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# Challenges for the retirement income market over the next few decades

Future of an ageing population: evidence review

Foresight, Government Office for Science

# Challenges for the retirement income market over the next few decades

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# Contents

# Executive summary

This Evidence Review explores the challenges facing the retirement income market over the next few decades, focusing particularly on how people might convert pension savings into income and exploring the characteristics of people reaching state pension age (SPA) in 2025 and 2040.

For people reaching SPA in 2025 and 2040, increases in life expectancy will result in people living longer, and resulting policy changes mean that they will be accessing state and private pensions later. Some people might need to work longer than previous generations, and some may have longer retirements to support, although longer, healthy life expectancies might allow people to work for longer than previous generations.

**People reaching SPA in 2025**:

- Will be more likely to have defined contribution (DC) savings than previous generations; many of these savers will be low to moderate earners.
- Will have median DC pension savings of around £24,000 (2014 earnings terms) at their SPA (England only).
- Will have SPAs of 66 and may have had life expectancies at age 65 of 22.7 years (men) and 25.3 years (women).
- Will have greater flexibility around accessing pension savings, barring future policy changes.
- Are less likely to purchase a lifetime annuity than those who reached SPA prior to 2015.
- May be more likely to purchase a fixed-term or deferred annuity rather than a lifetime annuity. People with health problems may still find that an enhanced or impaired life annuity will pay out a better rate than another retirement income product.
- Will be unlikely to have a high appetite for longevity insurance products. However by 2025 soft defaults are likely to be in place and these will probably include some form of longevity insurance.
- Are more likely to use drawdown products than those reaching SPA prior to April 2015. There is also likely to be more use of combinations of retirement income products during retirement.
- May be at greater risk of making poor decisions with their pension savings and, as a result, depleting savings in retirement than those reaching SPA prior to April 2015.
- Might have access to free impartial guidance, but those with complex circumstances may need to use independent financial advice in order to make optimal decisions about accessing pension savings. The advice and guidance industry may have developed by this time to accommodate a greater proportion of low earners who reach retirement with DC savings.

- May experience variety and some level of change in retirement income products on the market as industry develops in response to the new flexibilities and responds to consumer behaviour.

Those reaching SPA between 2015 and 2025 who are most likely to be dependent on DC savings also have low levels of numeracy and score low on other indicators of financial skill and engagement. This could exacerbate difficulties around making decisions about accessing DC pension savings.

**People reaching SPA in 2040**:

- Are likely to have more substantial DC pot sizes, on average, than those reaching SPA in 2025 as a result of automatic enrolment pots benefitting from longer periods of contribution.

- May have an SPA of 68 or above and may have had life expectancies at age 65 of 24.1 years (men) and 26.7 years (women).

- Will have greater flexibility around accessing pension savings, barring future policy changes.

- May be more likely to purchase a fixed-term or deferred annuity rather than a lifetime annuity. People with health problems may still find that an enhanced or impaired life annuity will pay out a better rate than another retirement income product.

- May not have a high appetite for longevity insurance products. However it is possible that, if it becomes apparent that some pensioners are running out of money during retirement, the appetite for longevity insurance products, including deferred annuities, or for regulation requiring these products, might be growing. Soft defaults are likely to be in place and these will probably include some form of longevity insurance.

- Are more likely to use drawdown products than those reaching SPA prior to April 2015. There is also likely to be more use of combinations of retirement income products.

- May be at greater risk of making poor decisions with their pension savings and, as a result, depleting savings in retirement, than those reaching SPA prior to April 2015.

- Might have access to free impartial guidance, but those with complex circumstances may need to use independent financial advice in order to make optimal decisions about accessing pension savings. The advice and guidance industry may have developed by this time to accommodate a greater proportion of low earners who reach retirement with DC savings.

- Barring further policy change, there is likely to be some coherency in the market as popular, market-tested products become the norm.

# 1. Introduction

This Evidence Review explores the challenges facing the retirement income market over the next few decades, focusing particularly on how people will convert pension savings into income, and the relationship between risk and reward during both the saving phase and the retirement (spending) phase. This is because the point at which people access pension savings is the key point at which the retirement income market engages with pension savers. The market will need to be cognisant of the characteristics and needs of consumers and how these might change going forward.

This review does not explore ways in which non-pension financial products, such as healthcare insurance or equity release, are accessed at or during retirement, but looks specifically at how retirement income products are accessed as these are likely to have a key role in affecting how successful people are at using pension savings to support themselves in retirement.

The review sets out the structure of the state and private pension system and explores how the balance of risk lies in different types of pension schemes and methods of access.

It then explores policy changes taking place within the state and private pension landscape, as well as demographic changes that affect needs in retirement.

The review then looks at the levels and nature of pension saving people are likely to reach retirement with, now and in the future, and reflects on how recent policy changes and changes within the private pensions market might reflect the risks that people face when they come to access their pension savings. It then considers behavioural and structural factors affecting behaviour and decisions about accessing pension savings. The review explores how policy changes, demographic changes, levels and types of savings and behavioural factors affect the way that the market should engage with consumers now and in the future.

# 2. Workplace pension scheme structures

Changes within the UK's private sector pensions market must be viewed in the context of the UK pension system as a whole and the various structural shifts occurring there. The next section of this review sets out the structure of the UK state and private pension systems.

## 2.1 The two main tiers of the UK pension system

The UK pension system has two tiers:

- a compulsory state tier;
- a voluntary private tier.

### 2.1.1 The state pension system

The state pension is a redistributive pension paid to most UK pensioners, although eligibility and level are dependent on contribution or credit record. Contributions to the state pension are compulsory for those earning above a certain level (£155 per week in 2015/16; HM Treasury, 2014a).

People who do not earn sufficient amounts to contribute can also earn 'credits' to the state pension through a variety of non-paid activities such as caring or being in receipt of disability benefits.

State pension benefits are based on length of contributions or credits. People reaching SPA after April 2010 but prior to April 2016 need 30 years of qualifying contributions or credits for a full basic state pension (many pensioners also receive income from additional state pensions, but income from these is partially earnings related). The full rate of the basic state pension in 2015/16 is £115.95 (Department for Work and Pensions, 2014a). Those with fewer than 30 years of contributions or credits are eligible to receive a proportionate amount of basic state pension. After April 2016 a new state pension will be introduced that will pay a flat rate, above the guarantee credit level of pension credit, and will require people to have at least 10 years of credits or contributions to qualify for any new state pension (www.gov.uk/new-state-pension/overview).

The state also supplements people on low incomes through means-tested benefits. The main means-tested benefit for pensioners is pension credit. The main element of pension credit is guarantee credit. Guarantee credit will top up a single pensioner's income to £151.20 (2015/16) (Department for Work and Pensions, 2014a). Pensioners can also qualify for support with housing and council tax costs as well as payments for having a disability or health problems.

### 2.1.2 The different structures of private pension schemes

Unlike the state pension, contributions to private pensions are voluntary, although there are some elements of soft compulsion. Benefits from private pension schemes vary in structure, depending on the scheme rules and structure.

Private pensions are generally provided through the workplace, although an individual (for example, someone who is self-employed or whose employer does not provide a pension) can take out a private pension directly with a pension provider. Pensions provided through the employer are called ‘workplace pensions’. Workplace pensions can be sponsored and managed directly by the employer (occupational pension schemes) or run by a third party (personal pensions). Workplace schemes can be structured as ‘defined benefit’ (DB), ‘defined contribution’ (DC) or ‘defined ambition’ (DA) schemes.

### 2.1.3 Varying balance of risk between private pension schemes

The balance of risk between employee and employer varies between different scheme structures. The main risks associated with saving and accessing pensions are (Blommestein *et al*., 2008):

- **Investment risk**: the risk of a fund losing value or not increasing fast enough to maintain value in line with inflation.
- **Inflation risk**: the risk that one’s income does not rise as quickly as price inflation, or does not rise at all, and as a result loses value relative to the price of goods and services.
- **Longevity risk***:* the risk of an individual running out of income or savings before their death as a result of living longer than expected.
- **Insolvency risk**: the risk of the provider or employer becoming bankrupt or insolvent.

There are many other risks associated with saving for and accessing savings in retirement, such as the risk of high charges, poor rates from a retirement income product or the risk in retirement of needs changing unexpectedly (Pensions Policy Institute, 2012a; Blake and Harrison, 2014). However, overwhelmingly, the main pension risk is the risk of having insufficient income in retirement to have an adequate standard of living, as a result of not saving or not saving enough (Pensions Policy Institute, 2013).

### 2.1.4 Varied risk balance between schemes

Different scheme structures involve different balances of risk:

- In traditional DB schemes the employer (or provider) bears all of the risks.
- In DC schemes, the scheme member bears some or all of the risks.
- DA or risk-sharing schemes aim to share the balance of risk more evenly between employer and employee.
- Collective DC schemes generally involve sharing of risk between scheme members rather than between employer and employee.
- **Defined benefit.** Retirement benefits received from DB schemes are based on a formula involving length of service multiplied by a percentage of final or average salary. In traditional DB pension schemes the employer (or provider) bears all of the above risks. This is because the amount of retirement income benefit is predetermined and therefore if there is a shortfall in the fund due to low growth, inflationary increases, or scheme members living for longer than expected, it falls to the scheme provider to fill the shortfall (although schemes can make adjustments to benefits or cap inflationary increases if they are in difficulty, subject to scheme rules).

- **Defined contribution.** DC schemes do not offer a predictable income in retirement, rather the individual (and/or their employer) pays a set amount or proportion of salary into the scheme. At retirement the fund can be used by the individual to access a retirement income, for example through a retirement income product, or through withdrawing lump sums. In some schemes (for example, some occupational DC schemes) the retirement income might be paid directly from the fund to retired scheme members. In DC schemes, the scheme member bears some or all of the risks (although some employer-sponsored DC schemes have in-built guarantees). If a DC scheme member's fund does not achieve sufficient growth, or their income does not keep up with inflation, the result is that the member will have to live on a lower income than they might have done had circumstances been more favourable.

- **Defined ambition.** DA schemes are those that are not clearly DC or DB but rather contain elements of both. There are several different ways to structure a DA scheme. For example, a scheme in which some contributions were funnelled into a DB pension and some were directed into a DC pension would be a DA scheme. A scheme in which some or all contributions were used to purchase deferred annuities that would pay out during retirement would also be a form of DA scheme. These are often called 'risk-sharing' schemes because risk (e.g. inflation risk, investment risk, longevity risk) is shared more evenly between the employer and employee than in traditional DB or DC schemes.

- **Collective defined contribution.** Risk-pooling schemes – the Government has recently introduced legislation (Pension Schemes Act 2015) to allow collective defined contribution schemes (CDC); these are DC schemes in which all members' funds are pooled rather than invested individually. CDC schemes generally involve sharing of risk between scheme members rather than between employer and employee, although the employer may bear some of the risks, subject to scheme structure.

# 3. Changes taking place within the private sector pensions landscape

Workplace pensions have traditionally been provided through employer-sponsored DB pensions, which generally provide a secure, inflation-linked income for life. Over the last few decades, DC pension schemes have become more popular with private sector employers, as a variety of factors have increased the cost of providing DB schemes (Pensions Policy Institute, 2012b). Over 85% of DB schemes in the private sector are now closed either to new members or to both new members and further accruals from existing members (The Pensions Regulator, 2014). Therefore the majority of schemes on offer to new members in the private sector are DC schemes and active membership of DC schemes is now higher than that in DB schemes (National Association of Pension Funds, 2014). As greater proportions of employees save in DC schemes, the balance of pension saving risk shifts from the employer to the employee.

## 3.1 The automatic enrolment programme

The UK is currently undergoing the phasing in of 'automatic enrolment', which requires employers to enrol qualifying employees (meeting particular age and earnings criteria) into a pension scheme. Automatic enrolment is intended to address under-saving for retirement by harnessing people's natural tendencies towards inertia, by turning saving into a pension scheme the 'default' option (Johnson *et al*., 2010). Automatic enrolment is targeted at low to moderate earners, who are less likely to already have had pension coverage (Department for Work and Pensions, 2014b). Employees have a window of opportunity to 'opt out' and receive back any contributions already made. The self-employed are not included in the programme, but can opt in to schemes set up to accommodate smaller employers without existing provision and low-income employees; in particular, the National Employment Savings Trust (NEST) allows self-employed people to join (www.nestpensions.org.uk).

Automatic enrolment has been shown to be a successful way of increasing pension scheme participation in other countries. Participation in US 401(k) schemes increased from around 40% or below to between 85% and 95% as a result of the introduction of automatic enrolment (Madrian and Shea, 2000; Choi *et al.*, 2004a,b). In New Zealand, the rate of opt out for those automatically enrolled is currently around 30% (although it was around 50% for the first 2 years). However, around 60% of current active members joined the New Zealand scheme, KiwiSaver, voluntarily, indicating that an automatic enrolment policy can also have the effect of promoting private pension savings among those not eligible for the scheme. However programme details, such as government contributions, affect the attractiveness of opting in (New Zealand Inland Revenue, 2015).

The required level of contributions that employers and workers who do not opt out must jointly make into a pension scheme is being phased in from 2012 to reach 8% minimum total contributions on band earnings (£5,824 to £42,385 in 2015/16) by 2018 (The Pensions Regulator, 2015a). At minimum levels, the 8% will be made up of 3% from the employer, 4% from the employee and 1% from the Government (in the form of tax relief). Employers can choose to pay more than 3% and reduce the amount that their employees are required to contribute. If the employer chooses to pay the entire 8% themselves, then employees who do not opt out are not required to make any contributions under automatic enrolment regulations, although their employer may still expect them to contribute (The Pensions Regulator, 2015b).
The Government is currently anticipating an average opt-out rate of 15%, for the life of the

programme, and that 9 million people will be newly enrolled or saving more as a result of automatic enrolment (Department for Work and Pensions, 2014c). Because of DB scheme closures, the vast majority of employees being automatically enrolled in the private sector are being enrolled into DC schemes. Pensions Policy Institute (PPI) analysis suggests that if 15% of people opt out of automatic enrolment, this could still result in 14 million people saving in private sector DC schemes by 2030, up from around 6 million in 2011 (Pensions Policy Institute, 2014a).

Pensioners reaching SPA in 2025 and 2040 will proportionally be more likely to have DC savings than previous generations partly because of the DB to DC shift, and partly due to automatic enrolment. These new savers are more likely to be low to moderate earners, the target group for automatic enrolment.

## 3.2 Changes occurring alongside automatic enrolment

Alongside the private sector shift from DB to DC schemes and the introduction of automatic enrolment, there are a host of other changes occurring in the pensions and retirement landscape. Policy changes include:

- The introduction of the new state pension, which is single-tiered, flat rate and contribution-based. It is being introduced from April 2016 at a rate above the guarantee credit element of pension credit, of no less than £148.40 per week.
- The SPA is rising from age 60 for women and age 65 for men in 2010 to age 65 for both by 2018, age 66 by 2020, and age 67 by 2028. A rise to age 68 is currently under review (Department for Work and Pensions, 2014d).
- The ages at which DB scheme members are expected to take their pension are rising (Pensions Policy Institute, 2012b).
- The default retirement age (the age at which an employer was legally allowed to terminate employment on the basis of age) has been removed (Department for Business, Innovation & Skills, 2011).

There are also demographic changes occurring that have affected the sustainability of state and private pension saving, as well as the length of time people are likely to spend in retirement. This has knock-on implications for saving and retirement income planning.

Demographic changes include:

- Longevity is increasing, meaning that people have longer retirements to support. In the second half of the 20th century, life expectancy has increased by 2 years for every decade. It is possible that half of people born since 2000 will live to 100 or older (Harper, 2013).
- Pensioners reaching SPA from 2025 to 2040 will have SPAs of 66, 67 or possibly 68 and will have life expectancies at age 65 of between 22.7 and 24.1 years (men) and 25.3 to 26.7 years (women).
- Pensioners reaching SPA from 2040 on may have SPAs of 68 or above and will have life expectancies at age 65 of 24.1 years or higher (men) and 26.7 years or higher (women) (Office for National Statistics, 2012).

- Healthy life expectancy is also on the increase, with babies born in 2009/11 being likely to spend 3.5 years (men) and 3.7 years (women) longer in good health than babies born in 2000/02 (Office for National Statistics, 2014a).

Increases in life expectancy result in people living longer, and resulting policy changes mean that they will be accessing state and private pensions later. Some people might need to work longer than previous generations, and some may have longer retirements to support, although longer, healthy life expectancies might allow people to work for longer than previous generations.

### 3.2.1 Greater flexibilities for accessing DC pension savings

Changes announced in the Budget Statement 2014 also mean that, since April 2015, people with DC savings have had greater levels of flexibility when they come to access their pension savings after the minimum pension age (currently age 55). Before these changes, people with DC savings above a certain level were required to use a secure retirement income product to access their DC pension savings. This was generally done through a lifetime annuity (which provides a guaranteed income for life) or an income drawdown product known as capped drawdown (which allowed for fund investment and further growth but limited income withdrawals to a percentage of an equivalent annuity). The Government introduced the reforms because it felt that annuities were no longer the right product for everyone and because it believed that the market was not working in the best interest of consumers (Thurley, 2015).

Pensioners reaching SPA in 2025 and 2040 will experience greater flexibility around accessing pension savings, barring future policy changes.

### 3.2.2 Changes in the way people with DC savings purchase a lifetime annuity

The introduction of flexibility will alter the way that people with DC savings access their pension savings in future. Until recently around 75% of people with DC savings purchased an annuity when they accessed these savings (HM Treasury, 2014a). However, annuity purchase levels since the announcement of the new flexibilities indicate that fewer people will purchase annuities in future. After March 2014, when people were able to flexibly access their DC pension savings, annuity sales dropped considerably. Annuity sales were 49% lower in the second quarter of 2014, 56% lower in the third quarter of 2014 and 64% lower in the fourth quarter of 2014 than in the same quarters in 2013 (see Figure 1).

It cannot necessarily be assumed that those who did not buy annuities prior to April 2015 may not do so at some point in the future. They may be waiting to see which products will be on offer now that flexibility is allowed, and some people may choose to annuitise some of their DC savings and access the remainder in a more flexible way.

The Coalition Government proposed to remove tax barriers that currently prevent people who have already bought an annuity from selling it to a third party, and is currently consulting on this proposal (HM Treasury and Department for Work and Pensions, 2015). If the Government proceeds with this policy then people would be allowed to sell annuities on from April 2016, if they can find someone willing to purchase them. While this would allow people who have already bought annuities the same flexibilities as those retiring with DC pension savings after April 2015, there are concerns around how much people might lose in costs and charges through the sale and whether those who might be best placed keeping their annuity would be motivated to sell them (Thurley, 2015).


**Figure 1: Annuity sales over the last eight quarters – Association of British Insurers statistics**

Take-up of drawdown products is currently lower than take-up of annuity products. In 2013 there were around 600,000 drawdown products in force with Association of British Insurers members, although this does not capture all of the market, according to statistics from the ABI.

### 3.2.3 Annuitisation and its relationship to risks in retirement

Lifetime annuity (and capped drawdown prior to April 2015) products provide some of the protection that is found in DB pensions because these products are structured so that there is either no or (in the case of drawdown) reduced risk of the fund being depleted before the death of the annuitant (capped drawdown holders faced some market-based risks that could have reduced their funds, but when funds in these products fell below a certain level they would automatically convert into a lifetime annuity, however drawdown products on offer now will not be required to contain these safeguards).

Although lifetime annuities don’t necessarily protect people from all market-based risks (for example holders of level annuities still face inflationary risks), people with DC savings who do not purchase a secure income product run greater risks of running out of funds before their death than those who do. This is exacerbated by the fact that people consistently underestimate their own life expectancies, on average by 3–5 years (60 year olds), and therefore may drawdown larger amounts in anticipation of a shorter lifespan (Blake, 2014). In 2011, an individual withdrawing an income from their drawdown account of 100% of what they would have received from an equivalent annuity would have had a 36% chance of depleting their funds before their death (Pensions Policy Institute, 2011). However, those who purchase a lifetime annuity forego further opportunities of fund growth and opportunities to leave savings as a bequest, except in the case of guaranteed funds.

Under a new, more flexible method of access, people with DC savings are not required to make a choice about access and there will be no mandatory default. Therefore, people who do not annuitise might be faced with choosing between inaction, several complicated retirement income products, or withdrawing lump sums directly from their pension fund. They will have to make choices based on imperfect knowledge as many of the factors that affect needs in retirement are surrounded by uncertainty, particularly future changes or factors such as health, longevity and economic changes such as inflation (Pensions Policy Institute, 2014b), as well as the tax and benefit implications of accessing DC pension savings.

There is concern that UK consumers are more likely to deplete savings in retirement as a result of the new flexibilities. In some other countries with similar freedoms, retirees do not appear on the whole to be running out of savings during retirement (Oxera, 2014), but in the USA there is concern that about half of people approaching retirement are likely to run out of savings during retirement (Pensions Policy Institute, 2015a), and in Australia, the main concern among those in and approaching retirement is that they will exhaust their savings (Commonwealth of Australia, 2014). People reaching SPA in 2025 and 2040 with DC savings may be at greater risk of depleting savings in retirement than those reaching SPA prior to April 2015.

# 4. People currently approaching retirement have low levels of DC savings

DC scheme members (and their employers) tend to contribute less to their pension schemes than is the norm in DB schemes. For example in 2013, the average total contribution to occupational DC schemes was 9.1%, compared to 20.6% in occupational DB schemes (Office for National Statistics, 2014b). Growth in DC scheme membership and a reduction in DB scheme membership in the private sector have led to concerns about whether people will save enough in pensions to meet their needs or expectations in retirement.

This is a particular concern in light of the 8% minimum required contributions required for those automatically enrolled into pension saving. PPI modelling has found that people have a 50% likelihood of achieving an income that would allow them to replicate working-life living standards in retirement (from a combination of state and private pensions) with an 8% contribution rate, contributing between age 22 and SPA (Pensions Policy Institute, 2013). People who contribute for a shorter period of time would need to contribute at higher levels. Therefore, many people may need to contribute at higher than 8% in order to have even a 50% chance of achieving a target rate of income.

## 4.1 Average DC pot sizes will increase over time

PPI analysis of English Longitudinal Study of Ageing data indicates that those reaching SPA between 2015 and 2025 in England will have median DC pension savings of around £19,400 (2014 earnings terms) at their SPA (assuming those in pension schemes continue to save at current levels and eligible employees are automatically enrolled) (Pensions Policy Institute, 2014b).

This is a low level of DC savings on the whole; a DC pot of £19,400 could produce between £70 and £90 per month from a level annuity (average from Money Advice Service [MAS] annuity comparison tables for a 65 year old, non-smoking, single man living in South London, assuming no tax-free lump sum is taken, calculated 6 May 2015). For someone on a low income, this amount of additional income could make a substantial difference to their standard of living, but this example is purely illustrative. People are permitted to access their DC savings through any method they like, and might choose a method other than an annuity.

Overall, the people reaching retirement in England between 2015 and 2025 will have median pot sizes of around £19,400, but the median for each cohort will increase year on year as people have more time to build up pots under automatic enrolment. In 2015, the median pot size for DC savers reaching SPA in England could be around £13,800, but by 2025, this could grow to around £24,000 (which could yield a level annuity income of between £90 and £110 per calendar month, MAS) (see Figure 2). This analysis assumes that those currently saving continue to save, and eligible employees are automatically enrolled.

The growth in pot sizes is likely to continue as automatic enrolment pots have time to benefit from longer periods of contribution as the DC market develops. Those reaching SPA in 2040 are likely to have more substantial DC pot sizes, on average, than those reaching SPA in 2025.

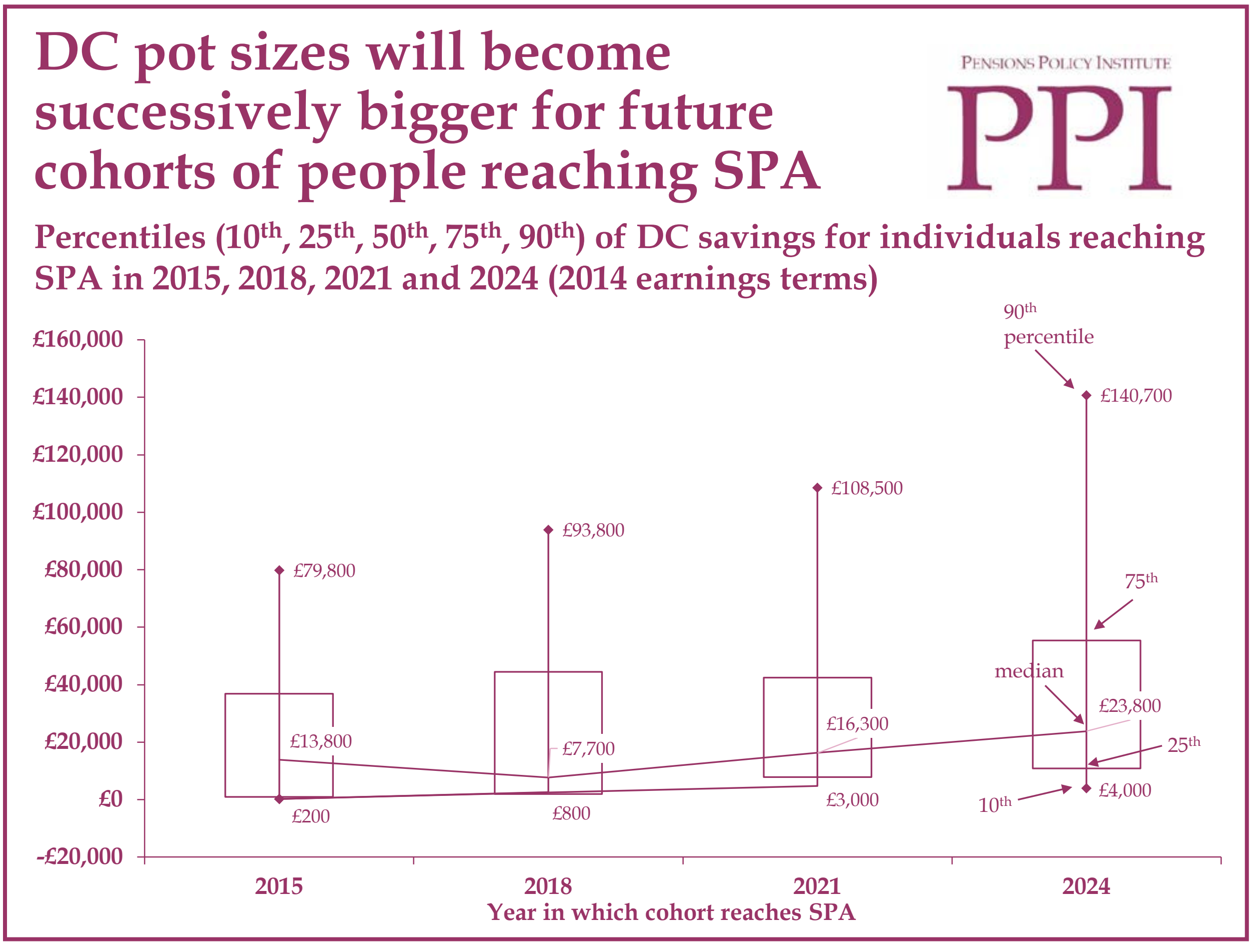


**Figure 2: DC pension savings for those reaching SPA in a given year – PPI modelling**

# 5. People with DC pension savings will have greater choice when they come to access savings in future

Until recently, people with DC pension savings had relatively limited choice at retirement. Under pre-April 2015 rules, those over the age of 55 could take up to 25% of their savings as a tax-free lump sum and do one or more of the following with the remainder.

Those with pots below £30,000 (£18,000 prior to 2014):

- could take the total as a lump sum, 25% tax-free and 75% taxed at their marginal income tax rate; this is known as trivial commutation and could be executed at any time after the age of 60;
- could take a further three pots of £10,000 or less (two pots of £2,000 or less, prior to 2014) could be taken as a lump sum, after the age of 60.

Those with a guaranteed minimum annual income of £12,000 from state and private pensions (DB or DC):

- could purchase an income drawdown product (flexible drawdown), which allowed withdrawals of income in unlimited amounts.

Those with pots above £30,000 but without a guaranteed minimum income of £12,000:

- were required to use a product that provided a secure retirement income, if they wished to access their savings, and they could do this in one of two ways:
    - purchasing a lifetime annuity, or
    - purchasing a capped drawdown product, which limited income withdrawals to 150% of an equivalent annuity based on rates set by the Government Actuary's Department.

## 5.1 Restrictions on access to DC savings have been removed

Restrictions on accessing DC savings were lifted in April 2015. People are now allowed to withdraw DC savings after the age of 55 in unlimited amounts, with 25% of each withdrawal tax-free and the remainder taxed at an individual's marginal rate. People are now permitted to do one or a combination of the following:

- Purchase a retirement income product, including annuities, drawdown products or any other type of retirement income or insurance product that is on the market.
- Withdraw directly from their pension fund or designated pension account; technically these will be called 'uncrystallised funds pension lump sums'.

These products and accounts will most likely have a greater variety of structures than those on offer today as they will no longer need to ensure that people are complying with requirements for using a secure retirement income product.

This means that while there will still be lifetime annuities on offer for as long as there is a market for them, there will be a greater variety of non-lifetime annuities such as fixed period (for example to provide an income for 5 to 10 years with a lump sum returned at the end) or deferred annuities, which pay out later in retirement. These are likely to be more popular with some people than lifetime annuities, particularly considering people's reluctance to pay out lump sums at the beginning of retirement (Pensions Policy Institute, 2015b).

People with health problems may still find that an enhanced or impaired life annuity will pay out a better rate than another retirement income product. It is not clear what will happen in the market for these types of annuities, but there is a challenge for industry and providers of guidance and advice to ensure these products remain available and good value for people with health problems.

### 5.1.1 How will people respond to the new flexibilities?

It is not known how UK consumers will respond to the new flexibilities. The response is unlikely to be uniform. People with different savings portfolios, needs, household circumstances and attitudes to risk might have varying expectations from their retirement savings and therefore may differ in behaviour and choice of products.

Some lessons can be taken from international experience. In other countries where annuitisation is not mandatory, uptake of annuities is fairly low, except in the case of Switzerland where 80% of people with DC savings annuitise. However, in Switzerland there is no access to drawdown, and annuities are the default for pension scheme members (but not mandatory) and are also subsidised, so pay out at a high rate (Oxera, 2014). These additional incentives are not currently available in the UK, although people with health problems can purchase annuities with favourable rates called enhanced or impaired life annuities (Thurley, 2015). It is not clear what will happen to the market for enhanced and impaired annuities under the new flexibilities. Trends in use of pension savings vary according to regulation and other contributing factors such as generosity of the state pension and provision of other benefits, cultural attributes and availability of products (Pensions Policy Institute, 2015a).

Drawdown products are popular in the USA, Australia, New Zealand and Ireland. Longevity insurance products are less popular, even though these have been found to protect drawdown users against running out of private income in retirement (Pensions Policy Institute, 2015a). Qualitative work with those approaching retirement indicates that appetite for longevity insurance products is low unless it is also accompanied by advice and education, and even then people are reluctant to pay over large sums early in retirement (Pensions Policy Institute, 2015b). This indicates that the appetite for longevity insurance products may not be high in the UK in the near future (2015–25).

The USA is currently responding to worries about pensioners running out of savings during retirement, and the Government is exploring options for encouraging a default deferred annuity, which pays out an income during later retirement and acts as a longevity insurance product (Pensions Policy Institute, 2015a). It is possible that after a decade or so in the UK, once the effects of the reforms on people's behaviour have become evident, and if a similar experience occurs, the appetite for longevity insurance products or for regulation requiring these products might grow in future, perhaps by 2040.

It is probable that people reaching SPA in 2025 and 2040 are less likely to purchase an annuity than those who reached SPA prior to 2015. Drawdown uptake is higher in countries without compulsory annuitisation and therefore it is likely that more people reaching SPA in 2025 and 2040 will use drawdown products than those reaching SPA prior to April 2015.

### 5.1.2 The risks vary between people with different savings portfolios

People face different levels of risk depending on their pension savings portfolios and their household circumstances.

The likelihood of having different levels and types of private pension saving differs by characteristics such as ethnicity, gender and disability. Among the current generation of pensioners, those from ethnic minority groups are significantly less likely to be receiving income from a private (personal or occupational) pension or from the state pension than the "white British majority" (Vlachantoni *et al*., 2014). Female pensioners are likely to have lower pension income than male pensioners, partly due to a lower historical attachment to the labour market (Pensions Policy Institute, 2008).

For future generations of pensioners, reaching SPA between 2025 and 2040, these inequalities may be reduced somewhat as automatic enrolment will have had time to bed in, and employees who may previously not have had pension coverage have time to build up private pension entitlement. Women today are more likely to work, and be eligible for automatic enrolment, than past generations of women may have been: 53% of UK working-age women were in employment in 1971, compared to 67% in 2013 (Office for National Statistics, 2013) and therefore, greater proportions of women may have private pension savings in future. A secondary effect of the increase in women working and saving in private pensions is that couples reaching retirement in future may be more likely to have a higher collective level of DC savings than previous generations in which the pension savings may have been mainly held by men in household units. The self-employed, whose private pension membership has fallen from around 50% in 2000 to around 20% in 2013 (men), are unlikely to be dramatically affected by the reforms to private pensions as they are not eligible for automatic enrolment (Office for National Statistics, 2014b).

For those with low levels of income, low levels of pension savings and other savings and assets, dependence on pension savings may be relatively higher than for those with more diverse and built-up portfolios. These people face particular risk when they come to make decisions about savings because the effects of making poor decisions (and running out of money) could have greater impacts than they might for those who have higher levels of savings, DB pension entitlement or extensive levels of non-pension savings and assets to fall back on. Around 12% (694,000) of those reaching SPA between 2015 and 2025 will be at high risk and 29% (1.6 million) will be at medium risk when making decisions about accessing their DC savings (Pensions Policy Institute, 2014b).

However, even people with higher levels of DC savings can run risks in retirement if they do not purchase a retirement income product with in-built protection against investment, inflation and longevity risks (Blake, 2014).

People reaching SPA in 2025 and 2040 with DC savings may be at greater risk of making poor decisions with their pension savings than people reaching SPA prior to April 2015. It is a challenge for the retirement income product market to design products and strategies that accommodate greater flexibility and choice while also offering protection against risks.

## 5.2 Behavioural and cognitive barriers to decision-making in retirement

Behavioural characteristics can act as barriers to making good decisions about accessing pension savings. For example, a lack of trust in organisations can impede engagement with guidance, advice or using particular strategies suggested by organisations. A natural tendency towards inertia can prevent action at the critical time (Department for Work and Pensions, 2012). Natural tendencies towards inertia can be exacerbated when people become confused, and people report that decisions about accessing pension savings are difficult and confusing to make. This confusion can lead to no action or to people choosing the option that involves the least amount of active decision-making, the 'default' option or choosing a poor option. These choices may not necessarily lead to optimal outcomes (Department for Work and Pensions, 2012; Pensions Policy Institute, 2014b).

Decisions about accessing DC savings are difficult because they require understanding of complex economic concepts such as investment, inflation and longevity risk as well as the potential impact of future changes in need (Blake, 2014). People might also need to understand the tax implications of certain decisions and how pension income can interact with eligibility for means-tested benefits. However, many people are likely to lack the cognitive or educational tools required to understand these concepts.

A US study has found that levels of financial knowledge are very low in countries where studies have been undertaken, and that low financial literacy is correlated with making poor investment and saving decisions. While those with higher levels of financial literacy tend to make better financial decisions and receive more return on their assets, targeted financial education interventions (such as one-off advice sessions) have been found to have a limited effect on people's behaviour and ability to make better choices within complex financial markets. There is some suggestion that more regulation is required to protect those with low financial skills from scams, or very poor decisions, as financial education interventions are unlikely to have a substantial effect unless they are prolonged and result in considerable growth in financial literacy (Lusardi and Mitchell, 2014). Financial literacy has been found to have a direct correlation with choosing to shop around for the best annuity price, rather than purchasing an annuity directly from the original provider (Banks *et al*., 2015), although shopping around could increase annuity income by 5–6% (Financial Conduct Authority, 2015).

Levels of numeracy in particular have been found to have correlations with ability to understand pension arrangements (Banks and Oldfield, 2006). However, there are low levels of numeracy among the UK adult population; around 4 in 5 adults have a level of numeracy below GCSE grade C level (www.nationalnumeracy.org.uk/what-issue).

When levels of numeracy are explored alongside levels of DC savings, it becomes clear that those reaching SPA between 2015 and 2025, who are most likely to be dependent on DC savings, also have low levels of numeracy and score low on other indicators of financial skill and engagement (Pensions Policy Institute, 2014b). This implies that while people with DC savings and low levels of other savings or assets to fall back on face the highest risk with their DC savings, they may also be less equipped than others to make these decisions.

For those who purchase a lifetime annuity or retirement income product with in-built protection, the need to understand these concepts will be diminished. But for those who choose to access flexibly after April 2015, there will be a need to make complex decisions at, and potentially during, retirement if needs change (Pensions Policy Institute, 2014b). Making decisions about pension savings during later life could also pose challenges because cognitive functioning has been shown to decline throughout old age and could impair ability to make financial decisions as people get older (Institute for Fiscal Studies, 2004).

## 5.3 The Government is offering guaranteed impartial guidance to help people make decisions

The Government recognises that the new flexibilities will result in DC savers having to make more difficult decisions at retirement than they did under the old system. Therefore it has committed to making "free and impartial guidance" available to people approaching retirement with DC savings. The Government has guaranteed that the guidance will be impartial and provided face-to-face, online or over the phone according to the needs and preferences of the person accessing the guidance (Financial Conduct Authority, 2014a). This advice is currently being provided under the brand 'Pension Wise', with the help of delivery partners including Citizens Advice Bureau, MAS and The Pensions Advisory Service (TPAS).

However, while the guidance is being offered to people approaching retirement, there is no obligation on people to take the offer up before making a decision about accessing their DC savings. Some people may choose not to engage with the guidance, for example because of behavioural biases, such as the tendency towards inertia some people display, which results in a reluctance to engage with decision-making in retirement. Around 92% of people indicated that they would "probably or definitely" use the guidance service once it became available (Chartered Insurance Institute, 2014), however, in a TPAS and Legal & General pilot of pensions guidance on at-retirement decisions, conducted with 9,000 customers between April and May, only 2.5% of customers took up the offer (pilot sponsored by TPAS and Legal & General; Money Marketing, 2014).

People reaching SPA in 2025 and 2040 with DC savings might have access to free impartial guidance, but those with complex circumstances may need to use independent financial advice in order to make optimal decisions about accessing pension savings. There is a challenge for the advice and guidance industry to have developed by this time to accommodate a greater proportion of low earners who reach retirement with DC savings.

## 5.4 Those who have trouble making decisions because of behavioural or cognitive barriers will be very dependent on the defaults on offer

What the above analysis indicates is that many people making decisions about accessing DC savings may easily end up making the default choice. If there is no particular default on offer, then natural tendencies towards inertia arising from a lack of trust or from confusion may mean that the default choice is merely the option that involves the least active decision-making.

### 5.4.1 Defaults should have in-built risk protection

Stakeholders, including the regulators and NEST, are exploring default options for those who reach retirement with DC savings. There is agreement that defaults need to contain protection, particularly from inflation, investment and longevity risk, in light of people's lack of understanding and under-estimation of the impact of these risks (National Employment Savings Trust, 2014; Financial Conduct Authority, 2014b).

One suggestion for a potential default is building the use of deferred annuities into retirement income strategies, for example encouraging people to buy an annuity that would pay a guaranteed income from an older age (for example an individual's life expectancy). The individual could then use the remainder of their savings to support themselves up until the age their deferred annuity would begin to pay out (National Employment Savings Trust, 2014). Deferred annuities can act as a form of longevity insurance because they will pay out from a certain age for the remainder of an individual's life, thereby providing protection for people who live for longer than expected. However they are structured, and most commentators agree that some form of longevity insurance should be included in 'soft defaults' in future, as a way of helping to prevent poverty in later retirement (Lloyd, 2015).

By 2025 and 2040, soft defaults are likely to be in place and these will probably include some form of longevity insurance. However, longevity insurance might not be appropriate for people with low amounts of savings, who might need to convert all of their pension savings into an immediate retirement income.

### 5.4.2 Income drawdown could become one of the soft defaults once full flexibility is allowed

While income drawdown has traditionally been used almost exclusively by people with large pots and has been accompanied by regulated independent financial advice, there is some anticipation that income drawdown products could become one of the soft defaults in future, without a requirement to receive financial advice attached (National Employment Savings Trust, 2014; Financial Conduct Authority, 2014b).

This means that people with low levels of savings and therefore low capacity for risk could start using drawdown without tailored advice about their own personal needs and circumstances. One of the challenges facing the industry and policy-makers is how to ensure that there is risk protection built into strategies involving drawdown. This could be done through the way drawdown funds are invested. NEST suggests that "various approaches to managing drawdown portfolios, such as asset allocation, life-styling, asset-liability matching, volatility management and risk hedging, present risks and opportunities in meeting retirees' needs" (National Employment Savings Trust, 2014). The use of longevity insurance in combination with drawdown could also become part of a soft default strategy (Lloyd, 2015). In Australia, where there are concerns that people are running out of savings during retirement, it has been recommended that a default option is provided, using a combination of products which, together, offer "a regular and stable income stream, longevity risk management and flexibility" (Commonwealth of Australia, 2014). US academics are currently looking at options for making partial, indexed annuitisation a more commonly used route for both DC and DB savers, in order to provide some protection against inflation and longevity (Beshears *et al.*, 2013).

For people reaching SPA between 2015 and 2025, there is likely to be variety and some level of change in products on the market as industry develops in response to the new flexibilities and responds to consumer behaviour. By 2040, barring further policy change, there is likely to be some coherency in the market as certain more favoured products become the norm and the industry has had time to develop products that there is consumer appetite for.

### 5.4.3 Increasing use of combinations of products

People who are less likely to use defaults, such as those who use financial advice, may use more complex retirement income strategies in future. Industry experts suggest that there will be more use of combinations of products that provide guarantees, income and lump sums and that people might change products and strategies to meet changing needs and circumstances during retirement. For example, people could annuitise a small amount every year while keeping the majority of savings invested in drawdown in order to slowly build up a higher level of security during retirement. People might also begin to use annuities as a form of longevity insurance by purchasing deferred annuities which will begin to pay a guaranteed and secure income at a later point in retirement. Some products might include drawdown and annuity features in one product (Financial Conduct Authority, 2014b; and informal interviews with industry experts).

There are risks attached to a greater variety of retirement income products being available to people, and beyond just the difficulty of making the initial decision. The increase in product features will reduce the ability of consumers to directly compare different products to judge value for money. This could reduce competition. It could also lead to consumers being unable to get the best deal or becoming confused by the options and less willing to shop around (Financial Conduct Authority, 2014b). Therefore, the Financial Conduct Authority (FCA) has suggested that there should be more support from providers for people making decisions about accessing pension savings as they are having to work with very sophisticated concepts that many struggle with (Financial Conduct Authority, 2014b).

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