

LOW-INCOME RETIREES, FINANCIAL CAPABILITY AND PENSION CHOICES

Since April 2015, workers with Defined Contribution (DC) pension savings have no longer had to turn their savings into a secure retirement income, and can instead opt to draw down or cash in their DC pension pots. How well choices are made, and the resulting implications for retirement income, will ultimately depend on individuals' financial capability.

Key points

- Across different types of financial capability, a clear life-stage pattern of levels of financial engagement was observable. Financial capability was usually lower among low-income retirees.
- Use of saving and investment products among low-income retirees with a DC pension is limited, with 34 per cent possessing neither a savings account nor ISA.
- There is evidence of low levels of financial capability which suggests a risk that the April 2015 changes to rules on DC pension savings will result in lower average retirement incomes and increasing pensioner poverty.
- The Government should implement and promote a default 'automatic income plan' for DC retirees, providing a predictable, secure and good-value income, while retaining people's right to cash in DC pension savings. Policy-makers should also consider creating a statutory provider of automatic income plans operating with a public service obligation to accept all customers, to ensure all individuals have access to good-value secure income in retirement, no matter what their pension pot size.
- Since one-third of low-income DC retirees were renting, the Government may also need to consider disregarding DC savings from the means test for support with rent costs. The Government should also consider making additional provision for the low-income group to fulfil its 'guarantee' of provision of basic financial guidance.

The research

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BACKGROUND

The individual effects of the changes to pension options will ultimately depend on the financial capability and decision-making of millions of UK retirees. For those retiring with only limited DC pension savings, the impact of poor financial decision-making could be particularly large.

Historically, workers with Defined Contribution (DC) pension savings had to convert these savings into a secure income when they retired, i.e. an income that lasts for life. For most, this involved buying an annuity from a life insurance company.

Since April 2015, individuals aged 55 and over are able to draw down or cash in as much of their pension savings as they want (although it is subject to income tax). No one is required to buy an annuity, or obtain a guaranteed income from their DC pension savings.

The research

To address an absence of reliable research on the financial capability of people affected by the changes, detailed statistical analysis was undertaken of Wave 3 of the Wealth and Assets Survey (WAS), which is a large-sample household survey representative of the population of Great Britain. Quantitative research was undertaken into low-income retirees who have a DC pension income to understand the decision-making, financial capability and financial behaviour of this group, and to explore potential policy priorities in the wake of the April 2015 changes.

The research – *Defined capability: pensions, financial capability and decision-making* – explored the characteristics of ‘low-income DC retirees’, defined as individuals aged 65 and over with DC pension savings or a DC pension income, whose overall equivalised (adjusted for household size and composition) household income is below the median. The research focused on this group to provide evidence of the financial capability, attitudes and financial behaviour of individuals, with only small amounts of DC savings and little other provision, who will be affected by the changes. The research also focused on all retirees with DC incomes, and workers approaching retirement with some DC savings.

Overall, across different types of financial capability examined in the research, a clear life-stage pattern was observable. For example, levels of financial engagement are low among young adults, but rise steadily to peak in the 55 to 64 age group, before declining again in retirement. A similar pattern is observable in relation to use of savings and investment products.

General characteristics

The majority of low-income DC retirees (61 per cent) are male, 5 per cent have a degree and half have some other qualifications. Over half (58 per cent) have a longstanding illness or disability. Despite being retired 7 per cent of low-income DC retirees have a mortgage, suggesting the April 2015 changes may see some opt to use their DC savings to pay off their mortgage. Around one-third (32 per cent) of the group rent their home; if such individuals cash in their DC pension pots, they may disqualify themselves from means-tested housing benefits.

Use of financial products

By increasing the scope for retirees to withdraw their DC pension savings and manage them throughout retirement, the April 2015 changes place strong emphasis on financial capability and effective decision-making. However, financial capability tends to grow with the experience that comes from using different financial products.

Among low-income DC retirees, median financial wealth is £8,200 (with £1,000 typically held in a current account), but use of financial products is limited. As many as one in three low-income DC retirees has neither a savings account nor an ISA. Only 18 per cent have a National Saving and Investment product and just 12 per cent have a fixed-term investment bond.

Apart from general insurance products, the purchase of new financial products among low-income DC retirees is very limited, with just 6 per cent opening an investment product during the previous two years, and 5 per cent opening a savings account – suggesting this group does not regularly move their money to get the best returns. Around one quarter (24 per cent) of the low-income group who had bought a financial product in the preceding two years reported they had not used any information or advice sources, such as best-buy tables or provider information, to help them choose the best product.

Financial engagement

To use their DC pension savings effectively, low-income retirees will need to make careful decisions, taking account of changes in inflation, interest rates and the performance of stock markets and investments. However, the research found substantial financial disengagement among low-income retirees. Just one third (29 per cent) keep an eye on interest rates, 22 per cent keep an eye on inflation, 11 per cent keep an eye on the stock market and only 4 per cent keep an eye on ‘best buy’ financial tables. In fact, 59 per cent report they do not monitor any financial or economic trends – higher than all other groups examined in the study, including young people and the oldest old.

Savings and risk

Analysis found that the low-income DC retiree group are in a relatively precarious financial position. One-fifth said they would be able to survive less than a month if their income dropped by a quarter, and a further one-quarter said they would be able to survive one to three months. This may explain why 41 per cent reported saving money during the last two years, with 60 per cent of this group reporting they were saving toward unexpected expenditure. Such a tendency toward precautionary saving – which is common across all retirees – may see some low-income DC retirees opting to use their DC savings as ‘rainy day’ savings, rather than to provide an income.

Policy development

A policy discussion paper *Default reform: preventing low-incomes with an automatic income plan* was published alongside the research. This paper explored the risk that the changes to rules on DC pension saving may result in lower average retirement incomes, and what policy-makers can do about this.

The paper noted that in other countries with high levels of flexibility and choice in the use of DC pension savings, very few people opt to buy an annuity – an outcome that has resulted in an extensive academic literature on the so-called ‘annuity puzzle’. The paper also noted the experiences of countries such as Australia and South Africa, where flexibility and choice at retirement for DC retirees has seen very few individuals opting to annuitise, poor value non-annuity financial products, and DC pension pots spent by retirees on vehicles and property.

The discussion paper argues that there is a significant risk that the changes to rules on DC pension saving will result in lower average retirement incomes for DC pension savers; indeed, there is a significant risk that pensioner poverty will increase. The report argues that the Government should:

- define, implement in regulation and promote a default ‘automatic income plan’ for DC retirees in the UK, while retaining the right for individuals to withdraw their savings from the age of 55 subject to their marginal income tax rate;
- ensure that such a plan provides a predictable, secure (guaranteed) and good-value income for DC retirees.

The report goes on to propose some guiding principles for a default automatic income plan:

- maximise average retirement incomes;
- balance consumer preferences for having access to cash versus receiving a guaranteed income;
- ensure consumers get good value for money;
- design a default option for ‘real people’, rather than assumed types of behaviour and levels of financial capability;
- ensure a default automatic income plan does not exclude small pension pots from good-value, secure retirement income;
- guarantee transparency;
- ensure the plan is adaptable and flexible to a person’s circumstances and the macro-economy.

Low-income DC retirees after April 2016

The paper also made policy recommendations for individuals who reach state pension age on or after April 2016, with just the new state pension and a small amount of DC pension savings, such as below £15,000.

First, given the limited financial capability observable among low-income DC retirees, policy-makers should consider making additional provision to fulfil its guarantee of basic financial guidance, beyond the Pension Wise service. Such provision could take the form of targeted, personalised, face-to-face, generic financial advice for low-income DC savers and retirees.

Second, since the pension industry has historically struggled to provide commercially sustainable products and services to low-income groups – because of the limited financial returns available from investing and managing small pension pots – the Government should consider the creation of a statutory provider of automatic income plans operating with a public service obligation to accept all customers, whatever the size of their savings pot.

Third, 32 per cent of the low-income DC retiree group rent their home. Those who rely on means-tested housing benefits, but opt to cash in their DC pension pots, may spend or give away their pension savings in order not to be disqualified from support for rental costs. Although rules on ‘deliberate deprivation’ of capital are already part of the Housing Benefit means test, it is uncertain how effective they are, particularly in relation to capital spent or if transferred before someone makes their first claim.

More widely, individuals who expect to rent in retirement may be discouraged from pension saving if they believe these savings will eventually count against them in means testing. The Government should therefore consider permanently disregarding ringfenced cashed-in DC pension savings from means testing for Housing Benefit. This could be done by raising the amount of savings disregarded in the Housing Benefit means test by the amount of a person’s DC pension savings, up to a defined threshold, such as the previous level below which pension savers were allowed to take their pot as cash, rather than buy an annuity (£30,000). Alternatively, DC savings could be kept in special earmarked financial products and disregarded on this basis.

About the project

The original research design for Defined Capability was undertaken by James Lloyd. The analysis plan was carried out by Chris Lord. The research comprised secondary analysis of data from Wave 3 of the Wealth and Assets Survey (WAS) and was published by the Strategic Society Centre.

FOR FURTHER INFORMATION

This summary is part of JRF’s research and development programme. The views are those of the authors and not necessarily those of JRF.

Defined capability: pensions, financial capability and decision-making by James Lloyd and Chris Lord, and Default reform: preventing low-incomes with an automatic income plan by James Lloyd are available free at www.jrf.org.uk

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