



# Income, Security and Wellbeing

Helping savers choose a good retirement



THE STRATEGIC  
SOCIETY CENTRE  
ANALYSIS • EVIDENCE • POLICY

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July 2015

[www.strategicsociety.org.uk](http://www.strategicsociety.org.uk)



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### **Acknowledgements**

This report has been made possible by the kind support of Just Retirement and the Joseph Rowntree Foundation.

**All responsibility for content and errors in this report rest solely with the authors.**

Citation: Lloyd J (2015) Income, Security and Wellbeing: Helping savers choose a good retirement, Strategic Society Centre, London

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# Executive Summary

The changes to rules on Defined Contribution (DC) pension savings implemented in April 2015 allow individuals to withdraw as much of their DC pension savings as they wish from the age of 55, paying only their marginal rate of income tax on withdrawals.

If many people opt to cash-in their DC savings rather than receive a guaranteed retirement income – behaviour observable in similar systems overseas – this may result in many UK **retirees having higher levels of cash savings and investments during retirement, but lower guaranteed retirement incomes.**

It would be reasonable to expect that a lower level of guaranteed retirement income could have a range of effects on people's experience of retirement, in particular, their wellbeing. Previous research has identified associations between level of income and subjective wellbeing. A limited number of studies have found a positive association between level of guaranteed income and wellbeing among retirees.

To explore these issues, the Strategic Society Centre undertook quantitative research entitled **Income Security and a Good Retirement**, which was made possible by the support of Just Retirement and the Joseph Rowntree Foundation.

This policy discussion paper accompanies the publication of this research, explores the implications of its findings for public policy and sets out recommendations to policymakers.

Income Security and a Good Retirement analysed data from the English Longitudinal Study of Ageing (ELSA). The sample analysed comprised retired individuals with some form of private pension income. Individuals in receipt of any employment income were excluded, as were the top and bottom income and wealth deciles to remove any effect from those in unusual financial situations.

The research explored associations between level of guaranteed income and a wide range of variables relating to wellbeing and people's outcomes during retirement. The analysis controlled for a number of factors – such as age, tenure and financial wealth – in order to get closer to the independent effect of level of guaranteed income. Given the April 2015 changes to DC pension rules may result in individuals having more financial wealth during retirement, the research also analysed the association between level of non-housing wealth and people's outcomes in retirement.

The research found level of guaranteed income is significantly associated with people reporting that “I feel what happens in life is often determined by factors beyond my control”, and “In general, I have different demands that I think are hard to combine”.

In relation to giving money to others, significant associations for both guaranteed income and non-housing wealth were identified for whether people had **given money to others.**

However, only level of guaranteed income was associated with giving money to their children and to charity.

Multiple significant associations were found between income, wealth and different aspects of **financial security**. Overall, these associations suggest that wealth has a stronger impact on financial security than income. Nevertheless, income seems to play a crucial role, and in many cases, its effects were comparable to those of wealth.

Level of guaranteed income appears to be consistently associated with participation in **leisure activities**, unlike wealth. Relevant activities include going to the cinema, eating out, taking a holiday or reading a newspaper. It seems likely that the regularity of a guaranteed income provides an impetus for expenditure on leisure activities, which is not provided by wealth.

Both income and wealth were associated with **civic participation**. However, income alone was associated with being a member of a “tenant or residents group”, a “political party or environmental group”, “education, arts or music groups or evening classes” and “sports clubs, gyms, exercise classes”. The associations tended to be larger for income than for wealth, for the respective organisations. As with participation in leisure activities, it seems that income is able to provide better support for participation in classes, organisations and other civic and social groups.

Income, but not wealth, was associated with people’s **satisfaction with life**, specifically, whether they report “the conditions of my life are excellent” and “so far I have got the important things I want in life”.

The findings of Income Security and a Good Retirement have a number of implications for public policy.

Overall, the research suggests an **average pension saver would be likely to have a better retirement if they seek to maximise their level of guaranteed income**. Although retaining DC pension wealth as savings or investments may provide some level of compensatory wellbeing, the total effect of guaranteed income is stronger than wealth in many of the domains identified in the research.

In addition, if an individual with DC pension savings cashes in such savings and proceeds to spend down this wealth, the wellbeing effect resulting from this wealth will decline commensurately. In contrast, the positive influence on retirement resulting from higher levels of guaranteed income is constant and lasts for the entirety of someone’s retirement.

As such, by adopting a position of neutrality as to how individuals use their pension savings in retirement, the **government may in fact oversee reductions in the wellbeing of retirees as a result of the April 2015 changes** to rules on DC pension savings.

International experience of voluntary annuitisation frameworks for DC savers – where there is no obligation to obtain a guaranteed pension income - is widely characterised by very low rates of annuity purchase. Why? The associations identified in Income Security and Retirement Wellbeing between non-housing wealth and different aspects of wellbeing may

well exist in relation to someone's DC pension savings before they reach retirement. However, most DC savers have never experienced a guaranteed income before they reach the point of retirement, so are unfamiliar with its wellbeing effects. At the point of choosing how to use their DC pension savings, **retirees may struggle to imagine or estimate the real wellbeing effects of a guaranteed income to their retirement**, in contrast to a pre-existing wellbeing effect resulting from their possession of DC pension savings – particularly a feeling of financial security.

Previous research has identified a 'savings bias' observable in the older population. The positive wellbeing effects of wealth – identified in Income Security and a Good Retirement – may in fact inhibit spending, and explain why guaranteed income appears to support spending in a way that wealth does not: individuals may be 'afraid' of spending down their wealth and foregoing the associated peace of mind and wellbeing of 'nest-egg' savings.

On the basis of the findings of Income Security and a Good Retirement, a number of recommendations to policymakers can be made:

- ▶ **Actively promote receipt of a guaranteed income in pension policy to improve the wellbeing of retirees.**
- ▶ **Educate savers before retirement about the role of guaranteed income for a good retirement.**
- ▶ **Include information about the importance of guaranteed income to wellbeing in retirement in Pension Wise guidance and information.**
- ▶ **Ensure receipt of a decent, guaranteed retirement income is the default option for DC pension savers.**
- ▶ **Undertake regular research into the effect of the April 2015 changes on older people's wellbeing.**

Alongside the main analysis, the research explored the importance of income and wealth for those living in **income poverty**, defined as less than £217 per week, which was the level of means tested Pension Credit income support for a couple in the year the ELSA data were collected (2012-13). Interestingly, there were virtually no associations for level of income, but there were multiple significant associations with wealth. These results suggest for retirees experiencing income poverty, wealth may provide a crucial security blanket, for which small changes in (low) income cannot substitute.

# 1. Introduction

## Key points:

- ▶ **The changes to rules on DC pension saving implemented in April 2015 will ultimately alter the retirements of millions of people in the UK, and may result in many retirees having higher levels of cash savings and investments during retirement, but lower guaranteed retirement incomes.**
- ▶ **It would be reasonable to expect that a lower level of guaranteed (secure) retirement income could have a range of effects on people's experience of retirement, in particular, their wellbeing.**
- ▶ **To explore these issues, the Strategic Society Centre undertook quantitative research entitled *Income Security and a Good Retirement*, which was made possible by the support of Just Retirement and the Joseph Rowntree Foundation.**
- ▶ **This policy discussion paper accompanies the publication of this research, explores the implications of its findings for public policy and sets out recommendations to policymakers.**

## 1.1. Background

For many years, UK pensions policy was built around the so-called 'annuities deal', which can be traced back to the Finance Act of 1921.

Under the annuities deal, in return for exceptional levels of tax-relief relative to other savings vehicles, individuals saving into Defined Contribution (DC) pension schemes were obliged to convert their private pension savings into a guaranteed pension income at retirement, i.e. an income that would last until the end of their life, whenever that occurred.

However, amid rising frustration with these rules, the government used Budget 2014 to announce that it would scrap this framework for DC pension savings. Since April 2015, individuals with DC pension savings have been able to cash-in or drawdown as much of their savings as they wish from the age of 55, paying only their marginal income tax rate on the value of withdrawals, with no obligation to obtain a guaranteed retirement income.

It was subsequently reported that over £1 billion was withdrawn from DC pension schemes in the UK by around 60,000 people during the first three months following implementation of this change.<sup>1</sup>

## 1.2. Income security and people's experience of retirement

The changes to rules on DC pension saving implemented in April 2015 will ultimately alter the retirements of millions of people in the UK.

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<sup>1</sup> Cumbo J and Pickard J (2015) *More than £1bn pension savings cashed in following UK reforms*, Financial Times, London

Although some individuals with DC pension savings may continue to obtain a guaranteed income by purchasing an annuity or entering some form of income drawdown, it is expected that a large number will cash-in their DC pension savings completely. At this point, individuals may:

- ▶ Place the money in a current or savings account;
- ▶ Invest the money in shares and bonds;
- ▶ Invest the money in a rental property.

In addition, it is expected that some will spend the value of their DC savings – for example, on holidays - pay off debts, or gift their pension savings to friends or family.

In this way, the April 2015 changes are likely to result in many retirees having potentially higher levels of cash savings and investments during retirement, but lower guaranteed retirement incomes, even if they also have some entitlement to a Defined Benefit (DB) pension income. For many DC pension savers, the choice around how to use their DC pension savings will be framed as ‘cash or income’.

Despite the significance of the April 2015 changes to DC pension rules to people’s retirements, the government has made it clear that it believes **it is not the role of the state to direct or nudge individuals as to how they use pension savings**. In particular, the government has made it clear that it is a private matter for individuals as to whether they opt to receive a significantly lower guaranteed income in retirement through cashing in the full value of their DC pension savings.

However, the prospect of lower incomes among retirees in the UK raises questions around what this will mean for people’s experience of retirement and old age.

Indeed, it would be reasonable to expect that a **lower level of guaranteed retirement income could have a range of effects on people’s experience of retirement, in particular, their wellbeing**.

In this context, a striking feature of the April 2015 changes to private pensions policy has been **limited consideration of what the changes will mean for people’s experience of retirement**. For example, in the consultation document about the April 2015 changes issued alongside Budget 2014, not one of the consultation questions related to the actual experience and retirement outcomes of individuals with DC pension savings.<sup>2</sup> The consultation did not seek to consider whether and how older people would experience better retirements as a result of the changes, nor what ameliorating measures might be required if the pension rule changes led people to have worse retirements.

To explore these issues, the Strategic Society Centre undertook quantitative research entitled **Income Security and a Good Retirement**, which was made possible by the support of **Just Retirement** and the **Joseph Rowntree Foundation**.

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<sup>2</sup> HM Treasury (2014) *Freedom and choice in pensions*, HM Treasury, London

This policy discussion paper accompanies the publication of this research, explores the implications of its findings for public policy and sets out recommendations to policymakers. In particular, this report explores:

- ▶ **What is the relationship between guaranteed retirement income and different aspects of wellbeing in retirement?**
- ▶ **Are the April 2015 changes to DC pension rules likely to lead to a reduction in levels of wellbeing in the older population, if many retirees opt to cash-in their pension savings rather than obtain a guaranteed income?**
- ▶ **What is the role of pensions policy in improving wellbeing in retirement?**

### **1.3. Income, Security and Wellbeing**

Chapter 2 sets out the policy context for the April 2015 changes, the experience of other countries with voluntary annuitisation frameworks and how DC pension savers in the UK may be expected to behave in the medium to long-term.

The third chapter briefly summarises the existing research literature on wellbeing, income and retirement.

Chapter 4 reviews the findings of Income Security and a Good Retirement.

The fifth chapter discusses what the findings of the research mean for public policy. Chapter 6 presents recommendations to policymakers and Chapter 7 concludes the report.

## 2. Policy Context: April 2015 and DC pension rules

### Key points:

- ▶ The government has adopted a position of neutrality in relation to income in retirement, arguing the state should not push individuals to obtain a higher pension income than the state pension, and should be neutral as to the proportion of their retirement wealth that individuals hold in the form of a guaranteed pension income.
- ▶ International experience with voluntary annuitisation frameworks for retirees has consistently shown very low take-up of annuities, i.e. the use of DC pension savings to fund a guaranteed pension income.
- ▶ The proportion of individuals in the UK with DC savings who choose to obtain a guaranteed pension income may also substantially decline in future, leading to a reduction in average pension incomes.
- ▶ However, it would be reasonable to hypothesise that retirees with higher levels of guaranteed pension income guaranteed until the end of their life experience better wellbeing and retirement outcomes than those with lower incomes, regardless of their level of savings.
- ▶ If true, by adopting a neutral position to levels of retirement income in the wake of the April 2015 changes to rules on DC pension schemes, the government may oversee reductions in the wellbeing of retirees.

### 2.1. Background

For nearly a century, UK private pension policy placed a firm emphasis on ensuring individuals have a guaranteed pension income in retirement.

To ensure that tax-incentivised pension savings were used to fund a pension income – a guaranteed income that is guaranteed until the end of a person’s life – successive UK governments coupled voluntary participation in private pension saving with compulsory conversion of these savings into a guaranteed pension income at retirement.

The so-called ‘**annuities deal**’ had its origins in the Finance Act of 1921, which introduced the “mandatory annuitisation of pension funds”.<sup>3</sup> Under the annuities deal, UK private pension savings benefited from exceptional levels of tax-relief compared to other types of saving vehicle: both income tax-relief on contributions and tax-relief on the investment gains accrued by pension funds.<sup>4</sup>

Following the ‘auto-enrolment’ reforms to workplace pension saving, which began in 2012, these incentives were strengthened further by **guaranteed employer contributions** for employees in qualifying schemes.

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<sup>3</sup> Finance Act (1921), quoted in HM Treasury (2014) *Freedom and choice in pensions*, London

<sup>4</sup> However, the future of this tax relief is uncertain

However, in return for such incentives, the ‘annuities deal’ required individuals to convert their pension savings into a **guaranteed pension income** that protects their income in retirement from **longevity risk**, i.e. uncertainty over how long they will live for and the risk of running out of money.

For many years, the annuities deal was policed in relation to ‘Defined Contribution’ (DC) pension savings by punitive tax charges: although in theory individuals could take their pension pot at retirement wholly as cash, beyond the first 25% of its value (the ‘tax-free lump sum’), individuals were charged **punitive tax-rates of 55%** of the money withdrawn. As a result, very few individuals exercised this option. Instead, most obtained a guaranteed pension income through purchasing an **annuity**, or – for those with very large pension pots – entering **income drawdown**.

### The ‘annuities deal’, DC pension savers and the annuities market

Although a foundation stone of UK pensions policy for nearly a century, in recent years several factors contributed to growing disquiet toward the compulsory annuitisation framework for DC pension savers. These factors include:

- ▶ **Declining ‘annuity rates’** – the average income paid by annuities (‘annuity rates’) has fallen in recent years, reflecting both changes in the underlying capital market instruments that insurance companies invest in (notably long-term government bonds), and continued increases in average life expectancy, which have extended the number of years during which annuities are typically expected to pay an income, thereby increasing the uncertainty (risk) facing providers;
- ▶ **Inadequate competition** – many individuals retiring with DC pension savings have not shopped around for an annuity to guaranteed the best income available, despite the options available. For example the Financial Conduct Authority noted in 2015 that many consumers were missing out by not shopping around for an annuity and switching providers, and some did not purchase the best annuity for their circumstances.<sup>5</sup>

## 2.2. Budget 2014

Against this context, Budget 2014 effectively scrapped the annuities deal for DC savers by **downgrading the tax-rate for withdrawals** from pension pots for those aged 55 and over after April 2015 from 55% to a person’s marginal income tax rate, i.e. treating withdrawals from DC pension pots as simply a form of taxable income for the year it is received.

Budget 2014 therefore imposed a radical change on UK pensions: since April 2015, DC pension savers are completely **released from any requirement to obtain a guaranteed pension income** with their pension savings and can, if they wish, withdraw their entire pot to spend on leisure, holidays and bequests, etc. In order to minimise tax exposure, individuals can phase withdrawals of their pension savings over a number of years to make use of any spare ‘Personal Allowance’ (tax-free income entitlement) they retain.

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<sup>5</sup> FCA (2015) *Retirement income market study*, FCA, London

As stated by the government at the time of the announcement, the Budget 2014 changes to pension taxation reflected several distinct beliefs that represent a departure from the previous regime associated with the 'annuities deal':

- ▶ It is not the role of the state to compel or direct individuals as to how they use their pension savings;
- ▶ Individuals are better placed than the state to understand their own retirement income and wealth needs and priorities, and have the financial capability to do what is best for their own wellbeing in retirement, without direction from the government;
- ▶ If individuals choose to take their pension savings as cash at retirement and maintain it in a non-annuitized form (such as savings), there are no negative externalities (costs) for public policy given the increase from 2016 in the value of the universal State Pension ('New State Pension') for new retirees, to a level above what the government considers the threshold of income poverty.

In short, Budget 2014 saw the government adopt a **position of neutrality** in relation to income in retirement: the state should not push individuals to obtain a higher pension income than the state pension, and should be neutral as to the proportion of their retirement wealth that individuals hold in the form of a guaranteed pension income.

This shift, which represents a fundamental break with the foundation of UK private pension policy for nearly a century, was summarised by the then Minister for Pensions, who stated that the government was "relaxed" with how retirees spend their retirement savings, noting: "If people do buy a Lamborghini but know that they'll end up just living on the state pension, that becomes their choice."<sup>6</sup>

### 2.3. Pension Wise

In order to help individuals with DC pension savings decide what to do with their money, the government set up 'Pension Wise' ahead of the April 2015 changes. Pension Wise is described as a free and impartial government service about savers' DC pension options. Individuals who choose to take up the Pension Wise service can use its website, or make an appointment for a telephone call or face-to-face session.

The Pension Wise service defines five options that individuals have since April 2015:

- ▶ Leave pot untouched;
- ▶ Guaranteed income;
- ▶ Adjustable income;
- ▶ Take cash;
- ▶ Mix your options.

Source: Pension Wise (2015)

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<sup>6</sup> BBC News (2014) Minister fuels pension debate with Lamborghini comment, <http://www.bbc.co.uk/news/uk-politics-26649162>

The Pension Wise service does not seek to guide or influence people's decisions, but rather, to make them informed of what their options are.

Subsequent to the government's decision to implement the April 2015 changes, the Financial Conduct Authority (FCA) set out requirements for pension scheme providers to highlight the existence of the Pension Wise service, or regulated advice, to DC pension savers. The FCA also responded to calls for additional protections for consumers by requiring pension providers to give relevant risk warnings to individuals, such as warning of the tax implications of clients' decisions, in response to answers from consumers.

#### 2.4. How do retirees behave in pension systems with voluntary annuitisation?

April 2015 saw the UK move from a compulsory to a voluntary annuitisation framework for DC pension savings. How do retirees behave in pension systems with voluntary annuitisation frameworks?

International experience with voluntary annuitisation frameworks for retirees has consistently shown very low take-up of annuities, i.e. the use of DC pension savings to fund a guaranteed pension income.

An extensive international academic research literature exists analysing this phenomenon – the so-called '**annuity puzzle**' – reflecting the fact that economic modelling suggests a rational, 'utility-maximising' individual with uncertain life expectancy would in fact annuitise all of their wealth.

A review of this literature by the Strategic Society Centre identified three broad sets of factors explored in academic research to explain the low voluntary take-up of annuities experienced by different countries.<sup>7</sup> **Supply-side factors** that may explain the annuity puzzle include:

- ▶ Poor value for money – the life annuities on offer to consumers do not offer good value-for-money;
- ▶ Selection effects – various factors may result in annuities being bought by more healthy individuals, pushing down annuity rates;
- ▶ Incomplete markets – annuity providers fail to offer annuity products that reflect the preferences of consumers sufficiently closely.

**'Rational' demand-side factors** for explaining the annuity puzzle are those that assume individuals are logical, rational and informed in taking financial decisions. These factors include:

- ▶ Bequest motives – individuals want to preserve their wealth in order to leave it as an inheritance;
- ▶ Consumption preferences around housing – since owner-occupied homes represent a good that is also a form of 'annuitised consumption', individuals prefer to allocate their wealth to housing as a guaranteed 'consumption stream', rather than an annuity as a guaranteed 'income stream';

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<sup>7</sup> Lloyd J (2014) *New Annuity Era*, Strategic Society Centre, London

- ▶ ‘Pre-annuitisation’ through state pension and other sources – some individuals, particularly with low levels of overall saving, may feel they have sufficient annuitised income from other sources, such as the state pension or other (DB) pension provision;
- ▶ Risk-pooling via families – individuals see families as alternative sources of pension income;
- ▶ Insurance/precautionary saving against spikes in income needs – individuals may opt to keep their pension savings in liquid, accessible cash savings as ‘insurance’ against potential ‘spikes’ in income needs such as future healthcare costs or ‘fixing the roof’.

Reflecting growing interest in behavioural economics across multiple academic disciplines, researchers have investigated **‘behavioural’ demand-side factors** that may explain the annuity puzzle, which emphasize psychological responses and various types of non-rational behaviour. These include:

- ▶ Framing – presented with the option of an annuity in an ‘investment frame’ – rather than a ‘consumption frame’ – individuals judge it a poor or risky investment compared to alternatives;
- ▶ Hyperbolic discounting – individuals excessively discount the value of receiving income in the future, as opposed to the present;
- ▶ Loss aversion – individuals over-emphasise the risk of ‘losing’ from an annuity (dying early), rather than living a long time and being a ‘winner’;
- ▶ Regret aversion – individuals fear subsequently feeling that they made the wrong choice, so opt against the ‘once-and-for-all’ choice to buy an annuity;
- ▶ Loss of ‘asset-effect’ dividend – research suggests that the possession of assets has a positive effect on wellbeing, expectations and confidence about the future, etc. As such, individuals in possession of DC pension savings may be reluctant to annuitise because they do not want the loss of the psychological ‘dividend’ associated with possessing a DC pension pot.

Overall, the wide range of hypotheses examined in research on the annuity puzzle suggest that it may be ‘over-determined’, i.e. it results from multiple factors, various combinations of which may inhibit voluntary demand for annuities.

## **2.5. How are UK savers likely to respond to changes to rules on DC pension savings?**

As noted in the Introduction, it was reported that over £1 billion was withdrawn from DC pension schemes in the UK by around 60,000 people during the first three months following implementation of the April 2015 changes.<sup>8</sup> However, such withdrawals are to some extent likely to represent ‘pent-up’ demand ahead of the rule changes being implemented, and may not be indicative of trends in the medium and long-term, even though the experience of other countries with voluntary annuitisation frameworks is of very low rates of annuity purchase.

How are UK savers likely to respond to changes to rules on DC pension savings? In addition to various factors inhibiting purchase of annuities identified in research on the ‘annuity puzzle’,

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<sup>8</sup> Cumbo J and Pickard J (2015) *More than £1bn pension savings cashed in following UK reforms*, Financial Times, London

the choices of DC pension savers after April 2015 will to a significant extent reflect their financial capability.

The Strategic Society Centre published quantitative research in 2015 on the financial capability of ‘DC ‘pre-retirees – individuals aged 55 to 64 with DC pension savings – as well as ‘DC retirees’ – individuals aged 65 and over with DC pension savings or a DC pension income.<sup>9</sup> The research – entitled ‘Defined Capability: Pensions, financial capability and decision-making among retirees’ – found generally low levels of financial capability in these groups. For example:

- ▶ One quarter (23%) of DC pre-retirees have neither a savings account or an ISA;
- ▶ Just one quarter (25%) of DC pre-retirees and DC retirees keep an eye on the stock market, and only 13% of DC retiree group keep an eye on financial best buy tables;
- ▶ Nearly 30% of DC pre-retirees and DC retirees do not keep an eye on any economic trends.

The research also found a tendency toward ‘over-saving’, noting that individuals continued to save from their income into their 80s, and the average amount that retirees have in their current account actually increases as they age, potentially reflecting an attachment to saving, the building of a ‘nest-egg’ and the reassurance and wellbeing effects resulting from such ‘rainy-day savings’.

These findings echo the results of qualitative research undertaken after Budget 2014 with individuals aged 55 to 70 with DC pension savings, focused on those with sufficiently large pension pots such that they may prefer to leave these invested rather than withdrawing them in their entirety as a cash lump sum.<sup>10</sup> Key findings of the research, published by the Pensions Policy Institute, included:

- ▶ Planning horizons are short, focusing on the next year or two rather than long term income needs – making it difficult to engage savers with detailed retirement planning ahead of, or even at, retirement;
- ▶ The 55-70 year olds were not confident with equity markets or making direct investments themselves and tended to invest their non-pension savings in cash-based investments such as ISAs – suggesting that pension savings accessed as one or a series of lump sums may simply be placed in “safe” or low-return investments;

Such research, together with existing research on the ‘annuity puzzle’, suggests that the **financial capability of many individuals with DC pension savings in the UK may be low relative to the complexity of retirement choices they face**, and the potential task of managing their retirement savings themselves to provide an income.

Ultimately, the choice around how to use a DC pension pot – obtain a guaranteed income or cash-in – is not something that individuals have prior experience of. This choice requires individuals to make a decision looking ahead 20 to 30 years. Interestingly, of six types of

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<sup>9</sup> Lloyd J and Lord C (2015) *Defined Capability: Pensions, financial capability and decision-making among retirees*, Strategic Society Centre, London

<sup>10</sup> Echalié M et al. (2015) *Supporting DC members with defaults and choices up to, into, and through retirement*, Pensions Policy Institute, London

financial capability examined in a study for the Office for National Statistics (ONS), capability to plan ahead was found to be lower than other types of capability, such as money management and making ends meet.<sup>11</sup>

Together with evidence of low rates of voluntary annuitisation of DC pension funds overseas, such research suggests **the proportion of individuals in the UK with DC savings who choose to obtain a guaranteed pension income may substantially decline in future.**

As a consequence, this may lead to **a reduction in average pension incomes and change the experience of later life for millions of people.**

## 2.6. Conclusion

The April 2015 changes to pension rules switched DC pension saving in the UK from a system of mandatory annuitisation to a system of voluntary annuitisation.

April 2015 represented a **fundamental and historic shift in government policy**, from requiring individuals to obtain a guaranteed pension income with their retirement savings to being entirely neutral about how retirement savings are used.

Where previously governments have sought to boost average retirement incomes toward the benchmark two-thirds income replacement rate, **the UK government's official position is now to be neutral as to levels of private pension income**, at both an individual and population level, beyond the income provided by the New State Pension.

In effect, the UK government has stated that if the new system of voluntary annuitisation results in a decline in average incomes owing to most individuals with DC savings opting for cash rather than an income – similar to outcomes found in Australia<sup>12</sup> – then this is of no concern to public policy.

However, **this change in government policy raises important questions.** In particular, it would be reasonable to hypothesise that:

- ▶ Retirees with higher levels of guaranteed pension income guaranteed until the end of their life experience better wellbeing and retirement outcomes than those with lower incomes, regardless of their level of savings;
- ▶ The security and 'peace of mind' provided by a guaranteed income would have a positive effect on individual wellbeing, relative to holding other forms of financial wealth.

If true, these hypotheses would pose important challenges for the government's policy position since Budget 2014.

Indeed, by adopting a neutral position to levels of retirement income in the wake of the April 2015 changes to rules on DC pension schemes, **the government may in fact oversee**

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<sup>11</sup> Finney A and Hayes D (2015) *Financial Capability in Great Britain, 2010 to 2012*, ONS, London

<sup>12</sup> Challenger Retirement Income Research (2012) *How much super do Australians really have?*, Challenger Limited, Sydney

**reductions in the wellbeing of retirees.** Put simply, the April 2015 reforms may see retirees with DC pension savings have worse retirements.

Importantly, if wellbeing is reduced, this could potentially result in knock-on additional demands on other areas of public spending, notably the NHS.

This position by the government is striking given the **widely accepted responsibility of governments to promote the wellbeing of their population.** For example, in 2010, the UK government launched the National Wellbeing Programme, which led to the annual publication of the 'Life in the UK' report starting November 2012, which provides a "snapshot of the nation's wellbeing".<sup>13</sup>

To explore this issue, the Strategic Society Centre undertook quantitative research into the relationship between people's experience of retirement – in particular, various aspects of wellbeing – and their level of guaranteed income (i.e. income guaranteed until the end of their life).

Through statistical analysis, the research was able to explore the relationship between guaranteed income and retirement outcomes, controlling for people's level of financial wealth.

To inform this research, a literature review was undertaken on the link between income and wellbeing, which is summarised in the next chapter.

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<sup>13</sup> ONS (2015) *Measuring National Well-being programme*, ONS, London

# 3.Literature Review: Income and wellbeing

## Key points:

- ▶ **Previous research has identified associations between level of income and subjective wellbeing.**
- ▶ **A limited number of studies have found a positive association between level of guaranteed income and wellbeing among retirees.**

## 3.1. Introduction

As the previous chapter noted, the April 2015 changes to rules on DC pension savings may result in many individuals having a lower guaranteed income in retirement because they have opted to cash-in their savings, with significant consequences for their experience of retirement and wellbeing.

The relationship between income and wellbeing has been the subject of extensive academic research, alongside research on what factors are associated with a positive retirement. This chapter provides a brief review of such evidence and explores:

- ▶ What is the relationship between income and wellbeing?
- ▶ What effect does income security have in later life?
- ▶ What other factors influence wellbeing in later life?
- ▶ What is the relationship between wealth and wellbeing?

## 3.2. What is the relationship between income and wellbeing?

There is longstanding academic research into whether **level of income influences subjective wellbeing (SWB)**.

In 1974, Easterlin argued that income affects SWB, but only relative to other changeable factors such as expectations, adaptation levels and social comparisons i.e. people are happier if they are richer than their neighbours. Therefore, if the GDP of a nation increases this will have an insignificant effect on average SWB because the population's position relative to each other will have remained the same (this is known as Easterlin's paradox).<sup>14</sup>

In contrast to Easterlin's 'relativist' thesis, Veenhoven (1988) suggested an 'absolutist' explanation,<sup>15</sup> arguing that income affects SWB by allowing individuals to meet certain universal needs, though once these needs are met income becomes less important for SWB due to declining marginal utility of money. This position is supported by a 1993 study,<sup>16</sup> which

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<sup>14</sup> Easterlin R (1974) "Does economic growth improve the human lot? Some empirical evidence" in David O and Melvin W (eds.) *Nations and Households in Economic Growth*, Stanford University Press

<sup>15</sup> Veenhoven R (1988) "The utility of happiness" in *Soc Indic Res*, Vol. 20, No. 4, p333-354

<sup>16</sup> Diener E et al. (1993) "The relationship between income and subjective well-being: Relative or absolute?" in *Soc Indic Res*, Vol. 28, No. 3, p195-223

examined cross-country data across 39 diverse countries and within-country data for the US, and Sacks et al.'s (2012) study, which uses data from the Gallup World Poll.<sup>17</sup> This study found that citizens of rich countries have higher wellbeing on average than citizens of poor countries. The “strikingly linear” correlation between average wellbeing and log GDP per capita in 2010 is 0.74. They also found that there is no satiation point beyond which the relationship between income and wellbeing diminishes. An ONS report in 2014 also found that individuals in households with higher incomes report higher life satisfaction and happiness, and lower anxiety, holding other factors fixed. However, higher household income is not significantly related to people’s sense that the things they do in life are worthwhile.<sup>18</sup>

Nevertheless, it is difficult to say with certainty whether correlation between GDP and SWB is due to causation. Income is also highly correlated with human rights and democracy, which may themselves affect SWB so influences become difficult to disentangle.<sup>19</sup>

It is also important to note that income loss has been associated with drops in SWB. This was observed in former Soviet nations at the end of communism, and at a micro-level, research has found that income loss has also been shown to have a greater impact on SWB than income gain.<sup>20</sup>

Such research findings suggest that level of income in retirement may indeed affect people’s wellbeing, raising important questions about the implications of more retirees in the UK having lower incomes owing to changes to rules on DC pension savings.

### 3.3. What effect does income security have in later life?

A limited number of US studies have sought to unpick the relationship between people’s experience of retirement and guaranteed (annuitised) income.

Panis (2004) used the US Health and Retirement Survey (HRS) to examine the role of annuities and wealth on retirement satisfaction and mental health. The study found that **annuity income from pensions increases retirement satisfaction and reduces the number of depression symptoms**, while Social Security reliance (measured by how much Social Security contributes to total income) has no statistically significant effect on either wellbeing measure, suggesting the wellbeing effect of income may be focused on those with mid-to-higher income.<sup>21</sup>

A 2012 study by Nyce and Quade for actuarial consultants Towers Watson examined the role

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<sup>17</sup> Sacks D et al. (2012) “The new stylized facts about income and subjective well-being” in *Emotion*, Vol. 12, No. 6, p1181-1187

<sup>18</sup> Lewis J (2014) *Income, Expenditure and Personal Well-being*, Office for National Statistics, London

<sup>19</sup> Diener E and Seligman M (2004) “Beyond Money: Toward an Economy of Well-Being” in *Psychological Science in the Public Interest*, Vol. 5, No. 1, p1-31

<sup>20</sup> Kahneman D and Deaton A (2010) “High income improves evaluation of life but not emotional well-being” in *Proceedings of the National Academy of Sciences*, Vol. 107, No 38, p16489-16493

<sup>21</sup> Panis C (2004) “Annuities and Retirement Well-Being” in Mitchell O and Utkus S (eds.) *Pension Design and Structure: New Lessons from Behavioral Finance*, Oxford University Press, cited in Bender K (2012) “An analysis of well-being in retirement: The role of pensions, health, and ‘voluntariness’ of retirement” in *The Journal of Socio-Economics*, Vol. 41, Issue 4, p 424–433

of annuitised wealth in shaping retirement satisfaction.<sup>22</sup> Using the 2010 Health and Retirement Survey (HRS), the study found that 48% of the full sample population had annuitised income other than Social Security benefits, and 27% received 30% or more of their income in the form of an annuity.

Over time, the analysis found that over time satisfaction scores were significantly lower for those without annuities, and retirees with less than 30% of their income annuitized were less satisfied than the highly annuitized group.

To isolate the effects of annuities from cohort and age factors, the researchers divided the full sample into groups at various stages of retirement. At each wealth level, annuitants were consistently more satisfied, with the effect particularly strong among families with less wealth. Even after controlling for wealth, health, income, age, education and other factors, annuitised income was still found to boost retirement satisfaction.

It could be expected that the ‘satisfaction effect’ of annuities would be stronger during periods of economic uncertainty and instability. Longitudinal analysis found that less affluent retirees with annuitised income were over 50% more likely to be highly satisfied in 2010 than their peers without annuitised income, compared with only 30% in 1998 during a period of relative economic stability.

### **3.4. What factors influence wellbeing in later life?**

In addition to income, various academic studies have investigated what factors are associated with variations in wellbeing in retirement.

Overall, it is important to note that multiple studies have found that wellbeing over the life course is ‘U-shaped’ and often increases in old age. For example, Blanchflower and Oswald deployed multiple statistical models using data from several different countries and found a generally robust U-shape pattern of reported wellbeing across age groups.<sup>23</sup>

In relation to individual factors, Butrica and Schaner (2005) found that retirees who work or volunteer have higher levels of subjective wellbeing than those who are not similarly engaged, although wellbeing declines after 1000 annual hours in work or volunteering activities.<sup>24</sup>

Bender (2012) used the Health and Retirement Survey (HRS) to explore what factors determine responses to: “All in all, would you say that your retirement has turned out to be very satisfying, moderately satisfying, or not at all satisfying?”<sup>25</sup> The analysis found that over 60% of retirees were very satisfied with their retirement, a third were moderately satisfied and

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<sup>22</sup> Nyce S and Quade B (2012) “Annuities and Retirement Happiness” in *Insider*, Issue: September, Towers Watson

<sup>23</sup> Blanchflower D and Oswald A (2007) *Is Well-Being U-Shaped over the Life Cycle?*, Institute for the Study of Labor (IZA), Bonn

<sup>24</sup> Butrica B and Schaner S (2005) “Satisfaction and Engagement in Retirement” in *Perspectives on Productive Aging 2*, Washington, DC: Urban Institute, cited in Bender K (2012) “An analysis of well-being in retirement: The role of pensions, health, and ‘voluntariness’ of retirement” in *The Journal of Socio-Economics*, Vol. 41, Issue 4, p 424–433

<sup>25</sup> Bender K (2012) “An analysis of well-being in retirement: The role of pensions, health, and ‘voluntariness’ of retirement” in *The Journal of Socio-Economics*, Vol. 41, Issue 4, p 424–433

8% were not satisfied with their retirement. The analysis found that male retirees have lower retirement satisfaction than female retirees, and being married increases the probability of being in the highest category of satisfaction. Ethnicity and education did not show statistically significant effects. Older retirees had higher retirement satisfaction than those under 62 years.

In relation to financial characteristics, the Bender study found that income and wealth tended to increase retirement satisfaction. Having no pension decreased the probability of being in the highest satisfaction category, compared to those with only DB pensions. Interestingly, having just a DC pension reduced the probability of being in the highest satisfaction category but there was no statistically significant difference to those with just DB plans.

Overall, the analysis found a relatively small impact of income on retirement satisfaction. The results showed that while economic wellbeing (as measured by income and wealth) did increase overall wellbeing, the effect of income is a nuanced one. On the one hand, the effect of an increase in income on retirement satisfaction was quite small, even for relatively large increases in income, suggesting that since many of the elderly are not at poverty levels, the increased income does not generate significantly increased wellbeing. However, relative income does play a significant role. Retirees seem to value having income above the typical amount, particularly in terms of relative pension income, but also for Social Security income. The analysis found that **whether retirement was voluntary**, and **health status**, was also associated with satisfaction.

A 2014 Canadian study by Boodoo et al. found that absolute personal income does have a small positive relationship with life satisfaction but only for retirees and not for the non-retired, and the relationship between relative income and happiness is much stronger for the non-retired than retired persons, likely reflecting the importance of comparisons among peers at the workplace.<sup>26</sup>

A 2014 study by Asebedo and Seay explored the relationship **between psychological attributes** and retirement satisfaction. It found that 'dispositional optimism', family support, purpose in life, and perceived mastery of day-to-day affairs were each positively associated with retirement satisfaction.<sup>27</sup>

### 3.5. What is the relationship between wealth and wellbeing?

In addition to income, various studies have explored the relationship between wealth and levels of wellbeing.

A 2004 study of five countries – Australia, Britain, Germany, Hungary and the Netherlands – found that wealth affects life satisfaction more than income.<sup>28</sup> Results from panel regression fixed effects models indicated that changes in wealth, income and consumption all produce significant, though not large, changes in satisfaction levels.

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<sup>26</sup> Boodoo U et al. (2014) "Relative income, absolute income and the life satisfaction of older adults: do retirees differ from the non-retired?" in *Industrial Relations Journal*, Vol. 45, Issue 4, p281-299

<sup>27</sup> Asebedo S and Seay M (2014) "Positive Psychological Attributes and Retirement Satisfaction" in *Journal of Financial Counseling and Planning*, Vol. 25, Issue 2, p161-173

<sup>28</sup> Headey B et al. (2004) *Money Doesn't Buy Happiness... Or Does It? A Reconsideration Based on the Combined Effects of Wealth, Income and Consumption*, Institute for the Study of Labor (IZA) in Bonn

Yadama and Sherraden noted that assets have a positive effect on expectations and confidence about the future; influence people to make specific plans with regard to work and family; induce more prudent and protective personal behaviours; and lead to greater social connectedness with relatives, neighbours, and organisations.<sup>29</sup> A UK study also found that asset holding is associated with positive health outcomes.<sup>30</sup>

### 3.6. Conclusion

The research reviewed in this chapter suggests that **a relationship between income and wellbeing exists**. Previous research also suggests a link between levels of guaranteed income and wellbeing in retirement; however, the availability of evidence is limited owing to the small number of studies that have been undertaken.

Nevertheless, the determinants of wellbeing in retirement in old age are **complex and multiple**, and must take account of a U-shape in levels of wellbeing found across age groups. In addition, income is not the only economic determinant of wellbeing, and various studies have highlighted a **wellbeing effect associated with assets and wealth**.

Such research was used to inform the design of quantitative research undertaken by the Strategic Society Centre into the link between Income Security and a Good Retirement among retirees in England. The findings of this research are set out in the next chapter.

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<sup>29</sup> Yadama G and Sherraden M (1996) “Effects of Assets on Attitudes and Behaviors: Advance Test of a Social Policy Proposal” in *Social Work Research*, Vol. 20, p3-11, cited in Lerman R and McKernan S (2008) *The Effects of Holding Assets on Social and Economic Outcomes of Families: A Review of Theory and Evidence*, The Urban Institute

<sup>30</sup> Bynner J and Despotidou (2001) *The Effects of Assets on Life Chances*, Center for Longitudinal Studies, Institute for Education

# 4. Income Security and a Good Retirement

## Key points:

- ▶ **Income Security and a Good Retirement analysed data from the English Longitudinal Study of Ageing (ELSA). The sample comprised retired individuals with some form of private pension income. Individuals in receipt of any employment income were excluded, as were the top and bottom income and wealth deciles.**
- ▶ **The research looked at the association between level of guaranteed income - and value of non-housing wealth – with a wide range of variables relating to wellbeing and retirement outcomes. The analysis controlled for a number of factors – such as age and tenure – in order to identify, as far as possible, the independent effect of level of guaranteed income.**
- ▶ **Level of guaranteed income was significantly associated with people reporting that “I feel what happens in life is often determined by factors beyond my control”, and “In general, I have different demands that I think are hard to combine”.**
- ▶ **In relation to giving money, significant associations for both guaranteed income and non-housing wealth were identified for giving money at all. However, only income was associated with retirees giving money to their children and to charity.**
- ▶ **Multiple significant associations were found between income/wealth and different aspects of financial security. Overall, these associations suggest that wealth has a stronger impact on financial security than income. Nevertheless, income seems to play a crucial role, and in many cases, its effects are comparable to those of wealth.**
- ▶ **Level of guaranteed income appears to consistently associated with participation in leisure activities, unlike wealth. Relevant activities include going to the cinema, eating out taking a holiday or reading a newspaper. It seems likely that the regularity of a guaranteed income provides an impetus for expenditure on leisure activities, which is not provided by wealth.**
- ▶ **Both income and wealth were associated with civic participation. Income alone was associated with being a member of “tenants groups, resident groups, etc.”, a “political party, trade union or environmental groups” or “education, arts or music groups or evening classes”. The associations tended to be larger for income than for wealth, for the respective organisations. As with participation in leisure activities, it seems that income is able to provide better support for regular participation in classes, organisations, and other civic and social groups.**
- ▶ **Income, but not wealth, was associated with people’s sense of satisfaction with life, specifically, whether they report “the conditions of my life are excellent” and “so far I have got the important things I want in life”.**

## 4.1. Introduction

As noted in previous chapters, the historic change to UK pension policy implemented in April 2015 may result in many retirees experiencing a **lower guaranteed income**. Confronted with the basic choice of ‘cash vs. income’, a range of factors may drive individuals to opt to cash-in

their pension savings, as found in many countries that operate voluntary annuitisation frameworks.

The government has made it clear that it is entirely neutral as to how individuals use their DC pension savings.

Previous research has found that both income and wealth are associated with differences in wellbeing, and some limited studies have suggested that guaranteed income may influence levels of wellbeing in retirement.

In relation to a guaranteed pension income in retirement, it would therefore be reasonable to hypothesise that:

- ▶ **Retirees with higher levels of guaranteed pension income experience better wellbeing and retirement outcomes than those with lower guaranteed incomes**, regardless of their level of wealth;
- ▶ **The security and ‘peace of mind’ provided by a guaranteed income would have a positive effect on individual wellbeing**, relative to holding other forms of wealth.

To explore the role of guaranteed pension income in influencing a person’s wellbeing and retirement outcomes, the Strategic Society Centre undertook quantitative research entitled **Income Security and a Good Retirement**.

## 4.2. Research methodology and design

Income Security and a Good Retirement comprised secondary analysis of data from Wave 6 of the **English Longitudinal Study of Ageing** (ELSA), which is representative of the older population in England.

The sample used in the research comprised retired individuals who received **some form of private pension income**, whether from a Defined Contribution (DC) or Defined Benefit (DB) scheme.<sup>31</sup> In this way, the research focused as closely as possible on a sample representative of individuals retiring with (DC) private pension savings who have to choose how to make use of these during retirement. In particular, the sample excluded low-income retirees without any private pension income who might be expected to have significantly different characteristics.

Individuals in receipt of any employment income were also excluded.

In addition, to reduce the effect of retirees with unusual financial situations on the findings of the research, individuals in the bottom and top deciles for both guaranteed income and non-housing wealth were excluded from the sample analysed.<sup>32</sup>

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<sup>31</sup> For the purposes of the research, whether a pension income was DB or DC did not matter to the analysis as both comprise secure pension income.

<sup>32</sup> For income, the percentiles of the resulting sample were as follows (2012-13 prices): 25<sup>th</sup>: £228.30; 50<sup>th</sup>: £288.32; 75<sup>th</sup>: £367.87; 95<sup>th</sup>: £477.02. The percentile distribution of wealth for the sample group under study was: 25<sup>th</sup>: £12,333; 50<sup>th</sup>: £33,167; 75<sup>th</sup>: £72,333; 95<sup>th</sup>: £156,000.

The statistical model used in the research examined the relationship between a range of retirement outcomes and level of equivalised total guaranteed (secure) income.

‘Equivalisation’ is a methodology for measuring household income or wealth adjusting for the number of people in the household, enabling comparison of households with different compositions.

Total guaranteed income comprised: income from the State Pension; private DB and DC pension incomes; and, certain benefit payments that could be expected to last indefinitely, such as Attendance Allowance.

In addition, income from other sources was included if individuals were likely to perceive the income as guaranteed – for example, in contrast to a one-off gift - including savings accounts, ISAs, etc. given many individuals may regard such as income as ‘guaranteed’. However, the average contribution of such income to total income was very small, particularly considering the top income decile that was excluded from the sample.

In looking at the relationship between level of guaranteed income and a range of retirement outcomes, the research controlled for a number of other factors. In effect, this allows the independent relationship of guaranteed income with the outcomes to be identified. These **control variables** comprised:

- ▶ **Age** - age in years (anyone over 90 was removed from the sample owing to them being grouped in the data);
- ▶ **Age<sup>2</sup>** – an ‘age squared’ variable, which allows the research to take account of non-linear changes in the effects of age on wellbeing (i.e. effects of age that do not simply follow a ‘straight line’);
- ▶ **Sex** – male or female;
- ▶ **Housing tenure** – owned or rented;
- ▶ **Receipt of benefits** – yes or no;
- ▶ **Presence of longstanding or limiting illness** – no, yes (not limiting) or yes (limiting);
- ▶ **Couple status** – married, single, widowed or divorced;
- ▶ **Education level** – degree, A’ level, O’ level, other or no qualifications;
- ▶ **Has children** – yes or no;
- ▶ **Number of friends.**

The model also controlled for level of **equivalised non-housing wealth**, comprising the value of wealth excluding the value of someone’s main home, and the value of their pension wealth, but including items such as savings accounts, ISAs, as well as second property.<sup>33</sup>

Non-housing wealth therefore represents many of the different types of wealth and assets that individuals with DC pension pots may choose to convert their pension savings into, rather than obtaining a guaranteed pension income.

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<sup>33</sup> Non-housing wealth comprises: current/savings accounts, TESSAs, Cash other ISAs, Premium Bonds, National Savings accounts, PEPs, Shares, Trusts, Bonds and Gilts, other savings and investments, second homes or other properties, farm or business properties, other physical assets, other business assets.

By using equivalised guaranteed income, the research could examine the **association between level of guaranteed income and retirement outcomes, controlling for the level of someone's non-housing wealth.**

Correspondingly, given non-housing wealth may also be associated with variations in different retirement outcomes such as wellbeing, the model was able to reveal whether a statistically significant relationship existed between non-housing wealth and a particular outcome, controlling for the level of someone's guaranteed income.

In this way, the statistical models were able to **explore the potential consequences of the choices of individuals retiring with DC pension savings**, who must choose how much of their DC pension savings are converted into a guaranteed retirement income as opposed to holding their savings as cash or as some other form of financial wealth.

The analysis identified associations between a range of retirement outcomes and level of guaranteed retirement income and non-housing wealth. Those associations which were found to be statistically significant at the 5% level were assumed to provide evidence that similar associations may be present in the general population from which the sample was drawn.

#### **4.3. Results**

Income Security and a Good Retirement examined the relationship between level of guaranteed income, level of non-housing wealth, and a total of **99 dependent variables**, across a broad range of domains relating to wellbeing and the lives that people lead. The large number of dependent variables reflected the exploratory nature of the research, and the thin availability of existing research on the influence of guaranteed retirement income on older people's wellbeing.

The findings from Income Security and a Good Retirement can be broken down into four broad groups:

##### **▶ Variables for which no statistically significant relationship was found**

For 53 variables, no association was found with level of guaranteed income or non-housing wealth. Such results may reflect reality in the population, but also reflect the methodology deployed in the study, and the substantial number of control variables applied.

##### **▶ Variables for which a statistically significant relationship with guaranteed income, but not non-housing wealth, was found**

These are outcomes in older people's lives for which level of guaranteed income appears to be influential, but their level of non-housing wealth is not.

The **21 variables** in this category included factors such as whether individuals have taken a holiday during the last 12 months, and their participation in various types of civic life.

▶ **Variables for which statistically significant relationships were found in relation to both guaranteed income and non-housing wealth**

These are factors for which both level of guaranteed income and level of non-housing wealth both revealed statistically significant relationships. Put another way, these were outcomes in people's lives which appeared to be influenced by level of guaranteed income regardless of their level of non-housing wealth – and vice versa.

In total, 18 variables fell into this category, of which 11 showed a more powerful effect for guaranteed income than non-housing wealth. These variables included: how often individuals feel they have too little money to spend on certain things, and whether individuals feel free to plan for the future.

▶ **Variables for which statistically significant relationships were found in relation to non-housing wealth, but not level of guaranteed income**

The research found that for a total of **14 dependent variables**, level of non-housing wealth displayed a statistically significant relationship, but not level of guaranteed income.

Variables in this category include whether people expect to leave an inheritance of £50,000 or more and how likely people think it is that at some point in the future, they will not have enough financial resources to meet their needs.

The results of the study were grouped according to the substantive area to which the modelled outcomes related:

- ▶ Health and mental well-being
- ▶ Giving money to family and charity
- ▶ Financial security
- ▶ Participation in leisure activities
- ▶ Civic participation, and
- ▶ Life satisfaction and quality.

The rest of this chapter describes the results in more detail.

#### **4.4. Health and mental well-being**

The health and mental well-being outcomes included:

- ▶ Self-rated health
- ▶ How young the respondent felt
- ▶ Whether the respondent had been diagnosed with a cardiovascular disease (CVD) in the last two years
- ▶ Questions measuring depressive symptoms over the past week (adapted from the Center for Epidemiologic Studies Depression Scale (CES-D), NIMH<sup>34</sup>)

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<sup>34</sup> Eaton W et al. (2004) Center for Epidemiologic Studies Depression Scale: Review and revision (CESD and CESD-R), in Maruish ME, ed. *The Use of Psychological Testing for Treatment Planning and Outcomes Assessment*. 3rd ed. Mahwah, NJ: Lawrence Erlbaum, p363-377

- ▶ Questions measuring autonomy and perceived control, and
- ▶ Questions measuring social isolation.

Few significant associations were identified for these outcomes. Both income and wealth seemed to have little effect on the health and mental well-being measures, possibly reflecting the choice to including long-term limiting illness as a control variable.

Significant associations which were identified for wealth related to an item from the CES-D scale – “felt everything I did in the past week was an effort” – and an association with the total score for this scale for the respondent.

However, there were three significant associations between level of guaranteed income with items measuring autonomy and perceived control:

- ▶ “I feel what happens in life is often determined by factors beyond my control”,
- ▶ “In general, I have different demands that I think are hard to combine”

In addition, the variable measuring a person’s ‘total score’ for autonomy and control displayed a significant association with income.

Overall, there was evidence that wealth and income had small effects on mental wellbeing, when controlling for sex, age, age squared, and long-standing/limiting illnesses. However, **level of guaranteed income does appear to be significantly associated with autonomy and control, controlling for someone’s level of wealth.**

#### 4.5. Giving money to family and charity

The outcomes related to giving money to family and charity included:

- ▶ Whether the respondent gives money at all (to friends and family or charity)
- ▶ How much money the respondent gives
- ▶ Whether the respondent gives money to:
  - their children
  - their grandchildren
  - other relatives
  - other non-relatives
  - charity, and
- ▶ Self-perceived chances the respondent will leave an inheritance of £50,000 or more

Significant associations for both guaranteed income and non-housing wealth were identified for giving money at all and, for those who give money, the amount of money given.

However, only income was associated with giving money to the respondents’ children and to charity. As such, **it seems that the security provided by an income increased the chances of respondents feeling able to give money in this way.**

As might be expected, only wealth was associated with self-perceived chances of leaving an inheritance of £50,000 or more.

No significant associations were found between income or wealth for giving money to grandchildren, other relatives (not children), and other non-relatives.

#### 4.6. Financial security

The outcomes related to financial security included:

- ▶ Questions measuring whether the respondent feels that having too little money stops them from doing/buying particular things;
- ▶ How often the respondent feels they have too little money to spend on their needs; and
- ▶ Self-perceived chances the respondent will not have enough money in the future to meet their needs.

Multiple significant associations were found between income/wealth and the financial security outcomes.

The only item from the first set of questions that was not associated with either income or wealth was the item “treat yourself from time to time”.

However, some items were only associated with wealth:

- ▶ “Have family and friends round for a drink or a meal”
- ▶ “Keep your home in a reasonable state of decoration”
- ▶ “Pay for fares or other transport costs to get to and from places you want to go”, and
- ▶ “Buy presents for friends or family once a year”.

These effects suggest that both income and wealth have moderate but important effects on reducing financial insecurity, but that wealth may provide a slightly stronger psychological reassurance.

The items were also counted in order to produce a total score for this scale. This score was associated with both income and wealth.

Turning to adequacy of resources, both income and wealth were associated with the outcome measuring how often the respondent feels they have too little money to spend on their needs.

Only wealth was associated with the respondents’ self-perceived chances they will not have enough money in the future to meet their needs.

Overall, these associations suggest that **wealth has a stronger impact on financial security than income. Nevertheless, income seems to play a crucial role, and in many cases, its effects are comparable to those of wealth.**

#### 4.7. Participation in leisure activities

The outcomes related to participation in leisure activities included:

- ▶ How often the respondent...
  - Went to the cinema
  - Ate out of the house
  - Went to an art gallery or museum, and
  - Went to the theatre, a concert or the opera
- ▶ Which of these activities the respondent would like to do more, and
- ▶ Whether the respondent...
  - Reads a daily newspaper
  - Has a hobby or pastime
  - Has taken a holiday in the UK in the last 12 months
  - Has taken a holiday abroad in the last 12 months
  - Has gone on a daytrip or outing in the last 12 months
  - Owns a mobile phone
  - Or, none of these statements apply to the respondent

Interestingly, participation in the first set of activities – how often individuals went to the cinema, etc. - was consistently associated with income, but not wealth.

Indeed, the only association with wealth related to going to “the theatre, a concert or the opera”, suggesting this activity is associated with higher socioeconomic status.

In terms of wanting to do these activities more, the only significant association was that of income with a reduced likelihood of wanting to eat out of the house more.

Income was also associated with most of the final set of questions, relating to reading a newspaper, etc. The only questions it was not associated with were going on a “daytrip or outing in the last 12 months” and the respondent answering that “none of these statements apply”. Wealth was associated only with having “a hobby or pastime”.

These associations suggest that income has an important effect on regular participation in leisure activities. It seems likely that **the regularity of a guaranteed income provides an impetus for expenditure on leisure activities, which is not provided by wealth.**

#### 4.8. Civic participation

The outcomes related to civic participation included a range of questions asking about membership of different types of clubs, societies, organisations and groups:

- ▶ Political party, trade union or environmental groups
- ▶ Tenants groups, resident groups, neighbourhood watch
- ▶ Church or other religious groups
- ▶ Charitable associations
- ▶ Education, arts or music groups or evening classes
- ▶ Social Clubs
- ▶ Sports clubs, gyms, exercise classes
- ▶ Any other organisations, clubs or societies
- ▶ Or, the respondent is not a member of any organisations, clubs or societies

Both income and wealth were associated with civic participation.

Income was associated with being a member of a “political party, trade union or environmental groups”, “tenants groups, resident groups, neighbourhood watch”, “education, arts or music groups or evening classes”, “sports clubs, gyms, exercise classes”, “any other organisations, clubs or societies” and not being a member of “any organisations, clubs or societies”.

Wealth was associated with being a member of a “church or other religious groups”, “charitable associations”, or “sports clubs, gyms, exercise classes”.

The associations tended to be larger for income than for wealth, for the respective organisations.

As with participation in leisure activities, **it seems that income is able to provide better support for regular participation in various classes, organisations and civic and social groups.**

The answers to the questions were also tallied in order to produce a total count of the number of organisation types the respondent was a member of. The count was associated with both income and wealth.

#### **4.9. Life satisfaction and quality**

The outcomes related to life satisfaction and quality included:

- ▶ Questions from the Satisfaction with Life Scale<sup>35</sup>;
- ▶ Questions from the CASP-19 scale of quality of life<sup>36</sup>;; and
- ▶ Self-perceived position on a ladder measuring how well-off the respondent is compared to other people.

Income was associated with agreement to two of the questions from the Satisfaction with Life Scale: “the conditions of my life are excellent” and “so far I have got the important things I want in life”.

None of the other questions were associated with income, and nor was the total score on the scale.

Wealth was not associated with any of the questions or the total score on the scale.

In contrast, several questions from the CASP-19 scale were associated with income and/or wealth.

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<sup>35</sup> Ed Diener , Robert A. Emmons , Randy J. Larsen , Sharon Griffin, The Satisfaction With Life Scale, Journal of Personality Assessment, Vol. 49, Iss. 1, 1985

<sup>36</sup> R. D. Wiggins, G. Netuveli, M. Hyde, P. Higgs, D. Blane, The Evaluation of a Self-enumerated Scale of Quality of Life (CASP-19) in the Context of Research on Ageing: A Combination of Exploratory and Confirmatory Approaches, Social Indicators Research, October 2008, Volume 89, Issue 1, pp 61-77

Both income and wealth were associated with the items measuring how often the respondents “feel free to plan for the future”, think that “shortage of money stops me from doing things I want to do”, and “feel satisfied with the way my life has turned out”.

Additionally, income was associated with the item measuring how often the respondents “feel full of energy these days”.

Likewise, wealth was additionally associated with how often the respondents feel that “age prevents me from doing the things I would like to”, “look forward to each day” and “[...] look back on my life with a sense of happiness” (negative questions were reverse coded).

Nevertheless, there seem to be subtle effects of income and wealth on life satisfaction and quality.

Both income and wealth were also associated with the total score on the CASP-19 scale.

There was also an association of both income and wealth with the respondents’ self-perceived position on a ladder measuring how well-off the respondent feel they are compared to other people.

These effects are more substantial, reflecting the important influence of both income and wealth on perceptions of social standing. It is interesting that income seemed to have a stronger effect than wealth in this case.

#### **4.10. Income poverty**

Alongside the main models tested in Income Security and a Good Retirement, it was hypothesised that the implications of a guaranteed income for those experiencing income poverty may be particularly important. In order to investigate this, models were also estimated separately for two groups: those who had an equivalised income of less than £217 per week, and those with an income of more than £217 per week.<sup>37</sup> The threshold of £217 was used as the income guaranteed by means tested Pension Credit income support for couples in the year (2012-13) that the data were collected.

Surprisingly, the results showed that there were virtually no associations of level of income with the outcomes for those in the low-income group. In contrast, there were many highly significant associations of the outcomes with wealth. The associations with the outcomes measuring financial security were particularly strong.

Strikingly, the associations between income and the outcomes *were* apparent in the higher income group. The associations with participation in civic and leisure activities, life satisfaction and quality tended to be larger in relation to income than for wealth. Nevertheless, the impact of wealth on outcomes related to perceived financial security was strong and consistent. These results suggest that wealth has an important role to play in providing financial security. For those with average income and wealth, income is of more practical importance in

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<sup>37</sup> This analysis was run on the entire sample of retirees with no employment income in ELSA, in order to boost available sample size - i.e. including those with no private pension and including the top and bottom deciles of income and wealth.

encouraging an active and engaged lifestyle, with greater life satisfaction and quality. For those with low incomes, wealth may provide a crucial security blanket, for which small changes in (low) income cannot substitute.

#### **4.11. Conclusion: The importance of guaranteed income for retirement wellbeing**

Income Security and a Good Retirement explored the relationship between level of guaranteed income, non-housing wealth and a range of retirement outcomes related to wellbeing.

In the absence of an established literature on these topics, the research explored associations with nearly 100 dependent variables.

The analysis identified a statistically significant relationship between level of guaranteed income and a range retirement outcomes, for example:

- ▶ **Going to the cinema**
- ▶ **Reading a daily newspaper**
- ▶ **Taking a holiday during the last year**
- ▶ **Owning a mobile phone**
- ▶ **Reporting that the “conditions of my life are excellent” and “I have got the important things I want in life”;**
- ▶ **Giving money to children and charity**
- ▶ **Reporting that “I feel what happens in life is often determined by factors beyond my control”.**

As noted, these findings are independent of level of non-housing wealth, i.e. **controlling for a person’s level of non-housing wealth, level of guaranteed income is associated with variations in these outcomes.**

Overall, it appears that guaranteed income is particularly associated with **leisure and civic participation, and key aspects of people’s perceptions of control and autonomy.**

These results suggest that if average private pension incomes drop in the wake of the April 2015 changes to rules on DC pension taxation, and a growing number of retirees opt not to obtain a guaranteed pension income, the **retirement outcomes and wellbeing of the older population could be substantially reduced across these domains.**

Further discussion of the results and their implications for public policy are set out in the next chapter.

# 5. Discussion: Achieving a good retirement

## Key points:

- ▶ **The findings of Income Security and a Good Retirement have a number of implications for public policy.**
- ▶ **The research suggests that an average DC pension saver would be likely to have a better retirement if they seek to maximise their level of guaranteed income. Although retaining DC pension wealth as savings or investments may provide some level of compensatory wellbeing, the total effect of guaranteed income is stronger than wealth in many of the domains identified in the research. In addition, if an individual with DC pension savings cashes in such savings and proceeds to spend down this wealth, the wellbeing effect resulting from this wealth will decline commensurately. In contrast, the positive influence on retirement resulting from higher levels of guaranteed income is constant and lasts for the entirety of someone's retirement.**
- ▶ **International experience of voluntary annuitisation frameworks for DC savers is widely characterised by very low rates of annuity purchase. Why? The associations identified in Income Security and Retirement Wellbeing between non-housing wealth and different aspects of wellbeing may well exist in relation to someone's DC pension savings before they reach retirement. However, most DC savers have never experienced a guaranteed income before they reach the point of retirement, so are unfamiliar with its wellbeing effects. At the point of choosing how to use their DC pension savings, retirees may struggle to imagine or estimate the real wellbeing effects of a guaranteed income to their retirement, in contrast to a pre-existing wellbeing effect resulting from possession of DC pension savings.**
- ▶ **Previous research has identified a 'savings bias' observable in the older population. The wellbeing effects of wealth identified in Income Security and a Good Retirement may in fact inhibit spending, and explain why guaranteed income appears to support spending in a way that wealth does not: individuals may be 'afraid' of spending down their wealth and foregoing the associated peace of mind and wellbeing.**

## 5.1. Introduction

Having reviewed the findings of Income Security and a Good Retirement in the previous chapter, this chapter discusses the implications of the research for public policy, individual DC pension savers, the decisions people make at retirement, and choices about spending in old age.

## 5.2. Retirement income security and public policy

The April 2015 changes to taxation of DC pension savings represented a fundamental break with the preceding 'annuities deal', which had shaped UK pension policy since 1921.

Underpinning this shift was a distinct view on private pensions policy:

- ▶ It is not the role of the state to compel or direct individuals as to how they use their pension savings;
- ▶ Individuals are better placed than the state to understand their own retirement income and wealth needs and priorities;
- ▶ If individuals choose to take their pension savings as cash at retirement and maintain it in a non-annuitised form (such as savings), there are no negative externalities (costs) for public policy.

However, Income Security and a Good Retirement found evidence of a statistically significant association between level of guaranteed income and the retirement outcomes and wellbeing of individuals with private pension income.

If the April 2015 changes to pension reform result in pension savers obtaining a lower guaranteed income with their DC pension savings – as found in other countries with voluntary annuitisation frameworks – it would appear that levels of wellbeing in the older population are likely to decline, for example, in relation to:

- ▶ Going to the cinema
- ▶ Reading a daily newspaper
- ▶ Taking a holiday during the last year
- ▶ Reporting that the “conditions of my life are excellent” and “I have got the important things I want in life”;
- ▶ Participation in civic life.

As noted, these findings are independent of level of non-housing wealth, i.e. controlling for a person’s level of non-housing wealth, level of guaranteed income is still associated with variations in these outcomes.

Since promoting the wellbeing of the population is a widely accepted responsibility of government, the findings of Income Security and a Good Retirement suggest there are in fact likely to be negative consequences for public policy from the April 2015 changes, if these changes result in retirees experiencing lower levels of wellbeing as a result.

As explored below, to the extent these effects result in additional demands for (mental) health services, these effects may be associated with additional costs for the Exchequer.

### **5.3. Income security and the choice for DC pension savers**

What do the findings of Income Security and a Good Retirement suggest for the choice facing individuals since April 2015 retiring with DC pension savings? These individuals must choose whether and how much of their DC pension savings are converted into a guaranteed retirement income.

While the circumstances of every individual with private pension savings are different, the findings of the research suggest that an **average DC pension saver would be likely to have a better retirement if they seek a high level of guaranteed income.**

Although retaining DC pension wealth as savings or investments may provide some level of compensatory wellbeing for savers, the effect of guaranteed income on outcomes in important domains of life (such as leisure and civic participation) was found to be stronger than for wealth in the research undertaken.

Indeed, it is important to note that the findings of Income Security and a Good Retirement relate to retired individuals with private pension incomes. The analysis therefore identified associations between wellbeing, guaranteed income and non-housing wealth across a broad age group, not just those at the point of retirement.

However, if an individual with **DC pension savings cashes in such savings and proceeds to spend down this wealth, the wellbeing effect resulting from this wealth will decline commensurately**. Put another way, non-housing wealth can only have a positive effect on wellbeing and retirement outcomes if it is not spent down.

In contrast, the positive influence on retirement outcomes and wellbeing resulting from higher levels of guaranteed income is constant, and lasts for the entirety of someone's retirement, as well as supporting spending.

As such, **whereas a guaranteed guaranteed income provides a permanent positive effect on wellbeing, if non-housing wealth is spent down to fund consumption, any wellbeing effect will decline accordingly**.

#### **5.4. Why do DC savers not opt for secure retirement incomes?**

As noted in previous chapters, international experience of voluntary annuitisation frameworks for DC savers is usually characterised by very low rates of annuity purchase.

Why do DC savers not opt for guaranteed retirement incomes? Building on existing research around the wellbeing effects of holding assets, Income Security and a Good Retirement provides important clues to why low rates of voluntary annuitisation of DC pension savings may be observed.

This is because the association between non-housing wealth and different aspects of wellbeing identified in the research for retirees with a private pension income are also likely to exist prior to retirement, i.e. the possession of DC pension savings as an 'asset' held by individuals is likely to have positive effects on people's wellbeing before they retire, for example, whether or not they feel able to plan ahead, whether or not they worry about running out of money in future, etc.

Importantly, the experience and attachment to such wellbeing effects from holding pension wealth may **long precede the moment at which DC pension savers must choose whether or not to annuitise their DC pension pot**.

In contrast to a potential pre-existing attachment and sense of wellbeing resulting from possession of DC pension savings, **most DC savers have never experienced a guaranteed income before they reach the point of retirement, so are unfamiliar with its wellbeing effects**.

Indeed, even ‘guaranteed’ permanent jobs ultimately hold the possibility of redundancy, especially during an economic downturn, and therefore the risk of income loss is universal for people of working age.

As such, **before retirement, individuals do not have the experience or memory of the wellbeing and security – identified and measured in Income Security and a Good Retirement – that is obtained from receipt of a guaranteed income.**

As a result, savers may be likely to undervalue something they have not experienced before. At the point of choosing how to use their DC pension savings, **retirees may struggle to imagine, feel or estimate the real wellbeing effects of a guaranteed income to their retirement, in contrast to a pre-existing wellbeing effect resulting from possession of DC pension savings.** This effect may be most acute if individuals know that they can use their DC pension savings however they wish, as they have been able to do in the UK since April 2015.

In this way, the positive association between levels of non-housing wealth and various aspects of retirement and wellbeing identified in Income Security and a Good Retirement may go some way **to explain low rates of voluntary annuitisation** in other countries, and suggests such an outcome will be observed in the UK in future years.

### **5.5. Why do retirees not spend down their wealth?**

Research on older people’s wealth has previously found that retirees tend not to spend down their wealth in retirement. For example, previous analysis of the UK Wealth and Assets Survey (WAS) by the Strategic Society Centre found:<sup>38</sup>

- ▶ Despite being above retirement age, 49% of the 65+ population reported saving during the preceding two years;
- ▶ Looking ahead, 44% of the 65+ population report they are likely to save money during the next 12 months;
- ▶ As individuals age, they are more likely to report that they always or most of the time have income left over at the end of the month;
- ▶ Over half of the 65+ age group report that they find it more satisfying to save for the long-term than to spend money;
- ▶ The amount that individuals have in their current account increases as they age.

In short, there is evidence of a ‘savings bias’ among older people, despite being in the ‘decumulation phase’ of the lifecycle.

These findings are supported by the results of Income Security and a Good Retirement, which found that among retirees with private pension income, consumption and spending was supported by receipt of guaranteed income - but not associated with level of non-housing wealth:

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<sup>38</sup> Lloyd J and Lord C (2015) *Defined Capability: Pensions, financial capability and decision making among retirees*, Strategic Society Centre, London

- ▶ Going to the cinema;
- ▶ Eating out;
- ▶ Going to an art gallery or museum;
- ▶ Buying a daily newspaper;
- ▶ Taking a holiday in the UK or abroad during in the last 12 months.

For example, the results of the research suggest that controlling for level of non-housing wealth, among those with private pension income it is level of guaranteed income that influences whether people go on holiday, not wealth.

Why is this the case? Although focused on individuals with private pension incomes, Income Security and a Good Retirement identified some positive associations between non-housing wealth and various outcomes.

The wellbeing effects of possessing wealth – and the possibility of losing such positive effects – may in fact inhibit spending, and explain why guaranteed income appears to support spending in a way that wealth does not: individuals may be ‘afraid’ of spending down their wealth and foregoing the associated peace of mind and wellbeing. However, such a risk is not present in relation to receipt of a guaranteed income. In this way, retirees may tend toward a ‘savings bias’.

## **5.6. Conclusion**

Income Security and a Good Retirement identified the association between level of guaranteed income and retirement outcomes for individuals with private pension income, and the importance of guaranteed income relative to levels of non-housing wealth.

These results suggest that if the April 2015 changes lead many DC pension savers to opt for cash over a guaranteed income – and to choose to have a lower retirement incomes – these individuals will have worse retirements.

By identifying the influence of both guaranteed income and wealth on retirement outcomes and wellbeing, the findings of Income Security and a Good Retirement also provide explanatory insights into existing financial behaviour such as low rates of voluntary annuitisation and a ‘savings bias’ observable among some retirees.

The research suggests that the April 2015 changes to rules on DC pension savings will see retirees experience lower levels of wellbeing, and reinforce existing financial behaviours that already pose a challenge to public policy.

The next chapter therefore makes recommendations to policymakers.

# 6. Policy recommendations

## Key points:

- ▶ **On the basis of the findings of Income Security and a Good Retirement, a number of recommendations to policymakers can be made.**
- ▶ **Actively promote receipt of a guaranteed income in pension policy to improve the wellbeing of retirees.**
- ▶ **Educate savers before retirement about the role of a guaranteed income in a good retirement.**
- ▶ **Include information about the importance of a guaranteed income for wellbeing in retirement in guidance and information from Pension Wise.**
- ▶ **Ensure receipt of a decent, guaranteed retirement income is the default option for DC pension savers.**
- ▶ **Undertake regular research into the effect of the April 2015 changes on older people's wellbeing.**

## 6.1. Introduction

This chapter sets out a number of recommendations to policymakers in light of the findings of Income Security and a Good Retirement:

## 6.2. Actively promote receipt of a guaranteed income in pension policy to improve the wellbeing of retirees

The April 2015 changes to rules on DC pension taxation reflect a belief that it is not the role of the state to compel or direct individuals as to how they use their retirement savings. However, in adopting this position, the government may directly oversee a reduction in levels of wellbeing in the older population if many savers opt for lower levels of guaranteed income following the changes.

In this context, the government should:

- ▶ No longer maintain a position of policy neutrality as to how people use their DC pension savings;
- ▶ Actively promote receipt of a guaranteed income in pension policy to improve the wellbeing of retirees.

While maintaining the voluntary annuitisation framework for DC pension savers introduced in April 2015, the government should nevertheless actively promote receipt of a guaranteed income in retirement as the goal for pension policy, and as a positive outcome for retirees.

More widely, pension policy debate must focus on retirement outcomes and people's lived experience of old age that results from the design of private pension policy.

### **6.3. Educate savers before retirement about the role of a guaranteed income in a good retirement**

Many people may not be aware of the importance of a guaranteed income in experiencing a good retirement.

Indeed, as noted above, many individuals with DC pension savings approaching retirement may have never considered how the receipt of a guaranteed income guaranteed until the end of their life will shape their choices, spending behaviour and wellbeing.

Although most people understand that higher levels of income increase the amount that they can spend, it is reasonable to assume that few people give significant thought to how the receipt of a regular, guaranteed income will shape their life in retirement, relative to simply holding wealth in a savings account.

In the absence of this knowledge, there is a significant risk that individuals may make uninformed and poor decisions around how to use their DC pension savings, and not give sufficient thought to the role of their guaranteed retirement income in shaping their wellbeing in retirement.

For this reason, the government should:

- ▶ Educate savers before the age of 55 about the role of guaranteed income in achieving a good retirement;
- ▶ Incorporate information about the importance of guaranteed income for wellbeing in retirement into education material on 'automatic enrolment' and campaigns to promote pensions saving.

For example, the government may wish to consider a greater role for advice and discussion between retirees and those approaching retirement, to share the insights and perspectives on income security accumulated by those who have actually retired. Wherever possible, individuals who have already retired should be part of providing the information and advice made available for DC pension savers.

### **6.4. Include information about the importance of a guaranteed income for wellbeing in retirement in Pension Wise guidance and information**

At present, information provided to retirees by the Pension Wise service does not seek to make individuals aware of the link between level of guaranteed income in retirement, wellbeing in old age and the experience of a good retirement.

The government should require providers of the Pension Wise service to:

- ▶ Inform service users about the importance of guaranteed retirement income for wellbeing in retirement;
- ▶ Inform service users that if they choose to cash-in their DC pension savings and receive a lower pension income, this may result in them experiencing a worse retirement.

In particular, users of the Pension Wise service should be invited to think through the challenge of longevity risk: how they would decide how much of their savings they could spend each year when they do not know how long they will live.

### **6.5. Ensure receipt of a decent, guaranteed retirement income is the default option for DC pension savers.**

Following the April 2015 changes to rules on DC pension taxation, individuals aged 55 and over with DC pension savings have the options of partially or fully cashing-in these savings, purchasing an annuity or entering income drawdown.

However, unless pension savings are left in a scheme in perpetuity, a default option is required for individuals who retire, request their pension savings but do not take any further action. In fact, there is growing interest in how default options for DC pension savers can be designed to encourage the receipt of a guaranteed pension income:

- ▶ In response to low rates of voluntary annuitisation, the Murray Inquiry into the Australian financial system recommended the government should require superannuation (pension scheme) trustees to pre-select a comprehensive income product in retirement for members to receive their benefits, unless members choose to take their benefits in another way;<sup>39</sup>
- ▶ A report from the Centre for Policy Studies proposed the introduction of auto-protection, i.e. a default option for people approaching private retirement age whereby their pension pot would be automatically used for the purchase of a good-value annuity;<sup>40</sup>
- ▶ In 2015, the Strategic Society Centre published a report arguing that given the risk of low-incomes – and income poverty – resulting from the April 2015 changes, the government should define, implement in regulation and promote a default ‘automatic income plan’ for DC retirees in the UK, which provides a predictable, guaranteed (secure) and good-value income for DC retirees. This automatic income plan should seek to maximize average retirement incomes, balance consumer preferences, ensure value for money, as well as provide adaptability and flexibility to changes in a person’s circumstances and the macro-economy;<sup>41</sup>
- ▶ The National Employment Savings Trust (Nest) has issued a ‘blueprint’ for a ‘core retirement income strategy’ (default option) for its members based on providing a guaranteed income and protection from longevity risk.<sup>42</sup>

To some extent, debate on the promotion of default options for pension savers has focused on the question of how to define ‘good’, i.e. what outcomes should policymakers be seeking to promote.

However, the findings of Income Security and a Good Retirement suggest that for an average individual with private pension entitlements, receipt of a guaranteed income is ‘good’. In this context, the government should:

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<sup>39</sup> Murray D et al. (2014) *Financial System Inquiry: Final Report*, The Australian Government: The Treasury

<sup>40</sup> Johnson M (2015) *Auto-protection at 55*, Centre for Policy Studies, London

<sup>41</sup> Lloyd J (2015) *Default Reform: Preventing low incomes with an automatic income plan*, Strategic Society Centre, London

<sup>42</sup> Nest (2015) *The future of retirement: A retirement income blueprint for NEST’s members*, London

- ▶ Make receipt of a guaranteed income in retirement the default option for all individuals retiring with DC pension savings above trivial commutation levels.

#### **6.6. Undertake regular research into the effect of the April 2015 changes on older people's wellbeing**

The government should undertake regular research into the effect that the April 2015 changes to rules on DC pension saving are having on the wellbeing of the older population, in order to understand the effect of these changes and inform subsequent policy development.

This research should look at average levels of wellbeing across the older population as successive cohorts of retirees face a wider range of choices as to how to use their DC pension savings, besides obtaining a guaranteed retirement income. The government should also research the wellbeing and retirement outcomes of individuals who cash-in DC pension pots following April 2015, to compare their experiences to those of individuals who do obtain a guaranteed income.

This would also require measures to coordinate a range of key data gathering exercises to consider the impact of the reforms in aggregate. This should include analysis of encashment rates, data on what support consumers are using before making key retirement decisions (including Pension Wise and regulated advice), and information from regulators covering product outcomes and findings from supervisory activity.'

# 7. Conclusion

## 7.1. Introduction

The changes to rules on DC pension savings announced at Budget 2014 broke with nearly a century of UK pensions policy in no longer seeking to promote the receipt of a guaranteed pension income in retirement.

As noted in the Introduction, policymakers leading the changes have not engaged with the issue of whether or not the April 2015 changes will lead individuals to have a better retirement or not. Instead, the government has made it clear that it does not see a role for the state in influencing how people use their DC pension savings.

## 7.2. A good retirement?

The findings of Income Security and a Good Retirement make clear the importance of level of guaranteed income and non-housing wealth for retirees. While some level of 'buffer', 'nest-egg' savings appear desirable and are associated with positive wellbeing effects, for individuals with private pension entitlements, the effects of a guaranteed income appear to be consistent and wider ranging, and actively support spending and consumption, unlike nest-egg savings.

As such, there is a contradiction between the government's stated neutrality on how DC pension savings are used, and the imperative to promote wellbeing in the older population.

Given the absence of a well-established research literature on guaranteed income and old age, Income Security and Retirement Outcomes was a deliberately exploratory study, ranging across multiple different domains of older people's lives. However, by identifying multiple associations between income and retirement outcomes, in the wake of the April 2015 changes, the coming years are likely to see many other studies coming forward on this topic, and the effect that these changes have on retirement in the UK.

While preserving the freedom and choice of the voluntary annuitisation framework implemented in April 2015, there is much the government could do as sensible, reasonable steps toward promoting better retirements, such as actively promoting receipt of guaranteed income in pensions policy, and educating individuals around the importance of a guaranteed income for a good retirement.

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