



# Independent Review of Retirement Income: Summary

**We Need a National Narrative:  
Building a Consensus around Retirement Income**



David Blake

March 2016



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**‘Pensions are precious’ – Ros Altmann – Pensions Minister**

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## 1. Introduction

The primary purpose of a pension scheme is to provide life-long retirement income security for however long the scheme member lives. This Report will examine retirement income in private-sector pension schemes, principally workplace schemes set up by employers for their employees. The Government's 'freedom and choice' agenda introduced in the Budget on 19 March 2014 is intended to apply to both DC and funded DB schemes, but not to unfunded DB schemes which most public-sector workers have.

The 2014 Budget added two new possible uses for a pension scheme. The first of these is inheritability – the residual pension fund on the death of the scheme member can be inherited by a nominated beneficiary tax free if the member dies before 75. The second new potential use is debt clearance. Previously, pensions could not be assigned to pay off a loan. After April 2015, everyone over 55 can take their pension as a lump sum.

In order to make any assessment about the retirement income from a DC pension scheme, we need to establish a benchmark for comparison. In other words, we need to establish what 'good' outcomes would be in a DC scheme, in terms of producing, for example, stable and predictable lifelong retirement incomes, or having the flexibility to withdraw funds to meet 'lumpy' expenses, such as the cost of a new boiler.

It is also important to be aware of the risks involved in the generation of retirement income from pension savings, such as investment risk, inflation risk and longevity risk. Following 'freedom and choice', these risks are now borne directly by DC scheme members. Unfortunately, many people do not understand these risks. Even with improved financial education, it is unlikely that many people will fully understand a number of these risks. This is because some risks have to be experienced before they can be genuinely understood, and often it is too late by that stage to do anything about them. In addition, many people will have problems understanding the full range of product choices that are now available. All this makes it difficult for many people to be in a position to make 'informed' choices. The Government is offering 45 minutes of guidance under the 'guidance guarantee'. Time will tell whether this is adequate.

If a large group of people cannot understand the risks they face in their pension scheme, despite being provided with information about those risks, then they should not be expected to manage these risks themselves. Instead, if people can have confidence that those designing and regulating pension schemes have dealt with these risks in the most efficient and cost-effective ways possible, then it might be possible to nudge (or even default) savers into making the right choice at retirement for them and their family. To do this, we will need to build on the lessons of auto-enrolment and, in particular, the issue of having a well-designed default decumulation process at retirement.



A wide class of pension scheme members will be affected by the new ‘freedom and choice’ regime:

- Members of workplace DC auto-enrolment schemes: active, deferred and pensioners
- Private-sector defined benefit (DB) scheme members who transfer to a DC scheme. Those who take advantage of the DB-to-DC transfer rules might use the DC scheme offered by their employer, if this includes a drawdown facility. Otherwise, they will have to switch to another provider
- The self-employed
- Workers with employment contracts that do not qualify them for auto-enrolment.

We will examine the characteristics and challenges presented by each group in relation to achieving good retirement outcomes.

*Table 1.1 Criteria for a good DC pension scheme*

- |   |
|---|
| <ul style="list-style-type: none"> <li>• Delivers adequate and sustainable pensions; by sustainable, we mean having support mechanisms in place that help people not to spend their pension fund too quickly after retirement</li> <li>• Produces stable and predictable lifelong retirement incomes, even if those incomes cannot be guaranteed (unless a lifetime annuity is purchased)</li> <li>• Offers the flexibility to purchase a lifetime annuity at any time (or at regular predetermined intervals)</li> <li>• Has the flexibility for members to withdraw funds to meet ‘lumpy’ expenses, such as the cost of a new boiler</li> <li>• Provides an investment strategy that reflects the scheme member’s attitude to and capacity to take risk, and generates a return at least as high as inflation</li> <li>• Provides value for money for every pound saved in the scheme</li> <li>• Has transparent charges and costs</li> <li>• Provides reliable and efficient administration</li> <li>• Delivers effective communications to members</li> <li>• Protects scheme assets from fraud or theft</li> <li>• Has minimum quality standards in terms of operational efficiency, charges and governance with a duty by the governance committee to act in members’ best interests</li> <li>• If individuals are constructing their own pension scheme, they should use products that are effective and easy to understand</li> </ul> |
|---|

Our discussions with representatives of employers, consultants, providers, investment managers and unions together with the feedback we received from our Consultation Paper provided invaluable inputs into our analysis as well as the recommendations we make. In terms of this Chapter, they have helped us develop the criteria for a good DC pension scheme that we propose in Table 1.1 and complete the list of key risks involved in the generation of retirement income from pension savings in Table 1.2. The discussions have also provided an insight into the longer term consequences that might follow from the introduction of ‘freedom and choice’.

*Table 1.2 – Key risks involved in the generation of retirement income from pension savings*

Contribution risk	The risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts
Retirement timing risk	Uncertainty about when the scheme member will retire and/or begin to make withdrawals
Product choice risk	Uncertainty about how the scheme member will make withdrawals, not least because of the very large set of choices now available
Investment risk	The risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement. A particularly important example of investment risk is sequence-of-returns risk
Inflation risk	The risk that inflation is higher than anticipated
Interest rate risk	The risk that interest rates are low at the point of annuity purchase
Longevity risk	The risk that individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk)
Cost risk	The risk that the total costs of running the pension scheme during accumulation and

	decumulation are higher than expected or understood
Political risk	The risk that the Government changes the rules in an adverse way (e.g., reduces the level of tax relief)
Regulatory risk	The risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates)
Demographic/cultural risk	The risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK)
Market conduct risk	The risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members); fraud and the activities of scammers would be included here
Behavioural risk	The risk that scheme members behave in a way that is not considered to be rational (i.e., is not in their long term interests, since they make short-term decisions that they subsequently regret and are unable to learn from past mistakes). Inertia and lack of engagement would be included here, as would be the risk that members fail to understand the risks they face
Financial knowledge and understanding risk	The risk that a member's financial

	knowledge and understanding are insufficient for the member ever to make an 'informed' choice
Mental impairment risk	The risk that a scheme member's mental faculties are reduced due to the onset of dementia, for example

### **1.9 Recommendations**

Our analysis in this Chapter leads to the following two recommendations.

#### **Recommendation 1.1: Criteria for a good DC pension scheme**

We recommend that scheme providers should be required to demonstrate to scheme trustee (or governance) committees and to regulators how their schemes provide good outcomes for members in terms of the following criteria:

- Delivers adequate and sustainable pensions; by sustainable, we mean having support mechanisms in place that help people not to spend their pension fund too quickly after retirement
- Produces stable and predictable lifelong retirement incomes, even if those incomes cannot be guaranteed (unless a lifetime annuity is purchased)
- Offers the flexibility to purchase a lifetime annuity at any time (or at regular predetermined intervals)
- Has the flexibility for members to withdraw funds to meet 'lumpy' expenses, such as the cost of a new boiler
- Provides an investment strategy that reflects the scheme member's attitude to and capacity to take risk, and generates a return at least as high as inflation
- Provides value for money for every pound saved in the scheme
- Has transparent charges and costs
- Provides reliable and efficient administration
- Delivers effective communications to members
- Protects scheme assets from fraud or theft
- Has minimum quality standards in terms of operational efficiency, charges and governance with a duty by the governance committee to act in members' best interests.

As part of this recommendation, each qualitative term (such as adequate, sustainable, stable, predictable, suitable, reliable, effective and efficient) needs to be given a quantitative measure that would gain wide acceptance by the industry, regulators and policy makers, along the lines of what is specified in, say, a service level agreement.

It is important to note that the recommendation implicitly assumes that the pension scheme provides both the accumulation and decumulation stages. If, as it is becoming increasingly likely, the accumulation and decumulation stages are separated and different providers service the different stages, then the above list of criteria would have to be modified to reflect this.

### **Recommendation 1.2: Explaining key risks involved in the generation of retirement income from pension savings**

We recommend that scheme providers should be required to explain to scheme trustee (or governance) committees (and where possible to members) the following key risks in retirement income provision and how their scheme deals with these risks:

- **Contribution risk** – The risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts
- **Retirement timing risk** – Uncertainty about when the scheme member will retire and/or begin to make withdrawals
- **Product choice risk** – Uncertainty about how the scheme member will make withdrawals, not least because of the very large set of choices now available
- **Investment risk** – The risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement. A particularly important example of investment risk is sequence-of-returns risk
- **Inflation risk** – The risk that inflation is higher than anticipated
- **Interest rate risk** – The risk that interest rates are low at the point of annuity purchase
- **Longevity risk** – The risk that individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk)
- **Cost risk** – The risk that the total costs of running the pension scheme during accumulation and decumulation are higher than expected or understood
- **Political risk** – The risk that the Government changes the rules in an adverse way (e.g., reduces the level of tax relief)
- **Regulatory risk** – The risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates)
- **Demographic/cultural risk** – The risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to

pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK)

- **Market conduct risk** – The risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members); fraud and the activities of scammers would be included here
- **Behavioural risk** – The risk that scheme members behave in a way that is not considered to be rational (i.e., is not in their long-term interests, since they make short-term decisions that they subsequently regret and are unable to learn from past mistakes). Inertia and lack of engagement would be included here, as would be the risk that members fail to understand the risks they face
- **Financial knowledge and understanding risk** – The risk that a member's financial knowledge and understanding are insufficient for the member ever to make an 'informed' choice
- **Mental impairment risk** – The risk that a scheme member's mental faculties are reduced due to the onset of dementia, for example.

## 2. How to ensure that savers can get the best products in retirement

### 2.1 Introduction

The principal purpose of a pension scheme is to provide lifetime income security. The 2014 Budget changes have not changed that requirement.

From 6 April 2015 (or Flexiday), individuals above the age of 55 will have to decide the retirement financial strategy for their DC pot. This comprises:

- an investment strategy – a strategy for investing the pension pot
- a withdrawal strategy – a strategy for withdrawing cash from the pension pot to finance expenditures
- a longevity insurance strategy – a strategy for determining when longevity insurance is purchased and when it comes into effect.

There are three broad classes of product for delivering the retirement financial strategy: annuities, drawdown and hybrids (which combine drawdown and annuities).

There are five legal forms for drawing funds from a DC pension scheme from 6 April 2015 (all of which are subject to income tax at the highest marginal rate while the member is alive, although 25% of the pension fund can be taken as a tax free lump sum, known as a 'pension commencement lump sum'):

- Lifetime annuities (LTAs). LTAs provide an income for however long the scheme member lives. Payments on LTAs can be guaranteed for a set period even if the member dies during that period. There are no death benefits with standard annuities. However, if the member has a joint life annuity or an annuity with a guarantee term or with capital protection, this can be passed on tax free if the member dies before age 75, while the beneficiary pays tax at their marginal income tax rate if the member dies after age 75.
- Capped drawdown. This option is not available for new schemes after 6 April 2015, but can continue if it was already in place on 5 April 2015. The member takes an income from the fund, but the income is capped at 150% of the equivalent annuity rate set by the Government Actuary's Department, known as the GAD rate. The cap will be reviewed every three years prior to age 75 and annually thereafter. The member can take up to 25% of the fund as a tax-free benefit. Whatever tax-free lump sum is taken, three times that amount will be treated as 'crystallised'. If members only take the tax-free lump sum, they can continue to make contributions to a scheme under capped drawdown up to the £40,000 money purchase annual allowance (MPAA) with tax relief available on contributions up to age 75. If they draw down more than the lump sum, the MPAA reduces to £10,000.

- Flexible drawdown. There are no restrictions on what can be withdrawn from the fund. Prior to the Budget, flexible drawdown was only available to members who had a guaranteed income (known as the minimum income requirement (MIR)) of £20,000 from other sources, such as the state pension or a defined benefit pension. Members choosing this option will have their pension fund transferred into a 'flexi-access drawdown (FAD) fund'. The trigger event for a reduction in MPAA is the same as with capped drawdown.
- Uncrystallised fund pension lump sum (UFPLS). The fund is drawn down in a series of payments when the member needs cash. The first 25% of each payment is tax free and the rest is taxed as income. What is left in the fund is uncrystallised on death. Members using this option have their MPAA for making additional contributions reduced to £10,000 and there will be no option to carry forward any unused annual allowance.
- Trivial commutation. Members with up to three pension pots each of £10,000 or less from three different providers can take them as a lump sum rather than transfer to a drawdown policy. This means that up to £30,000 can be taken as a lump sum (which is now the trivial commutation limit). The first 25% is tax free and the rest taxed as income. Any residual balance on death will not be taxed, but will instead will be included in the member's estate for inheritance tax purposes.

As a general rule, death benefits with capped drawdown, flexible drawdown and UFPLS are tax free if the member dies before age 75 and taxed at the beneficiary's marginal tax rate if the the member dies after age 75.

Of equal importance to the pension product itself is the delivery or distribution vehicle, the arrangement through which the scheme member receives the pension product. Traditionally, the distinction has been between institutional and retail distribution arrangements, but a new hybrid institutional-retail distribution arrangement is developing. Currently, the DC scheme member has to go to the retail market to buy a pension product, even if they have been a member of their employer's pension scheme during the accumulation stage. The retail retirement income market is currently characterised by a reputation for poor design and high charges.

Although, the 2014 Budget will revolutionise the retirement income market, this will only be of any benefit to customers if the new market is both efficient and effective in terms of both product design and delivery channels. It also needs to meet the customer's needs as well as recognise that retirement will no longer be a single point in time event in future, but instead will for many people be a process that takes place gradually over time.

A good product for delivering retirement income needs to offer:

- Accessibility – the degree of flexibility to withdraw funds on an ad hoc basis



- Inflation protection either directly or via investment performance, with minimal involvement by individuals who do not want to manage the investment risk
- Longevity insurance.

No single product meets all these requirements, but a combination of drawdown and a deferred (inflation-linked) annuity does, for example. So a well-designed retirement income plan will have to involve a combination of products.

Taking all these issues into account implies that the appropriate arrangement for providing income in the period between retirement and the age at which the longevity insurance comes into effect:

- Benefits from institutional design, governance, and pricing
- Is simple to understand, transparent and low-cost
- Requires minimal consumer engagement
- Benefits from a low-cost delivery system.

If any product satisfies these conditions as part of a hybrid solution in a good pension scheme, it might be considered to be a safe harbour product. Any adviser recommending such a product cannot subsequently be sued for poor advice. So far the Financial Conduct Authority has refused to grant safe harbour status to any UK investments.

## ***2.2 The products on offer for investing the accumulated pension pot and for providing an income in retirement***

We discuss the three main ways of providing an income in retirement: annuities, drawdown and hybrid products.

### **2.2.1 Annuities**

#### ***2.2.1.1 Lifetime annuities (LTAs)***

LTAs sold on the open market (via the open market option (OMO)) could be classified as safe harbour products.

#### ***2.2.1.2 Short- or fixed-term annuities (FTAs)***

FTAs could NOT be classified as safe harbour products, since they do not hedge longevity risk.

#### ***2.2.1.3 Annuities with more flexible payments and more flexible terms, including marketability***

Annuities with more flexible payments and annuities with more flexible terms, including marketability, could be classified as safe harbour products.

#### *2.2.1.4 Annuities with guarantees*

Annuities with extended guarantee periods and annuities with capital protection could be classified as safe harbour products.

#### *2.2.1.5 Investment-linked annuities (ILAs)*

If the issues surrounding standardisation, cost and investment risk can be resolved, then ILAs (with a minimum income underpin) could be classified as safe harbour products.

#### *2.2.1.6 Deferred annuities*

Deferred annuities could be classified as safe harbour products. One fundamental problem, however, is that a deferred annuity market does not currently exist in the UK. Another is that level deferred annuities would be subject to inflation risk.

#### *2.2.1.7 (US-style) Longevity Insurance Annuities (LIAs)*

LIAs are advanced life deferred annuities that are available in the US. They begin to pay out at a date in very late retirement, e.g., age 80 or 85, if the DC customer survives to that age. They could be classified as safe harbour products. As with deferred annuities, it would be important to recognise that level LIAs would be subject to inflation risk.

#### *2.2.1.8 Annuities linked to health status*

Enhanced annuities and immediate-needs/long-term care annuities could be classified as safe harbour products.

### 2.2.2 Drawdown products

Standard drawdown does not involve the purchase of an annuity at any stage after retirement. Instead, the buyer of a drawdown product can take the tax-free lump sum, leave the rest of the fund invested and make withdrawals as and when required. Withdrawals are taxed as income at the marginal income tax rate. People can invest in funds offered by life offices or investment managers, either directly or via a platform, or they can build their own investment portfolios. The investments can be actively or passively managed. If the withdrawals exceed the income generated by the investment fund, then the fund will be reduced. With an annuity, the product automatically provides a lifetime income in retirement. This is not the case with drawdown where the customer has to make an active decision to withdraw cash and the fund can run out of money before the customer dies.

Drawdown has three components: the investment product where the pension pot is invested; the arrangement for delivering the pension (e.g., a self-invested personal pension

scheme or SIPP); and the withdrawal strategy, the programme for withdrawing funds over time to finance expenditures.

All drawdown products need to balance income security, growth and cost. But modern drawdown products also need to be able to deal with much smaller pot sizes than before. With a current average pot size of £28,000, many retirees will prefer to take that as cash. But a percentage of retirees will want to experiment with drawdown.

The following classes of multi-asset fund have been proposed for use with drawdown (with an annual management charge generally below the 0.75% charge cap imposed on default investment funds in the accumulation stage): diversified growth funds, multi-asset target return funds, and multi-asset income funds. There are also examples of multi-manager funds (with annual management charges up to 2%). In addition to the annual management charge, there would be a platform charge of 0.25-0.5% p.a. and a potential advisory charge of 0.5%-0.75% p.a.

The main advantages of drawdown can be summarised as follows:

- Control over the investment strategy
- Flexibility to change the income drawn on an annual basis (subject to the maximum in the case of capped drawdown)
- Potential for higher returns over the longer term, but only if the fund is invested in riskier assets
- Death benefits – on death in drawdown, the investor's partner or other nominated beneficiary can continue to draw an income or take it as a lump sum
- Deferment of the annuity purchase – in theory indefinitely, although experts agree that in most cases the guarantees provided by the LTA will become attractive at some point.

The main disadvantages of drawdown can be summarised as follows:

- Ill-informed decisions – this is the risk that the guidance and advice market will not provide the level of individual support required to ensure all consumers make well-informed decisions, for example, in relation to taxation and the income level drawn
- Cost – drawdown can be an expensive product and not all of the costs involved will be visible
- Longevity risk if longevity insurance has not been purchased – the risk that the individual will run out of money before death
- Investment risk – the risk that the investment returns will not exceed those on a comparable annuity after the additional costs have been taken into account. In addition, there is the potential inability of drawdown products to generate stable returns over time. There is increasing evidence that investment returns since 2000 have been on average lower and more volatile than in the 50 years before 2000. The

implication is that retirees will have to draw down their capital to maintain their living standards, which increases the likelihood that they will run out of money before they die. Furthermore, investment risk increases as life expectancy reduces, since there is less time left to recover from a big fall in the stock market

- Annuity-conversion risk – a range of factors, including the level of interest rates, the mortality assumptions and the individual's health status, will all affect the LTA rate in the future, assuming the individual buys longevity insurance at some point
- Capacity to take risk – related to the previous three points, any longevity insurance needs to be in place before its price exceeds the funds available to purchase it and the capacity to continue taking risk disappears.

Standard flexible drawdown products could NOT by themselves be classified as safe harbour products, since they do not hedge longevity risk.

### 2.2.3 Hybrid products

Hybrid products combine drawdown with longevity insurance to provide a lifelong income. They are therefore part drawdown and part annuity to differing degrees, although this will not be apparent to the consumer for whom an 'annuity' is a bad product. Those that are more annuity-like are provided by insurance companies, those which are more drawdown-like with income guarantees tend to be offered by investment management houses and investment banks, as well as some insurers.

#### *2.2.3.1 Variable annuities*

The classic example of a hybrid product lying between lifetime annuities and drawdown is a 'variable annuity'. This offers both living benefits and death benefits. The most common death benefit is the (partial) return of premium. When the VA policyholder dies, a specified beneficiary will receive the larger of the account balance and the value of the initial investment less total withdrawals.

Subject to there being complete transparency over design and the absence of excessive charges, variable annuities (with a minimum income underpin) could be classified as safe harbour products.

#### *2.2.3.2 Guaranteed drawdown*

'Guaranteed drawdown' is a product that offers flexible drawdown (in the form of immediate income and deferred income) with guarantees. The drawdown rate is lower than an annuity by 20-30% (e.g., 4% when the annuity rate is 5.5%), but allows more flexibility of access, a guaranteed income and death benefits. There is no maturity date with the guaranteed drawdown product which therefore potentially provides a guaranteed nominal income for life. The death benefit paid is the higher of the initial guaranteed base minus

guaranteed income taken and the fund value. The annual charge is in the range 1.65-2.5%, depending on pot size and product provider.

Subject to there being complete transparency over design (in particular how the guarantee is underwritten) and the absence of excessive charges, guaranteed drawdown products (with a minimum income underpin) could be classified as safe harbour products.

#### 2.2.4 Other products

There are other products to provide income in retirement.

One example is the pension bank account. This is where the pension scheme is used as a cash machine (i.e., taking withdrawals via UFPLSs, where 25% of what is withdrawn is tax free) and has traditionally been available only for retail customers via a SIPP. Ad hoc cash withdrawals could cost anywhere between £30 and £400 per withdrawal depending on the SIPP provider. The charges are a lot lower in providers' schemes that allow UFPLS. Pension bank accounts would NOT be classified as safe harbour products, since they do not hedge longevity risk.

Other examples are buy-to-let pensions, extreme-inflation protection, and home equity release plans. There have also been proposals for ISA pensions and care ISAs. ISA pensions would NOT be classified as safe harbour products, since they do not hedge longevity risk.

### ***2.3 Current and planned delivery systems for retirement income products***

Until Flexiday, the most common vehicles for delivering retirement income from DC schemes were personal pensions, SIPPs, and group personal pensions (GPPSs), all of which are essentially retail products. Following the new pension flexibilities, three forms of retirement income delivery vehicle have been developed: institutional, retail, and a hybrid combination of institutional and retail.

#### 2.3.1 Institutional distribution vehicles

##### *2.3.1.1 Institutional annuitisation*

With institutional annuitisation, the DC scheme arranges for the pension to be paid until the scheme member dies. This is what happens in defined benefit (DB) schemes. There are two cases.

In the first case, the scheme self annuitises and is responsible for making good any deficit arising because, say, member life expectancy has been underestimated. The benefit from group self-annuitisation is that the scheme retains the mortality premium that arises from those members of the scheme who die earlier than their life expectancy. It can be used to enhance the annuity paid to those who live longer than their life expectancy. Group annuities are the only financial asset ever invented to benefit from this additional source of

return which increases the longer people live. Drawdown products do not benefit from the mortality premium (since they do not pool mortality risk).

In the second case, the scheme buys in annuities for its retired members from an insurance company via a bulk purchase annuities (BPAs). The idea is for the insurance company to underwrite the longevity risks, relative to a guaranteed lifetime income, presented by a cohort of retirees. If this model could be fully developed for the DC auto-enrolment market, it could deliver better value for money for retirees, and it might be implemented via a national clearing house, for example, to ensure universal access and competitive pricing. It might also be offered directly by the large-scale DC schemes, once they have achieved the necessary critical mass, and as a natural extension of scheme drawdown.

### *2.3.1.2 Scheme drawdown*

Scheme drawdown is where a pension scheme is used to provide a withdrawal facility together with an institutional investment management solution to meet the decumulation needs of DC customers in early retirement, i.e., until longevity insurance kicks in. In many respects, scheme drawdown is a natural extension of the default fund used by modern multi-trust, multi-employer schemes for the auto-enrolment accumulation stage. It is also a natural extension of the trustees' governance role and fiduciary duties, which, prior to 6 April 2015, ended very abruptly when members were steered towards the purchase of LTAs at the point of retirement. Under scheme drawdown, the trustees would be responsible for governance, which would include the selection of the investment manager(s) and administration of payments into retired members' individual accounts. This governance structure would avoid the need to rely on individual employers.

We were told that there would be no need for individual advice with this type of arrangement – as there is with retail income drawdown – because it is an income-paying fund with an administration facility offered by the scheme trustees. Even if this is the case, it will be necessary for trustees to provide clear member communications and much would depend on whether scheme drawdown is the default or an option. Where drawdown is the default, then for the early years of retirement, there would need to be some form of screening process to ensure members for whom the strategy is not suitable are offered alternative arrangements. For example, a single person with no dependants who is in poor health would probably be better off with an enhanced annuity or a cash lump sum. Where it is not the default, a professional decumulation service appointed and monitored by the trustees could steer members towards the most appropriate decision for their circumstances, in which case, the scheme drawdown fund would be one of the available options. The regulator would also have to settle the issue of whether any such steer constituted guidance or advice.

The attraction of scheme drawdown is that it has the potential to be much cheaper and deliver more consistent results than conventional drawdown, due to economies of scale,

trustee oversight, and the use of a well-designed institutionally managed fund. Scheme drawdown would also be more flexible than a FTA because members would be able to purchase an LTA at any time or at designated regular intervals, depending on the scheme rules.

Scheme drawdown could be used as a relatively short-term decumulation solution. This would provide members with a breathing space before purchasing the LTA. It might also be used for a longer period during the early stage of retirement. The scheme might have a default age to switch to an LTA, such as 75.

We did not have access to the pricing of products that are being launched, but we estimate that the member charge might be in the region of 0.6% to 1%. The breakdown for a member charge of 0.6% might be 0.40% for the fund management and 0.20% for the administration of payments to individual accounts.

The investment strategies with scheme drawdown will have to reflect the realities of the new world of 'freedom and choice'. In particular, scheme designers will have to reconsider the asset allocation of the glide path during the de-risking phase pre-retirement. Previously, most de-risking glide paths ended up with a fund that was 25% in cash, to hedge the tax-free cash element, and 75% in bonds, to hedge annuity rates. This would no longer be suitable for members who go into drawdown: it would be appropriate to have a much larger weight in growth assets at the beginning of the decumulation phase. However, for scheme members who want to take cash as soon as they can under the new flexibilities, a glidepath that ends with 100% in cash is more appropriate in this case.

Scheme providers will therefore have to ask their members what their likely choice will be – cash, drawdown and annuitisation – at the beginning of the scheme's de-risking glidepath, which might be 5 or 10 years before the nominated retirement age. If the choice is drawdown, then the next question that scheme providers will need to ask members is what income level they wish to achieve in retirement. This will allow members to reconsider their funding strategy and, if necessary, increase their contribution rate. They might also use the opportunity to consider the investment strategy they will employ post retirement (although, of course, that can be reviewed again much closer to the date).

A key aim of scheme drawdown is to deliver a low-cost and flexible drawdown facility. The most common investment vehicle for doing this is a target date fund (TDF) which spans the later years of accumulation and the early years of decumulation. The TDF is an investment strategy designed for DC default funds, whereby the scheme establishes a range of TDFs, each with its own de-risking glide path. This might involve a TDF for each possible retirement date, or there might be a single TDF for members who plan (or are expected) to retire within a given five-year window. The more traditional method of de-risking in the UK is to use lifestyle strategies.

There are scheme drawdown offerings from investment managers, life offices and consultants. Despite these offerings, there have been very few public announcements by companies that have adopted any of them in the days and months following Flexiday. This raises the question about how willing companies are to offer scheme drawdown in practice. An additional concern of trustees is that partnering with a drawdown provider might be seen by members as giving advice.

### 2.3.2 Retail distribution

With retail distribution, the scheme member chooses a drawdown provider either directly or via a platform and transfers their pension pot to them and sets up a SIPP with flexible access.

Charges for retail drawdown products can be very high. Which? investigated the drawdown market and found that one product was charging 2.76% p.a.

### 2.3.3 Hybrid institutional-retail distribution

With hybrid institutional-retail distribution, the occupational pension scheme only offers the accumulation stage and then sends its members to a provider of retirement income solutions, but as retail customers.

This reflects the reluctance of trust-based DC schemes to offer drawdown themselves. Members will have to transfer to a SIPP or a stakeholder pension scheme if they want to use drawdown. Some trust-based DC schemes will allow up to two lump sum withdrawals per year, but no more. Some contract-based schemes, while showing more flexibility on UFPLS, will also require people who want drawdown to move to a SIPP or a stakeholder pension scheme.

## **2.4 The withdrawal strategy**

Determining the withdrawal strategy for a DC pension scheme is a critical issue. If too much is withdrawn too soon, then there is the risk that the scheme member will run out of money while they are still alive. If too little money is withdrawn, then there is the risk that the scheme member dies with a large chunk of the pension pot unspent and hence could have enjoyed a much higher living standard in retirement.

### 2.4.1 Factors influencing the withdrawal strategy

A number of factors need to be taken into account.

The first factor is the level of income that should be drawn in relation to income tax (i.e., the avoidance of moving into a higher marginal rate band where possible) and to longevity risk (i.e., the avoidance of drawing a high level of income in the early years that would result in running out of money in later retirement should the individual live longer than expected).



The second factor is the state pension. For those with sufficient private pension savings and in good health, it pays to delay taking their state pension.

The third factor is the investment strategy. The withdrawal strategy cannot be made independently of the investment strategy. If the scheme member chooses to invest entirely in a LTA, then the income from the pension pot will be predictable and lifelong, but also inflexible. If, however, the scheme member chooses to invest in a diversified growth fund (DGF), it is possible to withdraw a higher average, but potentially more volatile income. But investing in a DGF will not hedge longevity risk, so, at some stage, longevity insurance needs to be purchased to avoid running out of money before the scheme member dies. A number of academic studies have shown that the optimal strategy for someone who is not extremely risk adverse is to begin retirement with a significant investment in growth assets and then to switch to an annuity in later life.

## 2.4.2 Is there a safe withdrawal rate?

### *2.4.2.1 The 4% rule*

The US financial planning community has developed the concept of a 'safe (sensible or sustainable) withdrawal rate' (SWR) which is based on the work of a financial planner called William Bengen. In 1994, he devised the '4% rule'. The rule stated that an individual could withdraw 4% of the fund in the first year and the same amount adjusted for inflation in subsequent years. Based on all the rolling historical periods in his dataset, Bengen showed that the fund would last for at least 30 years.

More recently, Wade Pfau, a professor of retirement income at the American College of Financial Services, investigated the 4% rule for the UK. Pfau showed that the safe maximum withdrawal rate for the UK is only 3.77%. If the individual is prepared to accept a 10% probability of failure (i.e., a 10% chance of running out of money before 30 years), the SWR increases to 4.17%. A 5% withdrawal rate results in a failure probability of 27.5%.

While a fixed SWR is simple to understand, it has a number of weaknesses. First and most importantly, it ignores longevity risk. Second, it ignores the individual's attitude to risk, both in terms of the underlying investment portfolio and the failure probability. Individuals with a low degree of investment risk tolerance and a low tolerance to running out of funds before dying would want to invest in a much more conservative fund and, consequently, have a much lower SWR. Third, the rule involves taking out a fixed (albeit index-linked) amount whatever market conditions. This leaves open the possibility that individuals could spend all their pension pot before dying. It also leaves open the possibility that individuals underspend their pension pot before dying and hence could have enjoyed a higher standard of living in retirement. Fourth, it is not safe in a low-yield world. Fifth, it ignores fund management charges. Sixth, it ignores the dynamic nature of market and portfolio returns and, in particular, 'sequence-of-returns' risk. This is the risk that there is a sequence of

negative returns on the invested portfolio in the early years after retirement. If a fixed (in real terms) amount of money is still withdrawn from the fund each year, many retirees will run out of money, not only well before they die, but also well before they have completed 30 years of retirement.

It is of course possible to reduce the failure rate by adjusting withdrawals down in bad years and up in good years. The main ways of doing this are through the use of variable spending strategies:

- Giving up the inflation uprating in years when there are poor investment returns
- Cutting spending when the portfolio withdrawal rate exceeds 20% of their initial level because the portfolio is declining
- Increasing spending when portfolio withdrawal rate falls by more than 20% of their initial level because the portfolio is growing
- Withdrawing a constant percentage from the fund, rather than a constant amount.

All these options involve, albeit to differing degrees, volatile income and hence expenditure from one year to the next, although with the last option, the retirees will never run out of money before they die.

#### *2.4.2.2 Alternatives to the 4% rule*

Some alternative withdrawal strategies to the 4% rule have been proposed which dynamically adjust withdrawals to market and portfolio conditions and we consider the most common of these.

This first is based on withdrawing the annuitised value of the fund, i.e., withdrawing the amount  $F_x/a_x$  at age  $x$ , where  $F_x$  is the value of the fund at age  $x$ , and  $a_x$  is the annuity factor at age  $x$ . This is known as the 'equivalent annuity' strategy. A variation on this is the ' $1/E_x$ ' rule, where  $E_x$  is the individual's life expectancy at age  $x$ , and the withdrawal amount at age  $x$  is given by  $F_x/E_x$ . With these strategies, retirees will never run out of money before they die.

The second is to draw only the 'natural' income from the fund, which is defined as the 'pay-out of dividends [coupons, rent etc] from income-generating investments'.

The third is auto-rebalancing. This involves making withdrawals from the asset classes that experienced the highest growth during the year.

The fourth is to use a cashflow reserve (or bond) ladder or bucket. This involves holding enough in deposits or short-maturing bonds to meet the next two years of expenditure.

The fifth is the rising equity glide path proposed by Wade Pfau and the US financial planner Michael Kitces. This starts with a low equity allocation which increases gradually during the

first decade of retirement. This strategy reduces portfolio return volatility at the time the portfolio is most susceptible to sequence-of-returns risk.

The sixth is the floor-leverage rule. This involves establishing a safe and secure spending floor with 85% of the assets in the portfolio. The remaining 15% of the portfolio is invested in a 3 times leveraged equity fund. If the equity portion of the portfolio exceeds 15% of the total portfolio, equities are sold to reduce the allocation to 15% allocation and the proceeds are used to increase spending.

The final one is a 'least cost' or 'collared' spending strategy. This involves using options to put a cap on spending when the market is underperforming and a floor on spending when the market is performing well and hence put a 'collar' on spending that eliminates the surpluses and deficits.

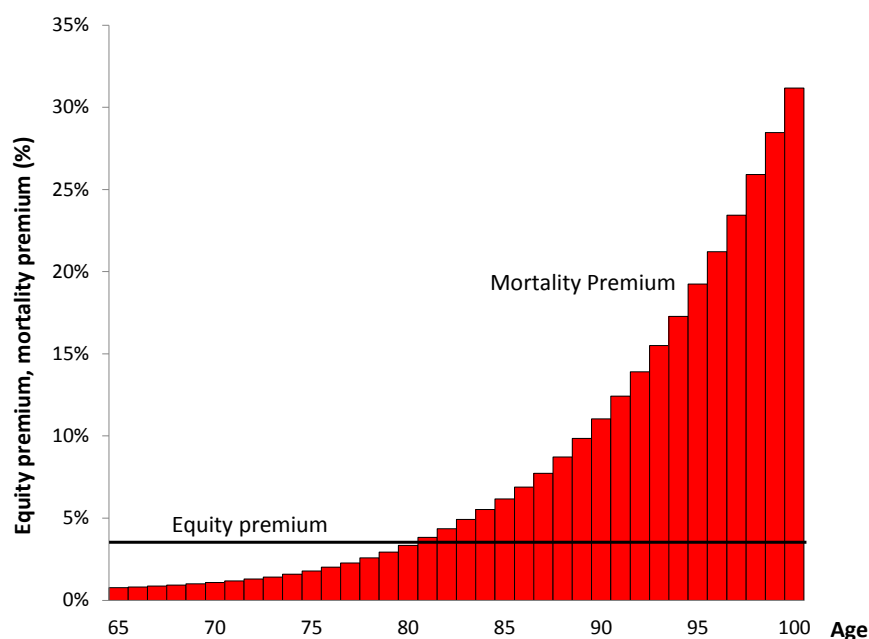
It is important to note that none of these strategies, apart from the first one, hedge longevity risk, unless longevity insurance in the form of a deferred annuity is purchased at retirement which comes into effect at, say, 85.

## ***2.5 The longevity insurance strategy***

The longevity insurance strategy determines when longevity insurance is purchased and when it comes into effect. The strategy is essential for ensuring that a pension scheme serves its primary purpose of providing an income for however long the scheme member lives. But when should longevity insurance be purchased and when should it come into effect? This essentially boils down to the choice between buying an immediate annuity when it is needed and buying a deferred annuity at the point of retirement with the deferred annuity beginning to make payments when it is needed.

The optimal combined investment and longevity insurance strategy in retirement is complex and impossible to implement properly without sophisticated stochastic dynamic programming software. However, Milevsky (1998) proposed a simple rule of thumb for deciding when to switch from risky equity-linked assets to an annuity: this is when the mortality premium exceeds the equity premium as shown in Figure 2.3. The mortality premium for a particular age ( $x$ ) can be thought of as the excess return on a level annuity over a risk-free investment. The equity premium is the excess return on equities over a similar risk-free investment: in Figure 2.3, the equity premium is assumed to be 3% p.a.

*Figure 2.3: The Milevsky switching rule*



In the early years after retirement, the equity premium exceeds the mortality premium and, all other things being as expected, the retiree receives a higher average return from investing in an equity-linked portfolio than investing in a level annuity which is equivalent to a bond-based investment. However, the level of the mortality premium increases each year and eventually exceeds the equity premium. Figure 2.3 shows that the switchover age is around 80 if the equity premium is 3%. This rule of thumb is a reasonable approximation to the optimal switching rule if the scheme member is risk-neutral, but it overestimates the switching age if the member is risk averse: for example, if they are extremely risk-averse they should annuitise at retirement and not delay.

Figure 2.3 shows the ‘average’ investment outcome with a 3% equity premium. But, presenting information on the basis of averages is deceptive: investment returns are not guaranteed and Figure 2.3 ignores important realities, such as sequence-of-returns risk. To show what could happen in the real world, we use the PensionMetrics stochastic simulation model.

Figure 2.4: Distribution of real income with 100% drawdown and no deferred annuity

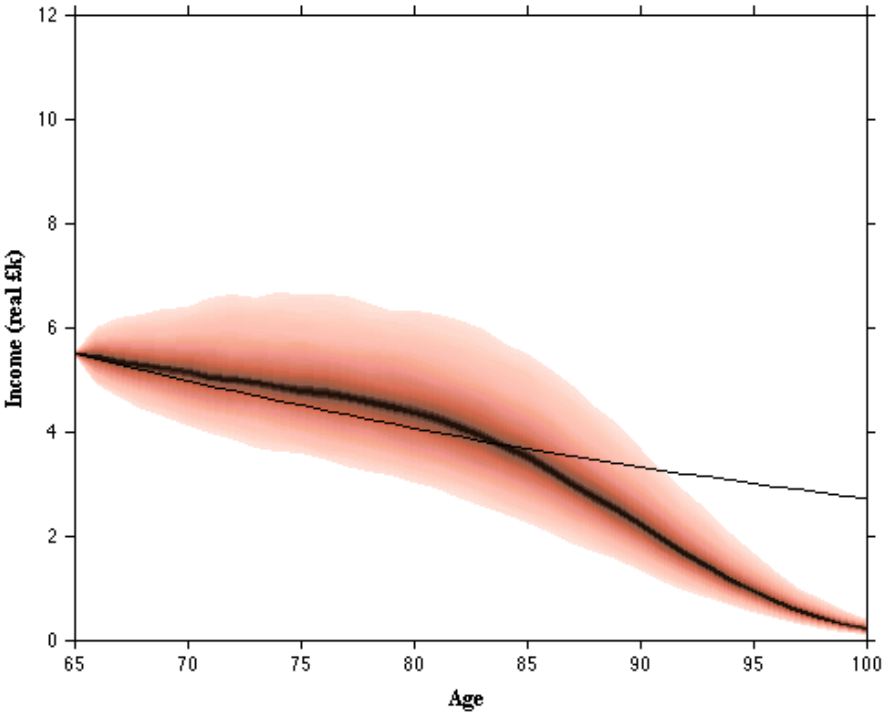


Figure 2.5: Distribution of real income with 120% drawdown and no deferred annuity

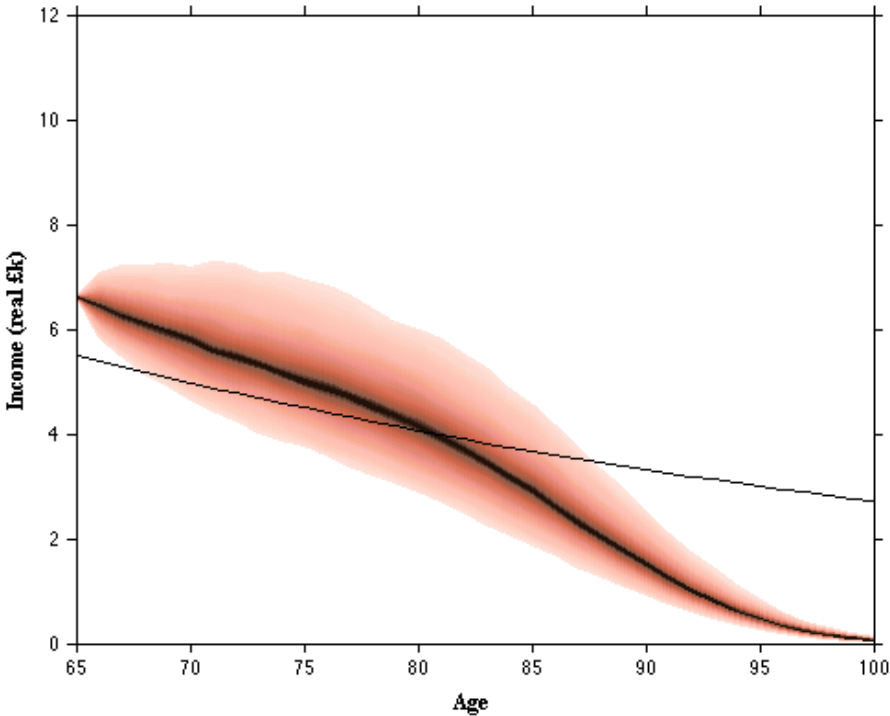


Figure 2.4 shows the distribution of real income with 100% drawdown and no deferred annuity for £100,000 pension pot. What is depicted is a fanchart showing the 90% prediction interval for the distribution of income from the 2,500 different scenarios. Also depicted in the Figure is a thin slightly curved downward sloping line. This shows the real value of the payments on a level annuity purchased at age 65, with the payments declining in real terms. The Figure shows that the user of drawdown will on average receive a higher income in the earlier years of retirement than the annuitant, but a lower income in the later years if they live that long. Of course, when the retiree dies, the residual fund with drawdown goes to their estate, whereas the family of an annuitant gets nothing.

Figures 2.5 and 2.6 show what happens if 120% and 150%, respectively, of the annuity equivalent is withdrawn each year. Individuals will enjoy a much higher standard of living in early retirement than a lifetime annuity, but they will pay for it in later retirement.

*Figure 2.6: Distribution of real income with 150% drawdown and no deferred annuity*

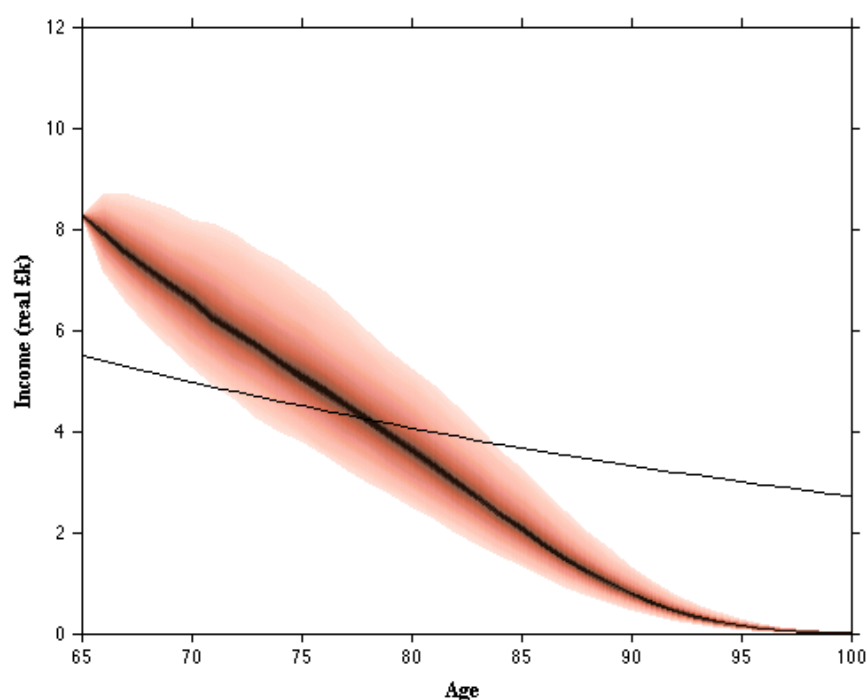
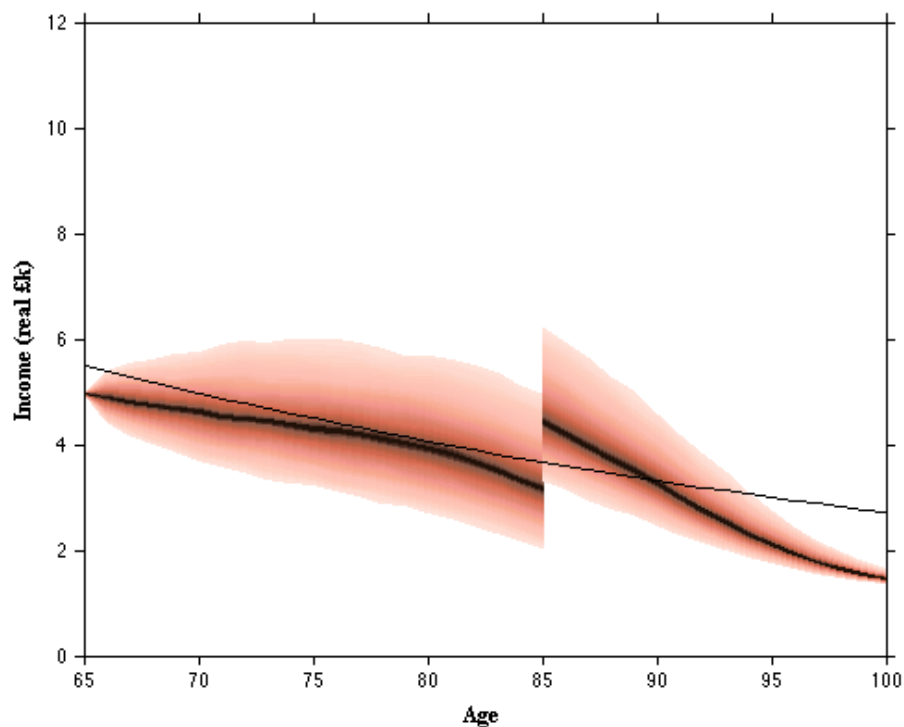


Figure 2.10 shows what happens in the case where 10% of the fund is used at age 65 to purchase a deferred annuity, and there is 100% drawdown on the remaining fund. Although lower on average than the income from an annuity at most ages, the income from this combination of drawdown and deferred annuity matches the annuity income quite closely – except at high ages – and certainly much better than the pure drawdown strategy shown in Figure 2.4. And drawdown has much more flexibility.

*Figure 2.10: Distribution of real income with 100% drawdown and 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85*



What these figures strikingly demonstrate is the two key unavoidable tradeoffs people need to make in retirement: (a) a higher income earlier in retirement and a higher income later (and vice versa), and (b) the higher overall lifetime income from an annuity against the extra flexibility and death benefits available with drawdown. Ultimately, the optimal decision comes down to choosing what risk of a reduction in future lifetime income a retiree is prepared to accept for retaining control over their assets.

## **2.6 Charges, charge disclosure and proposals to cap charges**

Charges for drawdown vary considerably and in total could have four components: the charge imposed by the scheme provider to cover operational costs (such as administration), the fund management charge, the platform charge, and the charge for advice.

Even for a simple fund structure from a low-cost provider, the annual charge might be 1% plus an administration fee of £250 per annum, which would cover the cost of income payments and income amount reviews, for example. A more common total cost is about 2% p.a. which is similar to that for an investment-backed annuity. Guaranteed drawdown products could cost up to 2.5% p.a. (or even more), although for large funds, the charge drops to around 1.55% p.a. We came across cases where the charges for a SIPP package and advice were 4%-4.5% p.a. Platform costs can be between 0.25-0.50% p.a. and advice can be between 0.50-0.75% p.a. There are also hidden costs, including bid-offer spreads, the cost of sub-funds within the main fund, etc. Where an actively managed fund is selected, there is a

risk that high turnover (churning) would add significantly to the total cost due to the transaction costs involved. Which? found 'one provider charging 0.5% more than another for investing in the exact same fund, and one provider's charges ranging from 0.44% to 1.24% for very similar funds, which can make a significant difference over the course of someone's retirement'. The worst case was a fund charging 2.76% p.a.

The Pension Schemes Act 2015 allows the Government to impose a charge cap on drawdown products in future.

## ***2.7 Product and provider regulation***

In general terms, product and provider regulation comes under the FCA's conduct risk regime which, in turn, relates to the FCA principle of treating customers fairly. The risk regime covers three main areas:

- The way the product is being developed (research, knowing target market, customer understanding, risks)
- The way the product is distributed to customers (training, do advisers understand the product that they are selling, are sales materials misleading?), and
- The way the products are subsequently serviced/administered and monitored (service levels, claim rates, are products performing as customers have been led to expect).

The FCA has seen fit to criticise the markets for annuities and structured products on all these grounds in recent years.

Some feel that the drawdown market could soon attract the attention of the FCA in the same way that the markets for annuities and structured products have. For example, Holly Mackay, founder of The Platform and Boring Money, believes that providers need to simplify drawdown charges or the regulator will intervene. She said she found it impossible to compare the cost of drawdown of different providers because of the variety of charging structures and types of fees. Further, her recent consumer research confirmed levels of engagement and understanding of retirement products were still low and fuelling the problem was the opaqueness of pricing of retirement products. She said if providers fail to act to streamline their charges soon the FCA will step in and force them to do so, leaving no further 'wiggle room': 'There is a real challenge here for drawdown providers, if they don't make [charges] clear what we will see is what happened in the platform pricing arena where the regulator came and [intervened]'.

## ***2.8 How to deal with stranded pots***

There is a final issue that will be covered briefly in the Chapter and that is what happens when people move jobs. A number of solutions have been proposed for dealing with this problem. The first is pot-follows-member. The second solution is the aggregator model. The



third solution is the Australian solution of scheme-follows-the-member or what is also known as one-member, one-scheme.

## **2.10 Analysis and Recommendations**

### 2.10.1 Analysis

As we stated at the beginning of this Chapter, an effective and efficient retirement income plan in the new world of ‘freedom and choice’ will be one that implements a retirement financial strategy – comprising an investment strategy, a withdrawal strategy, and a longevity insurance strategy – using products that offer:

- Accessibility – the degree of flexibility to withdraw funds on an ad hoc basis
- Inflation protection either directly or via investment performance, with minimal involvement by individuals who do not want to manage the investment risk
- Longevity insurance

which are combined together in an arrangement that:

- Benefits from institutional design, governance, and pricing
- Is simple to understand, transparent and low-cost
- Requires minimal consumer engagement
- Benefits from a low-cost delivery system.

Longevity insurance needs to be a key component of any good retirement income solution. Indeed, we believe that any retirement income plan that does not involve longevity insurance is seriously flawed, since it fails to achieve a pension scheme’s primary goal of providing retirement income security for as long as the scheme member lives.

#### *2.10.1.1 The problems with existing products and their providers*

Since no single product offers accessibility, inflation protection and longevity insurance, a well-designed retirement income plan needs to involve an appropriate combination of annuity and drawdown products.

Annuities and drawdown have different advantages and disadvantages which can be summarised as follows:

- Standard annuities give higher more stable (life-long) income than drawdown, but no flexibility or death benefits. However, Wadsworth et al. (2001) argue that investment-linked annuities fully hedge longevity risk, while also benefiting from both the mortality premium and higher average returns than fixed annuities. Tom Boardman (2006) shows how death benefits can be built into annuities.
- Drawdown gives more volatile incomes, greater flexibility and death benefits, but no longevity insurance. While people might well like the flexibility of drawdown, this

flexibility comes at a cost, either in terms of higher charges or lower average incomes compared with an annuity. Yet it appears to be a cost that people are prepared to pay. According to Rowena Griffiths, director at Female Financial Management: 'If the product suits their needs, they tend to be happy to pay the charge'. In addition, people also like the idea of guarantees on capital or income or both. They also appear to be prepared to pay heavily for these. Yet products with guarantees could be up to twice as expensive as products without guarantees.

The 2014 Budget changed the balance away from annuities in favour of drawdown products. This change in balance was reinforced by the announcement on 29 September 2014 ending the 55% tax charge on the residual pension fund when the member dies after 6 April 2015. This made pensions wealth inheritable if held in a drawdown product, but not in an annuity. Sales of annuities have more than halved since the Budget announcement. The inheritability of pension wealth is being emphasised at the expense of the longevity insurance that a pension is intended to provide.

This is potentially damaging for the sustainability of income at higher ages, since if people rely only on drawdown, more of them are likely to run out of money before they die than leave assets to inherit – recall the average pension pot is £28,000 and can be accessed from the age of 55. It also reduces the effectiveness of the annuity product as a longevity risk sharing device since it (a) reduces the overall size of the annuity pool and (b) shifts the pool towards the select group of voluntary and more healthy annuitants, thereby making them more expensive.

Further, annuities are either being publicly trashed or treated as just another, not especially good value product along with a number of others that might be considered for inclusion in a retirement financial strategy, without mentioning, or if mentioned underplaying, their unique ability to hedge longevity risk.

Typical are the following media comments:

- 'Annuities stink. That is the general message from consumer groups, regulators and the UK Government, which last year legislated to remove the de facto obligation on retirees to use their pension savings to buy one'.
- 'One of the great benefits of the new pension freedoms is that they make it easier for savers to take an income from their retirement fund without buying an annuity. While an annuity pays a guaranteed income for life, it does so at the cost of surrendering your savings at the outset; when you die, there is nothing to pass on to your family. The alternative offered by the new freedoms is to retain ownership of your pension savings but draw an income from them, either by taking income from investments, such as dividends, or withdrawing some of the capital. Either way, there should be money left to pass on to your family'.

While, in the second of these comments, the longevity risk feature of annuities is mentioned in passing, it is downplayed in favour of the inheritability of the pension pot. It's rather like a commercial aircraft designer who pays little attention to landing the plane safely at the end of the journey on the grounds that such a small proportion of the total journey time is devoted to landing that it can be ignored. It's right at the end any way and the inflight experience is much more important.

Even more significantly, the same sort of dismissive comments about annuities are being made by senior people in the investment management industry, which, for the first time in history, is able to compete unrestrictedly with the insurance industry to manage retirement assets. Typical are these comments by Martin Gilbert, chief executive and co-founder of Aberdeen Asset Management writing in the Financial Times (emphasis added): 'For the first time, individual investors have full and free access to their pension pots rather than being *compelled* to use the bulk of those funds to buy an annuity'.

Any close observer of the pensions industry will be aware of the long-standing running battle between the investment management industry and the life assurance industry to manage pension scheme members' assets. The situation used to be clearcut: the former (which included the investment management divisions of life insurers) ran the money during accumulation, while the latter managed the money in decumulation, mainly via life annuities, since only authorised and appropriately capitalised insurers are allowed to sell annuities in the UK.

Fund managers have long complained about the lack of a level playing field. Their various trade bodies have spent years promoting the merits of drawdown products, claiming that this would encourage innovation. Here, for example, is an extract from the report commissioned by the European Fund and Asset Management Association in 2009 which clearly fails to acknowledge the unique role that annuities play in providing a life-long income in retirement:

*The regulatory framework in Europe should find a reasonable balance between satisfying the concerns of policymakers and addressing the needs of retirees. Enforcing compulsory conversion of pension savings into annuities does not give individuals the level of flexibility needed to choose the best approach to suit their circumstances and risk tolerance. This is particularly the case given the very different range of retirement income likely to be available, ranging from a very strong support from state and/or salary-related pension schemes through to greater reliance on a defined-contributions savings pot.*

*Ideally, regulatory frameworks across Europe should support, on equal terms, both annuities and other payout solutions. Restrictions on non-annuity products should be relaxed and pooled, non-pooled and hybrid solutions should enjoy equal tax treatment.*

*A more balanced regulatory framework for the payout phase of funded pension schemes would spark innovation in the European financial market and stimulate the creation of payout products tailored to meet individuals' retirement needs. Competition between providers of payout products would also increase, thereby lowering the cost of products. The evidence from countries where drawdown plans and other non-pooled solutions are not hindered by legislative or tax rules, highlights the benefits of innovation and competition.*

*Less restrictive rules and regulation towards non-pooled solutions would also create incentives for the financial services industry to create a variety of standardised pooled, non-pooled and integrated payout products, designed especially for retirement. As such pre-packaged solutions are likely to include a range of choices with respect to risk attitude and preferences regarding the structure of periodic payments, improved information requirements, advice and financial education should assist individuals in deciding how to invest their accumulated pension savings. In addition, appropriate default options should be in place to help individuals who cannot or do not want to choose between the available payout products.*

*If nonetheless compulsion is still favoured, then the upper age limit for compulsory annuitisation should be pushed towards 85 in order to achieve a right balance between the objectives of securing a sufficient level of retirement income and protecting retirees from longevity risk at very old ages. This can be achieved by using some part of the accumulated assets to buy a deferred annuity starting payments at age 85 or requiring a switching of assets into annuities at that age.*

*One possible compromise between compulsion and a more liberalised market would be only to make pooled solutions mandatory if a basic standard of living is not available from other annuity-like sources, such as state pension, defined benefit schemes etc. Above that minimum level, individuals should be allowed to make a free decision for themselves given both that individual circumstances will vary considerable and that it is difficult to set regulatory restrictions that do not end up becoming burdensome for individuals.*

The 2014 Budget has opened up the management of UK retirement assets to all comers. The investment management industry claims that consumers will benefit from new products which provide higher expected returns and greater flexibility than annuities, Martin Gilbert, in the same article in the Financial Times, confirms that: 'The fund management industry is working to develop transparent and attractive investment vehicles to win this important new business'. A survey of investment advisers by State Street found that 70% predicted an increase in product development involving capital and income guarantees. There was expected to be, by contrast, very little innovation in annuities, except for U- and J-shaped annuities.

However, some commentators question whether much innovation has actually taken place. Tom McPhail argues: 'Since the Budget, we have seen development work on hybrid retirement income products which use complex investment guarantees and hedging strategies. So far we have not seen anything which appears to deliver a better mix of guarantees and potential investment returns than simply splitting a retirement fund between an annuity for certainty and a drawdown for flexibility'.

Another important issue is cost. This is recognised by Martin Gilbert in his FT article: 'We are stewards of other people's money, with an accountability and responsibility to those individual savers to deliver a valuable service at a fair price. Our interests must be aligned with the interests of our clients, and transparently so....This aim for transparency is more easily stated than delivered. In addition to the fees charged by the fund manager for investing the money, the individual's pension plan provider, financial adviser or investment platform will usually charge fees that may be as large or larger than the underlying fund charge. And there are transactional costs that are...rarely well understood, including broker commission...[W]e must be open and transparent, not least about the fees and all other costs that are borne by the client...[F]ee structures on funds should align the fund management business's interests with those of the clients'.

Yet, there is, very little evidence that this improved transparency over charges is taking place, despite attempts by Daniel Godfrey, chief executive of the investment manager's trade body, the Investment Association, to move the investment management industry very slowly in that direction, as, for example, with the publication of a position paper *Meaningful Disclosure of Costs and Charges* in February 2015. Such was the hostility to such moves from member firms of the Investment Association that Mr Godfrey was forced to resign in October 2015. A senior investment manager told the Financial Times: 'He launched initiatives on transparency of fees and fund performance and remuneration, which are all important, but there are other bigger issues out there that matter to our institutional clients, such as the pensions time bomb'. According to the FT, 'concerns about the direction of the trade body' were raised by Aberdeen Asset Management, Fidelity, Henderson Global Investors, Invesco Perpetual, Investec Asset Management, Legal & General Investment Management, M&G and Schroders.

The investment management industry is saying very clearly that 'fees and fund performance' are really second-order issues. Yet, David Ferguson, chief executive of 'wrap' specialist Nucleus, has branded retail fund management 'out of control' and called for it to catch up with good practices in the institutional sector. There was over reliance on 'risk-rated' funds, accompanied by poor performance and high charges. He said: 'Where the institutional market is tight and responsive, the retail market is slack and sluggish. Institutional clients wouldn't tolerate the pricing, the accountability or the performance of the retail sector, so why should your customers?'.

When it comes to insurers, it is evident that the insurance industry has no intention of letting 'asset managers eat their dinner'. They are taking full advantage of the natural inertia of their customers to stay with their existing provider when they move from the accumulation to the decumulation stages of their pension scheme. To switch the scheme to an investment manager, the member would have to 'take financial advice and move to a retail-based platform', according to Paul Bucksey, head of UK defined contribution at investment manager BlackRock. However, a reluctance to pay for financial advice 'may leave slim pickings for asset managers that do not have a large UK life insurance company as a parent or are unable to forge a relationship with one'. Further, people who have been auto-enrolled in a default investment fund are unlikely to suddenly want to become heavily involved in investment decisions after retirement and are therefore likely to stay with their current provider, according to Robert Holford, principal at Spence Johnson. Mr Holford believes that investment managers without a platform will only be able to gain some market share if they partner with pensions companies that do not have a particular investment expertise in-house or with the master trusts, such as NEST or The People's Pension. Spence Johnson predicts that there will be £125 billion under management in master trusts by 2025. The level of fund management fees charged is also likely to have an impact on the market share achieved by investment managers. According to Lorna Blyth, investment strategy manager for Royal London's pensions business, there is a 0.75% higher fee charged by external managers on Royal London's pension platform than that for internally managed funds, which explains why the in-house funds were gaining a greater market share.

So at the very start of the 'freedom and choice' initiative, we have the following. Annuities are being trashed in the media and the investment management industry is reluctant to acknowledge that there is any role for annuities in retirement income plans. At the same time, there are serious question marks over the effectiveness and cost of the alternative retirement income solutions being offered by the investment management industry. The insurance industry and the investment management industry are at loggerheads with each other. The insurance industry is relying on customer inertia rather than good valued decumulation products to capture market share. At the same time, it is bifurcating between pure insurance companies and those insurers which have investment management divisions, such as Legal & General and Aegon, which see the greatest growth prospects in investment management rather than in insurance. This explains why Legal & General and Aegon have both decided to resign from their trade body, the ABI.

This is not good news for consumers. Both annuities and drawdown products are necessary to provide a good outcome for pensioners under 'freedom and choice'. And this means that both life insurers and investment managers are needed to offer effective and good value annuities and drawdown products. This, in turn, means that the insurance and investment management industries need to cooperate as well as compete in order to improve customer outcomes. To illustrate, a deferred annuity is potentially an ideal asset in a drawdown programme. It would require investment managers to partner with insurance companies to

provide deferred annuities. The investment management industry is unable to sell products that provide longevity insurance, since these can only be provided by authorised life offices. This cooperation is simply not happening, although NEST has announced that it will look for such a partnership. In addition, annuities need to be rebranded as 'guaranteed income for life products', and deferred annuities need to be rebranded as 'longevity insurance'.

Even if it can be agreed that both annuities and drawdown products are necessary to provide an effective retirement income solution and that there is evidence of a partnership developing between insurers and investment managers, there are a whole range of other issues that need to be resolved before we can be confident that consumers have a good choice of retirement income solutions. These relate to the withdrawal strategy, the investment strategy, and the longevity insurance strategy. Our interviewees indicated that the following factors were important to take into account:

- If drawdown is offered by schemes, consultants believe it is important for the scheme to *suggest*, but not *set* a safe withdrawal rate. Further, the suggested rate must be reviewed regularly. Consultants are also concerned that if scheme members have complicated arrangements, such as multiple pots, and do not take advice, these members could soon find themselves in trouble in terms of increased tax liability and loss of means-tested benefits etc
- The appropriate investment strategy should balance the demands for both flexibility and a secure income for life that covers at least essential life-long expenditure
- When it comes to annuitisation to deal with the longevity risk, the later that this is deferred, the more challenging it becomes due to issues of pricing and cognitive impairment
- The most common age suggested by the consultants we interviewed for triggering annuitisation was 75 and this could be paid for in a number of ways: (a) set aside 10% of the fund at retirement (to buy an annuity at 75) and keep it in a reserve fund, (b) pay a monthly premium during drawdown, (c) buy a deferred annuity at retirement, or (d) buy a series of annuities over, say, 5 years.

#### *2.10.1.2 Issues with the arrangements for delivering retirement income*

The first point to clarify is about nomenclature. Only arrangements for delivering retirement income schemes which involve longevity insurance (in the form of current or deferred annuities) should be allowed to call themselves 'pension schemes'. Arrangements which do not involve longevity insurance should not be allowed to call themselves 'pension schemes', but should be required to use another name, such as 'drawdown management schemes'. In other words, the term 'pension scheme' should be a protected name. Furthermore, arrangements which do not involve longevity insurance should be classified as complex and high risk from a regulatory standpoint.



Turning to delivery systems, efficiency requires economies of scale. This is one of the most effective ways of keeping costs low. So products delivered by institutional delivery systems can be offered at lower cost than retail delivery systems. One overarching goal of innovation should therefore be to change the retail model for DC decumulation into an institutional model, in terms of product design, delivery and cost. This was a key lesson from auto-enrolment.

On the other hand, some providers told us that there was a false distinction between scheme (institutional) and retail drawdown in terms of value for money because drawdown involves individual accounts and it is possible to get low-cost non-advised drawdown in the retail market.

So there is a difference in view amongst industry practitioners about which type of arrangements would be more effective for delivering retirement income. We therefore need a clearer picture of the economics of scheme vs retail drawdown.

The disagreement might well be moot, however, since there has been little evidence since the 2014 Budget of new institutional delivery systems being offered. Two probable reasons are that the industry has been given so little time to implement the changes and that there has been so much uncertainty about how consumers would respond to the Budget changes. In short, no one has had the time or incentive to invest in new delivery systems.

#### *2.10.1.3 The criteria for safe harbour status*

There was support amongst those we interviewed for certain products to be classified as safe harbour products. Such products need to be ‘good enough’, since there could be no Financial Ombudsman Service referrals with safe harbour products, i.e., advisers, having confirmed their suitability, could not be sued for recommending them to clients. Bearing in mind that ‘the best is often the enemy of the good’, we would argue that, for most customers, the ‘best products’ are those that will be ‘good enough’ to be classed as safe harbour products for use in safe harbour retirement income plans.

This, in turn, would require products to be rated according to a set of agreed criteria. These would relate to how effective and efficient the products were in delivering the outcomes claimed for them.

We suggest the following criteria:

- Design and construction – There needs to be a much clearer picture of how products are designed and constructed, especially if they involve guarantees. For example, if the guarantees are hedged with options, there needs to be clarity over whether the options are exchange traded or over-the-counter and, if the latter, the nature of the counterparties. It also is critically important that the charges, particularly for guarantees, are not excessive



- Investment strategy – It needs to be made clear how the investment strategy meets the aims claimed for the product. The circumstances under which the investment strategy fails to meet these aims also needs to be specified
- Projected real returns – Providers of drawdown products should present stochastic projections of the range of likely real outcomes (i.e., incomes adjusted for inflation and total charges and costs) that their products could deliver based on the product's underlying investment strategy
- Accessibility – The degree of flexibility to withdraw funds on an ad hoc basis
- Longevity protection – The degree of longevity protection afforded by the product, illustrated by the probability of running out of money at different ages for a range of possible withdrawal strategies. Also included here will be the impact of the amount, if any, paid on death
- Value for money – The benefits and costs of the product need to be clearly stated and the balance between them assessed.

We should establish minimum standards for each of these criteria. Any product satisfying these minimum standards could be classified as a safe harbour product. Defaqto recently launched a provider rating service. What should be considered is a product rating service along similar lines.

#### *2.10.1.4 A metric for measuring value for money*

There needs to be an agreed metric for measuring value for money, but first we need to recognise how challenging the concept is. Despite constant references to 'value for money', policy-makers and regulators have yet to define clearly and fully what this means in relation to DC retirement income products.

Nevertheless, two broad definitions from government agencies, used in non-pensions policy areas, provide a good starting point:

- The National Audit Office: 'Good value for money is the optimal use of resources to achieve the intended outcomes. "Optimal" means "the most desirable possible given expressed or implied restrictions or constraints". Value for money is not about achieving the lowest initial price'.
- HM Treasury: 'Value for money is not about achieving the lowest initial price: it is defined as the optimum combination of whole life costs and quality'.

While these definitions are clear and simple, they are nevertheless challenging in the context of DC retirement products.

What is required is a policy and regulatory definition of value for money that cannot be gamed, as argued in the Murray Report. Murray said the measurement of value for money must be based on 'credibility and transparency: make relevant information public; avoid

room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate' (p.114).

A 2014 Pensions Institute Report, *VfM: Assessing Value for Money in Defined Contribution Default Funds*, argued that value reflects a range of features, including the appropriateness of the product structure for the target market, the price, a dynamic investment strategy (as opposed to 'set and forget'), effective communication, efficient administration, and good institutional-quality governance. While we agreed that cost is not the only consideration, we continue to believe that it is hugely important, especially when comparing products with similar objectives, such as SIPPs and drawdown funds.

Given its multi-dimensional nature, it is clearly impossible to find a single measure that captures all the different aspects of value for money. However, we believe that there is a measure that provides a good starting point and that is the 'money's worth' (MW) of a product. This is the ratio of the expected present value of payouts on the product to the price; in other words, it is the ratio of what you get back over time to what you put in. MW will always be less than 100% to allow for the provider's administrative costs and profit, but if the MW is high, then this implies that the value for money of the product is high.

MW can be used to compare different retirement income products, but we need a benchmark for comparison. We believe that the most obvious benchmark is provided by a life time annuity. This is because it provides a life-long income (hence satisfying the primary purpose of a pension scheme) and it is easy to understand how it is constructed. Moreover, the MW concept was invented for annuities.

For annuities, the empirical evidence shows that the MW of annuities is fairly high, but we would add the following caveats: the annuity type must be appropriate for the individual, medical underwriting is applied where appropriate, and the open market option is used to secure a competitive rate. Nevertheless, many people regard the product as unattractive. This is due to a combination of the irreversible nature of the purchase, lack of trust in the industry, and historically low rates, which, in turn, are due to external factors such as increasing longevity and low interest rates as a result of quantitative easing.

For drawdown products, assessing value for money is still a 'work in progress', not least because the charges for drawdown are reported in different ways – e.g., annual management charge, annual fund management charge, total expense ratio, ongoing charges figure, reduction in yield – none of which is as informative as MW.

The standard MW formula would have to be modified in the case of drawdown to reflect both the flexibility of being able to withdraw funds on an ad hoc basis and the death benefits. In a financial engineering sense, this flexibility can be expressed in the form of options. Each period while alive, the drawdown customer draws down a regular pre-agreed income (say, based on GAD rates), but also has the option to withdraw up to the entire

remaining pot. These options are valuable and, if exercised, add to the MW of drawdown, but reduce the present value of all the remaining regular income payments. The options could be valued using standard option pricing methods. The MW formula should also incorporate penalties for withdrawal strategies that lead to the pension pot being depleted before the member dies (e.g., in the form of a penal negative cash flow for these periods). Death benefits can be valued using the same framework.

While, the MW formula provides a measure of expected value, it does not take risk into account. Since drawdown products need to generate a sufficient additional return over the risk-free rate to beat the benchmark return on an annuity which benefits from the mortality premium, the risk of drawdown products could be expressed in terms of the likelihood of a potential shortfall relative to an annuity.

The need for better benchmarking to be able to assess value for money was discussed on a panel at the 2015 NAPF annual conference. Under the new DC governance rules, trustees are required to prepare a report on value for money and compare their offering with what other schemes provide. But the panel said it was very challenging and expensive to get hands on the data to do this. Lynne Rawcliffe, BASF pension manager, believes the data could be provided by the regulator, especially for trustees of small schemes that do not want to pay additional costs. Tim Banks, pension strategies group managing director at AllianceBernstein, said: 'We need more transparency and have better benchmarking that is then down to each scheme to decide what their setting value is'.

#### *2.10.1.5 Measuring and reporting charges, and a charge cap*

There needs to be a commonly agreed method for measuring and reporting the charges for all retirement income products. Currently, charges are either not reported at all or, if they are reported, they are reported in a range of different ways – sometimes the same term is used, but what is included is different – so that a comparison between products is difficult if not impossible. Further, if charges are reported, they are generally not reported in full.

For example, there is no explicit charge reported for life-time annuities. An annuity buyer pays a premium and receives an income stream and is never told what the 'charge' is. Yet depending on how the annuity is sold, a sales agent might receive a 1-3% commission. This would be the case with a non-advised sale. MW was invented in part to deal with this issue, but the MW measure for an annuity takes into account much more than any commission or other charge. Administration costs and provider profit are included in the MW figure, for instance. As mentioned in the previous section, drawdown, by contrast, has a number of different ways of reporting charges, but they all give different answers and none can be regarded as giving a complete measure of the total costs borne by the customer.

In our view, the charge measure should cover all the costs borne by the customer either directly or indirectly. The costs should be reported in the form of both a 'rate of cost' –

which could then be deducted from the gross rate of return to give a net rate of return – and as a monetary amount – which can then be compared with the monetary value of the customer’s fund.

For example, the cost of withdrawing funds, the platform charge and any adviser’s fee should be included in the cost measure. Also the following investment costs should be included:

- Visible cash costs (Level 1 costs)
  - Commissions
  - Taxes
  - Fees
  - Custodial charges
  - Acquisition costs
- Hidden cash costs (Level 2 costs)
  - Transactions costs of turnover, such as bid-ask spread
  - Transactions costs in underlying funds
  - Undisclosed revenue
- Hidden non-cash costs (Level 3 costs)
  - Market impact
  - Information leakage
  - Market exposure
  - Missed trade opportunity or market timing costs
  - Delay costs.

In terms of charge capping, we note that there is now a charge cap of 0.75% on auto-enrolment scheme accumulation default funds. This does not currently include transaction costs, although the FCA and DWP plan to revisit this issue. If transactions costs are included, will the cap remain at 0.75%?

What would be included in a charge cap on a decumulation default strategy if it were to be introduced? We believe that at, a minimum, the following should be included in scheme drawdown:

- The total expense ratio or ongoing charges figure on the default investment strategy (including the costs of any guarantees)
- Transactions costs (what is covered to be agreed)
- Cost per ad hoc withdrawal subject to a maximum number of withdrawals.

The following additional costs would apply with retail drawdown:

- Platform charge
- Adviser fee.

It was clear from our discussions with industry practitioners that there was a very strong view that any charge cap on drawdown products – including even on a default decumulation product – would reduce the scope to diversify risk, put guaranteed drawdown products out of reach, and stifle innovation.

There was equally strong support for a charge cap from consumer champions. They pointed out that the same sort of objections were made to the idea of a charge cap in default funds, yet we know that high charges are the surest form of consumer detriment and they compound dramatically over time. One told us: ‘all we have at the moment is a proliferation of expensive retail drawdown products which are being sold to individuals in place of annuities. There is also no real innovation, just a repackaging of existing multi-asset funds. A charge cap would in fact be a spur to innovation and would be one of the mechanisms that would help encourage institutional as opposed to retail solutions. The consequence of not having a charge cap will be a proliferation of thousands of non-innovative retail products which it will be prohibitively disruptive to then attempt to aggregate. An eventual cap will then be introduced, as in accumulation, which, in order to avoid damage to the multitude of providers, will just shave off the extreme excesses. That is why we have ended up with a UK charge cap for accumulation at 0.75%, while in Sweden charges are at 0.2% (and heading below) for a country where the scale is, in principle, much lower than the UK’.

We therefore believe that it would be reasonable to have a charge cap in due course on a simple default decumulation product. Such a charge cap would be relatively straightforward to justify if it can already be justified in the accumulation stage. If charges are linked to asset values, the charge is maximised at the point of retirement when the pension pot is at its highest, implying that the revenue received by decumulation product providers is front loaded. This contrasts with the providers of accumulation products whose revenues are back loaded, but can still run a profitable business. It would also be useful for product providers to be aware that a charge cap was going to be imposed, so that they are not surprised as in the case of the cap on the default investment strategy in auto-enrolment.

#### *2.10.1.6 Product and provider regulation*

Annuities are amongst the oldest financial products in the world and structured products are amongst the newest. Both have a critical role to play in the new pensions environment. Yet in the months leading up to the introduction of the new regime, the FCA found serious flaws in their design and delivery. This suggests that there is an important role for product regulation, given how poor most customers are at assessing the efficiency and effectiveness of financial products. We are not proposing regulation for its own sake, only in the case where consumers are particularly vulnerable. Even where consumers are generally good at assessing value themselves, such as in the case of food, they are still vulnerable to fraud, as

in the case of the 2013 horsemeat scandal and need the protection of the Food Standards Agency.

There could also be a role for provider regulation. Mick McAteer, director of the Financial Inclusion Centre, argues: 'asset managers [if they get involved in retirement income provision] will need to be subject to prudential regulation as annuity providers are'. He believes that investment managers would find it challenging to design products that had higher returns than annuities over the long term. He continued: 'We needed reform, but I think we are replacing something that is suboptimal with something that is catastrophic. We risk undermining the progress made with auto-enrolment and I feel that uncertainty and lack of confidence reverses trust'.

#### *2.10.1.7 Modelling outcomes*

An important part of determining whether a product meets the safe harbour criteria is modelling outcomes and this requires making projections of future returns on the product's investment strategy.

Traditionally, the modelling of outcomes of retail financial products in the UK has been very poor, since it involved the deterministic projections of returns. As Andrew Storey, technical sales director at eValue, says: 'Wouldn't it be great if markets performed in exactly the way they had done in the past? If, every year, equities managed to generate the 5% real return they have averaged since 1899, then advising on income drawdown would be a piece of cake? But as we all know, markets don't work in straight lines, even though a surprising number of projection tools, offered by big-name organisations, behave as though they do....Sequencing risk is one of the biggest challenges facing drawdown investors. It is not just a question of what returns an investor gets over their retirement, but the sequence in which these returns happen. As any adviser knows, suffer a couple of bad years in the early stage of drawdown and a client will never get their financial plan back on track. Yet many modelling tools being used by advisers today do not make any allowance for the fact that markets are complex, irregular and ever changing. It goes without saying that projections based on Excel spreadsheets – amazingly still used by a surprising number of advisers – are destined to be inaccurate from the outset. Base your projections on historical averages and they are guaranteed to set the client off with inaccurate information'. Mr Storey concludes that 'Advisers are putting themselves and their clients at very serious risk if they do not understand the considerable difference in the accuracy of the best and the worst financial modelling tools on the market'.

In October 2015, the FCA released a Consultation Paper in which it stated it was concerned that product providers' projections of what retirees can expect to receive if they buy certain products are too high, and it wants to standardise the process. In particular, it was concerned that firms using higher projections may be able to gain an unfair competitive advantage over their competitors. Since April 2014, the FCA requires firms to make

projections using three deterministic rates 2%, 5% and 8%, denoted the lower, maximum intermediate and upper projection rates. Firms are required to produce projections of future benefits for pension products that reflect the investment potential of the product, subject to the maximum rates. However, the FCA has discovered that there are two different ways of calculating the maximum intermediate rate.

For example, suppose two firms assume gilt returns of 3% p.a., and equity returns of 7% p.a. A customer buys a product that is invested 30% in gilts and 70% in equities. Firm 1 caps the equity return at 5% and uses a projection rate for the product averaging 4.4% (i.e., 30% of 3% plus 70% of 5%). Firm 2 calculates the average projection rate for the product as 5.8% (i.e., 30% of 3% plus 70% of 7%), but then caps this at 5%. Over a 20-year investment horizon, the retirement income would be 12% higher under Firm 2's projection compared with Firm 1. We also pointed out earlier the problems with 'Type A Critical Yield' analysis which is again a feature of using deterministic projections.

These examples illustrate the ludicrousness of deterministic projections. Projections must be stochastic and the uncertainty around the projections must be illustrated – we favour fancharts – as we showed in Section 2.5 above.

In September 2013, the Pensions Institute set out a methodology to model the quantifiable uncertainty associated with DC pension products and illustrated it with projections from the PensionMetrics model. The methodology established 16 good practice principles in modelling DC pension products as shown in Table 2.7. These principles could be adapted for modelling the outcomes with annuity and drawdown products.

<i>Table 2.7: Good practice principles in modelling DC pension products</i>
<ol style="list-style-type: none"> <li>1. The underlying assumptions in the model should be plausible, transparent and internally consistent.</li> <li>2. The model's calibrations should be appropriately audited or challenged, and the model's projections should be subject to backtesting.</li> <li>3. The model must be stochastic and be capable of dealing with quantifiable uncertainty.</li> <li>4. A suitable risk metric should be specified for each output variable of interest, especially one dealing with downside risk. Examples would be the 5% value-at-risk and the 90% prediction interval. These risk metrics should be illustrated graphically using appropriate charts.</li> <li>5. The quantitative consequences of different sets of member choices and actions should be clearly spelled out to help the member make an informed set of decisions.</li> <li>6. The model should take account of key member characteristics, such as occupation, gender, and existing assets and liabilities.</li> <li>7. The model should illustrate the consequences of the member's attitude to risk for the plan's asset allocation decision. It should also show the consequences of</li> </ol>



*Table 2.7: Good practice principles in modelling DC pension products*

changing the asset allocation, contribution rate and planned retirement date, thereby enabling the member to iterate towards the preferred combination of these key decision variables.

8. The model should take into account the full set of plan charges.
9. The model should take account of longevity risk and projected increases in life expectancy over the member's lifetime.
10. The model should project both at-retirement pension outcomes and post-retirement outcomes. The risks associated with the following strategies should be clearly illustrated:
  - a) the risk of taking a level rather than an index-linked annuity in terms of a reduced standard of living at high ages;
  - b) the risks associated with drawdown strategies in terms of taking out more from the fund initially than is justified by subsequent investment performance.
11. The model should consider the pre- and post-retirement periods in an integrated way. This is necessary to avoid undesirable outcomes at a later date – such as a big fall in the standard of living in retirement. It will also help to determine what adjustment in member choices – in terms of higher contribution rate, an increased equity weighting and later retirement – are needed to avoid this.
12. The model should consider other sources of retirement income outside the member's own pension plan. These include the state pension and home equity release. A well-designed DC model will also help with lifetime financial planning.
13. The model should reflect reality as much as possible and allow for such extraneous factors as unemployment risk, activity rates, taxes and welfare entitlements.
14. Scenario analysis and stress testing are important. For any given scenario, one should also:
  - a) Make key assumptions explicit;
  - b) Evaluate key assumptions for plausibility; and
  - c) Stress test assumptions to determine which really matter and which do not. This allows the modeller to determine the important assumptions and focus on getting them (as much as possible) 'right'.
15. The model will need to be updated periodically and the assumptions changed. Such modifications should be carefully documented and explained in order to make sure the model retains its credibility with users.
16. The model should be fit for purpose.

Kevin Dowd and David Blake (2013) Good Practice Principles in Modelling Defined Contribution Pension Plans, Pensions Institute Discussion Paper PI-1302, September;  
<http://www.pensions-institute.org/workingpapers/wp1302.pdf>



#### 2.10.1.8 Stranded pots

The current system whereby job movers leave behind stranded pots which can all too easily be forgotten about is simply too inefficient to be acceptable. However, each of the three solutions that have been proposed for dealing with this problem have weaknesses.

The pot-follows-member model has the disadvantage of requiring assets to be sold and rebought when someone changes jobs. The switching costs involved and the high weight in low-yielding liquid assets that schemes need to hold in anticipation of these switches will have a material effect in reducing the value of the pension pot at retirement. The aggregator model involves lower switching costs than pot-follows-member, but does have the advantage of economies of scale.

A third solution, scheme-follows-the-member or one-member, one-scheme, deals with the problems of switching costs and potentially lower returns, but requires a central clearing house to operate effectively. Further, this solution would not be able to exploit economies of scale if there remains a large number of company-based schemes, many of which might be quite small. However, this solution becomes considerably more attractive if there are a small number of very large schemes. Now this might be the natural outcome of the auto-enrolment process as the Pensions Institute predicted in its 2014 report *VfM: Assessing Value for Money in Defined Contribution Default Funds*: ‘We expect five or six trust-based multi-employer schemes to dominate the market by 2020....Single employer schemes are likely to transfer to multi-employer arrangements once employers have removed their defined benefit liabilities from the balance sheet, at which point they will be able to dismantle their DB trustee infrastructure’. This outcome would considerably lower the cost of the clearing house and make greater use of other scale economies. However, the model does involve a movement away from work-based pension schemes which have been the foundation stone of supplementary pension provision in the UK for the last 150 years.

#### 2.10.2 Recommendations

Our discussion in this Chapter leads us to make the following 10 recommendations.

##### **Recommendation 2.1: Implementing the retirement financial strategy**

**We recommend that providers offering retirement income solutions make clear to customers how their solutions for implementing the customer’s retirement financial strategy – comprising an investment strategy, a withdrawal strategy, and a longevity insurance strategy – make use of products that offer:**

- **Accessibility – the degree of flexibility to withdraw funds on an ad hoc basis**
- **Inflation protection, either directly or via investment performance, with minimal involvement by individuals who do not want to manage the investment risk**
- **Longevity insurance.**

We recognise that there may be important differences in implementation strategy and disclosure requirements, depending on the distribution channel, i.e., these will be different where a customer pays a fee for a personal recommendation – selected from the retail product market and based on an adviser’s understanding of the customer’s complete financial position/objectives – and where a trustee (or governance) committee offers a decumulation product to auto-enrolled members (which might also be via a default or default pathway). It is also important to bear in mind that many customers in the mass market may not have a clear retirement financial strategy.

## **Recommendation 2.2: Terminology**

We recommend that the pensions industry reviews the terminology it uses in order to both modernise the language and bring greater clarity to customers. In particular:

- Arrangements which do not involve longevity insurance should not be allowed to call themselves ‘pension schemes’, but should be required to use another name, such as ‘drawdown management schemes’. The term ‘pension scheme’ should be a protected name
- Annuities should be rebranded as ‘guaranteed income for life products’, and deferred annuities need to be rebranded as ‘longevity insurance’
- Arrangements which do not involve longevity insurance should be classified as complex and high risk from a regulatory standpoint.

## **Recommendation 2.3: Criteria for granting safe harbour status to key retirement income products**

We recommend that regulators agree a set of criteria for granting safe harbour status to key retirement income products. Providers and advisers could not subsequently be sued for offering or recommending a safe harbour product, having first determined its suitability for a client as part of a safe harbour retirement income solution.

We recommend the following criteria are used to do this:

- Design and construction – There needs to be a much clearer picture of how products are designed and constructed, especially if they involve guarantees. For example, if the guarantees are hedged with options, there needs to be clarity over whether the options are exchange traded or over-the-counter and, if the latter, the nature of the counter-parties involved. It is also critically important that the charges, particularly for guarantees, are not excessive

- **Investment strategy** – It needs to be made clear how the investment strategy meets the aims claimed for the product. The circumstances under which the investment strategy might fail to meet these aims also needs to be specified
- **Projected real returns** – Providers of drawdown products should present stochastic projections of the range of likely real outcomes (i.e., income adjusted for inflation and total charges and costs) that their products could deliver based on the product's underlying investment strategy
- **Accessibility** – The degree of flexibility to withdraw funds on an ad hoc basis
- **Longevity protection** – The degree of longevity protection afforded by the product, illustrated by the probability of running out of money at different ages for a range of possible withdrawal strategies. Also included here will be the impact of the amount, if any, paid on death
- **Value for money** – The benefits and costs of the product need to be clearly stated and the balance between them assessed.

The regulator should establish minimum standards for each of these criteria. Any product satisfying these minimum standards could be classified as a safe harbour product. As part of the process of product regulation, a product rating service should be established to assess whether products satisfy the minimum standards.

If the regulator fails to do this, the industry itself could establish a quality mark for in-retirement products – the Retirement Quality Mark (RQM) – as recommended in December 2015 by the Board of the Pension Quality Mark (PQM), building on the experience of the PQM and PQM READY quality mark. The RQM would:

- Provide strong governance to in-retirement products so they operate in the customers' best interests not just at the point of sale, but on an on-going basis
- Ensure there are high quality, clear and actionable member alerts
- Ensure that default investment options are well governed and appropriately designed, and
- Provide value for money to savers.

#### **Recommendation 2.4: Modelling outcomes for different retirement income products**

As indicated in Recommendation 2.3, an important aspect of product design and construction is modelling outcomes. We recommend that:

- The use of deterministic projections of the returns on products should be banned
- They should be replaced with stochastic projections that take into account important real world issues, such as sequence-of-returns risk, inflation, and transactions costs in dynamic investment strategies

- There should be a commonly agreed parameterisation for the stochastic projection model used, i.e., a ‘standard model’ should be developed
- There should be a commonly agreed set of good practice principles for modelling the outcomes from retirement income products, as outlined in Table 2.7.

#### **Recommendation 2.5: Establishing a metric for measuring product value for money**

We recommend that the regulator establishes a metric for measuring product value for money that would:

- Reflect the benefits and costs of the product and the balance between them
- Reflect key risks
- Have credibility and transparency
- Be clear, simple, difficult to dispute and difficult to manipulate (i.e., avoid room for gaming the process).

An example of such a metric would be the money’s worth (MW) of a product, which is the ratio of the expected present value of payouts on the product to the price, with due allowance made for the greater flexibilities of some products in terms of accessibility and death benefits. The MW of a product could be measured relative to the benchmark provided by a lifetime annuity. Similarly, the risk of a product could be expressed in terms of the likelihood of a potential shortfall relative to a lifetime annuity.

#### **Recommendation 2.6: Measuring and reporting charges and other costs**

We recommend that:

- A standardised method for measuring the charges (and other costs) for all retirement income products is introduced. The measure should cover all the costs borne by the customer either directly or indirectly, including operational (administration) costs, fund management (including transaction and guarantee) costs, and delivery (platform) costs
- A standardised method for reporting the charges (and other costs) for all retirement income products is introduced.

Charges are a key aspect of a product’s money’s worth. They could be reported in the form of both a ‘rate of charge’ – which could then be deducted from the gross rate of return to give a net rate of return – and as a monetary amount – which can then be compared with the monetary value of the customer’s fund.

## **Recommendation 2.7: Candidate products for safe harbour status**

Subject to meeting Recommendations 2.3 – 2.6 and to meeting suitability requirements, we recommend that the regulator grants safe harbour status to the following products used to provide retirement income:

- **In the annuities class:**
  - Lifetime annuities (with/without capital protection) – fixed and inflation-linked
  - Investment-linked annuities (with a minimum income underpin and with/without capital protection)
  - Enhanced annuities
- **In the drawdown class:**
  - Capped drawdown (with a minimum income underpin)
- **In the hybrid class:**
  - Variable annuities (with a minimum income underpin)
  - Guaranteed drawdown (with a minimum income underpin).

It is important that there is full transparency over the product design and over charges for each of the above products – and that the charges are demonstrably not excessive.

## **Recommendation 2.8: Provider regulation and the economics of both institutional solutions and retail retirement income solutions**

We recommend that the regulator:

- Aligns provider regulation with Recommendations 2.1 – 2.7
- Reviews the economics of both institutional solutions and retail retirement income solutions, and
- Encourages the use of institutional solutions over retail solutions where it can be demonstrated that these provide better value.

## **Recommendation 2.9: Capping charges**

We recommend that, in due course, a charge cap should be imposed on a simple default decumulation product. The regulator should undertake preliminary work on what a reasonable level for the charge cap would be.

At a minimum, the following should be included in any cap:

- The total expense ratio or ongoing charges figure on the default investment strategy (including the costs of any guarantees)
- Transactions costs (what is covered to be agreed)
- Cost per ad hoc withdrawal subject to a maximum number of withdrawals.

The following additional costs would apply to any cap for retail drawdown:

- Platform charge
- Adviser fee if any.

We do not have a view on the size of the charge cap or when it should be introduced. However, if there is little further evidence of innovation, there would be little point in delaying its introduction. Of course, products outside the decumulation default would not be subject to a charge cap.

#### **Recommendation 2.10: Stranded pots**

**We recommend that the Government investigates the feasibility of introducing one the following two models for dealing with the issue of stranded pots: a) the aggregator model and b) the scheme-follows-member or the one-member, one-scheme model.**

While both have disadvantages (principally switching costs and the requirement for a central clearing house, respectively), they are both consistent with a transition of the UK pension system towards a small number of large trust-based schemes – which might be the natural outcome of the auto-enrolment process, an outcome that the Government should encourage.

The pause on dealing with this issue, announced by the Government in October 2015, gives the Government an opportunity to completely rethink the problem of stranded pots.

### **3. Supporting savers to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment**

#### ***3.1 Introduction***

The optimal drawing down of retirement assets is a considerably more complex activity than the initial task of accumulating those assets. The two main reasons for this are, firstly, that most savers will not have a good understanding of many of the risks outlined in Table 1.2 and, secondly, the impact of those risks will differ for different people depending on their circumstances. People, for example, differ in terms of the size of their pension pot, the availability of alternative sources of income and wealth, their liabilities, their health status, their family circumstances, their tax position, and their risk appetite and capacity. The new flexibilities announced by the 2014 Budget will introduce additional complexity and uncertainty both to the final phase of the of the accumulation stage of DC pension schemes and to the retirement income market itself (i.e., the decumulation stage).

#### ***3.2 Understanding the retirement savings market***

##### **3.2.1 Pre-retirement**

The new pension flexibilities will make it much harder in future to design a de-risking investment strategy at the end of the accumulation period.

Whatever new de-risking solutions now develop in response to the new pensions flexibilities, it seems likely that they will be more expensive than previously. In part, this will be due to the increased uncertainty about when income will be drawn. In part, it will be because the new flexibilities will discourage investment in long-term illiquid growth assets, such as infrastructure, thereby lowering the potential returns on pension savings. Increased pension flexibility comes at a price.

##### **3.2.2 At retirement**

We reviewed a number of recent surveys covering the at-retirement market about attitudes to the new pension flexibilities. Collectively, they reveal that people welcome the new pension flexibilities, but many – especially in the middle market group lying between those who will rely mainly on the state for their retirement income and the well off – will find themselves poorly equipped to make best use of them, not least because they hold beliefs and preferences which are mutually inconsistent, a condition which psychologists call ‘cognitive polyphasia’.

### ***3.3 Segmenting the retirement income market***

When segmenting the retirement income market, we need to recognise that people differ in their types and resources and we review a number of surveys that investigate the different market segments.

We consider two ways of segmenting by type. This first is by spending type. An Aon DC Member Survey differentiates between: ‘certainty seekers’ and ‘steady spenders’ who both want a secure, stable, guaranteed income for life; ‘flexibility foremost’ who want to draw from their DC pot as and when needed; ‘early spenders’ who want to enjoy higher spending in the earlier years of retirement; and ‘residual required’ who want to provide for possible care costs or to make bequests to the family.

The second is by behavioural type and we distinguish between ‘econs’ and ‘humans’. In a retirement expenditure context, ‘econs’ are fully rational life-cycle financial planners. ‘Humans’, by contrast, try to make the best decisions for themselves, but are subject to behavioural traits that limit their ability to implement their plans. These include aversion to planning, aversion to paying for advice, inertia and procrastination, poor financial literacy, poor understanding of the nature of longevity risk, aversion to dealing with complex problems involving a sequence of choices, choice overload, illusion of control, unwillingness to contemplate unpleasant events, overconfidence, lack of self-control or too much self-control (depending on personality type), hyperbolic discounting (which leads to a poor understanding of the distant future), mental accounting, framing effects, susceptibility to negative norming, e.g., concerning so-called ‘poor value’ annuities, herding or peer effects, loss aversion, and regret or disappointment aversion.

The other important way of segmenting consumers is by resources and needs. In terms of resources, we differentiate between the ‘mass market’, the ‘mass affluent’ and ‘high net worth’. In terms of needs, we differentiate between:

- ‘essential’ income: the income required to cover the retiree’s minimum basic expenditure needs or ‘heating and eating’ as it was described to us
- ‘adequate’ income: the income required to achieve a minimum lifestyle that is acceptable in retirement
- ‘desired’ income: the income required to achieve the full lifestyle to which the retiree aspires.

These surveys collectively build up a very interesting picture of savers at retirement. The mass affluent and high net worth segments of the market appear to have the confidence and ability to manage the drawdown of its retirement assets effectively. One of their main concerns will be inheritance planning. Those at the other end of the wealth distribution will have small DC pension pots that would buy very low annuities. Most of their retirement income will be provided by the state and the freedom to choose how to spend these small



pension pots will probably be more valuable than a small addition to the state pension that an annuity would buy. Their main concern will be to act in a way that does not increase their income tax or reduce their welfare benefits. However, it is those in between – the mass market that is Middle Britain – who face the biggest challenges from pension ‘freedom and choice’. The surveys show that this group:

- are uncertain about when they will retire
- have a poor understanding of their spending needs throughout retirement, but value ease of access and the flexibility to change the amount of income
- lack engagement (even very close to retirement)
- are reluctant or unable to plan ahead
- are reluctant to do research, e.g., on the tax implications of withdrawing cash
- have a poor understanding of life expectancy and, in particular, the probability of living beyond age 85, which means DC savers are likely to underestimate the importance of longevity insurance
- are unwilling to give up their lump sum at retirement in exchange for an annuity
- are unwilling to pre-commit to the purchase of an annuity even at high ages
- are warm to the concept of a gradual payment for a longevity insurance product, with participants being able to see how this could help them to build up a ‘safety net’ against the risk that they live too long or take out too much income
- although some are confident about managing their finances, many appear to be very poorly equipped to make investment choices
- prefer low-risk investments
- are likely to be confused by the range of new products and delivery options for receiving retirement income
- at high risk of making poor decisions
- welcome guidance and advice, but are not prepared to pay much for it
- need support to make trade offs
- feel their employer or pension scheme provider has a ‘duty’ to offer a default drawdown option in retirement, but it must be well designed and they also want alternatives to a default.

So we are confronted with the following potentially toxic combination: people who do not fully understand the risks that they face, yet are offered a wide range of retirement income products and solutions, but have a poor understanding of how these products and solutions can help them manage those risks and also their costs. How do we deal with this? First, we should recognise that most people should not be expected to manage retirement risks themselves. This means that the provider must design products and solutions that effectively manage these risks. Second, we need to recall one of the important lessons from behavioural economics is that too much choice is a bad thing. This means that we should consider defaults or a small number of default pathways (using decision trees) that will lead

to good retirement income solutions for people given their circumstances. This will help to overcome the problems of choice overload and poor value for money.

There was a great of interest from customers when the new pension regime was introduced on Flexiday, 6 April 2015. There were around 60,000 phone calls and 10,000 emails and letters per day to providers, more than double the usual number providers typically receive. Most callers just wanted information, but a number of people exercised their new freedoms and cashed in at least part of their pension pot. The money was spent on a wide range of consumer items, most notably, a speedboat, a cruise on the Queen Mary, a Bentley, a holiday home in France and a child's wedding; some paid off debt.

In June 2015, the chancellor George Osborne announced that 60,000 pension savers had withdrawn more than £1 billion from their pension pots in the first month of 'freedom and choice', an average of £17,000 each. He said: 'These unprecedented freedoms have been widely welcomed...It is a sign that this is a real success, but we have to make sure that people get the best advice, that the market responds and that companies up their game in helping customers make use of these freedoms. We will be watching these things very carefully'. The amount withdrawn in the first six months was £4.7bn according to data released by the Association of British Insurers.

### ***3.4 A retirement expenditure and investment plan that helps to overcome behavioural barriers***

To overcome the behavioural barriers which prevent people behaving optimally in retirement, we need a plan to help people manage their retirement expenditure. One example of such a plan is a SPEEDOMETER (or Spending Optimally Throughout Retirement) retirement expenditure plan which has the following components (it is an example of what is known as a 'layering' plan):

1. First, make a plan. This can be done, either by being auto-enrolled into one as part of the retirement planning service offered by the plan member's company, or by an online or telephone-based service providing generic financial information and guidance, or, if wealth permits, involving a financial adviser whose role is to assist with making and implementing the plan and conducting annual reviews.
2. Second, secure 'essential' income. The plan needs to take a holistic approach to managing all assets and income sources in retirement and not just pension assets and income, with the aim of securing, as a very minimum, a core inflation-protected income sufficient to allow the retiree to meet 'essential' needs for the remainder of their life.
3. Third, have insurance and a 'rainy day' fund to cover contingencies.
4. Fourth, secure 'adequate' income.
5. Fifth, achieve a 'desired' standard of living and make bequests.

A SPEEDOMETER plan deals with behavioural traits. Critically, the plan utilises inertia and procrastination, since, once auto-enrolled, individuals do not tend to change their minds. The plan deals with the complexity of decumulation decision making not the member, via simple default choices depending on risk aversion, thereby avoiding choice overload and choice sequencing problems, as well as bypassing the problems of poor financial literacy, planning aversion, a poor understanding of longevity risk and the unwillingness of retirees to recognise their own mortality. The plan accepts individuals suffer from overconfidence and have self-control and hyperbolic discounting problems and would benefit from using commitment devices. The phasing of annuitisation deals with the aversion to making large transactions and possible regret about getting the timing wrong.

### ***3.5 Defaults and default pathways***

The experience of auto-enrolment in accumulation would suggest that the best if not the way that a plan like SPEEDOMETER will work for the mass market is if they are automatically enrolled into one during a pre-retirement guidance or advice surgery, arranged through their employer, their pension provider or following a discussion with Pension Wise. Everyone would have the right to opt out until the point at which longevity insurance kicks in. For the mass affluent and high net worth segments of the market, the first key nudge of the plan is to get pre-retirees to talk to an independent financial adviser.

For all market segments, the guidance or advice surgery needs to collect information on:

- Pension pot size
- Other sources of lifelong income (especially any state and defined benefit pension)
- Other sources of wealth (such as housing equity)
- Liabilities (e.g., mortgage, credit card debts)
- Health status
- Family circumstances, including bequest intentions
- Given other income sources, health status and family circumstances, decide the levels of expenditure that are considered essential, adequate and desirable
- Tax position
- Risk attitude
- Risk capacity.

Given this information, the following default pathway can be established:

- Given total assets and liabilities, decide whether or not to use part of the pension pot to pay off any debts (e.g., mortgage)
- Decide how to fund essential life-long expenditure if this is above the level that can be supported by the state and DB pensions. The only secure way of doing this is via an index-linked lifetime annuity or a guaranteed drawdown product offering inflation uprating. There might well be a temptation to delay the purchase of an

annuity if the individual retires at an early age and the value of the annuity does not look 'good' at this age, but it remains a matter of when not if part of the pension pot is used to provide a secure life-long income to meet essential expenditure – if essential really means 'essential' – unless the member is single and in extremely poor health. If the member is partnered, a joint life annuity should be considered.

- Decide on the level of insurance to cover contingencies or alternatively the size of the 'rainy day' fund and in what type of liquid investment this will be held.
- Decide how to fund adequate expenditure needs. There are two possible solutions depending on the degree to which the member wishes to guarantee the level of adequate expenditure. The first solution, for those wishing to have an absolute guarantee, involves annuitising another segment of the pension pot. The annuity could be a capital protected, inflation-linked, fixed, investment-backed, variable or enhanced annuity, depending on the degree of risk tolerance, level of wealth and health status of the member. The second solution, for those who want more flexibility and do not believe that annuities represent good value for money or who are prepared to reduce their expenditure if investment performance is poor, involves a drawdown programme with this segment of the pension pot invested in, for example, an 'income fund' that predominantly generates income, although has some growth potential. A further alternative is guaranteed drawdown.
- Decide how to fund a desired standard of living and make planned bequests. Depending on risk attitudes, the investment is likely to be some kind of 'diversified growth fund' with drawdown as and when required. However, to ensure that they are met on a life-long basis, the residual pension pot devoted to these expenditures would need to be annuitised. There are three ways of doing this: use a percentage of the pension pot (e.g., 10%) to buy a deferred annuity coming into force at say 75 or 80 if the plan member lives that long, pay for the deferred annuity in monthly instalments (this deals with the behavioural problem of giving up a capital sum) or hold a reserve fund which is used to buy an annuity at age 75 or 80. The advantage of this third method is that there is more flexibility over when the annuity is purchased. The disadvantage is that the member will not know what the income from the annuity will be until it is purchased. Guaranteed drawdown is again an alternative to annuitisation.
- Decide on any further annuitisation (e.g., into a voluntary life annuity or an immediate-needs annuity to cover long-term care costs) to reduce the variability around the level and timing of any desired inheritance.

When should the default process begin, given the reality that for many people, retirement does not occur on a single date, but instead is phased in? The default in contract-based schemes is that the funds stay with the provider. The same is true in trust-based schemes, although trustees have the power to force decumulation when a member reaches a certain age – in other words, they could inform the member that they will arrange the purchase of

an annuity for the member unless they hear otherwise. It seems appropriate that the member should trigger the default process. This is why some call this a 'quasi-default' rather than a true default which requires no action at all by the member.

We considered a number of other default proposals, including: the Age UK proposal, the Strategic Society Centre's proposal, Adrian Boulding's three step proposal, Automatic Trial Income, Michael Johnson's auto-protection proposal, automatic deferred annuitisation, and the Murray Report's proposal for a comprehensive income product for retirement.

There is support for a default from the Pensions Policy Institute, the International Longevity Centre – UK, the Strategic Society Centre, the National Association of Pension Funds, responses to the National Employment Savings Trust (NEST) Consultation released in March 2015, Steve Webb (for late retirement) and a number of industry practitioners. Other industry practitioners opposed the idea of a default. Typical reasons for opposing the default were: 'Default option absolves individuals of responsibility. Who takes ownership and deals with problems caused by lack of understanding?' and 'A one-size-fits all approach would disadvantage a large minority of retirees'.

### ***3.6. Information, advice and guidance***

There are important regulatory distinctions between information, advice and guidance in the UK. It is possible that customers will get confused between the distinctions.

There is a difference between 'information' and 'investment advice'. The difference involves an element of opinion or judgement on the part of the adviser, either in person or online. Two additional criteria need to be taken into account before deciding whether or not information is classified as regulated advice: suitability and appropriateness. If an investment is presented as being suitable, then this may constitute a personal recommendation and, hence, regulated advice. Even if a client is non-advised, the seller of an investment might need to determine whether the investment is appropriate for a client. Lying between information and regulated advice is simplified advice which relates to a specific need or a designated investment.

'Guidance' is not advice. The Government is offering a free 'guidance guarantee', called Pension Wise, to all those about to draw on their pension pot. The guidance offered by Pension Wise will involve taking stock of people's assets and liabilities and explaining the options available to them, with the aim of helping people understand how to turn their pension pot into income at retirement.

Members of DB schemes who take a cash equivalent transfer value (CETV) of more than £30,000 to a DC scheme (whether a personal pension scheme or an occupational DC scheme) in order to exercise the new flexibilities will be required to take independent

regulated financial advice before doing so. Our evidence shows that DB scheme members appear to be frustrated by the requirement to take regulated advice before transferring out.

In July 2015, the Government accepted that some consumers were frustrated by the new legislative and regulatory requirements to seek financial advice in certain circumstances, although it said there was no legal requirement to follow the advice offered. It believed there was ‘insufficient clarity’ on when advice was required and said that this issue would be raised as part on a Treasury consultation on pension transfers and early exit charges.

### ***3.7 Opportunities for advisers***

The new pensions environment is seen by some as a ‘huge opportunity’ for advisers, both in terms of regulated advice and simplified advice. The Financial Conduct Authority (FCA) has offered help to advisers to build simplified advice models.

### ***3.8 The impact of technology on advice***

It is recognised that technology is going to have an important role in delivering advice in future. For example, it is argued that platforms will be the primary facilitator for many pensioners and advisers in managing retirement funds. Similarly, robo-advice (or automated advice), online portfolio management advice with minimal human intervention, could have an important role in future.

### ***3.9 Is there an advice gap?***

Things do not appear to have gone according to plan. The year between the 2014 Budget and Flexiday, 6 April 2015, was devoted to establishing a system of guidance and advice to meet the needs of those exercising their pension freedoms. The Government would provide the guidance guarantee and following this, people would be queuing up to seek advice. Now it was not clear at first whether they would be looking at simplified advice or full regulated advice and there were different views within the advice community about which was more appropriate. It was felt that those with pension pots less than £30,000 would take cash and not seek advice at all. It was also felt that those with pension pots above a certain size (£100,000 or some amount above this) would be likely to – and certainly should be encouraged to – seek full regulated advice. The debate within the advice community was about how many of those with pension wealth between £30,000 and £100,000 would look for simplified advice and how many would take the fully regulated route. A new kid on the block is robo-advice. It is too early to predict what effect this will have on the advice market as a whole, except to say that it could be significant, despite not being able to deal with the ‘emotional’ needs of customers.

But this is not the way things have worked out. A number of advice gaps appear to have emerged:

- Pension Wise offers savers access to information, but early indications suggest this is being sorely under-utilised, with barely 15% of the available appointments being used. Some people may even be confused about the differences between advice and guidance and believe they've already had advice from their providers or Pension Wise, or think the guidance they've had is enough. There appears to be a gap in the market for affordable advice aimed at people with small pension pots
- The inability of some segments of the market to find advisers even when they want advice. Whatever the merits of using advisers, some believe that customers with small pension pots will struggle to find advisers who will take them on.

The issues of mass access to advice and people being priced out of advice has been an increasing concern of the FCA since the Retail Distribution Review (RDR) which came into effect in 2013. Its solution was simplified advice, but a perceived lack of clarity from the regulator around the rules and liability for simplified advice has meant the concept has not yet taken off.

In August 2015, the Treasury and FCA launched a major review of the financial advice market. The Financial Advice Market Review (FAMR) has been set up to improve consumers' access to financial advice. The review will consider the current regulatory and legal framework governing the provision of financial advice and guidance to consumers and its effectiveness in ensuring that all consumers have access to the information, guidance and advice necessary to empower them to make effective decisions about their finances. The FCA said it understood advisers' concerns about their liability for simplified advice that focuses only on specific client needs and dealing with this issue would be a core part of the review. The regulator said it would need to consider clearer and simpler options from both the consumer and adviser point of view.

In the same month as FAMR was announced, the results of a survey by comparison website Money showed that the majority of the 669 over-55s with a pension pot who were surveyed neither wanted advice nor were willing to pay for it. The reasons respondents gave for not taking financial advice were: they do not feel they need it (59%), they think advice is a waste of money (28%), they could not afford it (27%), and they want their money quickly without any hassle (15%); further 10% of women said they felt intimidated by advisers. Just one in five said they would use Pension Wise and give this as a reason for not going on to pay for advice. Only one in five of the over-55s – and just 13% of men – are willing to pay for financial advice. Of those who are planning to pay for advice, 82% said they wanted to get such a major financial decision right. In terms of cost, the average amount the respondents would be willing to pay for advice was £253, with more than half saying they wanted to pay £200 or less; according to Money, the average cost of an initial financial review is double this at around £500. Around 25% of respondents were planning to make a withdrawal from their pot, but only a third of these said they fully understood the tax implications of doing



so. The results of this survey indicate another aspect of the advice gap, namely the unwillingness of people to actually seek advice in the first place.

A survey by Aegon, published in November 2015, found that consumers thought they needed a pension pot of around £121,000 before advice was needed, and that they were reluctant to pay for advice with assets below this amount. While some advisers believe that £30,000 is a viable sum to make advice worthwhile, only 6% of potential clients thought paying for advice on a pot of £30,000 would be worth it. The survey also found that customers with £50,000 would, on average, be prepared to pay £191 for advice, while those with £250,000 would pay £314.

### ***3.10 Adviser charging***

Advisers do not appear to have a clear view about how to charge for their services, with some favouring a fixed fee (based on an hourly rate), while others preferring a percentage-of-assets (or ad valorem) approach. There is also an issue about disclosure of charges. A study by Which? found that more than half of the advisers surveyed did not reveal their charges until they had met with customers to see what they wanted.

In December 2015, the Schroders Adviser Survey was published. The survey of 575 financial advisers showed that financial advisers' fees had increased during 2015 as advisers have increasingly segmented their client bases by asset size. The average fee was 75bps, compared with 50bps prior to RDR. Robin Stoakley head of UK intermediary at Schroders, said: 'There has been an increase in fees by financial advisers, with 75bps becoming the new norm. Now, clients are paying different amounts as IFAs are cutting deals with bigger clients. Some 87% of respondents offer different levels of service based on a client's asset size or revenue generated, with 61% of those clients being formally asked to leave having under £50k. Most advisers have no place for smaller clients, usually under £150k'.

### ***3.11 The implications for a default pathway***

To be feasible, any default pathway would need to be aligned with the guidance guarantee process in a way that it is not classified as regulated advice or a personal recommendation. To meet this requirement, the decision tree would, according to the FCA, need to 'avoid making any judgement or assessment that would result in a single product or a list of products being identified as suitable'. Under the current regulatory framework, this is clearly a challenge, but it suggests we should be looking at the simplified advice route.

If the objective is a well-designed default pathway based on simplified advice, there are six important hurdles to cross:

- Suitability. Over what wealth range will simplified advice be suitable? The industry consensus seems to be up to £100,000 (the exception being those who believe almost everyone needs regulated advice)



- Cost. The process needs to be sufficiently commoditised that the cost of the advice (or at least a typical rate) is transparent to the customer at the outset. This allows customers to shop around to get the best deal. This is particularly important, since less than a tenth of the population has complex enough needs to warrant the fees they would pay for full advice, and would be better served by guidance. Further, cost is seen as a 'barrier to advice' rather than a sign of quality, leading to a 'tendency for consumers to revert to a DIY approach'
- Quality of and trust in the advice. Research commissioned by the FCA suggests that customers are put off seeking financial advice because they are unable to trust the advice they receive or judge its quality
- Potential confusion by customers about the difference between information and advice. Providers are concerned that that customers will wrongly assume that any information and guidance that they receive is in fact advice
- The 'model investment portfolio' which the FCA defines as a 'service which provides access to a pre-constructed collection of designated investments that meet a specific risk profile sometimes offered with a periodic rebalancing of investments to maintain a consistent asset allocation'. A model investment portfolio is used by advisers to illustrate to clients the outcome of different investment and drawdown strategies. However, when a model investment portfolio is re-balanced, an adviser will be acting 'with discretion' according to the FCA. This means advisers must ensure each re-balancing is suitable for the client
- How the Financial Ombudsman Service (FOS) treats complaints. FOS's view is that if suitability has been appropriately assessed or some effort made to 'know the customer', the case would be assessed as if regulated advice had been given. Otherwise FOS will 'expect customers to be responsible for their own choice'.

There are strongly differing views as to whether a default framework with simplified advice can work. Interestingly, opinion splits according to whether those giving a view work for a provider or an adviser/wealth manager. Providers tend to believe that 'the financial services industry ought to take simplified advice models very seriously'. Those working for advisers or wealth managers tend to disagree, believing that 'retirement options, in all but the smallest of pension funds, will benefit from professional regulated advice'.

### ***3.12 Consumer vulnerability and regulatory responses***

The purpose of regulation is to protect the consumer. But the nature and effectiveness of the regulation will depend on which model of consumer behaviour – econ or human – comes closest to describing real world consumers. In the case of econs, the role of the regulator is to ensure that the customer has the information needed to make well-informed decisions, sure in the knowledge that econs are perfectly capable of assessing value for money and protecting themselves against fraud. In the case of humans with their limited understanding and interest in pension matters, the question becomes whether any amount

of information however well presented will be sufficient for consumers to make well-informed decisions. What does the regulator do in the case of such potentially vulnerable consumers? Our research reveals a conflict in the regulatory response to the new pension flexibilities.

The Government has introduced new governance requirements for both trust- and contract-based pension schemes from April 2015 in response to the new pension environment. Governance in trust-based schemes require the setting of minimum quality standards from April 2015. Governance in contract-based schemes from April 2015 will be based around independent governance committees (IGCs), although questions have been raised about the real powers of IGCs, with a number of people claiming that their role is essentially advisory. There is third governance model – the master trust – which was around since the 1950s, but has been given a new lease of life with the introduction of auto-enrolment.

The FCA is aware of potential consumer vulnerability. In February 2015, the FCA published an Occasional Paper which identified up to half the UK adult population as being 'vulnerable' consumers. The paper found 'problems at every stage' in the way firms deal with vulnerable consumers from high-level policy, through system design, to the products that are available and ways that staff implement policies and sell products. Vulnerable consumers are those with poor literacy skills, those who have caring responsibilities, people with disabilities, dementia or the elderly.

The FCA has introduced a number of regulatory initiatives in relation to concerns raised by the new pension flexibilities. For example, in January 2015, the FCA announced a new layer of consumer protection called 'additional protection' or a 'second line of defence'. Prior to allowing a pension pot to be cashed in, providers will be required to find out clients' health and their comprehension of issues such as tax, impact on means-tested state benefits and pension scams before giving them personalised risk warnings. Similarly, in June 2015, the FCA published a Policy Statement clarifying its position on how advisers can avoid liability when dealing with insistent clients. Where the advice includes a pension transfer, conversion or opt-out, there will be additional requirements, such as ensuring the advice is provided by or checked by a pension transfer specialist in the case of transfers over £30,000.

Despite the new freedom to do so, it is likely to be the case that many if not most DB scheme members would not benefit in the long run from moving from a DB scheme to a DC scheme. Even in a well-funded DB scheme, members who transfer might get only 80-90% of the value of their benefits, but for a scheme in deficit it could be as low as 60%. Someone who switches from a DB scheme to a DC scheme and uses the transfer value to purchase an index-linked annuity (the same type of pension as in their DB scheme) at current rates will get little more than half their initial pension.

Nevertheless, DB scheme members appear to be frustrated by the requirement to take regulated advice before transferring out. Furthermore, not only will many members be

reluctant to seek and pay for this advice, they might actually find it hard to find advisers willing to offer it, because the advice might be not to transfer out. If someone goes against the advice of an adviser and makes a DB-to-DC transfer, they are classified as an 'insistent client'.

The potential size of the DB-to-DC transfer market could be huge. Some sources estimate that about 500,000 members of private sector DB pension schemes will give up their index-linked final-salary pensions and instead take a cash lump sum. Others put the numbers at 2m or 50% of those over 55.

The Government's consultation on its plans to create a secondary annuity market in 2017 closed in June 2015. There was widespread support from industry practitioners for the idea that annuitants wanting to sell their annuities for cash should be required to take independent financial advice to reduce the risk that they end up getting a raw deal, although some warned that it could hinder competition and choice. In December 2015, the Government announced that the secondary annuity market would start on 6 April 2017. The Government said it saw 'no reason to prevent retirees who have already purchased an annuity from selling their right to future income streams for an upfront cash sum if it is right for them'.

### ***3.13 Media and Government reactions to regulatory and provider concerns about consumer vulnerability: The issues of access and exit charges***

Despite the large sums of money that were withdrawn in the first two months following Flexiday, it soon became clear that many customers were actually finding it difficult to access their pension pots or were being made to pay significant exit charges by their providers.

While the measures put in place by regulators and providers were there to protect vulnerable consumers, some of them at the prompting of MPs on the Work and Pensions Select Committee hearing in December 2014, the media – led by Daily Mail and Daily Telegraph – saw them as unnecessary and costly barriers to people accessing their money and this view was immediately taken up by Government ministers. Further, many of those that were able to access their pension pots were being charged significant exit charges. A report in the Financial Times showed that exit charges could typically lie between 5% and 15%, although in a few cases the charge could be as high as 20% or even 50%.

The official responses to the criticisms raised over the issues of access and exit charges were swift in coming – from the FCA, The Pensions Regulator (TPR), HM Treasury and the Work and Pensions Select Committee. In July 2015, the FCA, TPR and the Treasury all announced investigations into how schemes were allowing their members to access their pensions and the exit charges they were imposing. In particular, the Treasury wishes to consult on

whether to place a cap on exit charges that may represent an ‘unreasonable barrier’ to accessing the pension pot. It has set out three proposals:

- A cap on all early exit fees – a blanket cap that would allow pension schemes to charge a fixed percentage of the value of the funds being transferred or a capped fixed amount. However, there is concern that a fixed amount would deter those with small pots from exiting.
- A flexible cap – this would try and address the small pot issue so pension providers would only be forced to use a cap over a ‘de minimis’ amount or tailor the fees to take into account small pots.
- A voluntary fee – this would allow the pension industry to set exit fees and even waive fees in cases where they see fit.

Also in July 2015, the Work and Pensions Select Committee announced it would launch an inquiry into the new advice and guidance regime. The Committee reported the results of its inquiry in October 2015. It found that the Pension Wise website, which provides information and guidance on options at retirement, but not advice, was ‘not fit for purpose’. It also found a lack of regulatory clarity over the difference between ‘advice’ and ‘guidance’ which is putting savers at risk of poor decisions, ‘particularly in the affordable middle ground between free general guidance and expensive independent advice’. The report said that ‘Good quality, co-ordinated and accessible guidance and advice will be the best tools to ensure people make the best, informed decisions about their retirement savings, and protect them from scammers...We call for clarification of the distinction between guidance and advice; the definitions of safeguarded benefits; and protections in providing advice to insistent clients. We also expect to see a reduction in the use of jargon and complex pricing structures’.

In January 2016, the Treasury announced that it will legislate to cap excessive early exit charges. The FCA will be responsible for setting the level of the cap and will consult fully on this in due course.

### ***3.14 Pension fraud and investment scams***

Even with safeguards in place, many pension scheme members, especially those with large DB pension pots, have attracted the attention of scammers and con artists. A typical concern was that cold-calling scammers are ‘going to take advantage of the Government sanctioned freedoms to persuade people that they can do better than investing in “traditional” pensions. In reality many of these schemes will be nothing but a rip off. They will use seductive offers of generous guaranteed returns. The two risks from this will be unexpected tax charges when they take money out of the pensions and then in some cases the loss of the rest of their money when the unregulated investments fail to live up to expectations.’

In July 2014, TPR relaunched its 'Scorpion' campaign which warns consumers not to be 'stung' by cold calls, text message spam or website offers claiming to be able to help them cash in their pension. In March 2015, the Pension Liberation Industry Group introduced a Code of Good Practice for combating pension scams.

As a consequence of investment scams, compensation payouts from the Financial Services Compensation Scheme jumped 156% in 2015 compared with the previous year to £183.1m. The average payout rose from £5,136 to £8,855. Mark Neale, chief executive, said: 'many savers had been poorly advised to move pension savings from safe workplace schemes to risky investments'.

### ***3.15 Customer engagement, customer communications and customer responsibility***

One key problem with auto-enrolment is that it does not require any customer engagement. However, the new pension regime will not work well without engagement. A survey of trustees and pension managers in March 2015 confirmed that their biggest challenge is improving engagement with members to ensure people understood what they wanted. The schemes agreed that engagement was more difficult than choosing an investment solution which one respondent said was 'quite simple'. The schemes had developed straightforward communications on the impact of the pension freedoms, but are looking for tools that can help them improve longer term engagement. Most employers and trustees believe the engagement process should begin 5-7 years before retirement.

The FCA believes that customer engagement can be increased by better communications with customers. In June 2015, it issued a discussion paper called *Smarter Consumer Communications*. The DP begins by arguing that information, while important, is not enough: there needs to be better communications with customers. The DP noted that: 'We can begin to understand why consumers often fail to make good decisions about financial products and services, when we take into account that:

- behavioural biases, low levels of financial literacy and the complexity of some financial services and products can limit people's ability to take appropriate action
- firms tend to use financial and legal jargon, which can make the materials they produce lengthy and impenetrable for the consumer
- in some firms, marketing material is much more consumer focused than other consumer communications'.

In terms of customer responsibility, Martin Wheatley, then chief executive of the FCA, speaking at the NAPF investment conference in Edinburgh in March 2015 said consumers will be liable for their decisions in retirement as long as the industry complies with conduct rules and standards which involve informing customers about the Pension Wise guidance service and about regulated advisers, and giving personalised risk warnings to people wishing to access their pension pots.

Yet Mr Wheatley left open some doubt about where responsibility ultimately lies: ‘It is perfectly reasonable for firms to question where accountability eventually lies if you end up in a situation where X percentage of consumers refuse to listen to any guidance or risk warnings given. Who, ultimately, is to blame if – 10 to 15 years on from now – those people regret whatever choice they’ve made, or complain they weren’t properly guided? And actually at that point, it becomes difficult to sensibly argue that individual consumers shouldn’t accept responsibility. Nor, I think, would wider society expect otherwise. [Under the new system, there will be a] division of responsibility [between consumers, firms and policy makers that is] a long way from today’s annuity-based system’.

### **3.16 Monitoring outcomes**

Monitoring outcomes under the ‘freedom and choice’ pension reforms will be a crucial part of assessing the success of the reforms, yet the Government has put no monitoring mechanism in place.

The following information sources will be crucial inputs into any evaluation of the success of the reforms (as outlined in a briefing note released by Just Retirement in June 2015):

- Take-up rates for Pension Wise; the characteristics of the consumers using the service; details of what people do next after exiting the service; and the outcomes for those who do not choose to use Pension Wise
- Data collected by the ABI and FCA will be crucial indicators of early trends. The ABI collects sales data from its members, though this does not cover the full range of providers across the wider financial services industry and so is limited. By contrast the FCA (and before that the Financial Services Authority) has been receiving product sales data from all regulated firms since 2005, providing a basic but complete data set from which to analyse product purchase outcomes.

In October 2015, the Work and Pensions Select Committee also reported that it was concerned about the lack of Government data on ‘freedom and choice’. It said that the available statistics were ‘unacceptable’ and asked the Government to do more to shed light on the impact of the reforms. Specifically, the committee wants regulators to collect information on: customer characteristics of those using freedoms from pot size to sources of retirement income; take-up of each channel of guidance; reasons for not taking up guidance and advice; subsequent decisions made and reasons for those decisions. Apparently, the Government is relying on incomplete HMRC data to assess the reforms.

### **3.17 The self-employed and non-eligible job holders for auto-enrolment**

There are two groups not eligible for auto-enrolment: the self-employed and non-eligible job holders for the purpose of auto-enrolment. There are 4.5m (i.e., 17% of the 26.3m employed population) who are self-employed and 6.2m (24%) non-eligible job holders. This

means that around 9.7m people working in the UK will not be auto-enrolled onto any pension scheme.

There have been two recent reports on the self-employed by the Resolution Foundation and Scottish Widows.

Both reports found that pension membership for the self-employed has fallen significantly behind that of employees, but only since 1998. Scottish Widows, for example, found that 39% of self-employed people (as well as 30% of employees working in a small business) are saving nothing for retirement, up from 23% the previous year. The Resolution Foundation report found that the self-employed do not form a homogeneous group. The main division is between those who run businesses with employees (17% of the total) and those who work for themselves without additional support. The former are much better prepared for retirement than the latter, since they can either sell their business or keep it and draw an income. In many cases, the self-employed were, as indicated above, previously employees and can therefore expect some occupational or personal pension income when they retire.

In September 2015, the Pensions Policy Institute published a briefing note on those who were ineligible for auto-enrolment. There are three main reasons why 6.2m people are ineligible for auto-enrolment:

- 3.5m (57% of the total) earn below the £10,000 Earnings Threshold because they work part-time.
- 1.8m (29%) are below age 22
- 843,000 (14%) are above state pension age.

Most (2.7m) of the 3.5m people earning below £10,000 are women. Some of the 3.5m will have a number of part-time jobs and may have a combined annual income above £10,000. However, the qualification for auto-enrolment is assessment on a 'per job' basis. Two other groups that fail the eligibility criteria are the disabled and carers. Around 30% of disabled workers (649,000 people) earn less than £10,000. Similarly, around 81% of employed carers are ineligible, including 35,000 who earn below £10,000.

Both the self-employed and non-eligible job holders will benefit in due course from the single-tier state pension. Similarly, members of both groups could join NEST which has a public service obligation to take on anyone who applies, but only around 800 self-employed people have done so to date. However, it is more likely that, if they do make any pension arrangements, this will be through the retail market. But we could find no accurate data on the combined number of the self-employed or non-eligible job holders with individual DC policies. Similarly, when it comes to decumulation, it is likely that these groups will fail to benefit from institutional value-for-money solutions and instead will have to rely on the high cost retail market.



As the Resolution Foundation report concludes: ‘Taken together, the evidence suggests there is a case for greater intervention to ensure the self-employed are adequately prepared for their later years’. A similar case could be made for non-eligible job holders. The PPI briefing note finds that ‘if the income from both first and second jobs was taken into account when assessing eligibility for automatic enrolment, then a further 80,000 people (60,000 women and 20,000 men) would earn enough to meet the qualifying criteria’.

We also discussed two reports by the RSA. These reports do not believe that auto-enrolment into NEST or another of the larger master trust schemes is a sensible solution due to the administrative challenges of dealing with the irregular and volatile incomes the self-employed tend to have, but also because of the clear preference amongst many of them to have flexible access to their savings. Instead, the RSA proposes the following two options:

- Present a ‘compulsory question’ for enrolment onto a pension or ISA scheme
  - The Government should present the self-employed with a compulsory question asking them whether they wish to join a workplace pension scheme and/or a Government-backed ISA, for example, one provided by National Savings & Investments (NS&I). To increase the likelihood of take-up, this should be done at a moment of financial reflection, such as when people complete their tax return or Universal Credit application.
- Establish automated saving schemes for the self-employed on low incomes
  - The Government should provide an option within the Universal Credit system that allows claimants to automatically channel a percentage of their benefits into a savings account. Banks should consider following suit by creating a ‘Save When Paid’ initiative for their self-employed clients, which would take a small amount off the value of every invoice and immediately transfer this into savings.

### ***3.18 Experience from abroad***

In April 2015, the Pensions Policy Institute released a report that compared the new UK pension system with those developing in Australia, Ireland, New Zealand and the US. It noted that the UK was moving in the opposite direction to these countries in terms of risk pooling. Whereas the new UK pensions regime completely individualises risk bearing, countries such as Australia have seen the benefits of greater pooling of risks, and, in particular, longevity risk. Commenting on the research, PPI Director, Chris Curry, said: ‘The findings from the research are encouraging in that the UK pensions industry as a whole has an understanding of various types of risk and a sophisticated market has developed here for, in particular, underwritten annuities. The challenge for the industry will be around the identification of effective default glide-paths where it can no longer be assumed that individuals purchase an annuity. So far, the focus of regulation in the UK has been the introduction of a standards regime to ensure the quality and consistency of guidance. This



contrasts with countries, such as Australia, which are now considering the introduction of rules to ensure defaults that manage longevity risk. It is possible that further steps will be considered in the UK that ‘nudge’ individuals towards decisions that ensure they have a regular income stream over the course of their retirement’.

### **3.20 Analysis and recommendations**

#### 3.20.1 Analysis

This Chapter is called ‘Supporting savers to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment’. In order to meet this aim, we need to examine, in turn, each of the players involved in or commenting on pension provision: savers, the national media, advisers, the wider financial services industry, and the FCA. We also consider pension fraudsters and investment scammers, and the self-employed and non-eligible job holders. We begin with savers (i.e., the pension scheme members).

##### *3.20.1.1 Savers*

The model of economic behaviour underlying the pension flexibilities introduced in the 2014 Budget is the exact opposite of the model underlying auto-enrolment.

The model used by the Chancellor George Osborne on 19 March 2014 was that of an ‘econ’, a rational lifetime financial planner:

*People who have worked hard and saved hard all their lives, and done the right thing, should be trusted with their own finances.*

*And that’s precisely what we will now do. Trust the people....*

*I am announcing today that we will legislate to remove all remaining tax restrictions on how pensioners have access to their pension pots.*

*Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want.*

*No caps. No drawdown limits.*

*Let me be clear. No one will have to buy an annuity.*

However, the model used in auto-enrolment (AE) to get people to save more for their retirement is that of a ‘human’ in which inertia and other behavioural biases drive behaviour. With AE, individuals make no active choice to join a pension scheme, are enrolled at a default contribution rate, and do not need to choose the fund into which their contributions are invested.

So the Government has relied on the model of ‘humans’ to get people to do something relatively simple – namely get them to save a bit more – and is now relying on the model of ‘econs’ to get people to negotiate the highly complex process of decumulation.

As Sara Benwell points out: ‘Auto-enrolment largely exists because we believe that people are either incapable or unwilling to save for their future. At the same time, “freedom and choice” makes the assumption that people are capable of making good decisions about retirement. It doesn’t take a behavioural economist to tell you something’s not right here, but what behavioural science can tell you is the two policies aren’t just contradictory; they are underpinned by diametrically opposed assumptions about the way people work’. As the FCA itself recognised in its June 2015 discussion paper *Smarter Consumer Communications*: ‘We can begin to understand why consumers often fail to make good decisions about financial products and services, when we take into account that behavioural biases, low levels of financial literacy and the complexity of some financial services and products can limit people’s ability to take appropriate action’. Either that or the Government believes that ‘humans’ have somehow transformed into ‘econs’ over the course of their working lives.

Greg Davies, head of the Barclays behavioural finance team, compared AE with ‘freedom and choice’:

*It’s not necessarily enough to ensure that everyone is in the right situation for them.*

*Essentially, nudging people to make pensions contributions creates better outcomes, but to ensure optimum outcomes, we also need to educate people to ensure they save more and in the right way.*

*That engagement has long-term benefits as well because it’s only by having engagement over time that we do actually build up the confidence and the knowledge for people to start approaching the decisions when they’re decumulating with any degree of confidence.*

*[With the new pensions freedoms], we now have a raft of behavioural issues that are going to be there that weren’t there before.*

*This is largely because the assumptions behind auto-enrolment are right. If we can learn anything from the past it is that when left to their own devices, people make sub-optimal decisions.*

*By shifting to an opposing behaviour assumption at the finish line of the pensions process, we are assuming people will act in a different way. When we look at the poor choices people made when choosing an annuity, it’s clear that this isn’t the case.*

*When left to their own devices, people make sub-optimal decisions.*

*The assumption seems to be that in the intervening decades between when we nudged people into savings when they wouldn’t do it themselves, we now seem to believe that they have magically become able to assimilate large quantities of information in a short period of time and make optimal decisions for their future.*

*Giving people choice on its own doesn't seem to be that well grounded in our behavioural knowledge, because we know that if you give people complex choices, in an area that they're not experts in, particularly one which involves trade-offs over time between actions now and outcomes in the future, these are all features that make people deeply uncomfortable.*

Complexity is indeed a key problem. Many of the risks in Table 1.2 are very hard to understand – even for pension professionals. Pensions must be made simpler to appeal to ordinary savers, according to Lesley Williams, the first chair of the Pensions and Lifetime Savings Association (PLSA), as well as group pensions director at Whitbread. In her first speech as chair, she said that ‘we're kidding ourselves if we think education will fix’ the problem of people not understanding pensions or being engaged in them and that it will only treat the symptoms. Savers should not be regarded as the problem – rather the industry and policy-makers are collectively to blame for creating complexity in pensions. Ms Williams said that, while she is a ‘real believer’ in default pathways, she believed that the industry could make pensions simpler and less technical for the end customer. Speaking at the same event as Ms Williams, Andy Harrison, chief executive of Whitbread, said: ‘Pensions have always been hard for people to understand, but the trust in pensions is probably the lowest it has been in my lifetime. Government really has not helped, but we need to do the best with what we have... The lesson from AE's success was simplicity and solid communication worked and this could be applied to other problems in pension’.

Of course, if the ‘econ’ model is right, we do not need to worry about any of this – econs are not troubled by complexity. If, instead, the ‘human’ model better describes most people's behaviour – which appears to be the case – then we should be looking for a framework for nudging people to behave in what is in their best long-term interests. Running out of money before they die and living in poverty in very old age is clearly in no one's long-term interests. It was to avoid this possibility that pension schemes providing lifetime incomes – rather than lump sums – first started in this country.

Given the complexities of decumulation and the risks in Table 1.2, the challenge is to design a simple and effective default decumulation strategy that deals with the key risks in the Table, yet allows for the flexibilities made possible by the 2014 Budget. At the very minimum, we believe that an effective quasi-default decumulation strategy – initiated by the scheme members, but which they can always opt out of – can be designed which allows for:

- access
- investment performance to beat inflation during retirement and
- longevity insurance.

This could be determined using a standardised decision tree (possibly with statutory approval) which will be suitable for those above the new trivial commutation level (£30,000) and below those classified as high net worth, i.e., middle income households.

Those opposing a default employ a ‘one size does not fit all’ argument. While this is a reasonable point to make – although much less so if the member can opt out of the default – we do not believe that most people’s circumstances are so complex that they cannot use a decision tree with a small number of pathways that lead them to a set of suitable retirement income products that will meet their life-long expenditure needs – especially if the alternative is 350,000-400,000 different bespoke solutions per year, one for each retiree whatever the size of their pension pot. We should always bear in mind the statement ‘the best is the enemy of the good’. If the default is ‘good’, then that should be ‘good enough’ for most members with relatively small pension pots – especially if the alternative is a huge set of expensive, highly engineered, over-complex solutions designed by providers and advisers.

An important aspect of the success of such a quasi-default will be consumer engagement. The value of any product or service depends on the time and effort that goes into planning it. Consumers understand this with products and services which give immediate gratification, such as holidays. Can we get them to understand that the same applies to products and services involving deferred gratification, such as retirement income solutions?

Related to this is the number of product and solution choices. While competition can be good and lead to product innovation, it also leads to a proliferation of essentially identical products which are marketed as being different. This leads to customer confusion. Consumer engagement will improve if there are only a small number of well-designed products and solutions being offered to customers.

We expect – and certainly hope – that, whether nudged, guided or advised, the majority of decumulation strategies after April 2015 will take the form of either (a) layering (e.g., SPEEDOMETER plans), or (b) cash and income drawdown, with longevity insurance in the form of annuity purchase deferred until later life. Retirees in poor health without dependants might well choose to access their funds in full at the date of retirement. Nevertheless, we would find it very hard to understand if savers in good health at retirement were not advised to purchase longevity insurance as part of their retirement expenditure plan. Careful tax planning will also be a feature of such strategies in order to avoid people paying too much tax in the early years of the plan. However, this can be quite straightforward for most people, if they have access to a simple table that allows them to calculate how much they can withdraw from their fund in one year in relation to their current income before they move into a higher tax bracket.

Another important aspect will be realism. Clearly, consumers value flexibility, but it can be expensive to provide. The new flexibilities have placed product providers in a similar

position to an airline pilot who believes her passengers want to fly from London to Sydney, but, as she is about to land, is told that the passengers have changed their mind and want to fly to Shanghai instead. It can, of course, be done, but only at a price. Consumers also value guarantees, but they are also expensive. For example, guaranteed drawdown which gives complete flexibility of withdrawal can result in the income that can be withdrawn being up to 30% less than an equivalent annuity.

Related to this is consumer vulnerability. Humans can be particularly vulnerable when it comes to financial services and the FCA has estimated that up to 50% of UK consumers are potentially vulnerable. Humans are also prone to overconfidence, bordering on arrogance. There is nothing potentially more toxic in financial services than consumers who are not aware of their own vulnerability and are dismissive when this is pointed out to them. This is particularly true when it comes to investment and longevity risks, the two key risks in retirement. Both risks are likely to be dismissed as unimportant by many humans.

### *3.20.1.2 The national media*

The situation has not been helped by national media reports that emphasise the immediate problems that people have accessing their pension pots, but which do not mention longer-term risks, such as investment and longevity risks, or the importance of the additional protection/second line of defence that was designed to protect consumers.

Typical are these extracts from Daily Mail articles:

*More than 100,000 savers have already discovered they face a fee if they take advantage of the new pension freedoms.*

*Radical reforms introduced two months ago promised that the over-55s could cash in their pots rather than being forced to use the money to buy an annuity, or income for life.*

*But a Money Mail investigation found some savers are being charged huge fees if they withdraw their funds or seek financial advice, while others are being allowed no access at all to their cash.*

*Now, industry analysts have revealed one in ten over-55s eligible to take advantage of the pension freedoms will have to pay if they want to get their hands on their hard-earned savings.....*

*Many pensioners have been told they cannot withdraw their money until they have seen a financial adviser.*

*But if the adviser believes it would be a bad idea to cash in their pot, some pension firms have then refused to let people do so. Advisers and pension firms are worried they will face fines for mis-selling if customers later blow their cash and end up penniless in retirement.*

*But critics said savers must be allowed to spend their money as they wish, even if it contradicts professional advice. Paul Green, of over-50s specialist firm Saga, said: 'People should be trusted with their own money.'....*

*We have identified six major failures of the reforms:*

*1: Firms refusing to hand over savings*

*Before the reforms, most pension providers promised they would take part. They admitted there were challenges, but that things would be ready on time. In practice, many savers are finding this is not the case.*

*Research from actuary firm Barnett Waddingham found that none of the major pension firms offer full access to all the freedoms.*

*Some have publicly admitted they won't allow savers to use their pension as a bank account.*

*2: £1,000 for advice you don't want*

*Some big insurers are so scared of being accused of mis-selling that they refuse to help customers unless they have had formal financial advice.*

*There are specific circumstances where savers have to take guidance for their own protection. These include anyone who wants to take all their cash at once from a pension of more than £30,000, and those with guaranteed payout rates written into their contracts.*

*But many firms are telling customers they have to see an adviser regardless of circumstances. A session with a financial adviser will typically cost £500 to £1,000.*

*3: Savers stuck in limbo with no help*

*Money Mail has been bombarded with letters from savers stuck in limbo after their insurer and financial adviser refused to help them.*

*Some have been turned away by dozens of firms who just don't want their business. In many cases, savers have visited advisers for help withdrawing all their cash from a pension.*

*The adviser has recommended that they don't do this, but when the customer insists they still want to press ahead, the adviser refuses to assist.*

*4: Delays of up to 90 days*

*Time and time again, Money Mail has come across savers being forced to jump through hoops before they can access their own savings.*

*It's leaving many facing substantial delays in getting their cash.*

*Often, savers are being made to move their money to a different type of pension and, though the official industry figures show this should be completed within ten days, readers and independent experts say it can take as many as 90.*

### *5: Sky-high fees and crippling red tape*

*Even when they are allowed to get their hands on their pension savings, many retirees are being confronted with sky-high charges.*

*There is also a dazzling array of terms and conditions that stop them using their pot as they would wish. Savers can be hit with a set-up fee of £184 and then charges to manage their pension fund on top of that. They can also be asked to pay from £20 to £90 – and in some cases up to £240 – every time they make a withdrawal.*

*Some firms only allow wealthy savers access to the freedoms. According to Barnett Waddingham, you can only have flexible drawdown at Legal & General if you have £30,000 saved, £20,000 at Royal London, or £50,000 at Zurich.*

*At the Government's approved low-cost pension provider NEST, you can only have access to the freedoms if you are prepared to take all your savings in one go – potentially exposing yourself to a massive tax bill.*

### *6: Insurers who cut value of your pot*

*Money Mail has also heard from savers who have been told they cannot enjoy the freedoms unless they move to a new type of pension – at a steep cost.*

*When they switch the money to the newer scheme they are hit with a charge.*

*A typical problem occurs when someone wants to take their pension over the age of 55, but then discovers their contract prevents them from doing so without penalty before the age of 60 or 65.*

Articles such as these give the impression that the pension fund is held in cash and people are being charged high fees for accessing it. If the pension fund were held in cash, the return on the pension fund would be very low. Instead the pension fund is invested in growth assets that aim to generate higher average long-term returns, but which are hard to liquidate at short notice. If the pension fund had to hold more assets in cash-like instruments, just in case someone wants to withdraw money without notice, this will bring down the return on the overall pension fund – which would lead to a different complaint from the national media. Even more important is that there is no mention of longevity risk. Pension assets have to last a lifetime – complaining that it takes 90 days to access a pension pot really is the wrong issue to be discussing at the start of someone's retirement.

#### *3.20.1.3 Advisers*

The evidence we have gathered in the earlier Sections of this Chapter suggests that advisers need to address five key issues.



First, advisers do not appear to be sufficiently focused on the consumer's real needs. Most consumers (as many as 90% according to one study) have very simple needs. They also have very modest resources in retirement. Such consumers need something very straightforward, namely financial help.

There is insufficient clarity amongst advisers about the appropriate way to segment the market and about the level of assets below which financial help in the form of a purely advisory default pathway will be adequate. We believe the market should be segmented by behavioural type, by spending type, and by resources and needs – and suitable integrated solutions offered to each segment. This would assist in determining the appropriate level of guidance, help and advice more effectively. The evidence we have gathered suggests that, as a rough rule of thumb, those below £30,000 need only guidance (provided it deals effectively with the impact on entitlement to welfare benefits or unless they actively choose something different), those with £30,000-£100,000 need help via a default pathway (unless they to actively choose something different), and those with more than £100,000 would benefit from full advice (unless they also choose something different).

Anyone who strongly believes that full advice is needed as a default by those with smaller amounts should bear in mind that the new single-tier state pension has a capital value of around £200,000 and no one is setting up a business to advise people how to spend their state pension. Also when drawdown was first introduced, it was deemed to be a suitable product for people with a pension fund above £250,000.

There has to be a middle way between guidance and regulated advice. Many people's pots are just not big enough and their financial circumstances are just not complicated enough to warrant full regulated advice. If we do not end up with a simple set of default pathways which the middle market can use with confidence, then there are two dangers. The first is that many people will not take advice at all, in which case, we need to answer the question raised by Ian Price, divisional director of pensions at St James's Place: 'Liberating pensions will be the new windfall and the new boost to consumption, but what happens when that money is all spent and people still have 10 to 15 left in retirement?' The second is that many of the 350,000-400,000 people who retire each year will be persuaded by advisers and providers that they need a personally designed bespoke retirement income solution that has been exclusively prepared for them. It would, of course, be nice if we could all afford our own interior designer when we redecorated our homes, but most people do not need one. Peter Bernstein coined the phrase 'interior decorator fallacy' for the argument that most people's investment portfolios should reflect investor characteristics such as attitude to risk in the same way that interior decorators attempt to reflect the personal taste of their clients. There is a hint of the interior decorator fallacy about the argument that every retiree needs full regulated advice.



There is, of course, an important role for advice for those prepared to pay for it, but it should be highly focused at its cost should reflect this. As John Porteous, head of client proposition at Towry, says: 'As a general observation, there seem to be three primary challenges that the industry faces in delivering both effective and valued client outcomes for a rapidly growing market:

- Advice policy around the relative merits of the options available
- Investment strategy to support a sustainable standard of living
- Ongoing communication and client engagement over time'.

Second, advisers appear to be too focused on their own revenue generation, rather than providing the right type of advice for the right type of client. We were told that the advisers were 'pushing for decumulation to be a retail market for obvious reasons: it's payback time, as they have lost out when auto-enrolment was introduced – with no need for advice'.

It is also somewhat surprising that advisers had not sorted out whether they should have a fee-based or percent-of-assets charging structure by the time that the pension freedoms began. Steve Lewis, head of distribution – retirement solutions at LV=, believes a fixed fee can work for smaller pots: 'The challenge is doing that in an efficient way which clearly explains the risk and balances to the client without creating an excessive burden of fee....A lot of people below £100,000 will come into the drawdown space. I suspect we will see adviser firms doing it on a fixed-fee basis; so perhaps fixed initial fees, and pre-determined fees for "advice events"'.

It is significant to note that very few professional services firms – lawyers, accountants, etc – now charge on an ad valorem basis. Instead they charge on the basis of the amount of work done, typically expressed as an hourly rate. One of the reasons for this change was the loss of professional indemnity cover in cases where clients successfully sued a professional services firm and the firm could not justify the size of the fee charged against the amount of work done, typically expressed in terms of hours worked. Many in the financial services industry, in particular advisers and investment managers, along with estate agents, still charge on an ad valorem basis and we wonder why that is the case.

The new pensions regime is an opportunity for financial advisers – and other financial services firms such as investment managers – to put themselves on the same footing as most of the rest of the professional services industry. We accept advisers need to be adequately rewarded, but there also needs to be much clearer evidence that the charging method used provides customer value for money. If advisers want to be compared with estate agents, then estate agents have smart high street offices, embrace the latest technology and have enthusiastic sales staff selling your property.

Third, and equally remarkable, is the lack of clear charge disclosure on advisers' websites. The argument that exact fees can only be established after a conversation to gauge the

work involved does not prevent fees for typical scenarios being published. With estate agents, lawyers, and accountants, for example, it is also easy to find out the sales commission or fees that will be charged without feeling committed to using a particular agent. We recognise that people want to sell their house, for example, whereas most people do not 'want' investment advice, but we should also ask why that is the case, given that many people have pension pots and houses of similar value.

Fourth, the advice industry also has to redesign its business model to deal with new technologies such as online advice and the competitive challenges this will bring for both the revenue and cost side of the model. Similarly, simplified advice will be suitable for many people and that has to be delivered at low cost, another challenge for the advisers' business model. There is a very clear role for low-cost, fixed-fee robo-advice for people with pension pots between £30,000 and £100,000 – with fees of around £100 p.a. per client.

Finally, there is the issue of the professional standards of advisers. Advisers have certainly become more professional in recent years. For example, the Financial Adviser School was launched in 2011 and offers vocational and academic training for financial advisers. It was established by the Sesame Bankhall Group and sold to Intrinsic in October 2015. Similarly, the Society of Later Life Advisers (SOLLA) has created an industry standard for retirement advisers called the SOLLA Retirement Advice Standard (RAS). To satisfy the standard, SOLLA accredited advisers need to hold a QCF level 4 financial planning qualification, a statement of professional standing (SPS), and the minimum qualifications in equity release and long-term care. In November 2015, the Chartered Insurance Institute (CII) announced that it would launch a new Life and Pensions Foundations examination unit (LF1) to support professional standards in the life and pensions sector. It is targeted at new entrants as well as those already working in customer-facing jobs. People who pass will get a CII Level 2 Award in Life and Pensions Foundations. The exam is designed to enhance public confidence in life and pensions.

Despite this, advisers are not a recognised profession, unlike accountants, and this is affecting recruitment into the industry. The average age of advisers is rising and could be as high as 50, according to recent surveys, implying that not enough younger people are looking at financial advice as a career choice. A debate on LinkedIn suggested reasons why this was happening and put it down to the absence of a recognised career path in financial advice. According to Lawrence Gosling: 'The cost of training is too high, not enough people are taking up some of the excellent financial services degrees which are available at universities, and the generally negative image of the profession outside the industry. One participant perceptively made the comparison with accountancy, pointing out trainee accountants have a clear career path – pass the two Chartered accountancy exams and you can practice. Then, after a couple of years, you can become a fellow of the Institute of Chartered Accountants. There is no such clear equivalent in the advice sector, which could read "take the exams, then a few more, be subject to a couple of FCA audits, realise the cost

of professional indemnity insurance is high, network like crazy, and you might get a few clients". But even after all of this, you do not have a career, unless you can find a firm to take you on, or get lucky and find a couple of good clients and set up on your own'.

#### *3.20.1.4 The wider financial services industry*

There is always going to be a tension between competition and cooperation, but the evidence we have gathered in this and the previous Chapter suggests that there is currently too much tension between (a) advisers and providers (who are fighting a turf war over access to clients), and between (b) investment managers and insurance companies (who are fighting a turf war over control of client pension assets) to the detriment of consumers.

On the one hand, we have customers, many of whom do not understand the risks they face in retirement, are not interested in finding out more about these risks, and even when told about them, do not care. Yet, they still need to use their pension pot to provide them with a 'good' life-long retirement income journey.

On the other hand, we have suppliers – advisers, providers, investment managers and insurance companies – which should be offering integrated effective value-for-money solutions to these customers, but which appear to be more concerned about protecting their own patch and their own revenues. This means that instead of an integrated approach in which each supplier contributes an appropriately designed component that fits well in an overall 'good' solution, we are seeing a fragmented approach in which each supplier offers what they consider to be the 'best' solution, without taking into account the full retirement journey that the member needs to make. So, for example, we are seeing investment managers recommending equity income funds as the 'best' solution for providing retirement income, without any acknowledgement of the importance of dealing with longevity risk. Or we have advisers who see full regulated advice as the 'best' solution for everyone, irrespective of the size of their pension pot. Just as bad, we have advisers more concerned with inheritance tax planning than with managing longevity risk. All this is actually worse than the customer getting a 'flat pack furniture unit'. At least with a 'flat pack furniture unit', you know what you are going to get, once you have put the pieces together correctly. What the customer is being offered now is a range of incomplete 'flat pack furniture units', with no clear way of putting them together and no obvious piece of furniture that is recognisable at the end of the exercise.

There are other examples of bad practice. For example, we see providers and insurance companies relying on customer inertia to retain accumulation-stage customers, once they enter the decumulation stage. As Janette Weir, founder of Ignition House, said: 'We are in danger in the drawdown market [that] we will make the same mistakes as in the annuity market. In the annuity market, inertia was key and people just went with their providers. It caused all sorts of problems. The FCA got involved and drawdown is compounding that,

because, if the providers don't offer drawdown solutions and have appropriate funds to go with that, then people will find it impossible to shop around. It is really difficult for them'.

Another example is client poaching. Advisers have recently accused providers of inappropriate contact with clients that the advisers have 'introduced' to them, e.g., Aegon was accused of poaching dozens of an adviser's clients for its direct-to-consumer (D2C) platform, although the FCA said the provider had broken no rules. A Professional Adviser survey of 76 advisers found that half had experienced at least one incidence of a provider contacting their clients in a way they felt was inappropriate. Some respondents thought that some providers were deliberately trying to undermine the relationship between the adviser and the client: 'One provider wrote to a client without copying to me, stating: "As your adviser has not made any changes to your investment in the last three years, we have removed them as the adviser for this plan". But we had been reviewing the plan annually. So this led to hours of work, needless contact and annoyance for the client'. Others said the problem could be resolved if the adviser was always notified of any contact: 'The relationship between client, adviser and provider should be seen as a partnership in its loosest form. As such, I am quite comfortable with providers contacting clients direct but with the proviso that a copy is sent to the adviser'. Nevertheless, most respondents wanted the FCA to intervene and limit the amount of freedom providers have to contact their clients.

Providers would certainly like to be able to give advice to their clients, as Paul Bucksey, head of DC at BlackRock, points out: 'My sense is that there is a reluctance among members of pension schemes to pay for advice. [Providers can, and should, step in to fill the gap.] From an advisory point of view, anything we can do as a provider which is more than listing out a range of funds is good. From our perspective, we certainly welcome a bit more clarity around firstly acknowledging that people need some help, most people want to be told what to do.... Providers, like BlackRock, can do more without getting into personal recommendations. This concept of simplified advice, rules of thumb, being able to tell people they should be aiming to contribute about 15%, for example, is not 'advice'. It is giving people some guidance, some rules of the road. If you go into drawdown, if you take an income of no more than 5%, that would be quite sustainable, but at the moment, people get there and ask: "how much should I take?"; "how much is too much?". Mr Bucksey's colleague Tony Stenning, head of UK retail at BlackRock, added: 'We should be able to say this stuff without thinking it is advice. Or that it would not be construed as advice if it came from TPAS or MAS, but it would be if it came from BlackRock'. Clearly a number of providers feel that they should be able to offer this sort of financial help to their clients without having to bother about advisers.

We believe that there should be a much more focused narrative based on an appropriate segmentation of the market and providing good integrated solutions for each market segment. There needs to be a much greater spirit of co-operation amongst the four main

players involved in pension decumulation – at least in the early stages of the development of the new market. Even so, there will be winners and losers. The winners are likely to be providers benefiting from the inertia of their clients and investment managers offering decumulation products with flexibility and guarantees. The losers will be insurance companies selling annuities and advisers trying to get people with less than £100,000 to pay very much for advice. Advisers offering simplified or robo-advice might have better luck in this market segment, but still might find it hard to get customers to pay much more than £100 per year for it. Advisers offering full regulated advice might find their client pool restricted to those with assets above £100,000 – although it is also clear that many will be comfortable with only this type of client.

### *3.20.1.5 The Financial Conduct Authority*

The current regulatory process is not working well either for customers or their advisers. The main reason for this is that the key regulator, the FCA, appears to be confused about whether the ‘human’ model of the customer is more appropriate than the ‘econ’ model. On the one hand, it talks of vulnerable consumers. On the other hand, its chief executive speaking at the NAPF investment conference in Edinburgh on 11 March 2015 says the consumers must take responsibility. Something that is really rather straightforward – the delivery of a pension, something we have been doing for hundreds of years – has become fiendishly complicated, not least because of endless regulatory interventions.

Taking first the customer. In terms of products, there are no safe harbour products that the FCA is currently prepared to recognise. In terms of advice, the regulator distinguishes between half a dozen definitions of advice, while the average customer is unable to differentiate between advice and guidance. There are just too many different types of advice.

Turning to advisers, they have become fearful of offering common sense solutions to clients. We are currently in the extraordinary position of having, on the one hand, people being given a whole new set of flexibilities, yet, on the other hand, it is apparently not possible for the industry to design a sensible default that helps manage the risks in Table 1.2 without coming up against the barrier of regulated advice. As Tony Stenning from BlackRock has said: ‘It is a minefield. People do need help and we have our hands tied behind our back. Clearly, one of the unintended consequences of RDR was the advice gap. Individuals now have much more flexibility and choice which is great, but that also increases their anxiety. When you ask people, they really want guidance and to be helped. [But] there is a very thin line between advising them and guiding them’.

There needs to be greater clarity on suitability and appropriateness. As Rachel Vahey has said: ‘Obviously, [the FCA] will need to develop new guidance on suitability. At the moment, it is clear drawdown is only suitable for those with large funds and who understand the risks and take them on comfortably’.

Does a decision tree constitute advice? If so, is it regulated? If so, this needs to change. As mentioned previously, there is an important difference between ‘advisory’ and ‘advice’ in English law. The decision tree is advisory but not advice. However, there is no distinction between ‘advisory’ and ‘advice’ in the current legislative framework. This too needs to change.

One way out of the impasse is for the FCA to recognise safe harbour retirement income plans. These involve the use of key safe harbour products and a decision tree. Any adviser or provider who uses the decision tree and assesses the suitability of the safe harbour products for their customers would not subsequently face problems with the FOS. It is important that the FCA approves both the decision tree and the default options at the end of the decision tree, even if these can only be classified as options that are ‘good enough’, rather than the ‘best’ possible options for member’s circumstances.

In Chapter 2, we provided a list of potential safe harbour products:

- In the annuities class:
  - Lifetime annuities (with/without capital protection) – fixed and inflation-linked
  - Investment-linked annuities (with a minimum income underpin and with/without capital protection)
  - Enhanced annuities
- In the drawdown class:
  - Capped drawdown (with a minimum income underpin)
- In the hybrid class:
  - Variable annuities (with a minimum income underpin)
  - Guaranteed drawdown (with a minimum income underpin).

It is important that there is full transparency over the product design and over charges for each of the above products – and that the charges are demonstrably not excessive.

Retirement income solutions which do not offer longevity insurance that (together with the state and any defined benefit pensions) covers at least essential expenditure should not be given a safe harbour status. Products not granted safe harbour status should not be sold without regulated advice. Anyone selling them should be open to future claims for mis-selling.

As Derek Bradley, CEO of Panacea Adviser, also argues, simplified advice cannot work without simplified regulation: ‘Simplicity of financial advice delivery, it seems, is difficult to define. There is considerable uncertainty and fear of regulatory retro-retribution for getting it wrong, a lesson well and truly learned by advisers. Now here’s a simple thought. What if the regulator were to define and approve what products could be safely placed in this simplified space, along with a simple set of tick-box questions and processes to confirm

client understanding of product, purpose and suitability in any application. We know that would require responsibility from the FCA,...[but] even if FCA clarity was possible, the FOS does not do 'clarity' to the extent it can be relied upon. It is the simplified advice killer. To prove this a number of major firms have concluded that simplified advice is not "currently commercially viable".

Finally, the FCA needs to sort out the question of customer safeguards. As Huw Evans told a Work and Pensions Committee hearing in September 2015: 'We must resolve the tension that came to light when the reforms were implemented around safeguards that have been put in place. Some customers deeply resent those safeguards and want to find a way round them. A decision has to be taken by policymakers to find a way forward. A resolution to that has to be sorted. As a part of that, we absolutely need to clarify what the advice requirements are. Some providers were still unclear when they had to ensure customers take regulated financial advice'.

#### *3.20.1.6 Pension fraudsters and investment scammers*

When it introduced pension freedoms, the Government completely underestimated the extent to which pension fraudsters and investment scammers would also seek to enjoy these pension freedoms. A great deal of belated effort has gone in to trying to rectify this problem, but with limited success to date. It is a potentially bigger risk to pension scheme investors than, say, investment risk.

#### *3.20.1.7 The self-employed and non-eligible job holders*

There are around 4.5m who are self employed and around 6.2m non-eligible job holders. This means that around 10.7m people working in the UK will not be auto-enrolled onto any pension scheme. Very little is known about their pension arrangements, although it is almost certainly the case that their pension arrangements need improving.

The RSA did not believe that auto-enrolment of these groups into NEST or another of the larger master trust schemes was appropriate due to the administrative challenges, and also because of the clear preference amongst many of them to have flexible access to their savings. Instead, the RSA proposed a Government-backed ISA to encourage these groups to save more, together with a nudge in the form of a 'Save When Paid' option to pay into the ISA when an invoice is received or a tax form has to be filled.

### 3.20.2 Recommendations

Our analysis in this Chapter leads us to make the following 12 recommendations.

#### **Recommendation 3.1: Safe harbour retirement income plans**

**We recommend that a quasi-default retirement income plan is designed and used by providers and advisers. This will involve a simple decision tree and a limited set of default**



pathways. The plan would be self-started following a guidance or advice surgery, and the plan member has the right to opt out until the point at which the longevity insurance kicks in.

The guidance or advice surgery needs to collect information on:

- pension pot size
- other sources of lifelong income (especially any state and defined benefit pensions)
- other sources of wealth (such as housing equity)
- liabilities (e.g., mortgage, credit card debts)
- health status
- family circumstances, including bequest intentions
- given other income sources, health status and family circumstances, decide the levels of expenditure that are considered essential, adequate and desired
- tax position
- risk attitude
- risk capacity.

The plan could be operated by a provider or an adviser. Two forms of the plan would be acceptable:

- drawdown plus a deferred annuity, or
- layering – first secure essential life-long expenditure ('heating and eating'), then allow for luxuries.

The plan must allow for:

- access – the flexibility to withdraw funds on an ad hoc basis
- inflation protection (either directly or via investment performance), and
- longevity insurance.

The customer will choose from a set of safe harbour products approved by the regulator. The purpose of the decision tree is to identify the products that are most suitable for meeting the customer's needs. To be feasible, any default pathway using a decision tree would need to be aligned with the guidance guarantee process in a way that it is not classified as regulated advice or a personal recommendation. This is because a decision tree is advisory – not advice – and so would be granted safe harbour status. Any adviser or provider making use of such a retirement income plan would be protected against future mis-selling claims.



A whole range of problems that emerged during the early months of ‘freedom and choice’ can be overcome by using such a default, e.g., lack of financial engagement and capability by members, ineffective communications, and scammers.

### **Recommendation 3.2: Simplifying the definitions of information, guidance and advice**

**We recommend that the Financial Conduct Authority:**

- **reviews its multiple definitions of information, guidance and advice with a view to replacing them with just two categories: ‘personal recommendation’ and ‘financial help’, with the latter replacing everything that is not full regulated fee-based advice where the adviser takes responsibility for the personal recommendation**
- **recognises that a quasi-default decumulation strategy is ‘advisory’ rather than ‘advice’ and that advisers and providers should be able to explain the quasi-default decumulation strategy and assess suitability without this being classified as regulated advice.**

The simplest solution involves only three routes:

- execution-only – the customer makes all the decisions (‘I want to do it myself’)
- ‘financial help’ – the customer is helped or steered towards tailored options using a decision tree; but this is currently classified as advice (‘Help me do it’)
- personal recommendation or full regulated advice (‘Do it for me’)

It is also important to recognise that guidance and advice cannot be a single event, but has to be a process. There needs to be periodic financial health checks or just simple reminders:

- 10 years prior to the nominated retirement date to confirm whether a de-risking glidepath is required and, if so, when it needs to begin
- 1 year prior to the nominated retirement date to re-confirm commencement date
- at age 74 to review death benefits
- at ages 80 and 85 to confirm implementation of longevity insurance (i.e., the switch to annuitisation if drawdown was used at the beginning of retirement).

### **Recommendation 3.3: Appropriate segmentation of the advice market**

**We recommend that:**

- **an attempt is made to segment the advice market in a way that would be helpful to consumers. There are a number of ways of doing this, e.g.:**

- by level of assets – Is there a level of assets below which ‘financial help’ alone will be adequate (for most people) and above which full regulated advice is recommended?
- by spending type – Are there spending types for whom ‘financial help’ alone will be adequate and are there spending types for whom full regulated advice is recommended?
- by behavioural type, e.g., ‘econ’ or ‘human’. Econs only need information in order to make informed decisions. Humans face behavioural barriers and biases which need to be identified early on (e.g., low levels of financial literacy, overconfidence, and self-control and hyperbolic discounting problems). Are there simple nudges that would improve effective decision making by humans, such as:
  - help
  - What do ‘people like me’ do?
  - advice (simple and targeted)?
- an attempt is made to agree on:
  - the appropriate level of help or advice for each market segment
  - the appropriate role of technology (e.g., robo-advice) for each market segment.

The service in economy class is broadly similar across different commercial airlines and the same is true for business class and first class. Millions of people are content with this simple classification. Why can’t the financial advice market be segmented in a similar way?

### **Recommendation 3.4: Turning financial advisers into a recognised profession**

We recommend that financial advisers undertake a review of their industry with a view to transforming themselves into a recognised profession. The following issues would be covered in the review:

- formalising and improving the professional (including training) standards of advisers
- introducing a fiduciary standard for financial advisers who provide full regulated advice
- the appropriate charging model for the service offered (fixed fee or percentage of assets), with the charges demonstrably delivering value for money to the customer and with full transparency over charges.

Financial advisers are not a recognised profession, yet they wish to provide advice on billions of pounds of UK retirement savings. Further, research by the FCA shows that customers are put off seeking financial advice because they are unable to trust the advice

they receive or judge its quality. The obvious solution is to transform themselves into a recognised profession. They should continue to improve their professional standards, accepting that the advice market might be smaller, although more profitable as a result. In particular, the professional training of advisers should be improved, with a much greater emphasis on understanding the risks involved in delivering retirement income solutions and how those risks can be measured, monitored and managed.

Advisers should also consider introducing a fiduciary standard for those who provide full regulated advice, as in starting in the US. This requires advisers to act solely in their clients' best interests.

The current disparate views expressed by the industry on both the nature of the service offered (ranging from 'everyone needs bespoke advice' to 'advice is only necessary for the very well off') and the charging model (fixed hourly rate vs percent-of-assets) is not helpful to consumers or in the long-term interests of advisers. We need a common national narrative on both these issues, bearing in mind that surveys show that most consumers are not currently prepared to pay very much for advice, because they do not place much value on it.

In terms of adviser fees, there needs to be much greater justification of ad valorem fees where the fee is unrelated to the amount of work done. Such fees are now very uncommon in most other types of professional services organisations. Charges also need to be transparent and easy to understand. It is not acceptable in this day and age that a potential client needs to have a long face-to-face meeting with an adviser before they are told what the charge will be, and then feel under some moral pressure to accept this charge.

### **Recommendation 3.5: Review of the unresolved implementation challenges of the pension reforms**

**We recommend that the Financial Conduct Authority:**

- **reviews the circumstances where mandatory advice is necessary**
- **clarifies the legal consequences for customers, advisers and providers when 'insistent clients' act against advice.**

We support proposals, made by the ABI and others, to deal with the remaining implementation challenges of the pension reforms.

### **Recommendation 3.6: Review of the powers of independent governance committees**

**We recommend that the Government reviews the powers of independent governance committees (IGCs) in contract-based schemes with a view to making them equivalent to the powers of trustees in trust-based schemes.**

This essentially means giving IGCs a fiduciary duty to act in the best interests of scheme members. For example, IGCs should be given the power to fire an underperforming fund manager without requiring the members' express consent.

### **Recommendation 3.7: Dealing with pension fraud and investment scams**

**We recommend the following measures are taken to deal with the problems of pension fraud and investment scams:**

- **all financial product sales (covering both regulated and unregulated products) should be brought under a common regulatory umbrella**
- **telemarketing (cold-calling) should be made illegal**
- **penalties for pension fraud and investment scams should be greatly increased.**

There can be no hiding place for pension fraudsters and investment scammers.

### **Recommendation 3.8: Customer responsibility**

**We recommend that the Government initiates a national debate amongst relevant stakeholders on the appropriate degree of customer responsibility and what industry and regulators need to do before consumers can reasonably become liable for their decisions in retirement.**

Associated with this should be attempts to improve customer engagement via better customer communications.

### **Recommendation 3.9: Introduction of an 'early warning system' to help retirees**

**We recommend that the Government introduces the following measures to support consumers as soon as possible:**

- **a 'pensions dashboard'**
- **'personal pension alerts' to help policymakers intervene where appropriate with the sub-groups it has identified as at particularly high risk.**

We support the various proposals that have been made to develop a ‘pensions dashboard’ that would enable consumers to view all their lifetime pension savings (including their state pension) in one place. In the past, this idea has been dismissed as too much of a technological challenge, given the multiple data bases that this information is held on, but we understand that the technology is now available to do this.

We also support the proposal for introducing ‘personal pension alerts’, developed by the Social Market Foundation, which would enable potential interventions, such as ‘targeted support and advice; initiatives to make retirees think twice before taking one-off decisions such as withdrawing all their pension savings; and, a “mid-retirement financial health check” to encourage older people to reconsider their financial position for their later years’.

### **Recommendation 3.10: Monitoring outcomes**

**We recommend that the Government puts in place a monitoring mechanism to assess the success of the ‘freedom and choice’ pension reforms. This should be benchmarked against the criteria for a good pension scheme listed in Recommendation 1.1 and Table 1.1.**

Data should be collected from sources such as Pension Wise, the ABI, the FCA and HMRC. Focus groups should be established to discuss their experience. We support the Work and Pensions Select Committee’s request for better information on: ‘customer characteristics of those using freedoms from pot size to sources of retirement income; take-up of each channel of guidance; reasons for not taking up guidance and advice; subsequent decisions made and reasons for those decisions’.

### **Recommendation 3.11: The annuities market**

**We recommend:**

- **The sale of immediate annuities should be via an auction**
- **The Government should facilitate and encourage the development of a market in deferred annuities.**

The first point deals with the problem identified by the FCA in 2014, namely ‘consumers’ tendency to buy from their existing pension provider [which] weakens competitive discipline. Not only do incumbent providers feel less pressure to offer competitive vesting rates, but challengers find it difficult to attract a critical mass of consumers. As a result, there has been limited new entry into the decumulation market in recent years’. It is also likely that these annuities will be medically underwritten, i.e., applicants have to fill in a medical questionnaire which asks health and lifestyle questions.

The second point attempts to address the problem that an open market in deferred annuities does not exist in the UK, yet is essential to provide the longevity insurance needed for the decumulation default to work (see **Recommendation 3.1**). The various reasons why a deferred annuity market does not exist (e.g., onerous regulatory capital requirements under Solvency II) need to be addressed.

### **Recommendation 3.12: The self-employed and non-eligible job holders for auto-enrolment**

**We recommend that the Government:**

- **considers revising the qualification for auto-enrolment from a ‘per job’ basis to an ‘combined jobs’ basis**
- **begins to collect more reliable information on the pension arrangements of the self-employed and non-eligible job holders for auto-enrolment**
- **investigates the possibility of establishing a Government-backed arrangement (like an ISA) to help these groups save for their retirement**
- **considers how to help these groups draw a retirement income in a cost-effective manner.**

The combined size of these two groups is significant: 4.5m self-employed people (17% of the employed population) and 6.2m non-eligible job holders (24% of the employed population), implying that around 11m people working in the UK will not be auto-enrolled onto any pension scheme.

The qualification for auto-enrolment is assessed on a ‘per job’ basis, which implies that individuals with a number of low-paid jobs will be excluded from auto-enrolment onto a pension scheme. The PPI estimates that ‘if the income from both first and second jobs was taken into account when assessing eligibility for automatic enrolment, then a further 80,000 people (60,000 women and 20,000 men) would earn enough to meet the qualifying criteria’. We fully recognise the practical difficulties of implementing this recommendation. Further, the recommendation might not actually be desirable if it results in workers falling into a benefit trap. Indeed, it might be the case that the only feasible way of dealing with this group of workers is through the state pension system.

We could find no accurate data on the combined number of the self-employed or non-eligible job holders with individual DC policies. Similarly, when it comes to decumulation, it is likely that these groups will fail to benefit from institutional value for money solutions and instead will have to rely on the high-cost retail market, unless NEST establishes a decumulation scheme which they could join.

We support the call of the Resolution Foundation ‘for greater intervention to ensure the self-employed [and and non-eligible job holders for auto-enrolment] are adequately prepared for their later years’. These groups should be encouraged to save more for their retirement, but in a way that allows them flexible access to their savings and has low charges. We therefore support the recommendation of the RSA for the introduction of a Government-backed ISA (e.g., provided by National Savings & Investments) to facilitate this. In addition, the groups could be encouraged to join NEST. We also support the RSA’s ‘Save When Paid’ proposal which automatically diverts a percentage of every pay cheque to a savings account.

When it comes to drawing an income in retirement, both groups should be allowed access to a national decumulation scheme like NEST (once its decumulation blueprint has been implemented).

## **4. Helping savers to manage longevity risk**

### ***4.1 Introduction***

In order to help savers manage longevity risk, we need to understand both life expectancy and longevity risk and we begin with some observations on these. The main concern is that people who underestimate how long they are going to live face the possibility of running out of money before they die. This, in turn, suggests that idiosyncratic longevity risk is a risk that individual savers are not able – and should not be expected – to manage themselves. To protect themselves from outliving their resources, most savers will need longevity insurance at some stage in retirement.

Systematic longevity risk is a trend risk facing the providers of longevity insurance which can only be hedged with a suitable hedging instrument. The key instrument for hedging systematic longevity risk is a longevity bond and we consider the role the Government could play in issuing longevity bonds. We end by examining the arguments that have been put forward by those who support the case for Governments issuing longevity bonds and those who are against the idea.

### ***4.2 Some observations on longevity and longevity risk***

We argued in Chapter 1 that the principal purpose of a pension scheme is to provide an income in retirement for however long the scheme member lives. But how long someone lives cannot be reliably estimated unless they have a terminal condition.

In advanced countries, life expectancy has been increasing at the rate of approximately 2.5 years per decade since 1840. Being told their life expectancy is a completely useless piece of information for someone who has just retired, since there is an approximately 50% chance that a 65-year old man, for example, will live beyond his life expectancy of 86.7 years. It does not get easier at higher ages. Telling an 85-year old man that his life expectancy is 91.6 years is also of little use, since one-in-three 85-year old men will reach 93 and 5% will reach 100. This illustrates the nature of idiosyncratic longevity risk, the uncertainty about how long any particular individual will live.

Furthermore, individuals are notoriously bad at estimating their own life expectancy. All age groups – and men more than women – tend to significantly underestimate their own life expectancy. While the extent of the underestimation decreases with age, men in their 60s still underestimate their life expectancy by an average of five years and women by three. So if a retiree plans to draw down their pension fund in line with their own estimate of their life expectancy, a typical male will outlive their pension pot by five years and a typical female by three. A key explanation for this is that people tend to over-estimate how many people die between 65 and 70, and under-estimate how many live beyond 80.



A report by Aviva notes: 'The risk of running out of money is likely to remain a constant threat for many people throughout their retirement, and, through planning, will become increasingly important as people take on more personal responsibility. People choosing to take some or all of their pension savings as cash ...can only assess whether this was a wise decision if they have an accurate understanding of their life expectancy. To fail to consider how much money they will need for their retirement years means they may risk a life in poverty if they outlive their savings'.

The report also gives the reasons why people believe they have a lower life expectancy than the average. The most common reasons – which are similar for men and women – are an existing serious health condition/illness, low family life expectancy, and lifestyle – drinking, lack of exercise and smoking.

A particularly worrying finding in the report is that many people do not appear to be too concerned about outliving their savings relative to other concerns they have about old age. People are concerned about going into a care home, but research by Just Retirement shows that only 10% of people stated that they were prepared for the cost of care. People are also concerned about dementia, but financial capability declines a long time before dementia sets in – at a rate around 2% a year after age 60 and this is from a base level of financial literacy that is also very low for most people. This suggests that many people will be financially vulnerable well before the onset of full dementia. The Aviva report concludes: 'Without a focused effort by the Government and the wider industry it may therefore be difficult to get people to really understand the importance of longevity in their retirement planning'.

One might assume that the Government would be better at estimating life expectancy than individuals. Unfortunately this is not the case. The official agency for estimating life expectancy in the UK is the Office for National Statistics, but the ONS has systematically and significantly underestimated the increase in life expectancy since 1971. This is one aspect of systematic longevity risk, namely the risk of underestimating the trend improvement in life expectancy.

Even if everyone – individuals and governments – could improve their forecasts of the trend improvement in life expectancy, there will always be considerable uncertainty around the trend. The best estimate of male life expectancy at age 65 in 2060 is 26 years, but it could be anywhere from 22 years to 28 years, a range of 6 years. This uncertainty around the trend improvement in life expectancy is another aspect of systematic longevity risk: how useful is it to tell a 20-year old male that his life expectancy could be anywhere between 87 and 93 years?

### ***4.3 Idiosyncratic longevity risk and its management***

#### **4.3.1 Longevity insurance**

It should be clear that idiosyncratic longevity risk is a risk that individual savers are not able – and should not be expected – to manage themselves. To protect them from outliving their resources, most savers will need longevity insurance at some stage in retirement – the possible exceptions being those with very significant wealth or those with a serious life-shortening medical condition, but without dependants, for example.

Given the primary purpose of a pension scheme, longevity insurance will be an essential component of a well-designed DC scheme at some point during decumulation, as we have said many times previously.

Longevity insurance can take two principal forms:

- A longevity-insured income, such as a lifetime annuity
- A deferred longevity-insured income, such as a deferred lifetime annuity.

Longevity insurance can be embedded in a range of retirement income products that also invest in growth assets during retirement, such as investment-linked annuities, variable annuities, and guaranteed drawdown products. However, these are retail products, and as such can have high charges, especially if they are sold on a voluntary basis and hence have to be extensively marketed. Furthermore, products with deferral features, such as a deferred lifetime annuity, are expensive to provide from a regulatory capital point of view if sold by insurance companies. This is because under the Solvency II regulatory regime for insurers that came into force in January 2016, the regulator requires significantly higher solvency capital for deferred annuities than for immediate annuities.

To reduce costs, we again need to look for economies of scale within the pensions regulatory regime, since this does not impose solvency capital requirements on pension schemes. The obvious solution for achieving these economies – as we saw in Chapter 3 – is to use ‘scheme drawdown’ combined with ‘longevity insurance’. In other words, the scheme itself provides income drawdown together with the longevity insurance. This would enable flexibility in spending in the early years of retirement, while also allowing for some investment growth, as well as ensuring that retirees do not outlive their assets.

#### **4.3.2 The optimal age to purchase longevity insurance and the optimal age at which the longevity insurance comes into effect**

While longevity insurance in the form of a lifetime annuity (LTA) provides a perfect hedge for idiosyncratic longevity risk from the date of purchase, the return is unattractive for many people in the early years of retirement compared with that available on other investments.

For the purpose of DC decumulation, it is helpful to separate the period prior to longevity insurance coming into effect and the period after. As a rough guide, we classify those who are aged between 55 and 75-80, in good health, with dependants as being in the pre-longevity insurance stage of their retirement. At some point between the ages of 75 and 80, it will become optimal for members of this group to switch between income drawdown and a LTA, since the implied return on a LTA at these ages exceeds any realistic return available on growth assets such as equities. This is because the mortality premium built into annuity rates increases with age. This means that it is optimal to annuitise around the time that the mortality premium exceeds the equity premium. This explains why it might well be optimal for healthy retirees with sufficient resources to wait until they are in their late 70s or early 80s before annuitising. People in poor health should, of course, purchase an enhanced annuity.

However, despite being optimal, this does not mean that people will be keen to buy longevity insurance, especially if they are not particularly concerned about living longer than expected and having insufficient money to live on. It might therefore be necessary to draw on the lessons of behavioural economics to find ways of nudging pension scheme members into buying longevity insurance when the time is right. One possibility is to use auto-enrolment onto a default decumulation strategy, as we discussed in Chapter 3. We also need to be innovative in annuity design and behavioural economics suggests that capital protected or cash-back annuities might be attractive to scheme members. Similarly, paying for longevity insurance in instalments might be more acceptable than paying for it upfront at the point of retirement.

#### ***4.4 Systematic longevity risk and its management***

Idiosyncratic longevity risk – the uncertainty over how long any particular individual is going to live after retirement – can be reduced by pooling and taking advantage of the law of large numbers. This is what insurance companies do when they sell annuities to a large group of people. Systematic longevity risk – uncertainty over how long members of an entire age cohort are going to live after retirement – cannot be reduced in this way. It is a trend risk and can only be hedged with a suitable hedging instrument. The key instrument for hedging systematic longevity risk is a longevity bond, in precisely the same way that an index-linked bond can be used to hedge inflation risk.

A longevity bond with the following characteristics can help to hedge systematic longevity risk:

- The bond pays coupons that decline over time in line with the actual mortality experience of a cohort of the population, say 65-year-old males from the national population: so the coupons payable at age 75, for example, will depend on the proportion of 65-year-old males who survive to age 75

- Coupon payments are not made for ages for which longevity risk is low: so, for example, the first coupon might not be paid until the cohort reaches age 75 (such a bond would be a deferred longevity bond)
- The coupon payments continue until the maturity date of the bond which might, for example, be 40 years after the issue date when the cohort of males reaches age 105
- The final coupon incorporates a terminal payment equal to the discounted value of the sum of the post-105 survivor rates to account for those who survive beyond age 105. The terminal payment is calculated on the maturity date of the bond and will depend on the numbers of the cohort still alive at that time and projections of their remaining survivorship. It is intended to avoid the payment of trivial sums at very high ages
- The bond pays coupons only and has no principal repayment (i.e., is an annuity bond).

However, it is important to recognise that the bond will only provide a perfect hedge for the systematic longevity risk faced by pension schemes and annuity providers if the scheme members and annuitants have exactly the same mortality experience over time as the cohort underlying the bond. If the scheme members and annuitants have a mortality experience that differs from that of the national population, this will introduce basis risk.

In practice, there will always be some basis risk. One reason for this is that pension schemes and annuity books have far fewer members than the national population and will therefore experience greater random variation risk than the national population and this is likely to cause the mortality experience of a sub-population to diverge from that of the national population over time, even if they have the same mortality profile at the outset. Another reason is that most pension schemes and annuity books will not have the same mortality profile as the national population, even to begin with. There can be differences in age, gender and socio-economic composition. It is unexpected changes in the trends in the survivorship experience of these different groups that causes basis risk. Although basis risk is important, it is a second-order risk compared with systematic longevity risk itself. It can also be hedged by having a small number of suitably designed hedging instruments.

Not only are longevity bonds useful for hedging systematic longevity risk once retirees are drawing a longevity-insured income, they could be used to hedge systematic longevity risk and long-term investment risk in the period leading up to this point.

#### ***4.5 Why should the Government issue longevity bonds?***

We believe that there are three important reasons why the Government should engage in sharing longevity risk with the private sector. It:

- has an interest in ensuring there is an efficient annuity market

- has an interest in ensuring there is an efficient capital market for longevity risk transfers
- is best placed to engage in intergenerational risk sharing, such as by providing tail risk protection against systematic trend risk.

#### ***4.6 Who benefits from Government issuing longevity bonds?***

Who benefits from Governments assisting in encouraging the optimal sharing of longevity risk? The simple answer is everyone. Everyone should benefit from having a market price for longevity risk and the ability to hedge systematic longevity risk. But there are also more specific benefits.

The Government:

- Gains by having both a more secure DC pension savings market and a more efficient annuity market, resulting in less means-tested benefits and a higher tax take
- Should gain access to a new source of long-term funding which, by widening the investor base, lowers the cost of government issuance
- Is able to issue bonds with a deferred payment structure to help its current funding programme and improve its cash flow
- Earns a market-determined longevity risk premium thereby further reducing the expected cost of the long-term national debt.

Defined benefit (DB) pension schemes:

- Have the opportunity to reduce longevity risks
- Can hedge longevity risk exposure prior to buy out.

Insurers:

- Can potentially establish a mark-to-market mortality rate term structure and hence hold the optimal level of economic capital or at least hold capital closer to the economic level
- Longevity bonds will help insurers to play an aggregating role in providing pension schemes and individuals with longevity insurance, whilst being able to pass on a proportion of their risk to the capital market; this would reduce their longevity concentration risk and facilitate the spread of longevity risk around the capital markets.

The capital markets:

- Get help to kick start market participation through the establishment of reliable longevity indices and key price points on the longevity risk term structure
- Can build on this longevity risk term structure with liquid longevity derivatives.

Investors:

- Get access to a new (longevity-linked) asset class whose returns are uncorrelated with traditional asset classes, such as bonds, equities and real estate.

Regulators:

- A longevity risk term structure should help the insurers' regulator (the Prudential Regulation Authority) validate insurers' economic capital, thereby making regulation more robust
- Longevity bonds should help an orderly transfer of longevity risk from DB schemes to the capital markets, thereby reducing reliance on an uncertain sponsor covenant and reducing concentration risk amongst insurers, and, in turn, giving comfort to the pension schemes' regulator.
- A longevity risk term structure should help facilitate the calculation of the risk-based levy to the Pension Protection Fund

Pension scheme members:

- DB pension scheme members potentially get better security
- DC pension scheme members get better valued annuities which produce a higher lifetime income when they retire
- Further, individuals with DC pension schemes would have a means of hedging the longevity risk associated with purchasing an annuity at retirement.

The potential demand for longevity bonds is high: of the £1.3trn in DB private-sector pension liabilities, around £600bn relate to pensions in payment; of the approximately £600bn in accumulated DC pension assets, £200bn relate to people over age 55; and insurance companies are committed to making annuity payments valued in excess of £150bn.

#### ***4.7 Support for Government issuance of longevity bonds***

Support for Governments to issue longevity bonds is growing steadily, from both UK and international organisations: the UK Pensions Commission, the Confederation of British Industry, the OECD, the World Economic Forum, and the IMF have all indicated support to a greater or lesser degree.

#### ***4.8 Arguments against Government issuance of longevity bonds***

A number of arguments have been raised against the issuance of longevity bonds by Governments.

The first is that Governments are not natural issuers of longevity bonds because of their large existing exposure – in excess of £5trn in the case of the UK Government – to longevity risk. Our response to this is that a Government’s exposure to unanticipated longevity improvements through the issuance of longevity bonds is – or at least could be – well hedged, principally by systematically raising the state pension age in line with increases in life expectancy, as recommended by the UK Pensions Commission.

The second argument is that there is no role at all for a Government in issuing longevity bonds. We would argue that there is a role for both Government and the private sector in developing a longevity market. The private sector is best at hedging idiosyncratic longevity risk, once it has hedged systematic longevity risk. The Government is the only agent in society with both the capacity and credibility to provide a long-term hedge for systematic longevity risk through the issuance of longevity bonds.

The third criticism is that even if longevity bonds are issued by the Government, there is a question mark concerning the potential liquidity of the market trading longevity bonds. Some have argued that liquidity is likely to be thin, since any new information concerning mortality that would be sufficiently significant to motivate trading is likely to arrive very infrequently. While this is true, we believe that there are important lessons from the inflation-linked financial futures market. Early attempts to introduce such a market were initially unsuccessful but they eventually succeeded and inflation indices have similar characteristics to longevity indices, especially in their low frequency of publication.

The fourth criticism is that longevity bonds are unnecessary since the load factor built into annuity prices is sufficiently large to (a) absorb the increase in regulatory capital that will be required after the introduction of Solvency II in the absence of longevity bonds, and (b) to absorb the longevity risk in countries not subject to Solvency II (e.g., the US and Australia). Our response is that there is limited scope for annuity providers to absorb either the costs of the additional capital requirements or the aggregate longevity risk without seriously reducing the money’s worth of the annuities they sell.

The fifth and final criticism that we consider is that basis risk is sufficiently large that it would negate any gains from holding longevity bonds. We recognise that basis risk is an important issue. Whilst it is hard to be absolutely sure at this stage in the development of the market, we do not believe that basis risk means that longevity bonds will be ineffective. Basis risk arises in other markets where imperfect hedging instruments are used, such as interest rate and currency futures contracts. Using these contracts leads to both contemporaneous and time basis risk, but this does not prevent them from providing highly effective – if not perfect – hedges.

#### ***4.10 Analysis and recommendation***

The evidence that we have put forward in this Chapter suggests that longevity risk is a risk that individual savers are not able – and should not be expected – to manage themselves. They need help to manage this risk in a cost-effective way, while retaining flexibility in spending and the investment growth potential of retirement assets in the early years of retirement.

Our analysis provides further support for Recommendation 3.1 in Chapter 3, namely a quasi-default decumulation plan, involving drawdown plus longevity insurance in the form of a deferred annuity (as one option). However, the providers of longevity insurance face systematic longevity risk for which there is currently no suitable hedging instrument, namely a longevity bond, being traded.

We make one recommendation as a result of the analysis in this Chapter:

##### **Recommendation 4.1: Longevity bonds working party**

**Since longevity bonds have a potentially important role to play in hedging systematic longevity risk, we recommend that the Government sets up a working party to undertake a cost-benefit analysis of government issuance of longevity bonds to help manage the associated longevity risk exposure.**

The terms of reference of the working party would cover the benefits that would accrue to all stakeholders, the scale of the longevity risk that Governments would be assuming, the actions Governments can take to mitigate this risk, and the issue of inter-generational equity. The working party should also work through the practicalities of issuing longevity bonds, including the construction of reference longevity indices, potential demand, pricing, liquidity and taxation.



## **5. The role of the National Employment Savings Trust in helping savers to access good quality retirement products**

### ***5.1 Introduction***

The National Employment Savings Trust (NEST) has revolutionised the DC pension savings market in the UK by providing a high-quality benchmark for private-sector schemes to compare themselves against. We consider whether it can and should do something similar in DC decumulation, both for its own members and for the members of other schemes that do not offer DC decumulation products.

### ***5.2 NEST and its membership***

By 2018, all private-sector employers must establish a qualifying workplace auto-enrolment scheme in order to fulfil their legal duties. This essentially means that any worker between 22 and state pension age with earnings above the Earnings Threshold of £10,000 (in 2015-16) must be auto-enrolled into a DC workplace pension scheme. NEST is one of the largest schemes with over 2m members from 14,000 employers. These numbers will increase significantly between now and 2018, as NEST will be the scheme of choice for many smaller companies that reach their staging date over the next two years.

NEST is a non-departmental public body (NDPB) and is run as a trust by NEST Corporation, which is the trustee, and which, in turn, reports to the Department for Work and Pensions. The scheme was introduced by the Government to avoid the danger of market failure under auto-enrolment, whereby employers considered economically unattractive to traditional life officers might not be able to find a suitable provider.

### ***5.3 NEST's approach to developing a retirement income strategy for its own members***

NEST expects most members retiring over the next few years to take their entire pot as cash and for this reason these members will be in a target date fund that will be fully invested in cash at the point of retirement.

#### **5.3.1 NEST's consultation on the future of retirement and the guiding principles for designing retirement income defaults**

NEST has set out its longer-term plans for scheme decumulation in several reports, starting, in November 2014, with a consultation paper, 'The Future of Retirement: A consultation on investing for NEST's members in a new regulatory landscape'. In March 2015, it published an interim report, *The Future of Retirement: Guiding Principles for the Design of Retirement*

*Pathways for the Automatically Enrolled Generation*, that set out ‘six principles for meeting the needs of new generation of savers’.

The key findings of the consultation include the following:

- There is a need for default retirement income solutions
- The design needs to be flexible
- There is a need to manage the risk that people will run out of money because they live longer than expected (i.e., longevity risk, which we examine in Chapter 4)
- No amount of education can prevent people from making complex decisions they later come to regret
- Choice is a double-edged sword. Most DC savers like to have choice in principle, but if the choices are complicated, then they get anxious and confused, often resulting in sub-optimal decisions
- People cannot and should not be expected to know when they will retire. This is partly because there are simply too many lifestyle, health and financial ‘unknowns’ in the decade before retirement. It is also due to the increasing trend towards flexible retirement, i.e., working past ‘normal retirement age’, often on a part-time basis.

NEST’s consultation respondents were broadly in agreement about the key features of the drawdown scheme. It needs to demonstrate:

- Simplicity from the member perspective
- Value for money through economies of scale and expert governance
- Freedom to opt out, which is essential under the ‘freedom and choice’ regime, and
- A clear choice architecture.

NEST’s six principles for designing retirement income defaults for auto-enrolment savers are as follows:

1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions
2. Savers should expect to spend most or all of their pension pots during their retirement
3. Income should be stable and sustainable
4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements
5. Providers should look to offer flexibility and portability wherever possible
6. Inflation risk should be managed but not necessarily hedged

NEST announced that it would be working on a blueprint for designing retirement income defaults based on these principles. It also recognised that these principles might be in

tension with each other and that providers need to prioritise and understand the trade-offs in designing default options.

### 5.3.2 NEST's proposals for implementing the guiding principles for designing retirement income defaults

NEST's final report, *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, was released in June 2015.

The report begins by revealing what members want from their retirement incomes. This is broadly the same as we found in Chapter 2, namely that:

- a substantial proportion of people want to use their pension pots to generate an income in retirement
- there is significant demand for using retirement arrangements to provide an inflation-protected income. This would be without significant market risk and guaranteed to last for life
- people are not only interested in a stable income for life, they also express strong preferences for having access to lump sums and the ability to pass on their savings, particularly in the event of early death.

It then identifies three phases of retirement during which people are likely to accept 'differing proportions of flexibility, inflation protection and longevity protection':

1. Phase 1, typically mid-to-late 60s to mid 70s, where the priorities are to maximise sustainable income in real terms and to preserve flexibility for later periods
2. Phase 2, mid 70s to mid 80s, where the aim is to provide a steady income that aims to keep pace with inflation, whilst keeping the majority of the pot liquid so that it can be passed on to dependants on death
3. Phase 3, mid 80s onwards, where the aim is to protect the member from all or most investment risk and longevity risk, at the cost of a loss of flexibility.

The main part of the report covers the blueprint for a core retirement income strategy. This has a number of aims:

- to provide a regular sustainable income for retirement
- to provide members with the ability to access lump sums without disturbing their regular income stream
- be low cost and feel straightforward for the member.

To achieve these aims, the blueprint discusses three building blocks which cover the three phases of retirement:

1. An income drawdown fund – To provide a steady income that aims to protect members against inflation, as well as give them full flexibility to change their mind and withdraw some or all of their money.
2. A cash lump sum fund – To be highly liquid so it can be used by members for unexpected events without impacting their core income stream. If market conditions are good then this pot can be topped up with additional lump sums. This would be a fund from which members could move money in ad hoc lump sums into their bank account to use as they like.
3. Later life protected income – To be ‘bought’ gradually in the form of deferred annuities over time through small payments from the drawdown fund. This would remain refundable up to a certain age, at which point that money is locked in to ensure a secure income is available for the remainder of a member’s life to protect against the risk of running out of money before they die.

NEST is aware of the challenges in delivering the blueprint for a core retirement income strategy. It accepts that the two key risks that will need to be managed in Phases 1 and 2 are sequence-of-returns risk and inflation risk. It also recognises that in Phase 3, advanced life deferred annuities might not be available, in which case other internal solutions, involving elements of risk sharing, might have to be considered. Cost, as well as hedge effectiveness, will also be an important consideration.

#### ***5.4 A wider role for NEST in the DC decumulation market?***

Is it possible that NEST could have a wider role in the DC decumulation market?

At present, there is no evidence of failure in the DC decumulation market, although this might emerge over time, for example, if (a) a significant number of DC savers are mis-sold inappropriate retail drawdown products that run out of money early due to a combination of high charges and inappropriate investment strategies, or (b) solutions with institutional standards – in terms of low charges, good governance and a well-designed decumulation default offering drawdown with longevity insurance – are not soon available to the mass market.

NEST – or an independently constituted sister organisation set up along the same lines – has the potential to provide a national decumulation scheme similar to its accumulation offering, since:

- It offers a low-cost, low-risk approach that is designed for the mass market, including lower earners
- It demonstrates high standards of governance through its independent trustee board
- It is open to the self-employed and employees whose contracts of employment make them ineligible for auto-enrolment.

### ***5.5 Reactions to the NEST proposals***

There were three main industry reactions to the NEST blueprint when it was published:

- The ‘complexity’ of the proposed solution, which appears more appropriate for engaged investors with large pension pots than to typical NEST members who are not interested in pensions and in any case have a small pension pot
- Whether the FCA would agree to disengaged investors being defaulted onto a risk-based retirement income solution
- The potential cost of developing the blueprint to practical implementation and whether this a good use of public funds.

### ***5.6 Responses to the consultation***

Respondents to our consultation expressed very mixed views about the potential for NEST to play a wider role in the decumulation market.

Some were positive about the potential for NEST to set a benchmark for a drawdown scheme costs, as it has done with accumulation. Others felt that NEST could have a positive impact on competition in the decumulation market.

However, several traditional providers of workplace schemes expressed the concern that if NEST offered drawdown to the market as a whole, this would represent a Government intervention that would skew competition. Others considered it is premature to debate the relative merits of NEST as a potential decumulation provider.

A particular concern was that NEST would enter the market as a scheme provider of drawdown ‘by the back door’, i.e., that it would not make a formal declaration of intent, but grow organically. This was described as ‘mission creep’. Some respondents were more positive about the potential for NEST to offer scheme decumulation to the self-employed and employees excluded from auto-enrolment.

### ***5.7 Analysis and recommendation***

There were mixed views on whether NEST should offer decumulation services. There was support from the unions and some consultants. Providers on the other hand tended to emphasise issues like ‘mission creep’ and distortion to the market by a ‘Government/taxpayer-subsidised loss-making provider’.

Even if the Government went ahead with the proposal, it would face at least two additional hurdles, according to a pension lawyer we interviewed. The first relates to EU rules on state aid which prohibit the state from supporting businesses that undercut other private-sector providers – this could be overcome with a letter of comfort from the EU as was used when NEST was set up. The second concerns giving NEST’s decumulation product an implicit safe

harbour status. This would undermine the FCA's current rules on regulated advice by giving an exemption to a Government-backed provider that was not available to advisers.

Notwithstanding these issues, NEST's blueprint for designing a retirement income strategy comes very close to how a rational life cycle financial planner would think about the problem. It is also very close to what we have recommended in Chapter 3. Of course, a rational life cycle financial planner would understand all the risk-return tradeoffs and be fully aware of – and be comfortable dealing with – the tensions between different principles, in particular, the tensions between having flexible access to the pension pot, the degree of investment risk assumed, and the risk of running out of money before dying.

The problem is that most NEST members will be 'humans' rather than 'econs'. As we have mentioned previously, pension flexibility is completely inconsistent with the philosophy underlying auto-enrolment in which the disengaged member is required to make no active decisions between the age of joining and the age of retirement. It is unlikely that such people will suddenly become engaged when the time comes to make a decision about their pension pot.

We therefore face the following conundrum. Flexibility requires drawdown and drawdown is risky. Lifetime income security requires deferred annuities and these are expensive. Further, as Tom MacPhail warns: 'The Financial Conduct Authority is unlikely to look kindly on a solution which involves putting disengaged investors into a risk-based retirement income solution'.

Can this conundrum be resolved? We do not believe it can be. Both DC savers and regulators are going to have to accept that there is a fundamental difference between a retirement income that is based on investment (drawdown plus deferred annuities) and a guaranteed income that is secured through an insurance policy (annuities). We have recommended that the best solution is to use a decision tree with a small set of default pathways that guide people towards one of these two key solutions, depending on the member's circumstances and risk appetite. We believe that both defaults are valid. This is unavoidable – and the fact that there can be more than one 'right' answer is just something the Government, regulators, practitioners and customers have got to get used to.

Given the blueprint, there are clearly issues about which we need to know a lot more:

- In order to achieve the report's ambitions, more clarity will be needed in particular on the underlying asset mix designed to produce real returns of up to 6.5% consistently over a 20-year investment horizon
- Very little has been said about charges, except for the general statement:

*Defaults need to provide good quality and value for money. Value for money is a likely consequence of solutions being designed to deliver good outcomes for the majority, as opposed to being highly bespoke and more*

*expensive to deliver. Solutions that work for the majority will also benefit from economies of scale'. In due course, we would expect NEST to produce a good value benchmark for charges in each of the three component parts the decumulation strategy, i.e.:*

- *Low withdrawal cost (some providers are charging a lot for withdrawals, either as a an annual % or per withdrawal – £240 for each withdrawal has been noted in the press)*
  - *Low AMC/TER for the default drawdown fund, plus*
  - *Competitively priced late-life annuitisation process/rates*
- NEST is anticipating that the markets will begin to offer deferred annuities. This, we believe, would be an excellent idea, but if this does not happen, will NEST self annuitise, i.e., offer deferred annuities internally? This is possible and they could also be reinsured as in the Rothesay arrangement with Zurich in May 2015
- The launch date (2017 at the earliest) and whether the product would be available to non-NEST savers. NEST does, of course, have the luxury of being able to wait until the time is right. As a new scheme, member pots are tiny at present (£200 on average). This plan will probably make more sense in 10 to 20 years' time
- The blueprint does not address how to engage with scheme members such that the fundamental conflicts concerning their attitudes to pensions are resolved:
  - members want secure inflation-proof income that is not impacted by stock-market falls, but, at the same time, they want flexibility, the ability to pass on their pensions when they die and the possibility of benefiting from stock-market gains
  - members value choice, but are often unwilling to engage with their savings options and make complex and significant decisions about how to access their savings
  - It is not clear why the first phase begins at 65 – what happens to people who want to start drawing from their pension pot at 55?
- Nor is it clear why the drawdown surplus at age 85 should be converted to cash – could it not be used to provide an enhanced income above and beyond that from the deferred annuity?

In terms of a wider role for NEST in the decumulation market to help improve retirement outcomes:

- From 2017, it can accept transfers in, which means that existing members will be able to consolidate previous pension pots through NEST (always taking care to check older policies for terms and conditions such as exit penalties and guaranteed annuity rates). This is very important if NEST intends to become a national aggregator scheme for DC decumulation. The question is: will transfers-in be classed as single contributions and attract the 1.8% contribution charge? We assume NEST would

prefer the answer to be 'no' which further delays the payment of the Government loan; the ABI and all major AE providers would want the contribution to attract the 1.8% charge. The DWP and the Treasury are also likely to be divided on this point, with the former supporting the continued growth of their 'baby' and the latter concerned about repaying the Government loan

- Employers and providers that do not wish to offer scheme drawdown directly could use NEST as a third-party provider for this function
- The self-employed and employees with employment contract that are ineligible for auto-enrolment could be encouraged to use NEST for both accumulation and decumulation purposes, putting them on a level playing field with employees who already have access to a low-cost, well-designed accumulation and decumulation scheme via their employer.

However, it is clear from the wide spectrum of opinions expressed by respondents to our consultation, that a move on NEST's part into the wider market would be greeted with both very positive and very negative responses. Despite this, we make the following recommendation:

#### **Recommendation 5.1: A role for NEST in decumulation**

**We recommend that NEST should be allowed to compete in the decumulation market from 2018 to provide a value-for-money decumulation product in the same way that it has in the accumulation market. This would enable NEST to set a competitive charge and governance standards that would provide a market benchmark.**



## **6. The role of collective pension schemes and how these could be introduced in the UK**

### **6.1 Introduction**

Supporters of collective defined contribution (CDC) pension schemes claim that they can produce higher and more stable incomes than individual defined contribution (IDC) pension schemes. Broadly speaking, there are two types of CDC scheme in existence: one that is a form of DB replacement and one that is a form of DC replacement. Because CDC schemes claim to have economies of scale that are not available to IDC schemes, we will examine whether this model for collective schemes can also boost incomes in retirement or at least make such incomes more stable across different cohorts of members. We will investigate how their performance might compare with standard IDC schemes. We will examine overseas examples of collective schemes that pool and share risks and hence make incomes in retirement more predictable (at least in principle). We will also consider what effect the new flexibilities for drawing down the pension pot in retirement have for the feasibility of a CDC pension. Finally, we examine an alternative type of collective scheme that might be more compatible with the new pension freedoms, namely collective individual DC (CIDC) schemes.

### **6.2 Collective defined contribution schemes: Features and criticisms**

The main benefits claimed for collective defined contribution (CDC) are risk sharing and lower operating costs. It is claimed that as a result of these benefits, CDC pensions can be 30% or more higher than in pure DC schemes.

CDC schemes typically have the following features:

- They involve risk pooling between members both within the same generation of members (i.e., intra-generational risk pooling) and risk sharing between different generations of members (i.e., inter-generational risk sharing). However, there is no risk sharing with the employer who pays fixed contributions (in the region of 10-12% of earnings) and provides no guarantees concerning the level of the pension
- They manage both the accumulation and decumulation phases, in contrast with individual defined contribution (IDC) schemes, which just manage the former. Each member has a target pension (typically related to career average revalued earnings (CARE)) which increases the longer they are a member (a typical accrual rate is 1% of earnings for each year of service). It is possible to have CDC schemes which are not earnings-related. One example is a with-profits scheme. Another is a unit-linked scheme with a dynamic asset allocation strategy that places a cap and a floor on the returns that are credited. It is important to understand that a CDC scheme offers a target pension, not a promised pension

- On a regular basis, the combined value of the target benefits of all members in the scheme is compared against the value of the total funds in the scheme (i.e., the funding status of the scheme). The target benefits will be raised or lowered depending on realised investment performance and the actual longevity experience of retired members
- There is a common investment fund for all members. This will be a diversified growth fund (DGF) that pools investment risk over a wide range of assets, including illiquid assets, such as infrastructure. Because of scale, the investment charges in the fund can be much lower than for funds sold to retail customers and to members of small schemes
- CDC schemes, through their management of both the accumulation and decumulation phases, can invest for longer periods in growth assets, such as equities, than IDC schemes, which currently only cover the accumulation period. By investing for longer periods in growth assets, it might be possible to generate higher average investment returns and hence higher pensions in CDC schemes compared with IDC schemes
- The extra investment risk that arises from an extended growth phase needs to be shared in an efficient and equitable manner. One way of doing this is through a smoothing fund. The rules for smoothing need to be made fully transparent from the start – this means that good communication is very important – and the process subject to considerable expertise and robust independent governance
- Longevity risk is pooled in CDC schemes. One way of doing this is through scheme drawdown. All members keep their accumulated assets (apart from the tax-free lump sum) in the scheme and draw a retirement income. This income, however, is not guaranteed. Depending on the fund's investment performance, it might rise or it might fall. Nevertheless, the cost of buying retail annuities, and hence paying the insurers' profit margin and solvency capital costs, is avoided.

A number of criticisms have been made of CDC, in particular, that the higher and/or less volatile potential pension comes at the expense of some severe restrictions on choice flexibility and that the schemes are complex to manage:

- CDC schemes appear to work as intended only if people stay in for life and draw an income from the scheme, rather than take the accumulated pension fund out at retirement. The 2014 Budget introduced greater 'pension freedoms' from April 2015 which would allow DC savers to take their pension fund in cash from age 55 (subject to income tax after the tax-free cash is withdrawn). By keeping their assets in the scheme, some would claim that members would be 'losing' their pension freedoms. If sufficient savers exercised these new freedoms, it would make CDC schemes unfeasible. The CDC schemes in the Netherlands, for example, do not permit this flexibility

- CDC schemes have little flexibility over the age of retirement. The CDC schemes in the Netherlands have a fixed retirement age and the investment strategy in the accumulation phase is designed with this retirement age in mind
- Members of a CDC scheme have no identifiable pension pot, so the valuation of each member's claim in a CDC scheme is as challenging as it is in a DB scheme. Members who transfer out of a CDC scheme when they change jobs might experience a reduced transfer value via a market value adjustment (MVA) if the scheme has an implicit deficit. The large CDC schemes in the Netherlands are industry-wide schemes and most people when they change employers move to different employers in the same industry and so stay in the same pension scheme. This suggests that CDC schemes should ideally be established on an industry-wide basis or that we move away from workplace pension schemes sponsored by an employer to a small number of very large nation-wide multi-employer pension schemes with employees choosing to join one of these when they first enter the labour market and then stay with it for the remainder of their career
- If the risk sharing in a CDC scheme is not fair between generations, it could turn into a Ponzi (or pyramid investment) scheme, with older members taking out more than their fair share at the expense of younger members. Supporters of CDC schemes need to answer the question why younger workers would join a scheme that was in deficit (which would happen if older workers were regularly drawing a pension based on the targeted performance of the investment fund which was higher than the realised performance)
- Related to this is the criticism that CDC schemes cannot work without an 'estate' or initial reserve that can be used for smoothing returns. Supporters of CDC schemes might argue that, with good governance, it is not necessary to have an estate. Alternatively, it might be possible to start a CDC scheme without an estate, but to require an estate to be built up by the first group of members. In other words, this group takes out less than is justified by the fund's investment performance in order to build a smoothing fund. This would help to establish the scheme's credibility
- The risk-sharing rules lack transparency. This is especially true in CDC schemes that operate on a similar basis to with-profit schemes. While it is claimed that there is greater transparency in CDC schemes that operate on a unit-linked basis, nevertheless, risk sharing usually involves actuarial discretion. It could be argued that discretion is the enemy of transparency. Some, however, have argued that some degree of opacity is necessary for such schemes to work at all
- While under current Government proposals, CDC schemes fix employer contributions, future Governments or EU directives might change this
- Some CDC schemes in Denmark have introduced a zero-rate minimum guarantee (i.e., the saver gets at least the accumulated value of their savings back) or a guaranteed minimum pay-out in nominal terms (equivalent to the purchase of a deferred annuity). This begins to introduce a defined benefit element to a defined

contribution pension scheme (i.e., makes the scheme a hybrid scheme). From a regulatory point of view, hybrid schemes are very complicated to run in the UK, especially if such guarantees require levies to be paid to the Pension Protection Fund

- Some employers might be attracted to CDC in preference to individual defined contribution (IDC) if they could convert their defined benefit (DB) pension schemes into CDC schemes. This would allow DB promises to be converted into non-guaranteed targets in the CDC scheme. This would require retroactive changes to accrued DB benefit entitlements. While this is permissible in Holland, for example, the Government has so far refused to allow this in the UK. The overarching Government objective is to make pure DC stronger rather than pure DB weaker
- A question mark has been raised over whether the proposed 0.75% charge cap would apply to CDC schemes
- The difficulty of imposing effective regulation.

### ***6.3 A comparison between collective defined contribution schemes and individual defined contribution schemes***

It is possible to show that a CDC scheme can generate a pension that is 30% higher than that in an IDC scheme. But this is because the two schemes follow completely different investment strategies. It is clear that if an IDC scheme followed the same investment and withdrawal strategies as the CDC scheme – which is now permissible following the 2014 Budget – and had the same cost structure as the CDC scheme – which large multi-employer trust-based IDC schemes like NEST, NOW: Pensions and The People’s Pension have – then it would have precisely the same average outcomes.

Another important point is that the two schemes have different risk exposures. The CDC scheme is exposed to equity risk for much longer than the IDC scheme. It should therefore not be surprising that it generates higher ‘average’ returns. But it also has higher risks and hence the outcomes will be more volatile. Supporters of CDC concede that the risks will be higher if the more aggressive investment strategies of CDC schemes are followed by IDC schemes, but they argue that these higher risks can be more effectively smoothed in CDC schemes than IDC schemes.

We therefore need to identify precisely the sources of both cost savings and risk pooling in CDC schemes that might give them an advantage over large multi-employer trust-based IDC schemes.

### ***6.4 Sources of cost savings and risk pooling in CDC schemes***

We should not expect significant cost differences between a large IDC scheme and a CDC scheme. Similarly, in terms of investment risk pooling within a given cohort of members, those members of the default fund in a large IDC scheme can achieve the same degree of risk pooling as members of a large CDC scheme. Further, increasing the number of members

in the same cohort cannot increase the degree of diversification in either type of scheme, since every member of the cohort has the same investments. So any additional benefits in terms of investment diversification that a CDC scheme has over an IDC scheme can only come from diversification across generations, i.e., risk sharing between different cohorts of members in the CDC scheme. It is possible to show that there are clear benefits from investment risk sharing using a smoothing fund across a number of cohorts of members.

In decumulation, CDC schemes pay pensions with conditional indexation, that is, pensions paid from the fund using scheme drawdown with any uprating of the pensions in payment dependent on the funding situation of the scheme. Hence CDC schemes offer the conditional hedging of inflation risk.

Longevity risk is the risk of the pension scheme member running down their pension fund before they die. This can happen with drawdown schemes but not with an annuity. CDC schemes use drawdown to pay the pension and the pension is adjusted – either by foregoing inflation uprating or in extreme cases by cutting the pension – to ensure that the scheme remains solvent.

## ***6.5 International examples of collective schemes***

### **6.5.1 The Netherlands**

The Netherlands is the home of the second-pillar workplace CDC scheme. The CDC structure being promoted in the UK – targeting a career-average revalued earnings (CARE) pension with conditional indexation – is based on the traditional Dutch CDC model. One key feature of a Dutch CDC scheme is a high fixed contribution rate of around 20%: the Dutch work one day a week for their retirement. The main policy lever to keep the scheme solvent is conditional indexation. Dutch schemes typically use a 10-year smoothing window, whereby any reduction in the pension paid is spread over a 10-year period.

However, Dutch schemes have failed to properly explain to members how peaks and troughs in returns are smoothed out. This has led young people to complain that they are subsidising older members of CDC schemes. The criticism that CDC schemes are not fair to young workers or indeed low-skilled workers has led the Dutch to search for alternatives that while maintaining the collective benefits of CDC schemes – in particular the collective sharing of the risks that are too large for individuals to bear themselves – nevertheless protect individual rights where possible.

One such alternative is the ‘collective individual defined contribution’ (CIDC) scheme. In a CIDC scheme, the collective features that promote economies of scale and lower costs are maintained, e.g., automatic enrolment and the pooling of investment and longevity risks.

However, there are also key features that are specific to each individual member and which make the scheme easy to understand:

- The CIDC scheme maintains individual accounts for all members in the accumulation phase, so it is easy to value each individual's pension pot
- The contribution rate is set to be actuarially fair to each member, implying that there is a direct relationship between the contributions that an individual pays into the scheme and the pension they eventually receive. This contrasts with CDC schemes in which contributions are averaged on a collective basis to meet a target average salary pension
- Each individual has their own de-risking investment strategy in the lead up to retirement.

### 6.5.2 Denmark

Denmark's ATP scheme, which was established in 1964, can be interpreted as a CIDC scheme.

### 6.5.3 Canada

The Canada Pension Plan (CPP) is partly funded and partly unfunded (pay-as-you-go, PAYG). It is therefore a combination of a CDC scheme and a non-financial (or notional) DC scheme. It is a nation-wide first-pillar scheme which covers all Canadian provinces except Quebec (which operates the Quebec Pension Plan (QPP) on a similar basis).

CPP is an example of what is known as either a 'pooled target-benefit (TB) pension plan' or a 'shared-risk pension plan' (SRPP). A TB pension plan has fixed contributions, a target defined benefit formula and a benefits/funding policy that prescribes the methods for varying benefits based on affordability, with pre-set reserve levels and a pre-determined order of benefit adjustments. A particularly interesting example of a TB or shared risk plan is that from the province of New Brunswick which will be discussed later.

## ***6.6 How new collective schemes might be introduced into the UK***

In this Section, we investigate how new collective schemes might be introduced into the UK and the potential issues that arise when a model that works in one country is introduced into a market characterised by a very different culture, history of labour relations and legal framework.

### 6.6.1 Current UK proposals

CDC is one example of the recently proposed 'defined ambition' (DA) workplace pension schemes that combine some of the risk pooling/sharing benefits of DB, but which impose zero or limited liabilities on the sponsoring employer. The aims are to provide more predictability for members than a typical DC scheme, but at the same time to ensure less cost volatility for sponsors of DB schemes than is the case with the traditional model.

The DA proposals for DB schemes ('DB-lite') for future accrual involve replacing the statutory indexation of pensions in payment with conditional indexation (which will depend on the scheme's funding position), change the scheme's normal pension age in line with changes in longevity assumptions, and automatically convert benefits to a DC pension when a member leaves the scheme, with the choice between a cash equivalent transfer value and full buy-out.

The DA proposals for DC schemes ('DC-heavy') for future accrual include (none of these options involves any risk to the employer):

- Money-back guarantee (MBG) which ensures members receive the same amount that they paid in (i.e., they get at least their money back)
- Capital and investment return guarantees (CIRG) which ensure that members receive back their contributions plus a minimum investment return
- Retirement income insurance (RII) which uses part of the member's fund to purchase insurance that guarantees a minimum level of income which is expected to grow every year as further insurance is purchased. At retirement, the insurance is triggered if the member lives long enough to exhaust their fund
- Pension income builder (PIB) which uses part of contributions to purchase a deferred annuity which provides a minimum pension in respect of that year. The rest of the contribution goes to a common pooled fund that is invested in riskier assets and is used to generate growth and pay conditional indexation. The deferred annuity can be bought from an insurer or provided from within the fund
- Collective defined contribution schemes (CDC).

#### 6.6.2 Lessons from abroad

If CDC (or one of its 'DC-heavy' alternatives) is introduced in the UK, then it is useful to take into account lessons from other countries. Of particular relevance are the Netherlands and New Brunswick.

CDC works in the Netherlands because the Dutch are willing to cooperate to make the system work. Large-scale industry-wide schemes are built on employer and union agreements. Employers and unions meet as 'social partners' in works councils in a spirit of 'social solidarity'. This type of collaboration is far less common in the UK, given its history of labour relations. Nevertheless, supporters of CDC schemes in the UK include the National Association of Pension Funds (NAPF) and the Trades Union Congress (TUC).

Scale and cost are important issues to deal with. The Dutch CDC schemes were not set up from scratch but were converted from DB schemes in which the benefits were not guaranteed, but instead were conditional on the performance of scheme investments and could be cut if necessary. By contrast, the accrued benefits in UK DB schemes are guaranteed and cannot be changed (in solvent companies). This means that UK DB schemes



cannot be converted into CDC schemes. Companies with DB schemes would have to set up new CDC schemes which would be a costly exercise. Further, the companies would have to be large ones with a large number of potential members in order to generate scale. It would, however, be possible for large companies with IDC schemes to switch to CDC at reasonably low cost should they wish to do so. However, it would be even cheaper for such companies to convert their IDC schemes to CIDC schemes.

Another important lesson from the Netherlands is that the CDC schemes are run by not-for-profit organisations that are largely trusted by all generations of scheme members. This trust is very important when risks are shared across generations. It is likely that a for-profit organisation would rapidly lose trust if it were awarding dividend payments to its shareholders at the same time as cutting pensions in payment which will inevitably happen at some stage in a CDC scheme – even if, as supporters of CDC schemes claim, this will happen rarely. This, in turn, would seem to suggest that a CDC scheme should operate in a trust-based framework where the trustees are professionally qualified and independent of the sponsor.

The New Brunswick SRPPs provide an interesting case study on how a collective scheme might be introduced. The New Brunswick SRPPs began in January 2014. The enabling legislation for the SRPPs was introduced in 2012 and the provincial Government worked with both the employers and the unions from 2010 to recognise the need for reform of the existing DB framework which was believed no longer to be sustainable or affordable. A taskforce was established to work with the provincial Government, employers and unions to establish three key principles for a new pension model: sustainability, stability and affordability. All existing DB plans in New Brunswick were assessed against the key principles and failed the test of long-term sustainability. The taskforce then worked with the unions of those plans in greatest deficit and developed the ‘shared risk pension model’. This combined the pension design features of the Dutch CDC schemes with the rigorous risk management procedures developed for Canadian banks and insurance companies.

Once a particular SRPP passes the stress test it becomes a candidate for adoption by employers and employees in New Brunswick. The Public Service SRPP has total contributions of 19.5% of pensionable earnings, with employees paying 8.25% and employers 11.25%. It also has a relatively cautious investment strategy: 41% equities, 39% bonds, 5% hedge funds, and 10% real estate and infrastructure.

Once adopted, the SRPP is subject to annual reviews, the aim of which is to identify any potential adjustments to benefits or investment strategy well in advance, and, hence, minimise the size of any adjustments that need to occur. If a cost of living adjustment is to be paid in a given year, the primary risk management requirement (concerning base benefits not being reduced) must first be met. A permanent benefit change can only be met if both the primary and secondary risk management requirements (the latter concerning



ancillary benefits being paid) are met. An adopted SRPP is subject to an annual actuarial funding valuation. In case the SRPP is underfunded in any year, there needs to be a recovery plan that specifies how contributions, investment strategy, and base and ancillary benefits are adjusted, with the reduction in base benefits being the last measure taken. In the case of overfunding, a funding excess utilisation plan will specify how contributions, investment strategy, and base and ancillary benefits are adjusted, with the restoration of previously reduced base benefits being the first priority.

For collective schemes to be introduced in the UK, the following areas need to be addressed:

- **Governance.** *Pension provision is notoriously open to conflicts of interest. And these are exacerbated by the fact that individuals have little knowledge of what their pension provider is doing and little leverage over their actions*
- **Management of the enterprise.** *There need to be guidelines as to:*
  - *The appropriate investment policy and the charges a pension fund can make*
  - *The actuarial assumptions upon which payments are to be made; that these are not unduly optimistic or pessimistic*
  - *Proper custody arrangements being in place*
  - *Members being fully informed over time of the likely level of their benefits, and of the nature of the promise being made. This latter point is of particular importance*
  - *Members' rights being clearly defined. So there needs to be transparency on how decisions will be reached. Members should also understand their rights with respect to withdrawing from one pension plan and placing their savings in another*
- **Attractiveness to sponsors.** *First and foremost must be an absolute assurance that there will be no attempt to ask the sponsor to underwrite promises which they had not signed up to.*

So with appropriate governance and management, it might be possible to introduce some form of collective scheme in the UK. A large single employer might find it attractive to do this. However, it is more likely that a multi-employer trust-based scheme (like NEST) would find it easier to do this if there was sufficient appetite amongst scheme members.

## **6.8 Analysis and recommendation**

### **6.8.1 Analysis**

The evidence that we have examined indicates that CDC schemes could generate smoother pensions across different cohorts of members than IDC schemes. This evidence comes from both theoretical models of intergenerational risk sharing using an overlapping generations framework and stochastic simulation models using CDC designs that are typical of those in

use in the Netherlands, such as career average revalued pensions with conditional indexation.

The theoretical models also suggest that CDC schemes are only likely to be sustainable in the long run if (a) everyone joins (i.e., participation is mandatory) and (b) everyone remains in the scheme for life. These two conditions potentially break down in the UK context.

Participation in second-pillar workplace pension schemes in the UK is based on the principle of auto-enrolment, namely that employees are automatically enrolled onto a workplace pension scheme when they start a job, but can opt out. Auto-enrolment began in the UK in October 2012 and will not be completed until 2018. The early evidence shows that around 90% of auto-enrolled employees have remained in their pension scheme. However, these were employees in very large companies where the company was very supportive of the pension scheme. We have yet to see what the participation rates are like with small and micro employers, where the support from the employer might not be so strong. Nevertheless, if participation rates remain high, it might be possible to argue that the first condition is more or less satisfied. Notwithstanding this, CDC schemes need to be credible to survive and they will not be if they are perceived to be unfair to future generations of members. To avoid such a misperception, it might be desirable for CDC schemes to build an estate or reserve fund immediately after starting. This would help to establish long-term credibility.

CDC schemes are designed so that the member joins and stays in for life, for both the accumulation and decumulation phases. This means that they are designed to provide an income during retirement, rather than a lump sum at the point of retirement. This is, of course, precisely what pension schemes are supposed to do, since their primary purpose is to provide an income in retirement for however long the scheme member lives. The problem is that the 2014 Budget reforms allow members to exercise their new pension freedoms and take their accumulated fund from age 55 from April 2015. However much they try to put a brave face on this, supporters of CDC cannot get around the fact that the Budget changes, which emphasise the rights of the individual over the shared benefits of the collective, greatly weaken the case for CDC schemes in the UK, however desirable that case is in principle.

The case for CDC schemes is further weakened in the UK context by the problem of transfers. As mentioned above, the theoretical evidence suggests that for CDC schemes to work best, everyone should stay in the same scheme for life. Transfers between schemes are, of course, possible, but this is in theory much easier with IDC schemes – where every member has their own account – than with CDC schemes – where members will simply know their target pension and could be subject to a market value adjustment if they transfer. Transfers are much more complicated in practice than in theory, at least in the UK.

In a CDC context, it would be much more efficient if the 'scheme followed the member' when the member changed jobs and hence transfers could be avoided. This, in turn, requires that there are only a few large CDC schemes in existence, all fully exploiting scale economies. A worker joins one when they first start work and stays with that scheme for life. This is only likely to be feasible if the CDC schemes are organised, not on a company basis, but on an industry-wide or national basis.

The claim that CDC schemes could generate outcomes that are 30% or more higher than standard DC schemes is based on an unfair comparison. A large CIDC scheme with the same cost structure as a CDC scheme and following the same accumulation and decumulation strategies would generate broadly the same outcome. The biggest cost saving in a CDC scheme comes from not having to buy individual annuities in the retail market, while one of CDC's biggest advantages is the pooling of longevity risk.

However, a large CIDC scheme using scheme drawdown could also avoid the costs of retail annuities, yet still pool longevity risk. It could also allow the individual underwriting of longevity risk in a way that CDC schemes cannot. In other words, CIDC could be used as an institutional alternative to the purchase of deferred annuities.

It is true that a CIDC scheme is, unlike a CDC scheme, unable to engage in intergenerational risk sharing and hence smooth pension incomes across a number of generations. But the question needs to be asked in a country like the UK – where both intragenerational and intergenerational solidarity are typically less strong than in, say, the Netherlands – is whether a CDC scheme is more likely to be perceived as a vehicle for intergenerational redistribution than a vehicle for intergenerational risk sharing. By contrast, a CIDC scheme avoids the intergenerational and other cross subsidies that CDC schemes involve, while maximising the benefits of economies of scale. It is also consistent with the new flexibilities following the 2014 Budget and personal de-risking investment strategies could be designed to enable members to take their pension as a lump sum from age 55. Such flexibility is not consistent with a CDC scheme. There could also be a default decumulation strategy using scheme drawdown which could be designed to give higher pensions to those with reduced life expectancies and maintain the benefits of economies of scale in the decumulation phase.

We also need to make a realistic assessment about the likelihood that CDC will be introduced in the near future.

Steve Webb was one of the strongest supporters of CDC when he was Pensions Minister and his support remains undiminished since he lost his seat in the May 2015 general election. He believes CDC is a 'slow burner' and that work on preparing for it could continue in his absence: 'It may not be the first priority – there are more pressing ones, but departments can do things in parallel. It was always for the long term, and that work will continue. The detailed work on producing regulations and consulting on them was always going to take a

couple of years. It was not just an academic exercise or Government putting out rules and regulations and then no one doing anything with it. There are professional people in the industry, trade unions and others, who want to see something less volatile than individual DC, particularly in sectors DB-dominated’.

Lord David Willetts, another pensions expert who also left Parliament in May 2015, also supports CDC: ‘I do think that pure DC ends up with too much risk being borne by the individual. In fact ... one of my regrets is that Lord Adair [Turner], between his first and his second report, pretty much gave up on any form of DB. I accept that conventional old-style final salary is on the way out. But Career Average Revalue Earnings, collective DC in various forms, hybrid schemes... I personally think that that’s the best way of having some pooling of risk. So I do think we need to be imaginative in promoting these types of instruments’.

Tim Sharp, pensions policy officer at the Trades Union Congress is another strong supporter of CDC – as is the Labour Party. He draws encouragement from NEST’s Retirement Income Blueprint, published in June 2015:

*It was easy to assume in the aftermath of the General Election that CDC pensions had been packed off to the West Country with outgoing Pensions Minister Steve Webb, never to return.*

*But the publication by Government-backed pension scheme NEST of its blueprint for retirement income in the era of pensions freedom not only brings desperately-needed rigour and analysis to the subject. It also places CDC in the mainstream as at least part of the potential solution to the nation’s retirement quandaries.*

*...In this model, incomes are supported by a collective pool of assets. Because capital requirements are less, this could operate with lower costs. Longevity risk is pooled. Incomes, however, are not fully guaranteed and underwritten – but the collective aspect means they should be more predictable than in the earlier phase of drawdown.*

*...NEST’s interest is significant because the principal criticisms of introducing CDC to the UK rarely concern its feasibility. They focus on demand for such a product and whether anyone will risk setting up the first scheme.*

*...[T]here is a strong argument that pensions policy is best when it doesn’t excite passions. And CDC really is merely a common sense solution to the dramatic shift in the pensions landscape that could leave the individual bearing unacceptable risks in both the accumulation and decumulation phases.*

*A number of barriers remain to the introduction of CDC in the UK.*

*NEST will need to persuade policymakers at home and in Brussels to give it permission to offer retirement income products.*

*There may also have to be an acceleration in the Department of Work and Pensions' work on developing CDC regulations, which have slipped down the department's lengthy to-do list.*

*But what the NEST blueprint tells us is that CDC.... is a practical answer to a pressing issue of public policy that is rightfully attracting serious consideration.*

It is clear that the loss of strong parliamentary supporters like Steve Webb and David Willetts will slow progress on the introduction of CDC. Even before the election, in March 2015, the DWP Select Committee called for a halt on the diversion of Government resources to the introduction of CDC until auto-enrolment is complete and the DC market operating effectively. Further, Baroness Ros Altmann, who replaced Steve Webb as Pensions Minister, has been publicly advised against pursuing CDC. For example, Fidelity Worldwide Investment has advised the new minister to 'Prioritise resources which would mean that we stop the defined ambition legislation'. Similarly, Nigel Waterson, the former Tory shadow Pensions Minister, hoped the new minister will resist the temptation of trying to do too much: 'That means leaving on the back burner ideas like collective defined contribution and defined ambition'.

The Pensions Minister has clearly heeded this advice. In October 2015, she announced that plans to move forward with both collective defined contribution and defined ambition had been put on hold. She said: 'The market needs time and space to adjust to the other reforms underway and these areas will be revisited once there has been an opportunity for that to happen'. She added: 'We have to protect DB and develop DC and I am of course interested in a middle way between the two but this is a future reform as I think we are either a bit too early or too late. If this shift had happened ten years ago then we might have seen interest but even if we were to work full pelt on CDC then we wouldn't even have regulation in place by 2018'. While she believed there is still a place for risk sharing, it is not a current priority, 'but we will come back to this at a later point'.

### 6.8.2 Recommendation

The best time to have introduced CDC was in 2009 when the Government of the day first looked at the possibility of introducing it, but turned it down. This might have helped stem the flow of private-sector DB schemes switching straight to IDC. That flow has since become a flood and the end of private-sector DB is now unstoppable in the UK. So CDC had a past. It might also have a future if employees use their new freedoms unwisely and deplete their pension pots to an extent that they cannot afford to retire: recall that pension schemes in the private sector were initially set up by enlightened employers to manage the exit of their employees from the workforce when they were no longer capable of productive work. But we do not believe that CDC has a present: the new pension freedoms are completely incompatible with CDC's requirement that members stay for life and draw a pension in retirement, rather than use the pension pot as a bank account.

However, since we recognise the benefits of risk pooling, we believe that collective individual defined contribution (CIDC) schemes might be the only form of collective scheme that is feasible in the short term following the introduction of 'freedom and choice'. Because they maintain individual accounts, they are better able to deal with sudden cash withdrawals than CDC schemes, yet are still able to exploit economies of scale to the full. For this reason, we make the following recommendation.

**Recommendation 6.1: Collective individual defined contribution schemes**

**We recommend that the Government looks at the feasibility of establishing collective individual defined contribution (CIDC) schemes – for both the accumulation and decumulation phases. Such schemes would be compatible not only with the defined ambition agenda, they would also be compatible with the new pension flexibilities following the 2014 Budget, while, at the same time, exploiting economies of scale to the full and allowing a high degree of risk pooling.**

## 7. Conclusion: Developing a National Narrative

### 7.1 Introduction

Everything used to be clear cut when it came to the generation of retirement income from funded occupational pension schemes. There was an accumulation phase, a de-risking phase leading up to a known retirement date, at which point the member took a 25% tax-free lump sum and the rest as a pension or an annuity that provided a retirement income for as long as the member (and possibly spouse or partner) lived. If there were weaknesses and inefficiencies in that system, there was case for fixing them. The simplest fix would have been to reduce the minimum income requirement (MIR).

However, instead of fixing it, the Government decided to completely abandon this system and, in particular, the requirement to annuitise any pension assets at all. Pension schemes no longer need to fulfil their primary role of providing a life-long retirement income. There is no doubt that the new pension freedoms are very popular with pension savers. Indeed, free market supporters describe them as ‘inspired’. It is clear the changes cannot be reversed.

Nevertheless, this does not change the fact that the decumulation decision – the optimal running down of assets in retirement – is extremely complex. Nor does it change the fact that there are now two completely different and mutually inconsistent models of individual behaviour underlying the two different stages of DC pension schemes in the UK. In the accumulation stage, we have a model that assumes people are ‘humans’ and which exploits inertia and other behavioural barriers to get people to start saving a bit (certainly not enough) for their pensions. In decumulation, we have the model of ‘econs’, rational lifecycle financial planners, fully capable of managing the complexities of decumulation decision making, following 45 minutes of guidance and, ideally, some good-valued and highly focused advice.

Then there is the issue of consumer vulnerability which has two key dimensions. The first is that many consumers, through ignorance, overconfidence, arrogance or reduced mental capacity, do not recognise their own vulnerability. The second is that many consumers are open to exploitation by being sold inappropriate, over-engineered high-cost products or overpaying for advice; even worse, they are open to fraud and investment scammers.

Making decisions about retirement income are the hardest financial decisions people ever have to make, because the risks in Table 1.2 are so significant and so poorly understood. Getting it right requires a national narrative about what pensions are for. Everyone in Parliament – whatever their political affiliation – and industry has to sign up to this narrative, just as they did with auto-enrolment.

So what can be done to help establish a national narrative and build a consensus around retirement income provision?



## ***7.2 Contributing to a national narrative 1: The pensions industry***

The first contribution needs to come from the pensions industry itself. This broadly comprises four key groups of agents: providers, advisers, investment managers and insurers. However, it is clear from our analysis in Chapters 2 and 3 that there are serious fissures in the relationships between these four groups, in particular, between investment managers and insurers, on the one hand, and between providers and advisers, on the other hand. Yet all these parties are needed to provide appropriate, effective and good-valued retirement income solutions.

Looking forward, the pensions industry is just not going to be able to get away with how it has traditionally operated. Instead, the industry is going to have to work together to offer the best designed and the best valued products and services and show clearly how these fit in to the retirement journey of their clients. Commercial airlines have to do this for the journeys their customers take, so why shouldn't those involved in the provision of retirement incomes? In addition, there needs to be much greater clarity over charges and fees. The full set of charges incurred in delivering a product should be made clear to customers. In terms of adviser fees, there needs to be much greater justification of *ad valorem* fees where the fee is unrelated to the amount of work done. Such fees are now very uncommon in most other types of professional services organisations.

'Freedom and choice' could be a disaster if these matters are not addressed. The particular segment of the market most at risk is mass market DC customers with pension assets between £30,000 and £100,000. Such consumers are unlikely to pay for full regulated advice and are therefore at risk of buying expensive, inappropriate poorly designed products on a non-advised basis. Those with pension assets below £30,000 are likely to have most of their retirement expenditure needs met by the state pension and by welfare benefits – they will welcome the extra flexibilities that the new pension regime offers in terms of how they spend their pension pot. Those with pension assets above £100,000 are more likely to see the value of seeking advice.

The simplest solution to the problem facing the market segment most at risk is a safe harbour retirement income plan which combines:

- A simple decision tree and a limited set of default pathways
- Safe harbour products that deliver income flexibility as well as inflation and longevity protection, and also meet minimum design standards in terms of efficacy and value for money
- Financial help, most probably delivered over the internet.

If between them, providers, advisers, investment managers and insurers are unable to deliver this solution, then we would regard this as considerably more serious than the market failure – the absence of voluntary pension savings by up 9 million employees in



companies without a pension scheme – that the Pensions Commission was set up to investigate and resolve – via the introduction of auto-enrolment.

The resolution to this new potential market failure would be a national master trust drawdown scheme that has a public service obligation to accept any DC retiree, irrespective of their pot size. This might be a simple continuation of NEST's public service obligation to accept any employer for accumulation (if EU regulations permit).

### ***7.3 Contributing to a national narrative 2: The national media***

The second contribution needs to come from the national media. As Aileen Lynch, head of technical services at Compliance First, has written: 'There's an unsettling dichotomy between the messages of the mainstream media ("This is your money and you are entitled to do with it whatever you want, whenever you please") and the more considered, long-term approach which is generally prevalent in financial services press and among advisers and providers'.

The national media has a very important role to play in getting the right message across about the real purpose of a pension scheme and the genuine risks that retirees face – much more now than in the days of final salary pensions when people received a life-long indexed pension and did not have to worry about the risks in Table 1.2.

However, there are two potentially significant long-term consequences of the 'this is your money' view of a pension pot currently prevailing in the national media. The first is a potential moral hazard. If a sufficiently large number of people behave in a reckless way and withdraw all their money and spend it too quickly, then they could claim compensation for mis-selling. Further, they will also demand an increase in welfare benefits and that, in turn, could lead to inter-generational conflict, with the next generation of taxpayers refusing to bail out their profligate and reckless predecessors. The second is the focus on reducing inheritance tax for those already sufficiently well off that, when they die, they will leave significant assets in their pension pot. Ordinary tax payers will soon start asking why they should subsidise the transfer of tax-privileged assets across generations of already wealthy families. The whole rationale for having tax incentives to encourage pension savings would soon come into question.

### ***7.4 Contributing to a national narrative 3: The regulatory system***

Our research has highlighted a number of problems with the current dual regulatory system, whereby The Pensions Regulator regulates trust-based schemes and the Financial Conduct Authority regulates contract-based schemes. Not only does this lead to inconsistencies in regulation, the two organisations have two different narratives. As a pension lawyer told us: 'The FCA looks at products and providers. It has customer protection as its focus. TPR is concerned more about giving guidance to trustees and employers'.

According to those we interviewed, the current fragmented regulatory system fails to encourage the design of effective, value-for-money products and solutions with a safe-harbour status or to adequately protect consumers from mis-selling and fraud. The solution would be to have a single pensions regulator, specifically tasked with these responsibilities. It would also have a responsibility for trying to change regulations which contribute to bad outcomes. As an example, we were told that prudential regulations in the UK increase the cost of prudential capital and reduce the value of annuities by 20% compared with the US. Another example is EU regulations, particularly MiFID II. If drawdown is reclassified as complex under MiFID II, it is likely that only those with large pots (above £100,000) who can afford regulated advice will be able to buy the product. What will mass market consumers who want to use drawdown do in these circumstances?

### ***7.5 Contributing to a national narrative 4: The political system***

The fourth contribution needs to come from the political system. It is increasingly clear that the five-year political business cycle is not suited to dealing with long-term issues like pensions, long-term care and long-term savings. Political parties, whether in power or in opposition, are totally focused on winning the next election and appear unable to think beyond that. It is therefore very hard to get any political party to adopt sensible long-term solutions to the problems of pensions, long-term care and long-term savings, especially if this involves sacrifices today, because it fears this would benefit its political opponents who could well be in power when the benefits begin to show.

This has fundamental consequences for intergenerational equity, since every generation passes the consequences of its own failures down to the next generation. While this can be a small problem when a population is growing, it becomes very severe when a population is rapidly ageing. To illustrate, a key reason why we would want each generation to hedge its own exposure to longevity risk is that, if it fails to do so, it is expecting the next generation to provide that hedge for free. The main objection to buying annuities – the classic longevity hedge – by the baby boom generation currently retiring is that they are ‘too expensive’. But they will be even more expensive for the next generation to provide if significant numbers of baby boomers run out of money and demand that the next generation provides them with an income for life (aka an annuity) to keep them out of ‘poverty’. For how much longer can the baby boom generation keep asking for a free lunch from the next?

One way of achieving a national narrative as well as dealing with the myopia of the political system is to have a permanent Pensions, Care and Savings Commission (PCSC). This would be an independent body that would have cross-party support and would make recommendations on issues related to pension and long-term savings. The PCSC would require an evidence basis for any policy recommendations, together with an impact and risk assessment. A particularly important role for the PCSC would be to ensure inter-generational equity.

There is widespread support for such a commission, including the Work and Pensions Select Committee, the Association of Consulting Actuaries, the National Association of Pension Funds, the Association of British Insurers, the Trades Union Congress, the International Longevity Centre – UK, TISA’s Savings and Investments Policy Project, Age UK, Pensions Age’s Unchaining Pensions from Politics campaign, and almost all the people we interviewed.

### ***7.6 Contributing to a national narrative 5: The pension tax system and the level of pension savings***

The fifth contribution needs to come from the pension tax regime and the level of pension savings it encourages. The pension reforms which ended the requirement to annuitise pension wealth – the fundamental rationale of a pension scheme – bring into question the whole system of very generous tax relief currently granted to pension savings and investment.

The present system of pension tax relief is predicated on the following principle. Individuals are incentivised to save for a pension via tax relief on contributions and investment returns. In exchange for this generosity, pension scheme members were – until recently – required to annuitise their pension pot in order to control their spending in retirement and not fall back on the state. At the same time, the pension would be taxed and the taxes received would be higher than if the tax relief on contributions and investment returns had not been given, by an amount that makes the system broadly neutral over the life cycle.

Now that there is no requirement to annuitise, one of the original justifications for providing tax relief has gone. A pension scheme is now no more than a wealth accumulation scheme. That raises some fundamental questions. Why should tax payers subsidise pensioners buying Lamborghinis or transferring their pension wealth to their grandchildren? It is still possible to make the regime tax neutral, but why bother in the first place? These questions have prompted renewed interest in the role of pension tax relief since the introduction of ‘freedom and choice’.

The newly elected Conservative Government released a consultation paper on pension taxation in July 2015. The consultation will examine whether there is a case for overhauling the current EET system of tax relief, where relief is given on contributions and investment income but the benefits on retirement are taxed.

We would argue that the following factors should be taken into account when designing a system of pension taxation and pension tax relief that encourages the optimal level of pension savings. We believe that the role of tax policy should be to help achieve one or more Government aims when private sector outcomes are considered to be sub-optimal or undesirable. In terms of pension tax relief, potential Government aims might be (different Governments will put different weights on these):

1. To encourage the level of pension savings needed to achieve a target standard of living in retirement which might be defined as:
  - a) 'essential' – income sufficient to cover an individual's minimum basic expenditure needs
  - b) 'adequate' – income sufficient to achieve a minimum lifestyle to which an individual aspires in retirement
  - c) 'desired' – income sufficient to achieve the full lifestyle to which the individual aspires in retirement.
2. To encourage individuals to make provision for long-term care. (While this is not directly a pension issue, the relationship between the joint increases in longevity and morbidity inevitably link the two.)
3. To achieve tax neutrality over the life cycle. One objective of pension tax relief is to encourage larger pension funds than otherwise, but to do so in a way that is tax neutral to each generational cohort, so that the cumulative value of tax reliefs during the accumulation phase broadly equals the present value of tax that will be collected during the decumulation phase (both valued at the date of retirement).
4. To achieve a degree of equity between members of the same generation through a redistribution of resources between low- and high-income individuals, men and women etc.
5. To achieve a degree of equity across generations and in particular to avoid unfair burdens falling on future generations.

The effectiveness of pension tax reforms in encouraging an optimal level of pension savings will largely depend on the balance between three types of individual:

- Econs – reforms will not alter the behaviour of econs who have already optimally set up their pension schemes, regardless of the level of tax relief; indeed econs do not need any tax relief to set up a pension scheme
- Humans facing extreme behavioural barriers – no amount of tax relief is going to nudge such people into setting up and maintaining a pension scheme, so again there is no need for tax relief in this case. Making occupational pensions compulsory rather than voluntary is the clear solution here, but all Governments have shied away from this, afraid of the accusation that this would be another form of taxation.
- Humans facing moderate behavioural barriers – here nudges in the form of tax relief will be effective. However, the biggest beneficiaries of pension tax relief are always going to be higher income and better educated people, unless tax relief is genuinely made tax neutral over the life cycle through some combination of limits to the tax relief on contributions (such as restricting it to the basic rate or a new flat rate of 33% which is probably less distortionary than increasing the cap on contributions) and increased taxes on benefits (such as taxing the lump sum above a certain limit).

## **7.7 Recommendations**

Our discussion in this Chapter leads us to make the following five recommendations.

### **Recommendation 7.1: Reviewing the working relationships within the pensions industry**

**We recommend that the pensions industry – via its trade associations – conducts a review of the working relationships of its various components – providers, advisers, investment managers and insurers – to remove the serious fissures and thinly disguised hostilities that currently exist, and which impede customers getting the best solutions for their needs.**

All these parties are necessary to provide appropriate, effective and value-for-money retirement income solutions, yet the evidence we have gathered for this report suggests that the working relationship between the parties is not working effectively in the best interests of customers.

### **Recommendation 7.2: Creating a single pensions regulator**

**We recommend that the Government creates a single pensions regulator, with the regulatory powers of the Financial Conduct Authority over contract-based schemes transferred to The Pensions Regulator.**

This would be consistent with the enhancement of the powers of independent governance committees in contract-based schemes to match those of the trustees in trust-based schemes proposed in **Recommendation 3.6**. It would also help to provide greater consistency of treatment between trust-based and contract-based schemes. Particularly important in this context is the issue compensation in the event of the insolvency of a pension scheme or a service provider to a scheme. Our research shows that there are many serious and significant discrepancies between the compensation rules of trust-based and contract-based schemes. The creation of a single regulator would help to bring clarity and consistency to pension savers' rights and protections.

### **Recommendation 7.3: Establishing a pension tax and tax relief framework that reflects how people behave**

**We recommend that the Government establishes a pension tax and tax relief framework that encourages the optimal level of pension savings given the reality that most people are 'humans' not 'econs'.**

The aims of the pension tax and tax relief framework would be:

1. To encourage the level of pension savings needed to achieve a target standard of living in retirement which might be defined as:
  - a) 'essential' – income sufficient to cover an individual's minimum basic expenditure needs
  - b) 'adequate' – income sufficient to achieve a minimum lifestyle to which an individual aspires in retirement
  - c) 'desired' – income sufficient to achieve the full lifestyle to which the individual aspires in retirement.
2. To encourage individuals to make provision for long-term care. (While this is not directly a pension issue, the relationship between the increases in longevity and morbidity inevitably link the two.)
3. To achieve tax neutrality over the life cycle. One objective of pension tax relief is to encourage larger pension funds than otherwise, but to do so in a way that is tax neutral to each generational cohort, so that the cumulative value of tax reliefs during the accumulation phase broadly equals the present value of tax that will be collected during the decumulation phase (both valued at the date of retirement).
4. To achieve a degree of equity between members of the same generation through a redistribution of resources between low- and high-income individuals, men and women etc.
5. To achieve a degree of equity across generations and, in particular, to avoid unfair burdens falling on future generations.

#### **Recommendation 7.4: Establishing a permanent independent Pensions, Care and Savings Commission**

**We recommend that the Government establishes a permanent independent Pensions, Care and Savings Commission which reports to Parliament.**

Its remit would be:

- To assess the impact of the Budget flexibilities on default investment strategies
- To consider whether a default decumulation option is required for savers making poor decisions
- To assess the impact of the reforms on the suitability and accessibility of retirement products
- To recommend market interventions where the market was not working in savers' best interest
- To tackle high charges and poor governance in legacy schemes
- To review auto-enrolment, including making recommendations on minimum contributions and defining adequacy of retirement income and how the policy

should be assessed as a success. The committee said using opt-out rates to measure success would not be meaningful in the long term

- To oversee any further changes in savings and tax policy
- To assess the minimum age at which people can exercise their pension flexibilities. The current age is 55 and this will rise to 57 in 2028 when the state pension age increases to 67. But allowing people to draw on the private pension ten years before state pension age could create unrealistic expectations about the age at which they can afford to stop working. The commission would consider whether this should be reduced to five years, except for those in ill health
- To look at issues relating to auto-enrolment: the challenges of extending auto-enrolment to smaller employers, the level of minimum contributions for employers and employees, how currently excluded groups, such as the self-employed and those in multiple low-paid jobs, can be brought into pension saving more effectively
- To review the structure of state pensions and the Government's timetable for raising the state retirement age to reflect both improvements in life-spans and overall financial costs to the taxpayer (given the current commitment to the 'triple lock' indexation of the basic state pension)
- To advise every three years on the need or not for a general increase in retirement age to reflect increases in longevity so as to keep pension funding costs broadly stable over the long-term where scheme specific information is unavailable
- To recommend policies designed to encourage more employers and employees to invest in retirement income plans, including auto-escalation and other measures to maximise design flexibilities and choices, advising on financial and tax incentives to encourage wider coverage, whilst taking account of the UK economic, demographic and financial backcloth and life-style changes
- To review and make recommendations on tax incentives for long-term care products
- To promote legislative and regulatory simplification to encourage quality provision, accepting that legislation must continue to protect members' retirement incomes from the impact of employer or provider insolvency or default
- At the request of Government, to review on a periodic basis the structure and rules of the NEST scheme to ensure employees are offered an appropriate fall-back retirement income plan where no better scheme is offered by a sponsoring employer
- To ensure that over the long-term, the cost of public sector pensions, and those that are largely funded by the taxpayer, are transparent in cost to the taxpayer, are sustainable and are fair set against the scale of private provision available to the majority of taxpayers
- To report on matters referred by Government to the Commission on an ad hoc basis and also on European directives that could have an impact on any of the above
- To conduct a cost-benefit analysis of any proposed pension reforms

- To investigate whether the Government should be recommended to introduce products such as longevity bonds or deferred annuities to help hedge longevity risk
- To examine the issue of inter-generational equity. For too long Governments have kicked this can down the road. Eventually they will run out of road, and this could happen sooner than we all think.

### **Recommendation 7.5: Adopting a national retirement savings target of 15% of lifetime earnings**

**We recommend that the Government adopts a national retirement savings target of 15% of lifetime earnings, achieved through auto-escalation, to avoid future pensioner poverty.**

## **7.8 Conclusion**

The unifying thread that runs through funded pension scheme is the requirement to annuitise enough pension wealth, at the appropriate age, to provide an adequate lifelong income in retirement when combined with the state pension – which is the rationale for establishing a private-sector pension scheme in the first place. It is this requirement which makes a funded pension scheme different from any other type of savings scheme.

When annuitisation becomes optional, that unifying thread is no longer present and there is a real danger that the pension system begins to unravel. At best, it just becomes a tax-favoured arrangement for operating a multi-purpose spending pot and once the money has been spent for one purpose, it cannot be spent on another. At worst, it becomes a honey pot for thieves and other opportunists: while you cannot steal someone's pension, you can steal their pension pot, as a number of people are now discovering. Lying between these extremes are millions of people who are now in control of their pension fund and who will be trying to do the best for themselves and their families. But for anyone who understands the risks in Table 1.2, many of these people could well find themselves in the same kind of control as a yachtsman in the middle of the Atlantic in a force nine gale.

A great deal of effort will now have to go into re-establishing what a good pension scheme is, as outlined in Table 1.1. This will need a commonly agreed national narrative. If we do not achieve this, we could end up in the position where people's aversion to annuitisation combined with their willingness to pay highly for both flexibility and guarantees in drawdown products leaves many of them not much better off and possibly worse off than if they purchased an annuity to begin with. In other words, the behavioural bias against annuities could be used by the pensions industry to extract as much if not more from a customer than a 'terrible poor value' annuity.



And to establish a national narrative that builds a consensus around retirement income will need the support of all the king's horses, all the king's men – and all the king's women. This is a significant challenge. But it is one that is well worth the effort because 'pensions ARE precious'.

*The key elements of a national narrative*

- The primary purpose of a pension scheme is to provide an income in retirement for however long the scheme member lives – that is, it will not run out of money before the member dies.
- A pension scheme needs to offer accessibility, inflation protection (either directly or via investment performance) and longevity insurance.
- A pension scheme needs to provide value for money with the benefits clearly and transparently exceeding the costs.
- Individuals should not be expected to manage the risks involved in the generation of retirement income from pension savings themselves.
- Middle Britain – with pension assets between £30,000 and £100,000 – should be recommended to use a retirement income plan that involves a simple decision tree with a limited set of pathways.
- The retirement income plan would be self-started following a guidance or advice surgery.
- The plan member would choose from a set of safe harbour products approved by the regulator. The purpose of the decision tree is to identify the products that are most suitable for meeting the plan member's needs. The aim is to achieve a simple solution that is appropriate (i.e., 'good enough') for those who do not wish to make any financial decisions themselves.
- The safe harbour products would include annuities, drawdown products and longevity insurance that meet minimum design standards in terms of efficacy and deliver clear value for money.
- The plan member would have flexible access to the pension pot until the point that longevity insurance kicks in.
- A national narrative requires the integration of the accumulation and decumulation phases. An essential part of this narrative is 'an adequate pension needs adequate contributions'. To have an adequate pension in retirement, Middle Britain, needs to understand that – together with the employer – it has to save 15% of its lifetime earnings in a pension scheme.
- A parallel narrative is required to address the needs of the millions of private-sector workers who are self-employed or whose contracts of employment exclude them from auto-enrolment.