Decumulation

Taking an income in retirement

Key points

- The pension freedoms have made choices harder for retirees. People now risk outliving their capital.
- There should be an easy path to a suitable retirement income product. Retirees should retain a free choice but the line of least resistance should lead to an income for retirees with DC pensions, just as it does for those with DB pensions.
- Retirees should benefit from high standards of product governance in retirement, just as they do when they are saving for a pension.

Reliably converting savings to income is tough

The economist William Sharpe describes turning savings into an income in retirement as the "nastiest, hardest problem in finance." It is a complex problem, mainly because savings are limited but no one knows how long they will live.

The problem does not exist for people with DB pensions as their pension scheme handles longevity risk and inflation risk on their behalf. It used not to exist for DC savers as the tax rules effectively compelled most people to buy an annuity with their DC pension savings.

Following the 2014 Budget, the Treasury relaxed the tax rules controlling withdrawals DC and DB pensions. Now, those with private sector DB pensions can convert them to DC. DC savers can take withdrawals from their pension fund at their marginal tax rate. Whereas drawdown from a DC used to be governed by rules intended to prevent retirees running out of money, now retirees are free to take as much or as little as they want from their fund.

Impacts of reform

Much has changed since the 2014 Budget. The annuity market has contracted substantially, partly as a result of sustained low annuity rates making annuities poor value for many people. Conversely, sales of drawdown have increased – according to the FCA, twice as many pots have been used to buy drawdown rather than an annuity. Most of these have been small (88% below £30,000) and most of these have been fully withdrawn (55%). Retirees with small pots are more likely to take them as cash. Retirees with larger pots are more likely to annuitise.

Freedom brings tougher choices

Retirees now have much more freedom to choose how they take their money but the decisions they have to make are much harder. Many of the retirees taking cash from their funds now have DB pensions to fall back on. Future generations of retirees are much less likely to have DB provision and will need to make a fixed sum of capital last for the rest of their lives.

They will have access to limited but free guidance from the Money and Pension Service. They may choose to pay for financial advice. But many will have to figure things out for themselves.

Automatic enrolment requires minimal interaction with pension saving. Indeed, it is unlawful to require a saver to make a choice when they are automatically enrolled. Many will make no financial choices through their savings career and risk arriving at retirement unprepared for the complex choices they now face.

Not only will retirees need to pick the best value and most suitable products on the market but they will also need to spread their savings across different product types.

What do retirees need?

We believe that most people will need an income in retirement and most people will be poorly equipped to convert DC savings into a reliable income that will not run out.

Rather than requiring retirees to make choices in a market, DC scheme trustees, who have a fiduciary duty to put member interests first, should be able to offer an easy path to a retirement income product. That product should pay an income from a member's fund while mitigating the common risks faced by retirees, principally longevity and inflation risk. It should also allow a degree of flexibility in how benefits are taken.

Of course, retirees should be free to reject this and make a free choice on the open market. But the line of least resistance should point towards a good value income product governed by a fiduciary.

Current policy needs to change

Current policy places too much weight on individual choice as a driver of value for money in retirement savings products. More weight should be placed on the role of fiduciaries as guardians of retirees best interests – provided that retirees are free to act as they choose with their own money.