

*LCP on point* 

# *The “Flex First, Fix Later” pension – is this the future of retirement?*

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## Executive Summary

*Since the start of automatic enrolment in 2012, millions of people have been enrolled into Defined Contribution pensions which will give them a pot of money at retirement.*

A lot of attention has rightly been focused on the process of building up that pot - the “accumulation phase” - with strict rules on charging levels and on the structure of the ‘default fund’ into which most members will be saving. But much less attention has been given to what happens at, and after, retirement - the “decumulation phase”.

This paper builds on our previous research and evaluates the relative merits of using a retirement pot in decumulation to go into drawdown compared with buying an annuity.

It highlights the fact that the ‘right answer’ for any given individual depends in part on their own circumstances, goals and values. But it goes on to suggest that for a broad range of people the best outcome may come from a hybrid approach, which involves enjoying the potential growth and flexibility of drawdown in the earlier phase of retirement before switching to the security of an annuity in later retirement.

But whilst this hybrid strategy is likely to be optimal for most people, we then consider the (many) reasons why people may not implement this for themselves in practice. This includes the inertia which is likely to set in once someone has got used to managing a drawdown pot, as well as the potential for cognitive decline as retirees get older.

We therefore propose a new type of product – the ‘flex first, fix later’ pension – which starts off with a drawdown phase but builds in an automatic switch to an annuity at a later age. The key point is that drawdown would be the default option at retirement but the decision to buy an annuity at some point (many years in the future) is made in advance thus overcoming the impact of both inertia and cognitive decline.

Our research suggests that the right age for that switch from drawdown to an annuity will vary from person to person, but that a “flex first, fix later” product which switches people to an annuity in their late seventies or early eighties could work well for most.

We envisage that such a product could be a ‘mass market’ default destination for millions of ordinary savers currently saving through the workplace, and this paper offers some thoughts on exactly how that product might be designed.

We are already in discussion with Master Trusts, insurers and asset managers about these ideas. We would be interested to hear from anyone who shares our view that the decumulation phase of the pensions journey is the one most in need of innovation and fresh thinking as the UK pension landscape evolves and the new tide of people with large pension pots approach their retirement in the future.

# 01 Introduction

*In 2021 we published a research paper<sup>1</sup> entitled ‘Is there a right time to buy an annuity?’. That paper contained the first results from a model which compared outcomes in retirement between those who buy an annuity and those who go into drawdown. It found that, for many people, the best strategy in retirement is to start with some or all of the pension pot invested in a drawdown account, but then to switch to an annuity in later retirement.*

This paper takes that analysis further on in three important ways:

- We believe that people approaching retirement will have a “target income level” in mind as they plan for retirement. We have therefore considered what that target may be, in terms of maintaining their pre-retirement standard of living as far as possible; in particular, we consider how the choice between drawdown and annuity can depend on the standard of living which the individual is targeting;
- We have refined our model, using the latest data on typical pot sizes, varying our assumptions about consumer attitudes to risk, and – crucially – taking account of the state pension system;
- We have then considered what this implies for the design of post-retirement financial products. For the reasons set out in this paper, we think it unlikely that many people will simply opt to annuitise in later retirement of their own accord, even if this is objectively likely to give them the best outcomes. We therefore propose a new, mass-market, ‘flex first, fix later’ product which could deliver this result and improve outcomes for millions of ordinary savers.

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<sup>1</sup> [Is there a right time to buy an annuity? \(lcp.uk.com\)](https://lcp.uk.com)

## 02 What are people trying to achieve in retirement?

*We start from the assumption that people want to make sure that their standard of living can be maintained as far as possible when they move from work to retirement.*

Given that many costs which are incurred during working life (eg mortgage repayments, childcare costs, travel-to-work costs, National Insurance Contributions) will generally be much reduced in retirement, it is not necessary to replace 100% of your pre-retirement income in order to maintain your standard of living.

Instead, we look first at a 67% replacement rate, which should provide for a relatively stable standard of living, seeing relatively little drop in living standards at retirement for someone with average earnings. But we also look at a 50% replacement ratio which for someone who has been on average earnings will provide them with a relatively basic standard of living. In each case we assume that this income has to keep pace with inflation through retirement.

Our scenarios are based on someone who was previously on earnings of around £26,000 as they approach retirement and who has accumulated a pot of £150,000 by the time they want to retire<sup>2</sup>. We look at someone who wants to retire at sixty and whose state pension will commence at the age of 67<sup>3</sup>.

We then consider two strategies by which they might achieve this outcome.

First is the annuity purchase strategy.

There are two phases to think about – a period prior to state pension age which we refer to as the ‘bridging’ period, and a period once state pension kicks in.

With this strategy, for the period up to state pension age (between age 60 and 67), the individual sets aside a part of their pension pot to draw in seven chunks, rising in line with CPI inflation. One way of doing this would be to buy a fixed term CPI inflation linked

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<sup>2</sup> This pot size figure is based on the average size of pot accessed for drawdown according to the FCA’s retirement market statistics. See: [Retirement income market data 2020/21 | FCA](#)

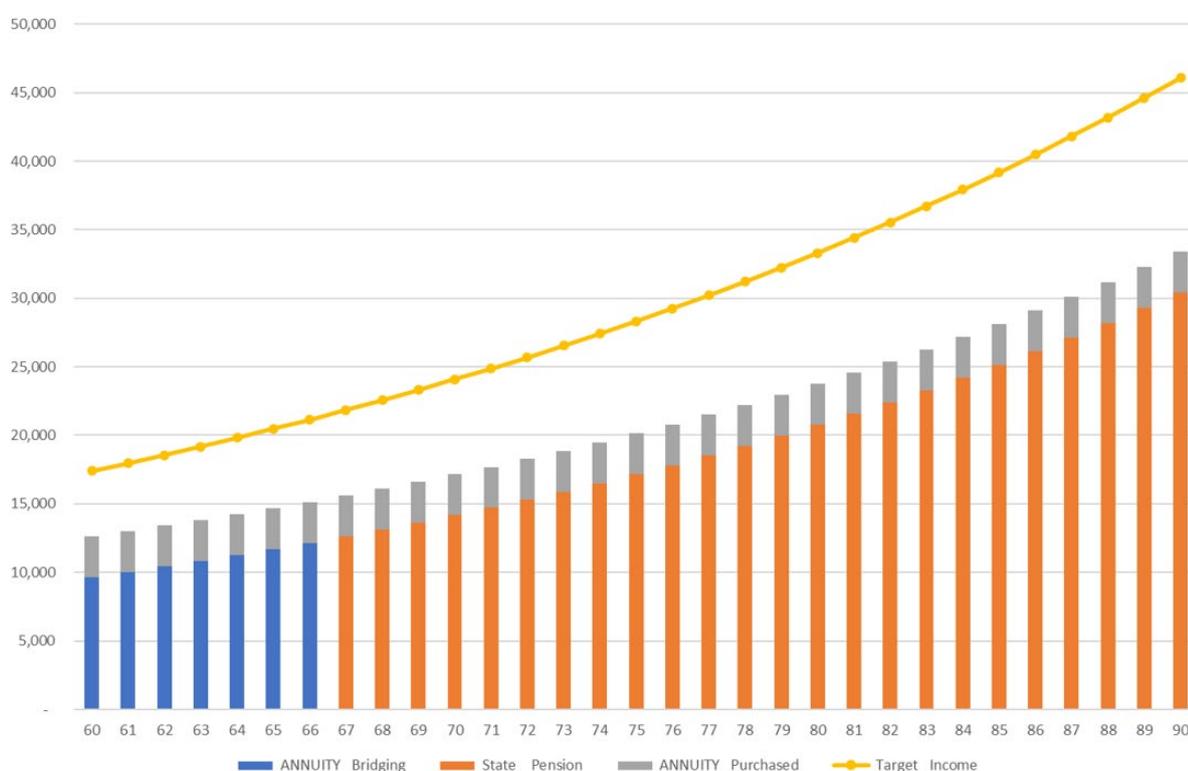
<sup>3</sup> For reasons we explain later, the age of retirement has relatively little impact on the conclusion that most individuals should switch to an annuity in later retirement, and does not significantly change the optimal age at which to do so.

annuity lasting for seven years with part of the pot<sup>4</sup>. At state pension age this ‘bridging’ annuity is no longer needed because the state pension takes over. The balance of the fund not needed to pay for the ‘bridging’ income is used at retirement to buy a lifetime annuity.

This strategy is illustrated in Figure 1. Note that we are assuming a state pension cutting in at age 67 (which will be the standard state pension age from April 2028) and that it increases in line with the ‘triple lock’ formula, rising by the highest of the growth in prices, earnings or a floor of 2.5%.

Figure 1. Annuity strategy

Annual income from a) long-term purchased annuity, b) bridging annuity and c) state pension, compared with target income



Note: Assumes i) £150k pension pot, ii) target is 67% of average wage of £26,000, index-linked

Second is the drawdown strategy.

Again, the individual has two phases of retirement – pre and post state pension age. In the first phase (before state pension kicks in) they make significant withdrawals from their drawdown pot to broadly match their income target<sup>5</sup>. Once the state pension starts, they

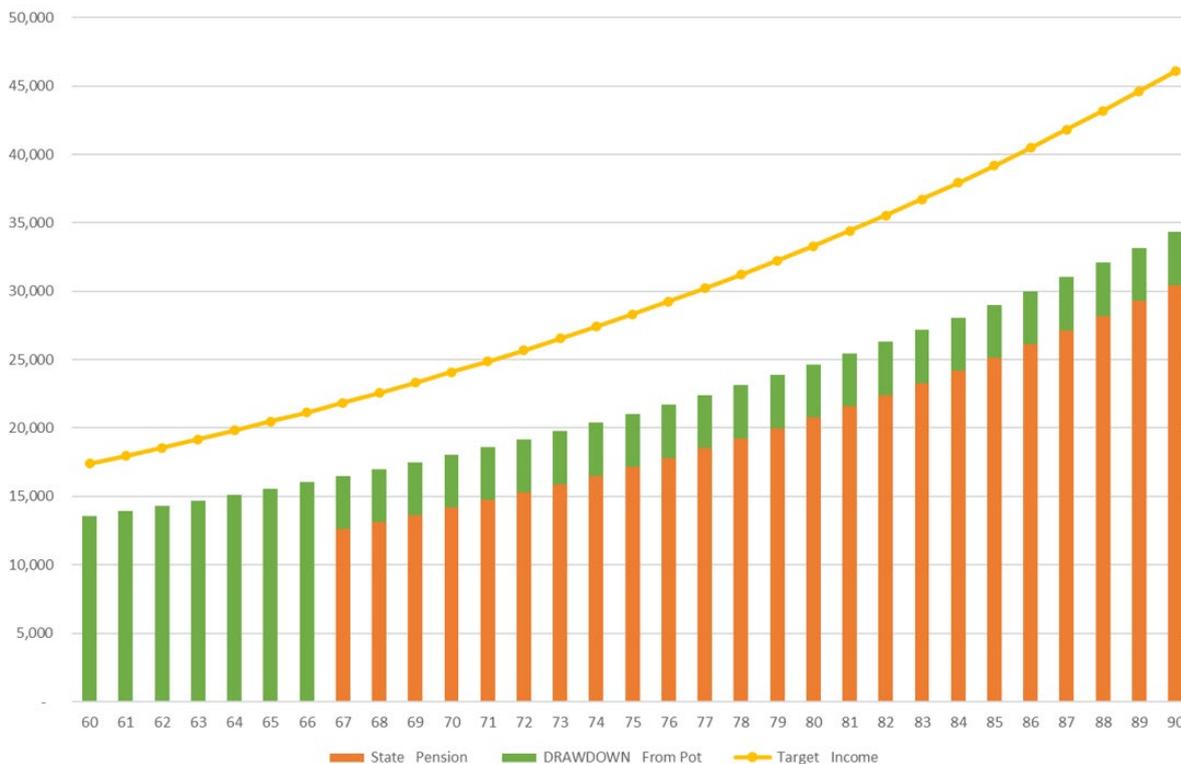
<sup>4</sup> Our modelling assumes a ‘fair value’ fixed term annuity, and does not take account of distribution costs etc which might lower the rate achieved. We note that in practice today it may not be possible to buy a CPI linked annuity but we assume that such a market will develop over time.

<sup>5</sup> To be more precise, we assume that drawdown would initially be at 130% of the income which could be achieved by annuitising the whole pot.

can reduce their withdrawals, producing a smooth total income throughout retirement. This is illustrated in Figure 2 for the person who retires at sixty and targets 67%.

Figure 2. Drawdown strategy

Annual income from a) drawdown from pot and b) state pension, compared with target income



Note: Assumes i) £150k pension pot, ii) target is 67% of average wage of £26,000, index-linked

In the next section we consider which approach is likely to generate the highest lifetime income for those who retire at sixty.

## 03 Annuity versus drawdown – which delivers the higher income?

*For the next part of our analysis we continue to look at someone who has a £150,000 pension pot (in addition to their state pension), and is targeting an income of 67% of their pre-retirement gross wage, rising through retirement in line with inflation.*

We can then compare three figures:

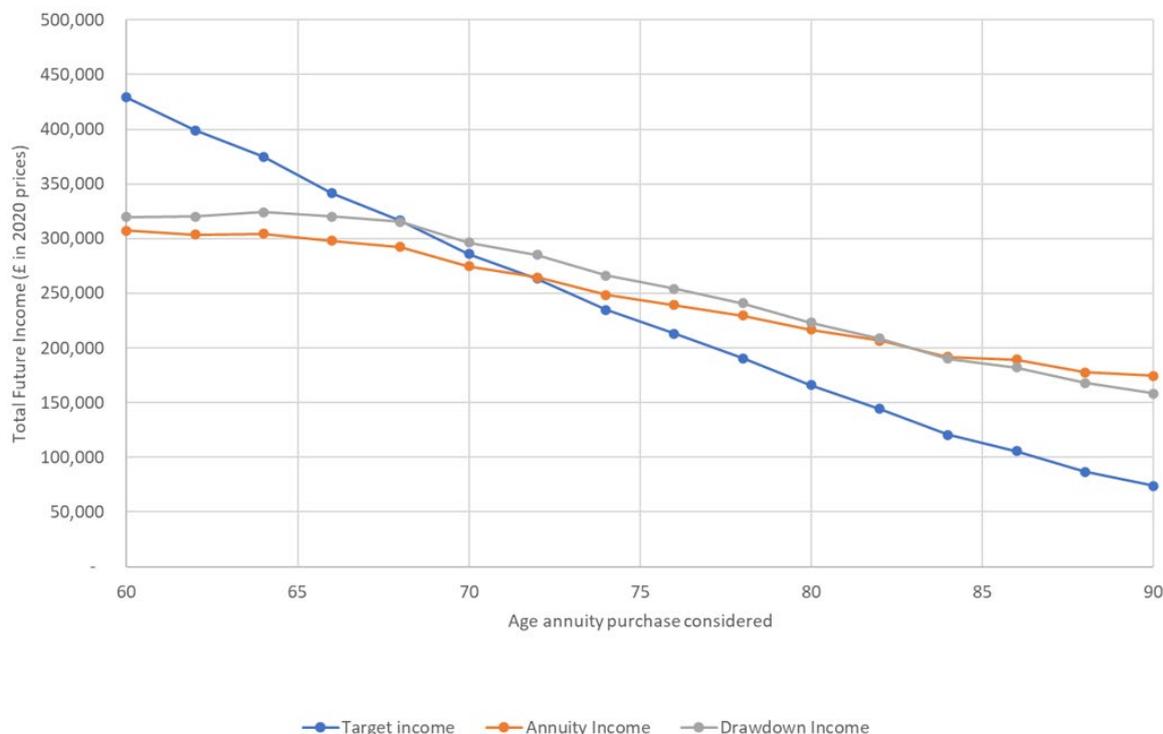
- a) The total ‘target’ income they would need for the rest of their retirement – this would need to come from a combination of a state pension of just under £10,000 per year plus their income from either annuity or drawdown depending on the chosen strategy;
- b) The actual amount of income they would get over their retirement if they use the ‘annuity plus bridging pension’ strategy
- c) The actual amount of income they would get if they use the ‘drawdown’ strategy

We perform this calculation at age 60, age 61 and so forth. The results are shown in Figure 3<sup>6</sup>.

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<sup>6</sup> Our market sensitive modelling assumptions were based on market conditions at the end of March 2022 and the remaining financial assumptions (such as our equity risk premium, asset class standard deviations and the asset class correlation matrix) are set out more fully in our previous paper. To summarise, our key financial assumptions in this paper are that long-term inflation (CPI) will be 3.3% pa, long-term gilt yields are 1.7% pa, equity returns are log-normal with median returns of 5.5% pa above gilt yields (so median equity returns = 1.7% + 5.5% = 7.2%pa). We have also assumed that the drawdown portfolio is invested in a long-term strategy of 75% in equities and 25% in bonds though any shorter-term drawdown funds (that are to be used to provide a bridging pension for the State Basic Pension) are assumed to be set aside in a cash portfolio.

Figure 3. Total income in retirement, including state pension, by age of retirement: a) at target, b) buying an annuity and bridging pension c) with drawdown



At the start of their retirement, and based on average life expectancies, the individual might expect to need a total income through retirement (from state and private income) of around £430,000. As they get older, the remaining amount of total income they expect to need declines steadily, as shown by the blue line in the chart<sup>7</sup>.

We can compare this target income shown by the blue line with the total income they can expect from the drawdown strategy and from the annuity strategy.

Looking first at the pure annuity strategy (the orange line in the chart), we estimate that the expected income over retirement is significantly lower than the target level for the person who retires at sixty. This means that it may not be possible for this individual to retire at 60 with a £150,000 pension pot and achieve their 67% target replacement.

However, as the chart shows, the longer they were able to defer their retirement (still with a pot of £150k), the closer they would come to being able to achieve their target outcome, as the orange line (annuity-based income) would then be closer to, and eventually in excess of, the blue line (target income).

Looking next at the pure drawdown strategy (the grey line in the chart), the expected income over retirement from this strategy is slightly closer to the target income if the

<sup>7</sup> Note figures in this table are based on the average total income from 2000 simulations of retirement. This is why the chart is stable but not smooth.

individual retires at 60, though still well short. As with the annuity strategy, the ability of the drawdown strategy to deliver (and exceed) the target income increases the longer retirement is delayed.

However, what is particularly striking about this chart is that there is a ‘crossover’ point. In this case, on average someone in their early 80s can expect a higher income in the rest of their retirement if they adopt the annuity approach at that point than if they continue with the drawdown approach.

This crossover point deserves some explanation.

The initial income drawdown in our model is set to be 130% of the income that could have been purchased as a guaranteed annuity and this figure then rises in line with inflation through retirement. We assume a higher income from drawdown than annuity because we expect that the greater investment returns derived from the drawdown strategy allow the retiree to sustain a higher standard of living in retirement than under the annuity strategy.

This is why the grey line in the chart is generally above the orange line. However, beyond age 82 this extra expected income of +30% in drawdown in the early years of retirement is fully eroded by the risk of running out of money towards the end of retirement under drawdown compared with the guaranteed annuity income.

This alone suggests that it might be worth considering a ‘hybrid’ strategy where the individual starts their retirement in drawdown but switches to an annuity later in retirement. We refer to this as approach as the ‘flex first, fix later’ strategy, and this is an idea to which we will return later.

However, a purely mechanistic calculation of this sort does not capture the complexity of the choice facing individuals when planning their retirement. This is for four main reasons:

- We have so far presented ‘average’ outcomes for the investment return on the drawdown strategy; in reality, a large variety of outcomes is possible, both better and worse than the scenario shown in the chart; we need to take proper account of this uncertainty;
- We have assumed average life expectancies for the purpose of constructing our chart, but each individual will have a different experience; we need to capture how uncertainty about life expectancy affects the choice between the two strategies;
- In these charts we can only consider the average income during retirement whereas under the drawdown strategy there is also the additional benefit of being able to leave some unused assets as an inheritance and we need to consider the additional utility that this gives to some pensioners;
- Crucially, what matters most is not simply cash, but satisfaction; for example, pensioners may have strong preferences to avoid downside risk, and may be willing to sacrifice the potential for considerable upside in order to avoid that downside risk;

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we therefore need to estimate what economists would call the ‘utility’ or satisfaction from each outcome, and not simply the average cash outcome.

To try to capture this complexity we have constructed a model which seeks to evaluate the relative satisfaction which an individual is likely to derive from a pure drawdown strategy and from a pure annuity strategy under thousands of different scenarios. And, in particular, we look at whether that relative satisfaction remains the same throughout retirement or whether there may come a point where switching from one strategy to the other could make sense.

## 04 Annuity versus drawdown – which delivers the higher satisfaction?

*Our utility based model is described in greater detail in our previous paper, but the key points are:*

- The purpose of the model is to compare expected outcomes at each age between those who buy an annuity and those who remain in drawdown
- In each case we come up with a measure of the ‘economic utility’ or ‘satisfaction’ which a saver would derive from each course of action. This reflects both the financial returns they would experience and also the fact that people may have a different attitude to different financial outcomes. For example, whilst people gain satisfaction from an extra £1 of income, research suggests that the dissatisfaction from losing £1 of income is greater. We therefore apply a greater negative weight in our calculations to cases where people lose money than the positive weight we ascribe when people gain money.
- The base case for our calculations in this updated research paper is a target income in retirement of 67% of median average earnings (around £26,000 per annum based on 2021 figures). In other words part 1 of our analysis asks the question:

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*“If you want a retirement income of 67% of your pre-retirement earnings, increasing with CPI inflation and you have a full State Pension payable from age 67 plus a retirement pot of £150,000 is it best to buy an annuity or to adopt an income drawdown strategy?”*

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We then go on to consider the impact of using a lower target of 50% of pre-retirement income, again increasing with CPI inflation.

- For each retirement age an annuity strategy is given a “utility score” for how well it delivers our target income and the drawdown strategy is also given a score for how well it delivers the target income. These two scores are then compared.

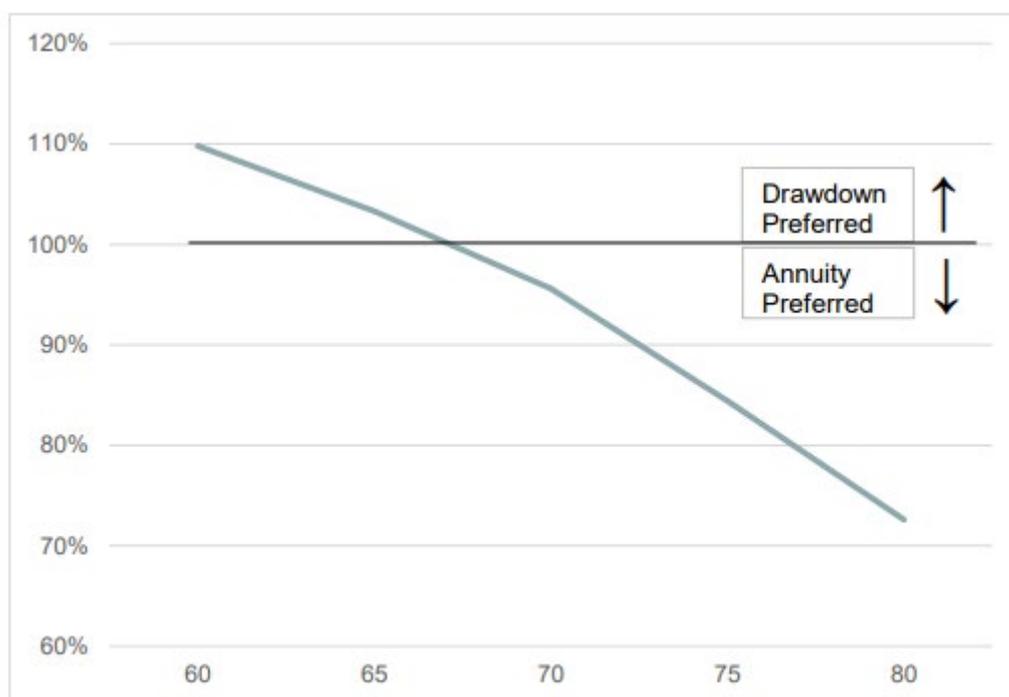
- In all of our charts any relative score of over 100% implies that going into drawdown is to be preferred, whilst a score of under 100% suggests that switching to an annuity would produce a better outcome. In other words a score above 100% means that drawdown delivered the target income better than an annuity strategy and vice versa.
- We calculate the scores for an annuity purchase and a drawdown strategy using 2000 different scenarios, including variations in economic conditions and variations in how long people live. The results we present are an average score over all of those scenarios.
- We can test the sensitivity of our results to a variety of factors including the investment mix of the drawdown portfolio, different attitudes to risk, different attitudes to leaving a bequest and so forth.

For ease, we reproduce below the base case chart from our previous paper.

Figure 4.

Base scenario from previous report:

Relative attractiveness of drawdown over annuity



In this base case we found that people at the age of sixty could be expected to do better by starting off in drawdown but that by the time they reach their late sixties they could expect a better outcome by switching to an annuity. This effect gets more pronounced as they get older. Remember that this analysis did not include an allowance for the State Basic Pension.

For the purposes of this paper we have made a number of refinements to our model.

The key points are:

- We now include the fact that the vast majority of people can expect to draw a state pension, currently worth just over £9,000 per year; we use a pension age of 67 as this is likely to be the state pension age for someone currently in their late fifties and coming up to making choices about retirement; we assume that the state pension rises in line with the ‘triple lock’ formula;
- In our original model we assumed a large (£1m) pension pot when assessing the balance between annuity and drawdown. In this paper we have used data from the Financial Conduct Authority (FCA) which suggests that the average pot size for those going into drawdown for the first time is around £150,000. Our results in this paper are therefore based on that much lower pot size.
- As discussed earlier, we now assume that the retiree is targeting a set percentage of a pre-retirement income – we start by looking at a 67% target of the national average wage but also consider a 50% target.
- In our previous base model we assumed that an unexpected loss (relative to the target income) of £1 would generate an equivalent amount of dissatisfaction to the satisfaction derived from an unexpected gain of £4. We also tested an even stronger aversion to loss, which had a six-to-one ratio between downside risk and upside gain. As this is a relatively strong weighting for risk aversion we have based this paper on a more modest assumption of a 2½:1 ratio between the utility loss per pound of loss and the utility gain per pound of gain, as this is closer to the findings from empirical studies of attitudes to risk and gain.
- As for our previous model any funds left after retirement in drawdown will give an extra utility of £0.1 per £1 up to a maximum inheritance of £150,000 plus CPI inflation. This cap is to prevent some of the very high return scenarios skewing the results too much.
- So, to summarise how the utility calculation works; if we lose £100 of pension relative to the target income then this actually feels like £200 worth of financial pain. If we gain £100 more income than we expected under the target income then this only gives us £80 of financial pleasure (note the £200:£80 ratio is the same as the 2½:1 ratio mentioned above) and if we leave an inheritance of £100 then this gives us an additional utility (financial pleasure) of £10.

Figure 5 provides an update of our core result, and extends the scale to cover ages up to 90<sup>8</sup>. This is for someone with a £150,000 pot, targeting 67% of their pre-retirement income, rising with CPI inflation and taking a moderate level of risk in any drawdown

<sup>8</sup> In our previous paper, which ignored the state pension, ‘crossover’ points for the switch to annuities could be as early as late sixties. In this paper, depending on the exact assumptions made, we find crossover points can easily be beyond the age of 80, so it makes sense to extend our analysis to older ages.

investments with an investment strategy that targets around 75% in return seeking assets like equities and 25% in lower risk assets like cash and bonds.

Figure 5 shows, at each age, the ratio between the utility of staying in drawdown as against the utility from switching to an annuity.

Figure 5. Utility Ratio – drawdown versus annuity – target income 67%

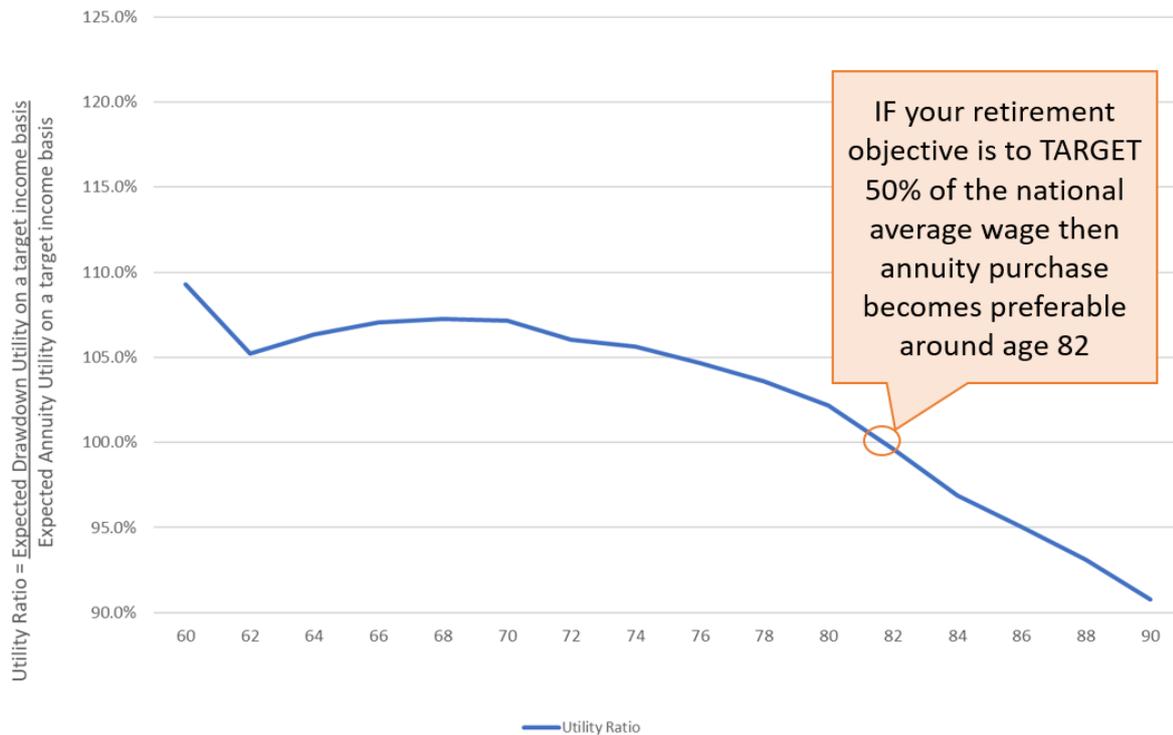


The refinements which we have made to our model do not change the central proposition, which is that there is a crossover point during retirement where switching to an annuity might make sense. **But the \*age\* at which that crossover takes place is now much later.** Whereas in our previous paper we were suggesting annuity purchase in your late sixties, we now find that if you allow for the state pension and if your nest egg is around £150k then the optimal strategy is to use drawdown in the early years of retirement and then to annuitise in your late seventies.

The main reason for this significant increase in the crossover point is the inclusion of the state pension which is, in effect, a large and valuable annuity paid by the state at age 67. Given the allowance for the much higher guaranteed baseline income from the state pension in our new model, the optimal strategy appears to be for a pensioner to remain invested in drawdown for much longer before eventually switching to an annuity so as to protect themselves from the uncertainty of life expectancy. Another reason for the increase is that the retirement pot in this analysis is much smaller and (in most cases) worth much less than the value of the State Basic Pension.

We can also test whether a lower target income – 50% of pre-retirement income – affects the crossover point, and the results of this analysis are shown in Figure 6.

Figure 6. Utility Ratio – drawdown versus annuity – target income 50%



As Figure 6 shows, in the case of the higher target standard of living, the individual would do best to annuitise in their early eighties rather than their mid seventies. Note that a key driver of the increased attractiveness of an annuity in later retirement is the growing variability of (remaining) life expectancy as you get older. This means that the optimal age to switch is not significantly affected by the age at which you start your retirement journey.

What is notable about both of these results is that the optimal strategy relies on the individual switching out of the drawdown account which they will have been managing for over a decade and using the balance to shop around for an annuity. In the next section we consider how likely this is.

## 05 Will people just buy an annuity?

*If our model is correct, there is a wide range of people for whom a switch to an annuity in later life could give them the best outcome. Our research suggests that annuity products at these ages do exist and appear to offer reasonable value for money so we might hope that pensioners would simply switch at their own relevant age and no further policy action from the Government or product innovation from the insurance industry was required to help facilitate this process.*

However, there are several reasons why hoping people will manage their own mortality risk by switching to an annuity of their own volition might not deliver the best outcomes:

- A) **Inertia** – whereas in the accumulation phase of automatic enrolment inertia works to the advantage of consumers, once in retirement inertia is a problem; once people have established a pattern of living off their state pension and drawing from their drawdown account, it requires a significant effort and awareness to consider switching to an annuity; even if the annuity option would be better, taking the trouble to switch (and deciding when to do so) might simply be too much trouble compared with leaving things as they are;
- B) **Cognitive decline** – although every individual is different, on average our cognitive abilities can expect to decline as we go through retirement; given that we are talking about people potentially switching to an annuity in their late 70s or early 80s, there may be a significant number of people who may struggle with the complexity of that decision or who may be at risk of making poor choices (or being taken advantage of by scammers etc);
- C) **Value for money** – even in the era before Pension Freedoms when annuity purchase was semi-compulsory, people often failed to secure the best value for their savings; many people simply stayed with their existing pension provider when buying an annuity rather than take advantage of the open market option; and many of those with poor health and lower life expectancy failed to secure an enhanced or individually-underwritten annuity; obtaining value for money would similarly be a problem in a world of voluntary annuity purchase in later retirement;
- D) **Access to advice / guidance** – even for those at or around retirement there is considerable concern that not enough people are taking financial advice or guidance when making decisions about their pension savings; the challenges of providing cost-effective advice or guidance would be likely to be much greater in the

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case of someone in later retirement with a modest pension balance considering whether or not to annuitise and if so how;

In short, if we are right that switching to an annuity in later retirement could make sense for many, we cannot simply hope or expect that people will do so of their own devices. In the next section we consider whether a new type of financial product could overcome these barriers.

## 06 A product solution? – the ‘flex first, fix later’ pension

*The experience of automatic enrolment has reminded us of the power of default options, with around 95% of members in most workplace pension schemes used for automatic enrolment saving via the default investment option. We may be able to use this fact to improve the post-retirement journey of these very same people.*

At present, default options largely apply only in the pre-retirement phase.

Our proposal is that a new product – a ‘flex first, fix later’ pension – could be introduced as the unadvised, mass market default post-retirement option for workplace pension savers.

The key feature of the product is that it starts as a regular drawdown account but it has a built in switch to an annuity at a later age. This switch to an annuity happens without further action by the policy holder, though they retain the ability to opt out of this annuity destination at any point.

It is worth noting that in our model the individual stays fully invested right up to the point of annuity purchase and then switches wholly to annuity on a single day. An alternative option would be to buy slices of ‘deferred’ annuity with part of the pot through retirement. The ‘overnight’ switch keeps the individual invested for as long as possible and may maximise total income, especially if deferred annuities are expensive to buy. But the deferred annuity route means the saver is less exposed to market movements around the time of the switch to an annuity.

We believe that such a product could address the barriers to buying an annuity (outlined in the previous section) as follows:

- **Inertia** – with the ‘flex first, fix later’ pension, inertia now works in the direction of the saver; with no further action on their part, they are switched to an annuity later in retirement; the ‘path of least resistance’ becomes the one which generates the optimal outcome
- **Cognitive decline** – the flex first, fix later product is commenced at retirement when cognitive ability is likely to be greater, rather than later in retirement; this increases the chance of people making an informed choice about whether this is the right product for them (and opting for something else if not);

- **Value-for-money** – a mass market product with large numbers of people switching into annuities later in retirement has the potential to drive better annuity pricing; one option would be for providers to use their buying power to purchase bulk annuities for all of their policy holders who reach the switchover age in any given quarter or month; this would be likely to generate better annuity pricing than if individual consumers went to the retail annuity market; another option would be to build in some checks to make sure that any annuity bought was on an enhanced basis where appropriate;
- **Access to advice/guidance** – the majority of policy attention at present is on improving access to guidance and advice at or around retirement; this includes initiatives such as the ‘stronger nudge’ towards the Pension Wise guidance service; in the case of the ‘flex first, fix later’ pension, the decision about post-retirement strategy would be taken at retirement, when the individual is most likely to be able to access guidance or advice to help them decide if this is the right product for them.

Another potential attraction of this product is that if it became the default fund for those saving (for example) in large Master Trusts, this could also have a beneficial impact on the size of the pot at retirement because of the likely change to \*pre-retirement\* investment approaches. Although precise practice varies from scheme to scheme, there are still many DC savers whose investments are being gradually de-risked in the run-up to retirement in an echo of the old ‘lifestyling’ approach which paved the way for the purchase of an annuity at retirement. If the saver was clearly heading for a ‘flex first, fix later’ retirement strategy which was wholly in drawdown at retirement, there would be much less case for de-risking in the run-up to retirement and this could help improve the size of pots at retirement.

## 07 Design issues around the ‘flex first, fix later’ pension<sup>9</sup>

*Considerable care would be needed in designing a mass market default product such as the ‘flex first, fix later’ pension. In this section we consider some of the key design questions which would need to be addressed.*

### **a) Communications**

As with any default arrangement, it is important that policy holders feel in control and well-informed about the product. In this case, the key fact that has to be communicated at the point of taking out the product, and on a regular basis through the life of the product, is that the balance of the pot will be used to buy an income for life when the policyholder reaches a certain age. Communications would need to be ramped up as the point of annuity purchase drew near, and the ability to opt out should be stressed and made straightforward. It would be vital to avoid a situation where an individual was left wondering where their pot had gone because it had been used to automatically buy an annuity.

### **b) Flexibility / Customisation**

Whilst a period of drawdown followed by a switch to an annuity might look optimal for someone at the point they take out the product, things could change. For example, they might inherit a large capital sum from the death of an elderly parent, or they might lose a partner. Events such as these could have a big impact on whether switching to annuity made sense and, if so, on the best time to do so. The product would need to have the flexibility to allow people either to opt out completely or to flex the product. Flexibility could be over the date of annuitisation or perhaps the proportion of the final pot which was used to buy an annuity.

Flexibility would also be needed in the ‘flex first’ phase of the product. As our previous paper showed, the optimal strategy can depend on the investment mix in the drawdown phase, and different individuals will be comfortable with different levels of risk. The product would ideally need to be customised to reflect this.

### **c) Simplicity**

Our conclusion that a switch to an annuity is likely to make sense for large numbers of people is based on sophisticated modelling of the ‘economic utility’ under thousands of scenarios. This modelling suggests that each individual will have a unique age at which the switch to an annuity makes sense. But it would be impossible to design a financial

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<sup>9</sup> We are grateful to Mark Ormston of Retirement Line for his insights on the annuity market. All views expressed in this section are however those of the authors.

product that was customised to this extent, especially if we are talking about one sold without financial advice.

It may be that a simple product with a default switch to annuity at a standard age (perhaps age 80, based on our core results), might not be exactly optimal for each individual but would be much better than not switching at all.

#### d) Nature of the annuity

An annuity can come in many shapes and sizes and it is important that the product into which the individual is switched later in retirement provides good value for money. For the purposes of this paper we have assumed that a single life, index-linked annuity would be purchased. But in practice there are a number of design features that would need to be considered.

Some key issues would include:

- *Would there be any minimum guarantee period?*

It is common for annuities bought at retirement to come with a minimum payout period so that if the policy holder dies not long after the product has been purchased the family will continue to benefit for a minimum period (or receive an equivalent lump sum); in the context of the ‘flex first, fix later’ pension, a minimum payout period could make the product look more attractive and reduce objections from those who may under-estimate their life expectancy and think that the product does not look like good value.

- *Would there be any provision for a surviving spouse or partner?*

Annuities can be sold on a ‘single life’ or a ‘joint life’ basis. In the latter case the annuity is paid out at some level to a surviving spouse or partner if the policy holder dies. The cost of providing for a second life may be relatively modest but again could make the product more attractive.

- *Would the annuity be linked to inflation?*

When buying an annuity at retirement it is important to consider how far several decades of inflation could erode the spending power of a fixed annuity. One option is to buy an annuity with some form of inflation protection (an ‘escalating’ annuity). However, this does result in a much lower starting payment and this can make the product look like poor value. Given that in the case of the ‘flex first, fix later’ pension we are talking about an annuity bought in later retirement, the exposure to inflation is more limited in duration and it may not be necessary to build this feature in by default, especially if the state pension is providing a substantial measure of inflation protection.

- *Would the annuity be good value for money?*

Leaving an individual to do their own shopping around and buy an individual annuity (which is in effect the current approach) could mean that they end up with an expensive

product or poor terms. But if the ‘flex first, fix later’ pension became a default post-retirement option, much better outcomes could be secured. For example, the provider could buy ‘bulk individual annuities’ for all scheme members who reached the switchover age in a given month or year, and they could get a better annuity rate by doing so. The provider could also consider whether some screening questions could be asked at the point of annuity purchase so that those with very poor health still got a good value product.

Given that we are used to thinking about annuity purchase at retirement, rather than at a much later age, it may be helpful to look at the sort of annuity rates which could be achieved if an annuity were to be purchased at age 80 or even 85.

The following table shows results for a single life level annuity, a joint life level annuity (with 50% survivor’s pension) and a single life annuity with annual increases.

Table. Annuity values for a £100,000 pension pot bought at later ages

Age of purchase	Single life, level	Joint life, level	Single life, 3% escalation
Age 80	£11,130	£9,672	£8,653
Age 85	£14,617	£12,542	£12,201

Source: Estimates kindly supplied by Mark Ormston, Retirement line as at June 2022

The figures in the table show that even if the drawdown pot was much reduced at the point of buying an annuity, the steady improvement in annuity rates as the individual ages means that they are still likely to be able to generate a meaningful guaranteed income to top up their state pension if they choose to annuitise in later retirement.

In terms of what goes on ‘under the bonnet’ of the product there is also an important choice to be made about whether the individual literally switches on a single day from drawdown to annuity or whether between retirement and the switchover day they might buy slices of ‘deferred annuity’. In this case they would be building up a set of promises to pay annuities which could be brought into force at a later date.

One advantage for the consumer of buying slices of deferred annuity is that this provides a degree of smoothing and predictability around the final annuity figure, whereas using the whole pot to buy an annuity on a switchover day could make the final figure much less predictable. A middle way option could be to go for the single switchover point but to have some form of de-risking built into the drawdown investment strategy (similar to pre-retirement lifestyling) which would reduce the uncertainty over the size of the final pot, even if not removing uncertainty over the annuity rate on date of transition. Some further modelling might be needed to assess the optimal strategy on this point.

## 08 Conclusions

*Much policy attention has been focused on the ‘accumulation’ phase of pensions with the introduction of automatic enrolment, the introduction of a charge cap on default funds, regulation of Master Trusts and so forth. Growing attention has also been focused on what happens at retirement, notably with the introduction of ‘Pension Freedoms’ in 2015 and the introduction of Pension Wise to provide free guidance for those exercising pension freedoms. But very little attention (with the limited exception of the FCA’s ‘investment pathways’ initiative) has been given to what happens in the crucial post-retirement phase.*

Our previous research, updated in this paper, has suggested that for many people the best outcome will be achieved by starting at retirement in drawdown and switching later to an annuity. But, as we argue in this paper, this is unlikely to happen without something to make it happen. A combination of inertia and other barriers to good decision-making in later life may leave people ‘stuck’ in drawdown for longer than ideal.

We have therefore proposed the ‘flex first, fix later’ pension which could be an unadvised, mass market default option. With this product the individual starts in drawdown (which they can customise to match their attitude to risk if they wish) and is then switched automatically into an annuity at a later stage – perhaps around age 80. We think that this would produce better outcomes for most people than sleepwalking into drawdown and staying there.

If this concept is appealing, much more work needs to be done on how the product could best be designed and communicated. But there is no doubt in our minds that such a product could fill the gap in post-retirement provision for millions of people who have built up a Defined Contribution pension pot as a result of automatic enrolment. Having worked hard to get defaults right for this group in the accumulation phase, we owe it to them to help them manage the pension pot which they have now accrued and to put it to best use in their retirement.

## **Authors’ note on independence**

LCP is a wholly independent firm of actuaries and consultants. This research is borne out of the intellectual curiosity of the authors and draws on the skills and expertise built up at LCP to be able to analyse the retirement conundrum. We have no affiliation with any providers of drawdown products or annuity providers. Our starting point was to be entirely agnostic as to which is best: drawdown or annuity purchase, and we have no commercial incentive to reach any particular conclusion. We are simply interested in understanding what is the best way for savers to make the most of their nest egg at and through retirement.

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LCP, July 2022

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