pension flexibilities raise interesting questions about how lenders will treat an uncrystallised DC pension pot when negotiating with consumers. For example, under the old regime there would be no way for most consumers to use more than 25% of their DC fund to repay their mortgage. This might have made the lender more likely to compromise by agreeing an extension to the mortgage term and/or a lower monthly payment. Under the new flexibilities, the lender could demand that the consumer withdraws money from their pension to repay the mortgage or sell the house. Similar issues might arise if a consumer falls into mortgage arrears after the age of 55. There are questions about whether the lender would insist that the consumer accesses their pension to avoid repossession.

Factors which will determine whether consumers should make withdrawals from their pension fund to repay debt will be:

- Overall level and type of debt
 - Interest rates charged and whether they can be reduced by refinancing debt
 - When the debt is due for repayment and whether there are any Early Repayment Charges
 - Whether there are any alternative repayment strategies/vehicles in place
 - Attitude to risk
 - Access to emergency fund
 - Whether the consumer might have to incur significant expenditure during their retirement in the near future
-

Unsecured debt

Unsecured debt includes overdrafts, credit cards and personal loans. Interest on these types of loans range from 5% for large personal loans to 19.67% for overdrafts. The returns from the pension are not likely to exceed that which could be gained from paying off the higher cost unsecured debt such as credit cards, overdrafts and personal loans. This means that consumers overall could benefit from accessing their pension flexibly to repay this debt. However, they should only consider doing this if they do not have any alternative means of repaying the debt such as sufficient cash in savings accounts or other income. If the debts are manageable and could be cleared in a relatively short timescale then the consumer could consider refinancing them by using a special offer such as a 0% balance transfer deal and clearing them over the life of the deal. If consumers do need to access their pension to clear unsecured debts then they should do it in the most tax efficient way possible, utilising their tax-free personal allowance wherever possible and ensuring that they never pay tax at a marginal rate of 40%.

Table 7: Average interest rates on unsecured debt

Type of debt	Average Interest Rate
Credit Card	17.47%
Overdraft	19.67%
Personal Loan (£5,000)	8.57%
Personal Loan (£10,000)	5.00%

Mortgage debt

Whilst fewer consumers will have mortgage debt at retirement, the absolute size of these debts is likely to be much greater. Many of those with a need to repay a mortgage post retirement will have an interest-only mortgage. FCA modelling predicts that just under half of interest-only mortgage holders whose loans mature before 2020 will have a shortfall between their mortgage and their expected repayment vehicle. In the near-term there is a peak of mortgages maturing in 2017/18 – many of which will be those who were sold an endowment mortgage in the early 1990s. Some of these shortfalls could be significant – the FCA estimates that a third of those with a shortfall whose loan matures in 2020 will have a shortfall greater than £50,000.^{xxii}

Whether a consumer would be better off using their DC pension pot to repay their mortgage will depend on their financial circumstances and attitude to risk. If they are paying a high interest rate on their mortgage which could exceed the return they could gain on their pension and they are risk averse then they using the DC pension to repay the mortgage would be more suitable. On the other hand, the consumer could have a long-term deal on their mortgage rate and be paying interest at close to the Bank of England base rate and have a high attitude to risk. In these circumstances the return from investing the DC pension could exceed the return from repaying the mortgage. Consumers should also consider whether they have any expenses in the future which can only be met by taking on additional debt. For example if a consumer knows that they are going to need to spend money on essential house maintenance that they would only be able to get by taking on expensive credit card debt then it may make more sense not to use the DC pension or their other financial assets to repay the mortgage.

Table 8: Consumer characteristics which make using their DC pension for repaying the mortgage more or less suitable

Using DC pension for mortgage repayment more suitable	Using DC pension for mortgage repayment less suitable.
Higher interest rate on mortgage	Lower interest rate on mortgage
Can repay debt penalty free	Early Repayment Charge applies
Will remain in house during retirement	Considering downsizing in the near future
No need to take on additional debt	Knows that will have an expense in the future which they will only be able to meet by taking on additional debt
Has emergency fund	Has no other way of meeting an unexpected expense other than borrowing
Low attitude to investment risk and capacity for loss	High attitude to investment risk and capacity for loss
Can clear mortgage using tax-free lump sum	Will incur high marginal tax rate

If a consumer (or their adviser) decides that they would be better off repaying their mortgage debt, then the duration over which they should do so has important consequences for the amount of tax they will pay to access the pension. Consumer type 4 - 'Debt' - has an outstanding interest-only mortgage of £60,000, a DC pension pot of £45,000 and cash of £30,000. If they were to withdraw all of their DC pension immediately post-retirement to repay their mortgage then they would pay tax at the higher rate and would only have £6,000 of their cash savings remaining. Spreading the withdrawals over 2 tax years and reducing their tax bill would mean that even after paying for the additional mortgage interest they would have an extra £2,000 of savings.

However, they would gain an even better outcome by using their entire cash savings of £30,000 to repay part of the mortgage and using the tax-free lump sum from their DC pot and then gradually repaying it by keeping withdrawals within their annual allowance. This would clear the mortgage after 7 years and they would still have around £16,500 in their DC pension pot. Even accounting for extra mortgage interest payments they would be over £5,000 better off.

Using holdings of other financial assets to generate retirement income

Holdings of other non-pension financial assets can be used to generate additional retirement income. The same factors which have led to falling annuity rates have also reduced the returns available from other income producing assets. In particular the rate of return on safer assets such as cash and government bonds has fallen to the lowest levels in a generation – meaning that if consumers want to generate significant amounts of extra income then they will need to take extra risk.

Consumers' holdings of financial assets could also influence how they use their small DC pension fund. If they have sufficient holdings of other financial assets to fall back on then they may be able to take greater risk with their DC pension.

In this paper it is not possible to review the pros and cons of each asset type as regards their use to generate an income. They clearly involve a range of risks, from cash which offers security of capital,

but minimal returns through to high risk stockmarket investments which can be volatile and place capital at risk but might generate higher long-term returns.

Some of these assets would also not be available within a DC pension – or if they are might be in a different form if held within a DC pension. This is relevant because a consumer who accesses all of their pension fund or takes a tax-free lump sum which exceeds their need for immediate income will need to decide where to save or invest it. Once the capital has been withdrawn from the pension, consumers will also need to decide whether they are going to erode the capital over time to fund their spending or whether they are going to only spend the income produced by the savings or investments.

Cash - Taking the fund as cash

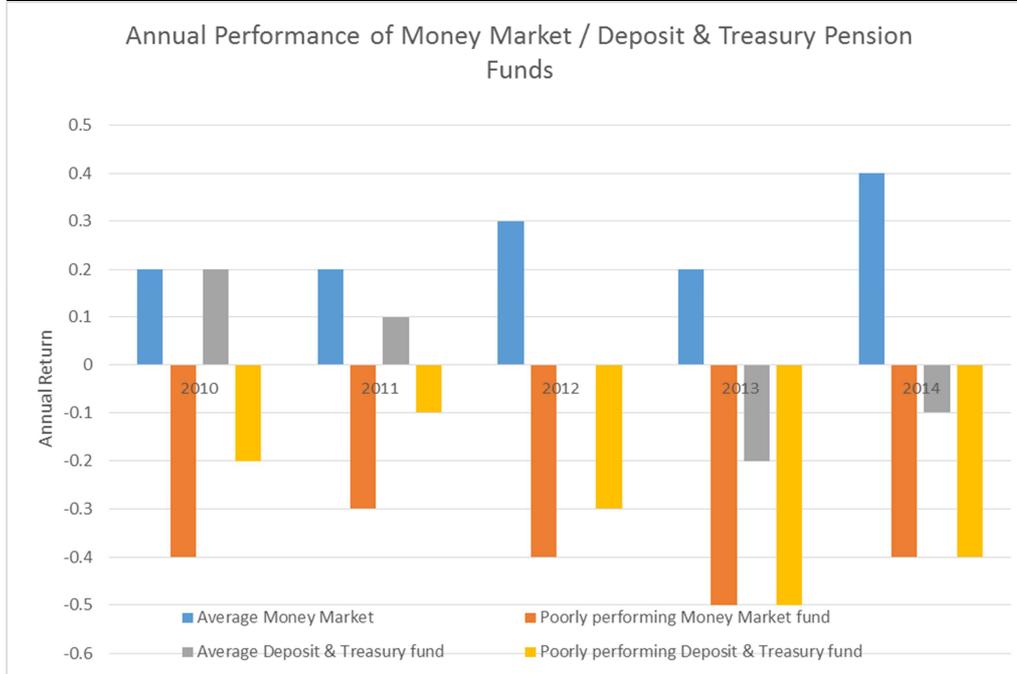
The returns available on cash are the lowest for a generation. In January 2008 the average Cash ISA interest rate was over 5%, now it is just over 1%.^{xxiii} These falls have been driven by the record low Bank of England base rate and the Government's Funding for Lending scheme, which has reduced the need for banks to attract cash deposits. There has also been criticism of the way the cash savings market operates, with banks offering excessively complex ranges of savings accounts. Consumers who don't switch account regularly can find themselves in superseded 'zombie' accounts paying low rates of interest. In January 2015, the Government (through National Savings & Investments) will be launching a new range of fixed rate savings accounts, dubbed 'Pensioner Bonds', which will be exclusively available to those aged over 65. Interest rates on these products have not yet been announced, but they have been promised to be "market leading". The maximum investment held by an individual will be £10,000 in each issue for each term. They cannot be held within a pension.

Holding their assets in cash funds within the pension or in a cash deposit account or ISA would lead to security of capital/income but would not maintain the real, inflation-adjusted, value of the consumer's savings.

Taking a withdrawal from a pension and placing it in cash could also mean potentially taking two tax hits, one on the initial withdrawal from the pension and a further tax deduction on the income from the savings account. The Tax impact can be partially mitigated by savings through an ISA. With the higher allowance now in effect it would take those with a £45,000 pension pot a maximum of 3 years to move the money into an ISA.

However, one factor in favour of making a withdrawal from the pension is that interest rates could be higher outside the pension. The average pension fund in the 'Deposit and Treasury Sector' has returned zero over the last 5 years and the average pension fund in the 'Money Market' sector has returned 1.4% over 5 years or less than 0.3% a year. The performance of some cash funds, combined with high levels of charges would actually see the fund eroded over time. A Money market fund held in a stakeholder pension has actually declined by 2% over the previous five years.^{xxiv}

Chart 5: Money Market and Deposit & Treasury pension fund annual performance



Peer-2-Peer lending

Peer-2-Peer lending (P2P) is a relatively new form of investing. It involves using a P2P platform to lend directly to other consumers and businesses. It is possible that some consumers could be tempted by the high headline rates on offer to withdraw some of the money from their pension and use it for P2P lending. However, P2P lending is not covered by the Financial Services Compensation Scheme and so consumers could lose their capital if the borrower defaults. Some P2P sites have established 'provision funds' to cover the cost of defaults, but there is no regulation concerning the size these funds. P2P lending is currently not available within a pension, although it will become available within an ISA.

Bonds and Bond funds / Stock market linked funds

Funds invested in bonds and shares will offer varying levels of risk and return for the consumer, depending on the assets within the fund. These funds will be available both within the pension and within an ISA. Taking a tax-free lump sum from a pension and using it to invest in funds (preferably held within an ISA) might make financial sense for some consumers – depending on their financial circumstances and attitude to risk. Taking a taxed withdrawal from a pension to invest in similar funds outside a pension will not make financial sense for most with DC small pots. It would immediately reduce the capital available for investment by 20% or 40%, depending on the amount taken out and the tax rate applied. If the funds are held outside an ISA then the income produced from them would be taxable. Leaving the money invested the funds inside the pension will also result in them passing tax-free to the consumer's spouse or partner should the consumer die before the age of 75.

Structured products

Structured products are a type of investment which offer a return linked to the performance of an underlying investment such as a stock-market index. The formula used to calculate the return can be complex and difficult to understand. Whilst high headline rates may be on marketing material, the

average performance could be substantially worse. Capital is at risk and consumers with structured products may lose money if the underlying investment performs poorly. If the bank or other financial institution backing the structured product collapses – as happened with Lehman Brothers in 2008 – consumers can suffer significant losses.

Property

Funds which invest in commercial and residential property are available within pensions, inside and outside ISAs. Direct investment in residential property is not allowed within a pension. Although some SIPP's can hold direct investments in commercial property, these will not be appropriate for those with small DC pension pots. Some consumers might be tempted to make withdrawals from their pension and use it to invest in a Buy-to-Let (BTL) property. Given the amount in a small DC pension pot, using it for a BTL property would also require the consumer to borrow through a BTL mortgage. Investing in a sole asset or asset class in this way to fund retirement income is an extremely risky investment strategy. This could particularly be the case if consumers are borrowing to invest in an overvalued asset class at a time when interest rates could potentially rise.

Alternative investments

Perhaps the biggest risk in this area is for consumers to be tempted to place money into risky alternative investments on the promise that they are safe and will offer higher levels of income. In some cases these could be outright scams, with consumers losing all of their money to fraud. As the FCA website notes "Investment scams can look and sound believable, with smooth-talking salespeople, slick websites or sophisticated brochures and prospectuses. This can make it hard to tell them apart from genuine investment opportunities". The FCA has issues warnings about share fraud and boiler room schemes, land-banking, overseas property and crop investment schemes, carbon credit trading, rare-earth metals and graphene.^{xxv} There is always a risk that consumers typing their details into marketing websites could have their details sold on to scammers. Trading standards officers and some police forces have been working with banks to help their staff can be alert if someone who is elderly comes in to withdraw a large amount of money in suspicious circumstances. This is part of drives to prevent older people falling victim to scams and rogue traders. It is unlikely that pension companies have similar training schemes in place.

Conclusions

Financial assets can be a useful supplement to the retirement income available from a DC pension pot. Depending on the asset, these will provide differing levels of income. Some will offer security, but low levels of income and others the potential for growth but place the consumer's capital at risk. Levels of non-pension financial assets can be taken into account by consumers and their advisers in how they manage their DC pension. The system of Pensions Guidance introduced by the Pensions Schemes Bill is classified as guidance given for the purpose of helping a member of a pension scheme make decisions about what to do with the pension benefits provided to the member. It will not automatically include guidance helping them maximise income and make decisions about their non-pension financial assets. Guidance could encourage consumers with small DC pension pots to:

Be wary of taxation: Consumers withdrawing money from their pension to hold in cash or invest in other financial assets should be wary of the impact of taxation and try to limit the tax paid on withdrawals from their pension.

Maximise the use of ISA allowances: Financial assets and investments held outside a pension should be held in ISAs wherever possible to minimise the payment of tax on the income they generate.

Holding money in a cash fund within a pension could give poor returns: Given how existing pension products are structured, excessive charges and poor interest rates could lead to some consumers invested in cash funds within pensions losing money.

Shop around for the best deal in savings accounts: Consumers who move their pension savings or their tax-free lump sum into cash savings account should shop around and switch regularly to obtain the best deal.

Avoid scams: Consumers should be wary of being targeted by scammers and fraudsters promoting alternative investments. The pensions industry may be able to do more to prevent those withdrawing money from DC pensions being subject to scams.

3C: Retirement income products

There are three main types of retirement income products which consumers with small pension pots could access from within their pension. These are:

Conventional annuities: An annuity provides a secure income for the rest of the consumer's life in return for the accumulated pension fund.

Income Drawdown: This involves leaving the pension fund invested and taking income by making regular or ad-hoc withdrawals.

Hybrid products: These include investment-linked, fixed-term and variable annuities. These are effectively packages of investment products, combined with some guarantees of the amount of income they will deliver or how much of a consumer's fund they will return after a set number of years.

Annuities have dominated the retirement income products market for many years – accounting for 94% of the retirement income products sold in 2012, with the remaining 6% of consumers opting for income drawdown. The overwhelming number of annuities sold were standard or conventional rather than the hybrid or investment linked products.

The products sold were the result of three main influences on the market:

- 1) To access their pension many consumers had to buy a retirement income product as the limits which applied at the time did not enable many to take their fund in a cash lump-sum.
- 2) Annuities were the default retirement income product offered to consumers, with most pension schemes and insurance companies funnelling consumers towards these products.
- 3) Income drawdown was seen as risky and potentially unsuitable for those consumers with small pension pots. The FSA was clear that it was normally unsuitable for those with pension funds of less than £100,000.

The introduction of additional flexibilities will inevitably see a decline in the sales of conventional annuities. Sales are already down by 56% in Q3 of 2014^{xxvi}, with some predicting that they could fall up to 75%. However, even with these declines between 100,000-160,000 annuities will be sold each year. Questions remain about what types of products will replace conventional annuities and whether they will be suitable for those with small to average sized pension pots.

A report from Which? and the Pensions Institute^{xxvii} believed that income drawdown will become the norm rather than the exception. However the research found that none of the alternative products to conventional annuities (including income drawdown and hybrid products) are currently suitable for the mass market due to the costs and investment risks. The report concluded that a suitable retirement income product that can be integrated into an auto-enrolment pension for the mass market would meet the following characteristics:

- a. Benefits from institutional design, governance, and pricing
- b. Delivers a reasonably reliable income stream (i.e., with minimal fluctuations)
- c. Maintains the purchasing power of the fund
- d. Offers the flexibility to purchase the Lifetime annuity at any time (or at regular predetermined intervals to hedge interest rate and mortality risk)
- e. Is simple to understand, transparent and low-cost
- f. Requires minimal consumer engagement, e.g., by offering a high-quality default option
- g. Benefits from a low-cost delivery system.

Which type of product is suitable for which consumers will depend on their financial circumstances, attitudes to risk, total size of their DC pension pot and their number of dependents.

- Annuities will be more suitable for those consumers who want to have a secure income for the rest of their life, are not willing to take investment risk and have no dependents.
- Income drawdown will be more suitable for consumers who have other sources of secure income they can rely on, are willing to take investment risk and the risk of running out of money in return for the possibility of higher income. It will also be more suitable for those who want to leave an inheritance or bequest.

Income drawdown will need to be transformed from an expensive and potentially risky product so that it meets the criteria set out above. At the moment, its significant cost could mean that consumers fail to benefit from higher long-term growth due to excessive charges. Many consumers will also find it very difficult to take decisions about where to invest their pension and how much to withdraw without independent financial advice, which might be too expensive or difficult for them to access. Even with reform, income drawdown products will still expose consumers to investment and longevity risks. Poor performance of the investments will mean that some consumers will face having to cut their income or running out of money altogether.

The differing risks from annuities compared with income drawdown and hybrid products and the flexibilities available are shown in the table below:

Table 9: Risks and flexibility of different retirement income products^{xxviii}

Method	Risks exposed to	Risks protected against	Flexibility
Annuities	Risk of missing out on investment growth though some annuities are investment linked Time-of-purchase risk	Longevity risk Investment risk (of capital loss) Risk of forgoing consumption	Level of withdrawal: low flexibility – there will be a range of options at time of annuity purchase Growth: No ability to benefit from

	<p>Irrevocable decision risk</p> <p>Inflation risk – unless annuity is index linked</p>		<p>potential growth</p> <p>Bequest: low flexibility - guaranteed annuities provide some by paying out for up to 15 years from the date of purchase. Joint life annuities can provide income to a dependent which will now be tax-free if the consumer dies before the age of 75</p>
Income Drawdown	<p>Longevity risk</p> <p>Investment risk (of capital loss) leading to Income risk (the need to reduce the annual income taken from the plan)</p> <p>Risk of forgoing consumption</p> <p>Cost risk: That costs of running the drawdown plan or the investments are higher than anticipated</p> <p>Annuity rate risk: the risk that when it comes time to secure an income annuity rates have declined</p>	<p>Partial protection from the following risks:</p> <p>Risk of missing out on investment growth</p> <p>Time-of-purchase risk</p> <p>Irrevocable decision risk</p> <p>Inflation risk</p>	<p>Level of withdrawal: high flexibility up to maximum withdrawal cap</p> <p>Growth: high flexibility - to potentially grow fund but will depend on asset allocation</p> <p>Bequest: high flexibility – if consumers have money remaining in their drawdown pension and they die before age 75 then it is passed on tax-free. If they die after age 75 then there will be a tax charge</p>
Hybrid products	<p>Investment risk (within the limits set by the product)</p> <p>Some products could involve:</p> <p>Counterparty risk: that those providing the guarantees can't meet their obligations</p> <p>Annuity rate risk: the risk that when it comes time to</p>	<p>Partial protection from the following risks (depending on the product):</p> <p>Longevity risk</p> <p>Risk of missing out on some investment growth (although consumers will always have given up some investment growth in return for guarantees)</p>	<p>Level of withdrawal: The rate at which the income can vary by depending the performance of the investments can be determined by the consumer</p> <p>Growth: Medium flexibility to benefit from investment growth over time – depending on the</p>

	<p>secure an income annuity rates have declined</p> <p>Interest-rate risk: the risk that when the product matures and requires re-investment, interest rates and hence the income which can be generated from the product have declined</p>	<p>Inflation risk</p>	<p>product</p> <p>Bequest: Low to medium flexibility – but some products will offer the return of a proportion of a consumer’s fund if they live for a set time period</p>
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Income drawdown

Under Income Drawdown, the consumer leaves their pension fund invested and over time can withdraw up to 25% of it tax-free, with withdrawals in excess of this amount being taxed at the marginal income tax rate. Until the introduction of the new flexibilities there was a cap which applied to the amount consumers could withdraw from their pension each year through income drawdown unless the consumer could demonstrate that they had a secure source of retirement income exceeding £20,000 a year. With the introduction of the new flexibilities consumers will be able to withdraw as much or as little as they like of their pension fund each year.

Most income drawdown plans are sold with regulated financial advice and some pension companies will insist that the consumer takes advice before offering them income drawdown. In 2007, the FSA was generally of the view that income drawdown was unsuitable for those clients with funds of less than £100,000^{xxix} – although they accepted that there may be circumstances where this may not be the case. Insurance companies also apply limits to the size of funds they would accept for income drawdown – and in some cases these have now been reduced to £30,000 and are likely to be reduced further when the full Budget flexibilities are introduced. Schemes do not have to and will not have to offer income drawdown and if consumers in these schemes want access to it then they will have to switch to a different scheme.

Charges

Consumers using income drawdown will incur initial and ongoing charges. The level of charges for income drawdown is currently outside of the scope of the Government’s charge cap for qualifying automatic enrolment pension schemes.

There are five main types of charges which consumers could pay:

Administration charges specific to drawdown: These could include (a) Set-up fees for entering income drawdown (b) Annual fees for being in income drawdown (c) Charges for altering the level of drawdown payments (d) Charges for altering the frequency of payments or making one-off withdrawals (e) Charges for depleting the fund or reducing it below a certain size.

Investment charges: The costs and charges paid in return for managing the funds and investments. These include (a) Direct Fund Management costs and charges paid to the fund manager, which could

include initial charges, annual charges and performance fees (b) Legal and audit fees which would be included in the Total Expense Ratio (c) costs incurred by any stock lending undertaken by the fund (d) commission payments made to the financial adviser who sold the consumer the investment (these have been banned for new business from 1st January 2013, but existing legacy arrangements can continue).

Platform charges: The costs of holding the pension funds and investments through a platform such as a SIPP. These could include (a) Initial/set up fees (b) Annual fees which could be charged as a fixed fee, a percentage of the investment held on the platform or both (c) Administration charges for transferring in/out or on death (d) Net interest margin on cash held in the bank account on the platform.

Transaction costs within and between funds: These include (a) The costs incurred both by the investor when switching between different pension funds (b) The transaction costs incurred within individual funds as a result of the fund manager buying and selling the assets.

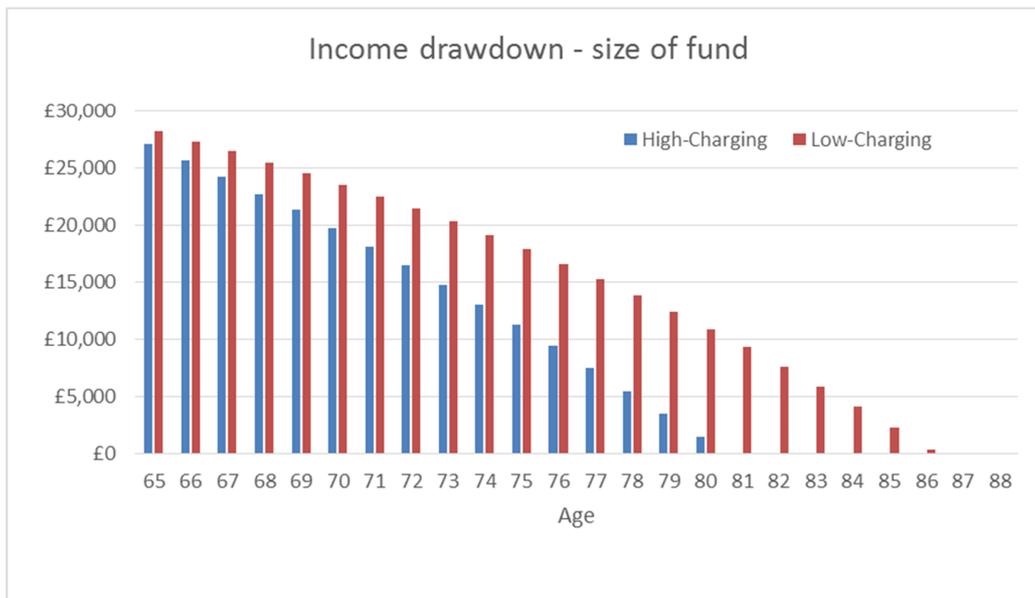
Advice costs: If the consumer receives advice about whether to enter income drawdown, how their investments should be managed and how much they should withdraw each year then they would need to pay initial and/or ongoing charges to a financial adviser.

A low-cost portfolio might have ongoing investment and platform charges of around 1% a year. A more expensive portfolio might cost between 1.5% and 2% a year. Additional administration charges could be levied by the platform or pension provider for entering income drawdown and for taking withdrawals. Research from the found significant variability in one-off event charges, such as set up fees which range from zero to £240, additional crystallisation charges that could go up to £100, and withdrawal charges that could be as high as £60.^{xxx} However, several providers have recently announced the removal of set-up fees. Advice costs might be in the region of 2% initial adviser charge and a 0.5% ongoing annual adviser charge for regular reviews. However, some advisers may have specified minimum charges for advice on income drawdown and advice may be difficult for those with small DC pots to access unless they are willing to pay these charges.

The implication of these different charging structures are that it will be difficult for consumers to understand and compare the total cost of income drawdown. Shopping around for income drawdown is likely to be even more difficult and complex than shopping around for an annuity. Inertia and complexity could mean that those consumers are at risk of paying higher charges.

The long-term impact of costs and charges for income drawdown for those with small pots could be significant and result in consumers having to take less income out of their pension or running out of money quicker. The chart below shows that a high-charging income drawdown plan could see consumer type 1 with a DC pot of £29,000 withdrawing £2,000 a year run out of money almost six years earlier and receive £11,000 less in income payments than one with a total cost of 0.75% a year.

Chart 6: Income drawdown – comparison between high-charging and low-charging fund



Notes: High-charging scheme has charges of 2% initial, and 2% + £150 annual charges. Low-charging scheme has an annual charge of 0.75%

Investment strategy / Asset allocation

Consumers entering income drawdown will also have to choose an investment strategy. At present most drawdown policies are sold with regulated financial advice and so the adviser is likely to make a personal recommendation regarding the investment strategy. Those consumers who do not take advice will either have to choose a new investment strategy themselves or remain in the strategy they chose when they last made a decision or the default investment strategy offered by their pension scheme.

Some pension schemes will have a default strategy which includes ‘lifestyling’ which means that as the consumer approaches retirement their investments are gradually moved into safer assets. The default investment strategy for many pension schemes is currently designed for those buying an annuity at retirement. This could mean that at retirement age the consumer’s pension fund is invested in 75% bonds and 25% cash. However, in a survey of default funds used in stakeholder pension schemes some used 100% bonds and some used 100% cash as the asset allocation at retirement.^{xxxi}

Stakeholder pensions are required to use a lifestyling strategy but in other types of pension scheme there may be no such approach in place. Lifestyling as a concept was only introduced around 10 years ago so it is less likely to apply in older schemes. This means that the investment strategy at retirement might no longer be suitable as it could either be the one selected by the consumer when they joined the scheme or the one set by the scheme provider when it was established.

The investment strategy of the scheme after retirement has significant implications for the amount of risk the individuals pension will be subject to, the level of income they can withdraw and how likely they are to run out of money. Broadly, a low-risk investment strategy will reduce the level of income that can be taken from the scheme, but reduce the risk of having to make cuts to the level of income and the

probability of the consumer running out of money. A higher risk investment strategy, with exposure to riskier assets is more likely to provide growth over the longer-term, but with the trade-off of increased risk and volatility for the consumer's investment. A higher risk strategy could mean that consumers could face a greater prospect of having to reduce their income because of poor investment performance or running out of money.

Policymakers and the pensions industry should also recognise that the removal of the prompt to purchase an annuity could result in consumers simply leaving their funds invested. By removing the prompt for action that comes from being offered and having little choice about whether to purchase an annuity, more consumers may simply leave their fund where it is. This may be a conscious decision – they may not need to use the pension fund to supplement their income – or it may be the result of inertia. This means that funds will continue to accumulate, but if it is invested in low-return assets then it may not keep pace with inflation.

Level of withdrawal

Consumers entering income drawdown will need to take (with or without advice/guidance) complicated decisions about how much income to withdraw each year and how often the level should be reviewed. The general advice for those entering income drawdown is to only take the 'natural income' from their fund to avoid eroding their capital. But those with small pots are unlikely to be able to attain their desired level of income without eroding capital – the key question will be over what time period the capital should be eroded. If consumers withdraw too much of their money each year then they could run out of money. On the other hand if they restrict withdrawals because they are worried about running out of money they might under-consume in the first few years of their retirement and still be left with a significant funds on death.

The rate at which consumers want to drawdown their pension will also help determine the asset allocation. Consumers are known to under-estimate their life expectancy and over-estimate how much income their pension will deliver. A consumer with a spouse/partner would also have to take into account how long their partner might live when deciding how much to drawdown each year. Consumers who die before the age of 75 will be able to pass on their accumulated fund without paying tax. If they are above the Inheritance Tax threshold then it may be worth them using other assets first before starting to use their DC pension.

The tables below show the age when the small DC pension pots will run out under various scenarios, assuming they are claimed at age 65. They show how long the DC pension will last given a fixed withdrawal each year, or a withdrawal which starts at a certain level and increases with inflation – assumed to be 2.75% a year.

Table 10: Age when DC pension pot runs out (Consumer type 1: Multiple small pots – Total DC fund £29,000)

		Yearly income					
		£1,000 Fixed	£1,000 Index- Linked	£2,000 Fixed	£2,000 Index- Linked	£3,000 Fixed	£3,000 Index- Linked
Portfolio return (pre charges)	1%	92	85	78	77	74	73
	3%	>100	90	81	78	75	74
	5%	>100	97	84	80	76	75

	7%	>100	>100	92	83	78	76
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Table 11: Age when DC pension pot runs out (Consumer type 2: DC and DB – Total DC fund £15,000)

		Yearly income					
		£750 Fixed	£750 Index-Linked	£1,500 Fixed	£1,500 Index-Linked	£2,000 Fixed	£2,000 Index-Linked
Portfolio return (pre charges)	1%	84	80	74	73	72	71
	3%	88	83	75	74	72	72
	5%	98	86	77	75	73	72
	7%	>100	94	79	76	74	73

Table 12: Age when DC pension pot runs out (Consumer type 4: Debt – Total DC fund £45,000)

		Yearly income					
		£2,000 Fixed	£2,000 Index-Linked	£3,000 Fixed	£3,000 Index-Linked	£5,000 Fixed	£5,000 Index-Linked
Portfolio return (pre charges)	1%	86	82	79	77	73	72
	3%	92	85	81	78	74	73
	5%	>100	89	85	81	75	74
	7%	>100	100	94	84	77	75

Assumptions: Consumer retires at 65, enters income drawdown with their entire DC pension pot and withdraws either a fixed or inflation-linked amount from their pension each year. Investment growth occurs equally over the time period. Charges are 1.5% a year.

During the income drawdown phase protection from downside risks is important – particularly in the first few years after retirement. Poor performance in the early years can lead to a far earlier erosion of a consumer's pension pot. As research by NEST has demonstrated "Strong returns in the early years can provide a significant buffer against poor performance in later years. Conversely, poor performance in early years is very difficult to make up when the capital is being depleted through drawdown".^{xxxii} A consumer who entered income drawdown in 1999 aged 65 and took the amount of a standard annuity, would be due to run out of money next year, aged just 81 – 5 years below average longevity for males and 7 years for females.^{xxxiii}

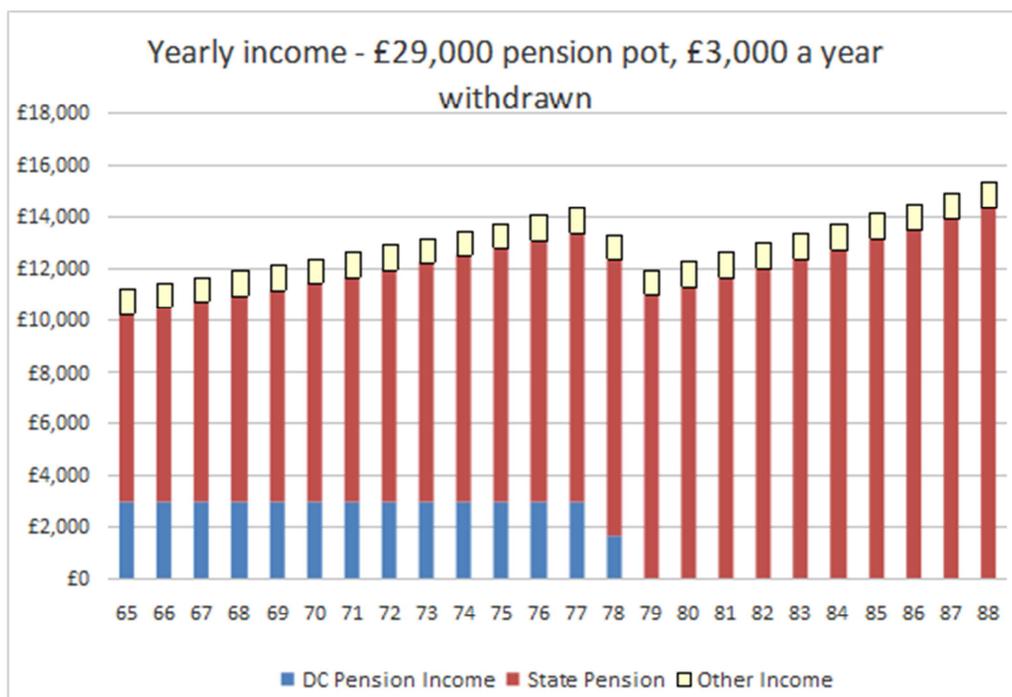
The total income received by the different types of consumer and the impact on their total income when they run out of money in their DC pension

Whether consumers (and their partners) can afford to take the risk of running out of money will partly depend on what other forms of secure income they can access. The Charts below show the impact on the 3 example individuals of running out of money at around the same age. These assume a fixed annual withdrawal from the DC pension. The different colour bars represent the income from different sources, with the blue bars representing the income taken out of the DC pension pot.

All 3 will experience a drop in income the year after they run out of money. However, for the consumer type 2 with a DB pension the drop will be relatively modest. The multiple small pots consumer experiences a larger drop in annual income, from over £14,000 to under £12,000, but may be able to

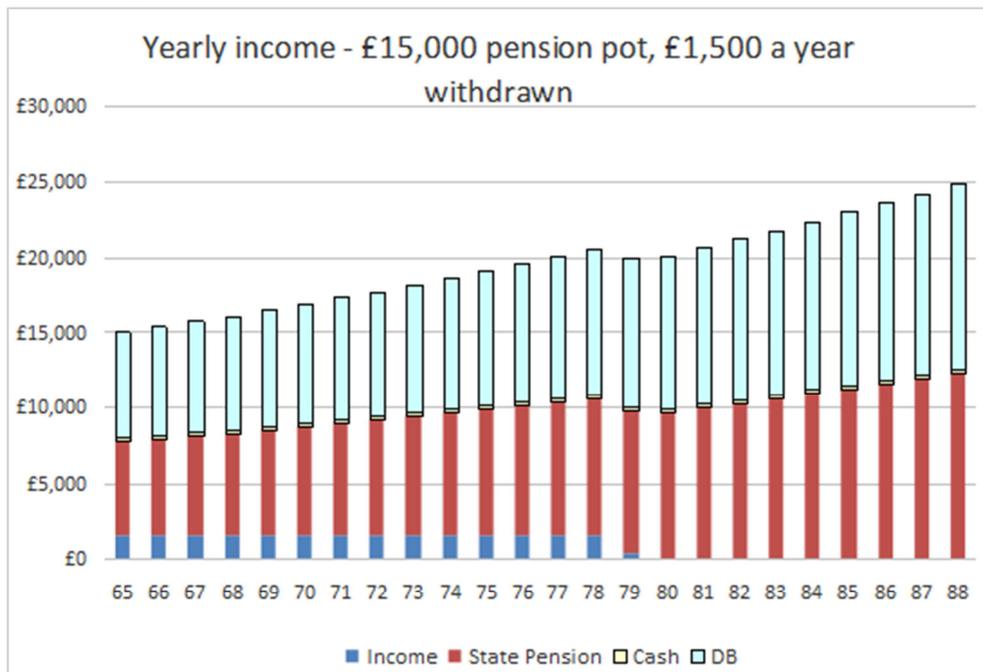
better manage this due to their other financial assets which they could use to supplement their income. At this point they could consider spending some of their other financial assets to cushion the drop in income. The drop will be largest for the consumer who entered retirement with debt and had to use all of their financial assets to repay debt – consumer type 4. They would experience a drop in annual income from £13,600 to £9,000. From the age of 78 they would be entirely reliant on the State Pension for their retirement income. If that consumer is going to decide to drawdown at that rate then they should consider whether they can cope with the potential drop in income.

Chart 7: Yearly income for consumer type 1 – Multiple small pots – withdrawing £3,000 a year from their DC pension



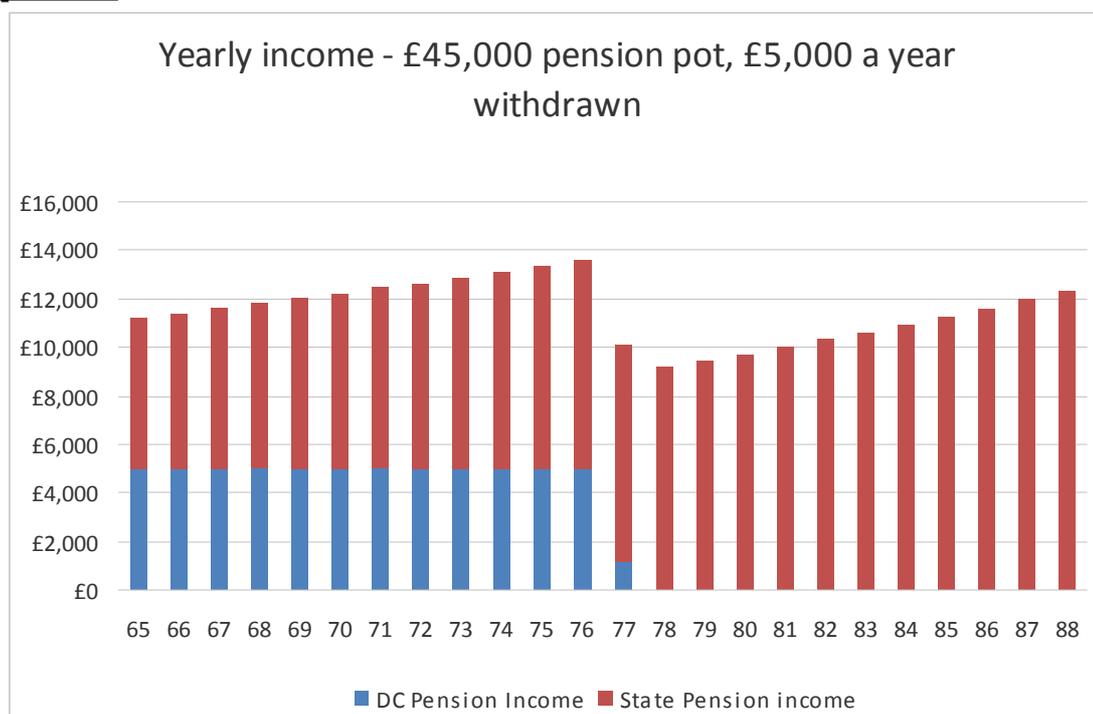
Assumptions: Consumer retires at 65, enters income drawdown with their entire DC pension pot and withdraws a fixed amount each year. Yearly investment growth within the pension of 7% and charges of 1.5% a year. Fixed annual withdrawals from the pension of £3,000 a year. Other income is taken from Cash and an Investment ISA.

Chart 8: Yearly income for consumer type 2 - DB and DC - withdrawing £1,500 a year from their DC pension



Assumptions: Consumer retires at 65, enters income drawdown with their entire DC pension pot and withdraws a fixed amount each year. Yearly investment growth within the pension of 7% and charges of 1.5% a year. Fixed annual withdrawals from the pension of £1,500 a year. Income from DB pension scheme is index-linked and increases at 2.75% a year.

Chart 9: Yearly income for consumer type 4 - Debt - withdrawing £5,000 a year from their DC pension



Assumptions: Consumer retires at 65, enters income drawdown with their entire DC pension pot and withdraws a fixed amount each year. Yearly investment growth within the pension of 7% and charges of 1.5% a year. Fixed annual withdrawals from the pension of £5,000 a year.

Lifetime annuities

When purchasing a lifetime annuity the consumer pays their accumulated pension fund to an insurance company and in return receives an income for the remainder of their life. The insurance company invests the money it receives and pools the risk across a large number of consumers, using the money from those who die earlier than average to pay the income for those living longer than average. The main advantages of annuities are that they offer those with small pots a secure lifetime income for themselves and their partner. This means that they are protected against losing their capital and running out of money whilst they are still alive. Once bought, conventional lifetime annuities cannot be unwound and so those purchasing them are exposed to annuity rates (and inflation expectations) at the time of purchase.

There are also questions which have been raised about the age at which it is appropriate for consumers to insure against the risk of living longer by purchasing an annuity. The report from Which? and the Pensions Institute suggested that it might be sensible for consumers to defer purchasing an annuity until a later age – especially for those in good health.^{xxxiv} Buying an annuity later might allow consumers to get a higher-rate if they had a deterioration in health or needed to enter long-term care. However, if the returns on their pension fund whilst it was in drawdown were disappointing then they may not have enough left to buy an annuity which would give them the secure income they need.

Despite the new flexibilities, annuities are likely to remain a significant part of the retirement income market. Consumers considering buying an annuity with their DC pension plan will need to make the following decisions:

- How seriously would I, my partner or my family be affected if I depleted my DC pension and had to rely on other sources of income?
- Should I buy an annuity now, or wait a few years and buy one later?
- Do I want a secure income that ends when I die or do I also need to provide an income for my partner?
- Do I want an income that remains level or starts lower and keeps pace with inflation?
- Do I have any medical conditions which mean that I could get a higher annuity rate or which might make buying an annuity inappropriate?

Those with small pots who buy an annuity from their existing pension company rather than shopping around are at risk of receiving poor value for money. This is particularly the case due to far lower annuity rates and a general lack of competition for annuities of smaller sizes. However, even for average sized annuities the differences between the best and worst rate can be significant. Instead of actively competing for business in the open market some insurance companies are able to make greater profits by offering poor rates to their internal customers.

In 2012, 60% of consumers bought an annuity from their existing pension company. The FCA estimated that four in five of these consumers could have got a better deal from shopping around and switching, with the average potential benefit being 6.7% extra income.^{xxxv} In surveys of annuity rates published by the ABI and the FCA some consumers could improve their income by up to 15%-20%. These poor rates can result in significant losses to consumers with small pension pots. Taking an annuity rate 20% off the market best is doing the equivalent of taking the last 11 years of a consumer's pension contributions out into the street and burning them.

Using the latest data from the ABI's example rates^{xxxvi}, the consumer type 1 with multiple small pots who buys an annuity worth £21,750 would gain an annual income of £1,367 from the best provider offering rates on the open market. If they were with the worst provider then they would receive an income of £1,117 – over 18% less.

Enhanced annuities

If a consumer has a medical condition or lifestyle health risk then they could be eligible for an 'enhanced annuity'. These enhanced annuities can boost the income a consumer receives each year, with the more serious the condition the greater the increase. Insurance companies are not required to offer enhanced annuities to their pension scheme customers.

Those consumers who exercise the Open Market Option and switch providers are far more likely to get an enhanced rate. 50% of consumers who switched exercised the OMO received an enhanced rate, compared to 5% who bought an annuity internally from their existing pension provider.^{xxxvii} Those who qualify for an enhanced rate could be losing significant amounts of money if they are sold a standard annuity.

Consumer type 5, 'Health condition' has a serious problem with their health. This means that they would qualify for an enhanced annuity paying £2,500 a year. If they had purchased a standard annuity then they would have received an income of around £1,800 a year. It will be important for all consumers buying annuities to be asked clear questions about their medical conditions and lifestyle factors and for all those who are eligible to be offered enhanced annuities.

Single life / Joint life annuities

Consumers will also need to decide whether they want their annuity to also provide a secure income for their partner. They could do this by either purchasing a 'Guarantee' on their annuity that it will continue for a set number of years regardless of whether they survive, or they could purchase a joint-life annuity. These options will reduce the annual income they receive. If the consumer type 1 wanted to buy an annuity with their entire £29,000 DC pension fund then they would receive an income of approximately £1,700 a year from a single life annuity, but a reduction to £1,526 for a joint-life annuity which paid their surviving partner 50% of this amount.

Hybrid products

There are a variety of 'hybrid' products available in the market, which typically combine some protection against longevity risk with exposure to investment risk. This research does not examine these products in detail. However, three options include:

- 1) **Fixed-term annuities:** These products pay an income for a set number of years. If the consumer is still alive when the term ends then the consumer will receive a "guaranteed" value at maturity. Variants of these types of products include guarantees or income or death benefits. These products will involve trade-offs between the amount of income which can be taken and the maturity value. The higher the income the lower the maturity value. A Key risk of this type of shorter-term product is that after maturity annuity or interest rates have changed and the amount of income which can be produced from re-investing the maturity value is less than expected.
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- 2) **Investment backed annuities:** These products pay an income for the rest of the consumer's life. But unlike a conventional annuity the amount of income can go up or down depending on investment performance.
- 3) **Deferred annuities:** These products pay an income from a set age. They could be useful as part of a consumer's portfolio. For example, a consumer could place some of their fund into income drawdown and buy a deferred annuity starting in 10 or 15 years time in case they run out of money or outlive their investments. The downside is that if the consumer dies before reaching the age of deferred annuity then they won't receive any benefit.

All three of these product types are complex and involve risks, costs and guarantees that could be difficult for consumers to compare or understand.

Section 4: Recommendations

The reforms introduce greater flexibility, but also add to the complexity faced by consumers making decisions about retirement income. They also transform what was often a ‘one-off’ and irreversible decision into one which needs to be monitored and reviewed every year.

Pensions Dashboard: This research demonstrates that it will be harder for individuals to take decisions unless they can access details of all of their pension entitlements in one place. In Sweden there is a website jointly owned by the industry and the Government which consumers can use to see details of all of their pensions. To promote this in the UK, the Government or the FCA could use their powers to require pension schemes to make machine-readable data available to their members. This would enable a tool to be developed – called a Pensions Dashboard – which would allow a consumer to see all the information about their private DB and DC pension schemes alongside their State Pension entitlement. This dashboard could also be used to help engage and prepare consumers for decisions about their retirement income.

Pensions Jam-Jars: There has been some discussion of whether accessing a pension will become like using a bank account. Most bank accounts help people spend their money but don’t help them manage their finances. Instead the pensions industry should embrace principles and tools which have been developed around new forms of bank account to help people budget, control their spending and set aside money for future goals. It will also help them manage the inevitable trade-offs and conflicts which exist when taking a retirement income. These tools could help consumers decide how much money to take out of their pension each year. Once consumers have made a plan, specific alerts can be used if consumers are departing from it or at risk of running out of money or triggering a higher tax charge.

Integrate decisions about small DC pots with decisions about State Pensions: Maximising State Pensions can help those with small DC pension pots achieve higher levels of secure lifetime income – in some cases far greater than that which can be achieved from a conventional annuity. It is essential that decisions about how to access small DC pension pots are aligned and integrated with decisions about how and when to access State Pensions and whether to use some or all of their DC pot to buy Additional State Pension. This will require these issues to be addressed as part of the Guidance Guarantee, in the information provided by pension schemes in ‘Wake-up’ packs and during discussions between consumers and their pension provider.

Introduce a ‘Second-line of defence’ requiring pension providers to ask specific questions at the time the pension is used to generate a retirement income: The service available through the Guidance Guarantee will be designed to help consumers understand their options and decide what to do with their small DC pension pot. There might be some time between consumers taking the Guidance and accessing their pension. To help consumers make the best decisions pension providers should be required to introduce a second line of defence, consisting of a further set of questions when consumers access their pensions. The questions would include issues around their medical circumstances, whether they had a partner, what they would live on if they exhausted their DC pension, how to avoid scams and the need to minimise taxation.

Strong governance requirements around retirement income processes: It is important that those responsible for specifying which retirement income processes within pension schemes have strong duties to act in the best interests of pension scheme members. This should include requirements to

ensure that all annuities, income drawdown and other retirement income products available through the scheme offer value for money.

Review default investment options in DC pension schemes: The new flexibilities mean that many previous default investment options will be inappropriate. With more people entering income drawdown, a higher exposure to growth assets may be justified immediately after retirement, with continued lifestyling post-retirement into less volatile asset classes.

Reasonable returns for those holding cash within their pension: Current cash funds can mean that consumers invested in them for several years can suffer significant erosion of the purchasing power of their pension. The industry and Government should do more to make better products available. One option might to make the new Pensioner Bonds available within pensions.

Charge cap for income drawdown pensions: Understanding and comparing the total charges for an income drawdown pension is very complicated. It will be very difficult for consumers to compare the cost of different schemes, shop around and switch to better value arrangements. Most drawdown schemes are currently sold with regulated advice, but this is guaranteed to change due to the new flexibilities. All of these factors mean that there will be significant inertia around the purchase of drawdown pensions. The extension of the charge cap to income drawdown will help prevent consumers from paying excessive charges.

Clearing house for annuity purchases and mandatory medical questions: Annuities will remain an important source of retirement income for many consumers. The new flexibilities will not change the strong incentives which some pension providers face to offer their internal customers poor rates. Those with small pots are particularly vulnerable to receiving a poor rate. An annuity clearing house could help maximise value and prevent consumers being defaulted into a poor product. Pension providers would need to check their own internal rates against those which were available through the clearing house. Pension providers and intermediaries should also be required to ask specific medical questions when selling an annuity and to provide enhanced annuities to those consumers eligible for higher rates due to medical or lifestyle issues.

Pensions industry to work with regulators, the Government and the police to prevent scams: Staff in pension providers need to be trained to spot consumers who may be vulnerable to investment scams and to provide specific warnings.

Lenders to clarify how they will treat small DC pension pots when attempting to collect debts: There should be clarity about how mortgage and other lenders should treat small DC pension pots when collecting debts or starting repossession procedures.

About the author

Dominic Lindley is an independent consultant specialising in financial services, consumer protection and conduct risk issues. He is a member of the European Banking Authority's Banking Stakeholder Group. Prior to becoming an independent consultant he was leader of the financial services policy team at Which? and an economist for the UK Parliament's Treasury Select Committee.

Notes:

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- ⁱ The Pensions Regulator, DC trust: a presentation of scheme return data 2013 – 2014,
- ⁱⁱ ABI, The UK Annuities Market – Facts and figures, February 2014
- ⁱⁱⁱ IFS Briefing Note BN127, Fund holdings in defined contribution pensions, March 2012
- ^{iv} ABI, Consumers in the Retirement Income Market, March 2012
- ^v Pensions Institute / Which?, The Future of Retirement Income, 2014
- ^{vi} The following list is a summary of behavioural factors taken from other research including NEST (Boardman & Blake), Spend More Today Safely: using behavioural economics to improve retirement expenditure decisions with SPEEDOMETER plans, 2014; NEST, The future of retirement, 2014; FCA, Pensions Annuities: A review of consumer behaviour, January 2014
- ^{vii} DWP, Deferring your State Pension, October 2014
- ^{viii} DWP, Press release, Older People’s Day: 1 million in work over 65, October 2014
- ^{ix} DWP, How to increase your State Pension if you reach State Pension age between 6 April 2010 and 5 April 2015
- ^x DWP, Class 3A Voluntary National Insurance, Policy Detail, December 2013
- ^{xi} HM Treasury, Autumn Statement 2014, Para 2.66
- ^{xii} “IFS analysis of Wealth and Assets Survey found that around a quarter of Defined Contribution pension holders have multiple pension pots and 20% of DC pension holders also have a DB pension. Survey-based social research from Standard life found that 43% of people said they had multiple pension pots.” Which?, Response to Government consultation on Freedom and Choice in Pensions, June 2014
- ^{xiii} Which? Money, Is your pension stuck in the mud, January 2013
- ^{xiv} Dr Paul Cox, Private pension wealth among 55-64 year olds in the UK, 2013
- ^{xv} FCA, TR 14/12 Enhanced transfer value pensions transfers, July 2014
- ^{xvi} HMRC, Pensions Flexibility: Draft guidance on clauses for the Taxation of Pensions Bill, Section 8.9
- ^{xvii} Ibid, Section 8.10
- ^{xviii} Which?, Response to Government consultation on Freedom and Choice in Pensions, June 2014
- ^{xix} Prudential, One in Six Planning to Retire this Year will have debts, January 2014
- ^{xx} Age UK / ILC, Problem debt among older people, 2013
- ^{xxi} Lovemoney, Are you too old to get a mortgage?, July 2014
- ^{xxii} FCA, The FCA publishes findings of review into interest-only mortgages and reaches agreement with lenders to contact interest-only borrowers, May 2013
- ^{xxiii} Which?, The Savings Trap, July 2014
- ^{xxiv} Performance figures taken from trustnet.com
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^{xxxv} FCA Website, 25th October 2014, <http://www.fca.org.uk/consumers/scams/investment-scams>

^{xxvi} ABI, Retirement Income Statistics, Q3 2014

^{xxvii} Pensions Institute / Which?, The Future of Retirement Income, 2014

^{xxviii} This table builds on one which was included in a report from the Pensions Policy Institute: Retirement income and assets: the implications of ending the effective requirement to annuitise by age 75, 2011

^{xxix} FSA, Finance in and at retirement – results of our review, December 2007

^{xxx} FT Adviser, Study exposes drawdown ‘hidden’ charges disparity, May 2014

^{xxxi} The Pensions Institute, Default funds in UK Defined Contribution Pension Plans, 2007

^{xxxii} NEST, The future of retirement, 2014

^{xxxiii} John Lawson, The feast and famine of drawdown, Moneymarketing, 18 November 2014

^{xxxiv} Pensions Institute / Which?, The Future of Retirement Income, 2014

^{xxxv} FCA, TR 14/2 Thematic review of annuities, February 2014

^{xxxvi} ABI, Annuity window example rates, July 2014, Healthy individual living in Manchester aged 65

^{xxxvii} FCA, TR 14/2 Thematic review of annuities, February 2014
