Deep Contemplations #3

Shouldn’t the outcome be income?

Matching what you’ve got with what you need in retirement

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Summary

As a saver, when you retire, you have many options for what to do with the Defined Contribution pension pot you and your employer have paid into. But these options shouldn’t distract you from the fact that you’ll need a regular income to cover the cost of living in retirement. Pension schemes, too, should remember this need when it comes to the investment choices they give their members.

A regular retirement income matters because:

- You face ongoing costs in retirement, just as you did while you were working. These costs could be must-haves, like housing, or nice-to-haves like holidays.
- Your regular wage may stop when you retire, but your regular costs don’t.
- The costs go up over time, so your income needs to go up to cover them.

Many savers have turned their backs on buying a guaranteed income for life, known as an annuity, at retirement. This followed the ‘freedom and choice’ changes to regulations, which let people take their whole pension pot as cash, in one go or more, when they retire. But this increases the risk their money won’t last through their life in retirement.

Even savers in Defined Benefit pension schemes have been tempted to switch to Defined Contribution. The Government has cut tax on the Defined Contribution savings retired people leave when they die. But this is little comfort to them if they get through their savings after switching, and then struggle to get by.

We believe a steady income, preferably linked to inflation, is still the best option for most savers. A one-off cash lump sum, while tempting, won't pay retirement's regular bills in the long-term. The lump sum might also lead to a higher tax bill. So, pension schemes should only offer cash to members as an option, not a 'default' for those who don't choose a target for their savings. That way, if a cash lump sum is more appropriate for some savers, they can pick that option. Even so, only 30% of larger Qualifying Workplace Pension Schemes, used for Automatic Enrolment, have made a retirement income the default choice for their members.

Jargon buster

Defined Benefit pension – you get a retirement benefit based on how long you've saved and what your salary has been over that time.

Defined Contribution pension – you and your employer pay agreed amounts in to your pension pot, which you or the pension scheme then invest. You get a retirement benefit based on how big the pot is and the cost of the option(s) you choose when you take the money.

Annuity – a guaranteed regular income for life, which you buy with your pension pot when you retire.

Drawdown – you keep your savings invested after you retire and take money out as and when you need to.

Retirement income – income from pension savings which you take when you're retired. It might be in the form of an annuity and/or drawdown.

Default – an investment fund where your pension scheme puts your pension savings if you don't choose one of the options they offer.

Introduction

You've started the journey, but where are you heading?
For a plan to succeed, you have to know what you want the result to be. It's the same when it comes to saving for retirement. How do you know if you're on track to reach your destination if you don't know where that destination is?

In this paper, we look at where we think pension savers should be aiming to get to when they retire. We put the spotlight on Defined Contribution pensions, where you, the saver, and your employer both pay in to your pension pot.

Why focus on Defined Contribution? The short answer is that millions of UK savers now use Defined Contribution schemes to provide for their retirement. Almost all employers offer new savers a Defined Contribution pension. And those savers get a choice of retirement benefits.

More choice…but more confusion
There are now more options than there used to be for what you can do with your pension pot when you retire. That's down to the 'freedom and choice' changes that the then Chancellor of the Exchequer, George Osborne, made to Defined Contribution pensions in his 2014 Budget. The changes mean you can:

- still buy a guaranteed income for life (an annuity), as before.
- still leave your savings invested to take a more flexible income (drawdown) when you need it.
- still take 25% of your pension pot in one go, tax-free. But you can also take all your pension pot as cash, either in one go or as a series of lump sums.
- mix some or all of these options.

These changes took the pensions industry completely by surprise. And they got a lot of savers excited about being able to do whatever they wanted with savings they'd spent a lifetime building-up. The excitement spilled over into the world of Defined Benefit pensions, which pay people a retirement income based on their salaries and how long they've been in the pension scheme. Defined Contribution now looks so attractive that even people in much-envied Defined Benefit pensions are starting to switch to it.

But amid all the excitement, savers risk taking their eye off what really matters: how much money they'll need to see them through their whole retirement. If anything, more choice means more confusion about what kind of retirement benefit to aim for.

We want to try re-focus the decision-making process. That might help savers provide more effectively for their financial needs for the rest of their lives.

But how can you be clear now about what you'll need perhaps decades from now?

Let's start by understanding what costs you face after you retire, and how you pay for them.

Racking up the cost of living

The cost of day-to-day life adds up, regardless of how old you are or whether or not you're working. It includes must-haves like:

- housing (plus associated costs like Council Tax, water, electricity, gas etc.)
- food and drink
- clothes
- transport
- internet connectivity.

The need to save for retirement ends when you retire.

Once you've covered the must-haves, you can look at other things – nice-to-haves, like:

- entertainment
- holidays
- gifts
- private medical care
- upgrades of must-haves (a bigger house, a more expensive car, faster broadband etc.).

Footing the bill

Covering the essentials

You pay for most must-haves as you go – weekly, monthly, quarterly or perhaps annually. Paying for anything less often than once a year is unusual. While you're working, you get paid weekly or monthly. So, the timing of your income and spending roughly match, making it relatively easy to manage your finances.

Covering the non-essentials

How you consume, and pay for, nice-to-haves varies. You buy the upgraded must-haves in the same way as the basic versions. You use other nice-to-haves less often, but generally at least once a year. Mostly, you pay when you consume.

What do all these have in common? No provider offers the option to buy them for the rest of your life for a one-off lump sum. Even with timeshare (where the one-off purchase approach has worked, in some cases) there's a regular servicing fee alongside the upfront purchase.

Also, the cost of these things goes up over time, although at different rates.

Regular costs need a regular income

When you stop working, so does your regular wage. But the costs, except saving for retirement, keep on coming. Part-time work and the State Pension might cover some of the must-haves. But another income will have to cover the rest. Ideally, it will come at the same regular intervals as the spending. And it will go up over time to match the rise in your expenses.

It's this rising retirement income we believe savers should be aiming for with their Defined Contribution pensions. If you have an idea of how you might use nice-to-haves in the future, you can structure the savings to pay for them. Of course, you can't know exactly when you'll go on holiday in ten years' time. But if you allow for a holiday once a year, you can start to build an idea of your spending. And from that you can build an idea of the income it will take to mirror it.

Saving and spending for one or two?

People tend to run up most costs as households, not individuals. Sometimes, a single income covers one household before retirement, and savings from this income will have to cover the household after retirement. This will probably be a 'joint-life' retirement benefit that covers two people. In other cases, there are two incomes and two lots of savings. And that produces various options for how to arrive at a post-retirement income. The State Pension, a single-life benefit, is part of this mix.

Freedom and choice – different options, same costs

As we've seen, freedom and choice created new possibilities for savers, including the option to take their whole pension pot as cash in one go.

Before the Chancellor dropped his bombshell, most savers with Defined Contribution pensions chose a set monthly income for life when they retired. As well as this 'fixed annuity' they'd often also take 25% of their pension pot as tax-free cash, as allowed by the regulations. Even so, they were using most of their pension savings as a regular taxable income, much like their wage before retirement.

While that income was steady, there was the risk that it would steadily go down in value because of inflation. As prices went up, savers' set amount of money would buy less than it did to start with. Some dealt with this by paying extra for annuities that went up with inflation.

Less than 20% of savers[1] chose to keep their pension pot invested to give them a drawdown income when it suited them.

A handful of better-off Defined Contribution savers could already spend their pension savings exactly as they wanted, through drawdown, once they'd retired. But to get this flexibility, they had to show the authorities they had a retirement income of more than £20,000 a year (£12,000 after March 2014) from other sources.

When a change isn't a change

Freedom and choice has changed people's idea of what retirement benefits they need. But the costs they need to cover are still the same.

Also, many were happy to see the Chancellor cut the tax on Defined Contribution pension savings that retired people leave when they die. That does look attractive if your retired parents, for example, still have pension savings to pass on. But if they get through those savings too quickly, there's no benefit. There's just the prospect of them spending their later years struggling to get by financially.

Savers change their thinking

Nevertheless, freedom and choice has changed the Defined Contribution pensions market. While eight out of ten savers chose annuities in 2013[1], that plunged to under two out of ten in 2016[2]. Instead, while drawdown became more popular, some inevitably took their whole pension pot in cash.

The impact of freedom and choice on Defined Benefit pensions has been slower. But we're now seeing a sharp rise in the number of people asking to switch to Defined Contribution. That's even though most Defined Benefit pensions give members at least some kind of built-in protection against rising prices and out-living their pension savings.

Many find the new flexibility of Defined Contribution attractive, along with the high value they've been quoted for the Defined Benefit savings they want to move over. The lower tax on any Defined Contribution benefits they leave when they die is another sweetener.

[1] Financial Conduct Authority – 'Retirement Income Market Study, Interim Report' (December 2014)

[2] Financial Conduct Authority – 'Retirement Outcomes Review – Interim Report' (July 2017)

Pension schemes change their investment options

Those running pension schemes, too, have started thinking differently. Defined Contribution savers usually get to choose how the money they and their employer pay in gets invested. The options depend on how you want to take your pension benefits. If you don't pick one, your money goes into a 'default' fund.

Before the 2014 Budget, defaults mostly aimed at annuities – the most secure kind of retirement income for life. But 'flexible' defaults now claim to target any one of an annuity, drawdown or a cash lump sum at retirement. Our recent paper showed that only 30% of the default options that larger Qualifying Workplace Pension Schemes, used for Automatic Enrolment, offer have retirement income as a target. But over 40% target a mixture of annuity, drawdown and/or cash.

It's not just us that thinks the emphasis should be on retirement income. A panel of trades union representatives and consumer groups told the Independent Review of Retirement Income[3] that: "The primary aim of a good Defined Contribution scheme should be to provide a lifelong, index-linked income in retirement."

Is it ever right to take the cash?

What if you've got Defined Benefit savings as well?

The temptation to take all your Defined Contribution pension pot as cash is obvious. Some in the industry see it as a good option if you've already built-up Defined Benefit savings to cover your must-haves.

But that's becoming less and less likely. Defined Benefit provision has been shrinking for many years. In 2010, the proportion of private sector workers active as Defined Benefit savers fell below 10% for the first time, and it's carried on falling[4]. About 70% of people with Defined Contribution pensions don't have any Defined Benefit savings[5]. And that will carry on rising as more first-time pension savers are automatically signed up to their employers' Defined Contribution schemes.

If Defined Contribution savers do have a lot of Defined Benefit savings as well, they could take 25% of their total pot, i.e. Defined Contribution and Defined Benefit combined, as tax-free cash. But that's no reason to impose a cash lump sum on other savers as a default. It might be a suitable option if all members of a Defined Contribution scheme have big Defined Benefit pots behind them. Most people work, and save, for 40 years and sometimes more. So, they'd need 30 years of

[3] 'Independent Review of Retirement Income: Report' (March 2016)
[4] Cardano calculations based on Office for National Statistics' data
[5] Financial Conduct Authority – 'Retirement Outcomes Review – Interim Report' (July 2017)

Defined Benefit savings to provide their retirement income. They could then focus 10 of the 40 years (i.e. 25%) on Defined Contribution saving to produce the 25% cash lump sum. But how many people have actually been saving in Defined Benefit schemes for 30 years?

If they don't have this level of Defined Benefit savings, we'd suggest that saving for a regular retirement income is still the best option. The Pensions Regulator[6] agrees: "Pension scheme members save in a pension in order to achieve an adequate income in retirement. This is the ultimate outcome of a good Defined Contribution scheme."

What if your pension pot is small?
If you've only just started a pension because your employer has automatically enrolled you in their scheme, you might not build-up a very big pension pot. That's either because you haven't got enough time before retiring or because you can't pay in more than a small amount of money each month. The costs of giving you a regular income in retirement could make a lump sum a better option than a small income in this case.

But, if you've built up a considerable pot, you lose out by paying more tax when you take it as a lump sum. Your investment gains on money you keep in your pension are tax-free. But these gains might be taxed if you earn them outside a pension. Gains earned in an ISA are also tax-free, but there are limits on how much you can put into an ISA each year. So, it might not be possible to put all of a pension lump sum into an ISA in a short time. Also, you'll pay tax on anything over 25% of your pension pot that you take out. In the first two years after freedom and choice came in, the Government raked in £1.4bn extra in taxes from savers taking their pensions as cash lump sums.

Don't get distracted from your destination
The best destination to aim for at retirement with your pension savings is an income for life – preferably one that goes up with inflation to match rising prices.

That's because:

- It's as close as you'll get to replacing the wage you earned before you retired.
- You'll need it to pay for your must-haves, nice-to-haves, and possibly more.

[6] The Pensions Regulator – 'Enabling good member outcomes in work-based pension provision' (January 2011)

- You’ll have similar costs after you retire to what you had immediately before.
- These costs will go up over time. So, tying your income to inflation is the best way to protect yourself.

Whether you choose a regular income through an annuity, or a more flexible income through drawdown, is down to your finances and how you feel about risk.

Steady or flexible income?
If you value certainty most of all, particularly about not outliving your savings, then an annuity will probably suit you best. If you can live with the ups and downs of investments after you retire, drawdown could also be an option. You’ll have more choice about when to take your income. But you’ll need to plan carefully to make sure you have enough to cover your whole life in retirement. You might decide to mix an annuity and drawdown to give yourself security alongside some flexibility.

Cash won’t pay the bills in the long-run
Taking all your pension pot as cash might look attractive. But it doesn’t match what you’re likely to need through your whole retirement. That’s because it’s one immediate cash flow rather than a lifetime stream of cash flows. So, in most cases pension schemes should only offer a cash lump sum as an option, not a default. That way, it’s there for people who want to choose it, but it’s not forced on people who don’t choose at all.

Experienced actuary Alan Smith summed up the considerations neatly: “People need a wage in retirement, not a dollop of money to waste.”