

# City Research Online

## City St George's, University of London

**Citation:** Blake, D. (2016). Independent Review of Retirement Income Report: We Need a National Narrative: Building a Consensus around Retirement Income. UK: Independent Review of Retirement Income.

This is the published version of the paper.

This version of the publication may differ from the final published version. To cite this item please consult the publisher's version.

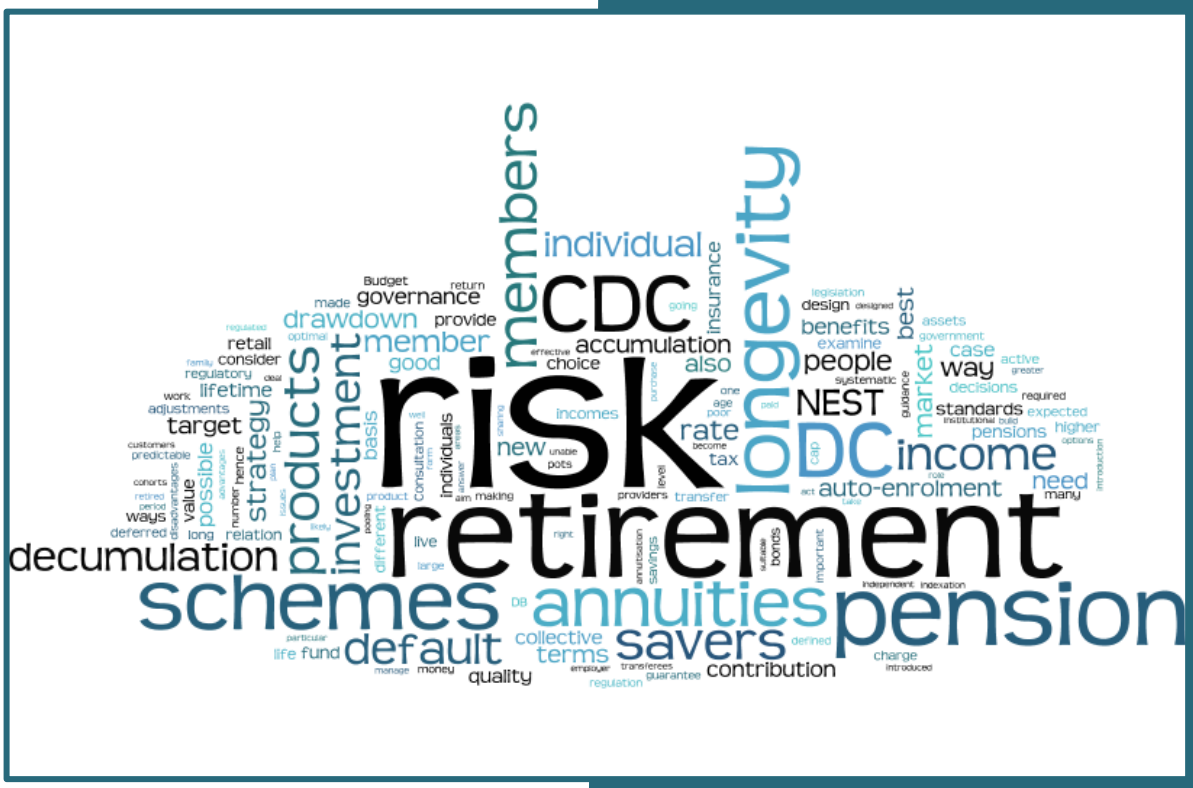
**Permanent repository link:** https://city-ref-test.eprints-hosting.org/id/eprint/13739/

**Copyright and Reuse:** Copyright and Moral Rights remain with the author(s) and/or copyright holders. Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge, unless otherwise indicated, provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way. For full details of reuse please refer to City Research Online policy.

City Research Online: http://openaccess.city.ac.uk/ publications@citystgeorges.ac.uk

# Independent Review of Retirement Income: Report

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




**David Blake**

**March 2016**



# Independent Яeview of Retirement Income

# Report

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

**David Blake**

**March 2016**

'Pensions are precious' – Ros Altmann – Pensions Minister

Published by the **Independent Review of Retirement Income**

The Report of the **Independent Review of Retirement Income**, entitled *We Need a National Narrative: Building a Consensus around Retirement Income* can be found here: http://www.pensions-institute.org/IRRIReport.pdf

ISBN: 978-0-9935615-1-1 [v2/130416]

A *Summary* can be found here: http://www.pensions-institute.org/IRRISummary.pdf

ISBN: 978-0-9935615-2-8

The *Consultation* can be found here: http://www.pensions-institute.org/IRRIConsultation.pdf

ISBN: 978-0-9935615-3-5

## Contents


Preface ..... 1

List of organisations and individuals participating in the consultation exercise ..... 4

Organisations ..... 4

Individuals ..... 5

List of abbreviations ..... 8

Recommendations of the Independent Review of Retirement income ..... 13

1. Introduction ..... 29

1.1 Pension schemes – uses and risks ..... 29

1.1.1 Uses ..... 29

1.1.2 Risks ..... 32

1.2 Pension scheme members ..... 36

1.2.1 Who will be affected by the pension reforms? ..... 36

1.2.2 The impact of the pension reforms on welfare benefits ..... 37

1.2.3 Pension adequacy and pension inheritance ..... 40

1.3 Employers and consultants ..... 42

1.4 Providers and investment managers ..... 45

1.5 Trade unions ..... 48

1.6 Wider issues ..... 49

1.7 Responses to the consultation paper ..... 51

1.8 Analysis ..... 51

1.9 Recommendations ..... 53

1.10 The remainder of the Report ..... 55

Appendix: Studies on the adequacy of pension savings ..... 55

2. How to ensure that savers can get the best products in retirement ..... 61

2.1 Introduction ..... 61

2.2 The products on offer for investing the accumulated pension pot and for providing an income in retirement ..... 67

2.2.1 Annuities ..... 68

2.2.2 Drawdown products ..... 90

2.2.3 Hybrid products ..... 98

2.2.4 Other products....103
2.3 Current and planned delivery systems for retirement income products....114
2.3.1 Institutional distribution vehicles....114
2.3.2 Retail distribution....127
2.3.3 Hybrid institutional-retail distribution....128
2.4 The withdrawal strategy....129
2.4.1 Factors influencing the withdrawal strategy....129
2.4.2 Is there a safe withdrawal rate?....131
2.5 The longevity insurance strategy....140
2.6 Charges, charge disclosure and proposals to cap charges....148
2.6.1 Charges....148
2.6.2 Charge disclosure....150
2.6.3 Proposals to cap charges....152
2.7 Product and provider regulation....155
2.8 How to deal with stranded pots....158
2.9 Feedback from our interviews and responses to the consultation paper....161
2.9.1 Feedback from our interviews....161
2.9.2 Responses to the consultation paper....169
2.10 Analysis and Recommendations....173
2.10.1 Analysis....173
2.10.2 Recommendations....192
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....199
3.1 Introduction....199
3.2 Understanding the retirement savings market....200
3.3 Segmenting the retirement income market....207
3.3.1 People differ in their types....207
3.3.2 People differ in their resources and needs....214
3.3.3 Implications of the market segmentation analysis....218
3.3.4 Initial customer reaction to the introduction of 'freedom and choice'....221
3.3.5 Initial scheme reaction to the introduction of 'freedom and choice'....227

3.4 A retirement expenditure and investment plan that helps to overcome behavioural barriers ..... 230
3.5 Defaults and default pathways ..... 233
3.5.1 Default and default pathways with SPEEDOMETER plans ..... 233
3.5.2 Other default proposals ..... 236
3.5.3 Support for a default ..... 247
3.5.4 Opposition to a default ..... 252
3.6. Information, advice and guidance ..... 253
3.6.1 The distinction between information and advice ..... 253
3.6.2 Generic advice ..... 258
3.6.3 Guidance ..... 259
3.6.4 The implications for members of DC schemes ..... 264
3.6.5 The implications for members of DB schemes transferring to DC schemes ..... 266
3.7 Opportunities for advisers ..... 271
3.7.1 Opportunities for advisers in regulated advice ..... 271
3.7.2 Opportunities for advisers in simplified advice ..... 274
3.7.3 The frequency of advice ..... 276
3.8 The impact of technology on advice ..... 277
3.8.1 Platforms ..... 277
3.8.2 Robo-advice ..... 282
3.8.3 RetirementSaverService ..... 295
3.9 Is there an advice gap? ..... 297
3.9.1 A number of advice gaps have emerged ..... 297
3.9.2 The Financial Advice Market Review ..... 301
3.10 Adviser charging ..... 312
3.11 The implications for a default pathway ..... 317
3.11.1 A default pathway with simplified advice ..... 317
3.11.2 Can simplified advice work in a default framework? ..... 320
3.12 Consumer vulnerability and regulatory responses ..... 323
3.12.1 Governance of pension schemes in the new pension environment ..... 324
3.12.2 Vulnerable consumers ..... 330

3.12.3 The FCA's proposed new rules and guidance following the 'freedom and choice' reforms....356
3.13 Media and Government reactions to regulatory and provider concerns about consumer vulnerability: The issues of access and exit charges....360
3.13.1 Access....360
3.13.2 Early exit charges....365
3.13.3 Official responses....366
3.14 Pension fraud and investment scams....372
3.15 Customer engagement, customer communications and customer responsibility....382
3.15.1 Customer engagement....382
3.15.2 Customer communications....383
3.15.3 How responsible is the consumer?....388
3.16 Monitoring outcomes....389
3.17 The self-employed and non-eligible job holders for auto-enrolment....392
3.18 Experience from abroad....396
3.18.1 Australia....396
3.18.2 Switzerland, Chile and the US....400
3.19 Feedback from our interviews and responses to the consultation paper....401
3.19.1 Feedback from our interviews....401
3.19.2 Responses to the consultation paper....406
3.20 Analysis and recommendations....410
3.20.1 Analysis....410
3.20.2 Recommendations....425
Appendix: Information services for customers and advisers....433
4. Helping savers to manage longevity risk....437
4.1 Introduction....437
4.2 Some observations on life expectancy and longevity risk....438
4.3 Idiosyncratic longevity risk and its management....445
4.3.1 Longevity insurance....445
4.3.2 The optimal age to purchase longevity insurance and the optimal age at which the longevity insurance comes into effect....446
4.4 Systematic longevity risk and its management....448

4.5 Why should the Government issue longevity bonds? ....452
4.5.2 An efficient capital market for longevity risk transfers ....453
4.5.3 Intergenerational risk sharing....455
4.6 Who benefits from Government issuing longevity bonds? ....456
4.7 Support for Government issuance of longevity bonds ....458
4.8 Arguments against Government issuance of longevity bonds ....459
4.9 Feedback from our interviews and responses to the consultation paper ....464
4.9.1 Feedback from our interviews ....464
4.9.2 Responses to the consultation paper ....465
4.10 Analysis and recommendation ....466
5. The role of the National Employment Savings Trust in helping savers to access good quality retirement products....469
5.1 Introduction ....469
5.2 NEST and its membership ....470
5.3 NEST's approach to developing a retirement income strategy for its own members 471
5.3.1 NEST's consultation on the future of retirement and the guiding principles for designing retirement income defaults....472
5.3.2 NEST's proposals for implementing the guiding principles for designing retirement income defaults ....477
5.4 A wider role for NEST in the DC decumulation market? ....481
5.5 Reactions to the NEST proposals ....483
5.6 Feedback from our interviews and responses to the consultation paper ....485
5.6.1 Feedback from our interviews ....485
5.6.2 Responses to the consultation paper ....486
5.7 Analysis and recommendation ....487
6. The role of collective pension schemes and how these could be introduced in the UK...491
6.1 Introduction ....491
6.2 Collective defined contribution schemes: Features and criticisms ....492
6.3 A comparison between collective defined contribution schemes and individual defined contribution schemes ....499
6.4 Sources of cost savings and risk pooling in CDC schemes ....501
6.4.1 Accumulation phase issues ....501

6.4.2 Decumulation phase issues ....505
6.4.3 Academic studies ....507
6.5 International examples of collective schemes....507
6.5.1 The Netherlands....507
6.5.2 Denmark....510
6.5.3 Canada ....511
6.5.4 USA....513
6.5.5 Sweden....515
6.5.6 Australia ....517
6.6 How new collective schemes might be introduced into the UK....518
6.6.1 Current UK proposals....518
6.6.2 Lessons from abroad....520
6.7 Feedback from our interviews and responses to the consultation paper ....525
6.7.1 Feedback from our interviews....525
6.7.2 Responses to the consultation paper ....526
6.8 Analysis and recommendation ....532
6.8.1 Analysis ....532
6.8.2 Recommendation....536
7. Conclusion: Developing a National Narrative....539
7.1 Introduction ....539
7.2 Contributing to a national narrative 1: The pensions industry....541
7.3 Contributing to a national narrative 2: The national media....544
7.4 Contributing to a national narrative 3: The regulatory system ....545
7.5 Contributing to a national narrative 4: The political system ....552
7.6 Contributing to a national narrative 5: The pension tax system and the level of pension savings....565
7.6.1 The original system of pension taxation....565
7.6.2 The new system of pension taxation....567
7.6.3 What is the role if any of pension taxation relief? ....569
7.6.4 The Government's consultation ....574
7.6.5 The effectiveness of pension tax relief....577
7.7 Recommendations....582

7.8 Conclusion.....586

Appendix: The Professional Pensions guide to how pensions tax relief restrictions have developed since A-Day in 2006.....588

## Preface

On 29 May 2014, Rachel Reeves MP, then Shadow Work and Pensions Secretary, launched an Independent Review of Retirement Income to look at how to boost defined contribution (DC) savers' retirement income following the introduction of the Coalition Government's 'freedom and choice' pension reforms announced in the 2014 Budget. She invited Professor David Blake, Director of the Pensions Institute at Cass Business School, to lead the review, with Professor Debbie Harrison of the Pensions Institute as a senior consultant.

The terms of reference are as follows. 'The Independent Review of Retirement Income will consider how to support a pensions market that works for all, retaining flexibility and choice on how savings are accessed and drawn down, while ensuring all savers, including those on low and modest incomes, are able to secure a decent and reliable retirement income.

Specifically, this will include:

- How to ensure that the workplace pension retirement products available to people are those best suited to ensure they have security and confidence in retirement
- The support savers need to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment
- How savers can be helped to manage longevity risk
- The role of the National Employment Savings Trust (NEST) in helping savers to access good quality retirement products
- The role of collective pension schemes and how these could be introduced in the UK'.

On 24 November 2014, the Review team issued a Consultation Paper containing 76 questions. As part of the consultation process, we also held a number of meetings at which representatives of consumer groups, trade unions, scheme sponsors, providers, consultants, and fund managers participated. These meetings generated very useful feedback and we are also grateful to the participants in those meetings. They were held under Chatham House rules which means that the quotations we use from these meetings are unattributable. A summary of the feedback to the consultation paper has been prepared by Dr Edmund Cannon from Bristol University and a Fellow of the Pensions Institute. Again, the responses that we cite are unattributable.

The Review team are members of the Pensions Institute, an independent academic research centre, based at Cass Business School. We believe that the subject of this Review is crucial to the long-term success of both 'freedom and choice' and auto-enrolment, the latter being a policy decision which has cross-party support. We agreed to undertake this study because we believe it is important to have pension schemes which generate good consumer outcomes in the face of the significant structural and social challenges facing people at retirement. The Report is independent and not party political. We would have undertaken

the same task had we been invited to do so by any other organisation. The Labour Party has not sought to influence the Report in any way. Our model for writing the Report was the Pension Commission and its two reports of 2004 and 2005.[1] Nevertheless, we believe that this is the kind of report that the Government should have commissioned before introducing the pension reforms announced in the 2014 Budget.

We used four sources of evidence gathering: published reports and surveys, individual interviews and panel session discussions, the responses to our consultation paper, and press articles. In total, we reviewed around 100 reports and surveys, read more than 2,000 press articles, and had discussions with around 100 people. In addition, 30 individuals and organisations kindly responded to our Consultation Paper. We are grateful to all the individuals and organisations that have directly and indirectly helped us to prepare this Report. We would particularly like to thank the pensions journalists whose articles summarising the often turbulent developments in the UK pensions market over the last 18 months have been invaluable to us: they allowed us to listen in on the fascinating conversations taking place in the pensions industry during this period. However, we absolve all these people and organisations from any responsibility for the contents of this Report.

In terms of the Report's structure, the early sections of each Chapter are used to assemble the relevant facts, arguments and industry views. These are followed by a section summarising the specific feedback we received from our interviews and the consultation. The final section of each Chapter is used to provide an analysis and recommendations. The vast amount of material that we sifted through and the discussions that we had enabled us to identify themes and patterns in industry practice, regulatory pronouncements and political decision making which both informed our analysis and guided our recommendations. There is also a separate Executive Summary of the Report.

I would like to thank: Professor Debbie Harrison for conducting a significant amount of the background research and interviews and for commenting on early drafts of the Report, Tom Boardman (Visiting Professor at the Pensions Institute) for commenting on early drafts of the Report, Dr Edmund Cannon (of Bristol University and a Fellow of the Pensions Institute) for preparing a summary of the feedback to the Consultation Paper, and Professor Kevin Dowd (of Durham University Business School and a Visiting Professor of the Pensions Institute) for preparing the illustrations of drawdown withdrawal strategies using the

[1] U.K. Pensions Commission 2004, *Pensions: Challenges and Choices: The First Report of the Pensions Commission*, TSO, London.
(image.guardian.co.uk/sys-files/Money/documents/2005/05/17/fullreport.pdf);
U.K. Pensions Commission 2005, *A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission*, TSO, London.
(webarchive.nationalarchives.gov.uk/+/http:/www.dwp.gov.uk/publications/dwp/2005/pensionscommreport/main-report.pdf)

PensionMetrics software. I have tried to check all the facts as well as I can and I apologise for any errors that remain.

The Report uses the following terms interchangeably: saver, investor, consumer, scheme member, client, customer, policyholder and individual. We also need to recognise that the pensions world is one of constant change. Even an organisation as longstanding as the National Association of Pension Funds (NAPF) has decided that it needs a new name and in October 2015 rebranded as the Pensions and Lifetime Savings Association (PLSA). However, for most of this Report, it will still be referred to by its original name. Constant change is a feature of pension policy and regulation. This Report was finalised in mid-February 2016 and does not take into account developments after this point.

The overarching question that the Report seeks to address is this: What is the best way for the private-sector DC pension system to reconcile the fundamental principle of auto-enrolment during accumulation – the success of which is predicated on member inertia – with 'freedom and choice' during decumulation – the success of which is predicated on the ability of members to make informed decisions?

The Report, despite at times being critical, is intended to be helpful and constructive. It is also intended to start a debate on the future of retirement income provision in the UK following the introduction of 'freedom and choice'. We look forward to participating in this debate.

**Professor David Blake**
**Director, Pensions Institute**
**Cass Business School**
**London**

March 2016

## List of organisations and individuals participating in the consultation exercise

We are grateful to the following organisations and individuals that took part in individual interviews, panel sessions, or responded to the Consultation Paper. We apologise to those who participated but whose names we inadvertently failed to record.

***Organisations***

ABI
ACAEW
Adviser Advocate
Aegon
Age UK
AllianceBernstein
APFA
Aon Hewitt
Aviva
Axa Wealth
B&CE: The People's Pension
Barnett Waddingham
BlackRock
Brighton Rock
Buck Consultants
Capita
CBI
Eversheds
Fabian Society
Fidelity
Finance & Technology Research Centre
Financial Inclusion and Markets Centre
Financial Services Consumer Panel
First Division Association
Friends Life
GMB
Hargreaves Lansdown
Hymans Robertson
Investment Association
JLT
Joseph Rowntree Foundation
JP Morgan
Key Retirement Solutions
the lang cat
Lane Clark & Peacock
Legal & General
LSE
LV=
Macfarlanes
MetLife
MGM Advantage
Money Advice Service
NAPF
NFU Mutual
NOW: Pensions
OECD
Partnership
Pension Playpen
The Pensions Policy Institute
The Personal Finance Society
Pimco
Reed Smith
Retirement Intelligence
Royal London
RSA
Prudential
Slaughter & May
Society of Pension Professionals
Standard Life
Strategic Society Centre
SSgA
Trinity Mirror
TUC
Unite
Which?
Wragge Lawrence Graham
Xafinity

***Individuals***

| | | |
|---|---|---|
| Jo | Ahern | ABI |
| Anete | Andermane | Met Life |
| Ken | Anderson | Xafinity |
| Matthew | Arends | Aon Hewitt |
| Camilla | Barry | MacFarlanes |
| Ted | Belmont | Xafinity |
| Philip | Bennett | Slaughter and May |
| Derek | Benstead | First Actuarial LLP |
| Alastair | Black | Standard Life |
| Rob | Booth | NOW: Pensions |
| Adrian | Boulding | L&G |
| Caroline | Bowles | JP Morgan |
| Jim | Boyd | Partnership |
| Yvonne | Braun | ABI |
| Christopher | Brookes | Age UK |
| Philip | Brown | LV= |
| Duncan | Buchanan | Society of Pension Professionals (President) |
| Alistair | Byrne | State Street Global Advisors |
| Edmund | Cannon | University of Bristol |
| Simon | Chinnery | JP Morgan |
| Naomi | Cooke | First Division Association |
| Pete | Cottingham | Prudential |
| Dale | Critchley | Friends Life |
| Katie | Dash | CBI |
| Jurre | de Haan | APG |
| Donald | Duval | Aon Hewitt |
| Ponds | Eduard | APG-NL |
| Huw | Evans | ABI |
| David | Fairs | Association of Consulting Actuaries (Chairman) |
| Jamie | Fiveash | B&CE |
| Helen | Forrest | NAPF |
| Bryan | Freake | Unite |
| Teresa | Fritz | Financial Services Consumer Panel |
| David | Geale | FCA |
| Keir | Greenaway | GMB |
| Dominic | Grinstead | Met Life |
| Steve | Groves | Partnership |
| Carl | Hampton | JP Morgan Chase |
| Andy | Harrop | Fabian Society |

| | | |
|---|---|---|
| Alan | Higham | Fidelity |
| Steven | Hill | Standard Life |
| John | Hills | LSE |
| Peter | Holtzer | Independent International Consultant |
| Stephen | Hull | Eversheds |
| Caroline | Jackson | Partnership Assurance Group |
| Rajiv | Jaitly | Jaitly LLP |
| Jamie | Jenkins | Standard Life |
| Richard | Jones | Scottish Widows |
| Con | Keating | Brighton Rock |
| Louisa | King | Axa Wealth |
| Joanne | King | Axa Wealth |
| Mike | Lawler | NFU Mutual |
| John | Lawson | Aviva |
| Patrick Heath | Lay | B&CE |
| Richard | Lee | Wragge Lawrence Graham |
| Kevin | LeGrand | Buck Consultants @ Xerox |
| Zina | Lekniute | APG |
| José | Leo | The 100 Group of Finance Directors |
| Patrick | Levy | Standard Life |
| Dominic | Lindley | Independent Consultant |
| Jonathan | Lipkin | Investment Association |
| James | Lloyd | Strategic Society |
| Avril | Logan | Society of Pension Professionals |
| Will | MacDonald | Aviva |
| Harinder | Mann | RSA |
| Simone | Massey | Met Life |
| Sandeep | Maudgil | Slaughter and May |
| Mick | McAteer | The Financial Inclusion and Markets Centre |
| Ewan | McCulloch | Scottish Widdows |
| Luke | McCullough | Friends Life |
| Tom | McPhail | Hargreaves Landsdown |
| Andrew | Megson | Partnership |
| Gary | Moore | B&CE People's Pension |
| Neil | Morgan | Capita |
| John | Mortimer | Society of Pension Professionals (Secretary) |
| Robin | Nimmo | Royal London |
| Hugh | Nolan | ACA |
| Richard | Parkin | Fidelity |
| Stuart | Paton Evans | Scottish Widows |
| Darren | Philp | The People's Pension |

| | | |
|---|---|---|
| David | Pitt-Watson | RSA |
| Eduard | Ponds | APG |
| David | Robertson | ACA |
| Hilary | Salt | First Actuarial |
| Nick | Salter | Institute and Faculty of Actuaries (President) |
| James | Shafe | Which? |
| Tim | Sharp | TUC |
| Joanna | Sharples | Aon Hewitt |
| Kate | Smith | Aegon |
| Nicola | Smith | TUC |
| Kate | Smith | AEGON |
| Ben | Stafford | Just Retirement |
| Nigel | Stanley | TUC |
| Hill | Steven | Standard Life |
| Henry | Tapper | Pension Play Pen |
| Jamie | Thunder | The Money Charity |
| Joe | Tomlinson | Tomlinson Financial Planning |
| Bill | Tonks | St James Place |
| John | Turner | Pension Policy Center |
| Ruth | Turnock | Aon Hewitt |
| Graham | Vidler | NAPF |
| Phil | Warner | Hargreaves Lansdown |
| Will | Watling | Altus Limited |
| Jackie | Wells | NAPF |
| Kevin | Wesbroom | Aon Hewitt |
| Richard | Willets | Partnership |
| Seth | Williams | ABI |
| Rob | Yuille | ABI |

## List of abbreviations

| | |
|---|---|
| ABI | Association of British Insurers |
| ABM | Automatic Balancing Mechanism |
| ABR | Anticipated Bonus Rate |
| ACA | Association of Consulting Actuaries |
| AE | Auto-Enrolment |
| AIMSE | Association Of Investment Management Sales Executives |
| aka | Also Known As |
| ALDA | Advanced Life Deferred Annuity |
| ALM | Asset-Liability Management (or Modelling) |
| AMC | Annual Management Charge |
| APR | Annual Percentage Rate |
| ATR | Attitude to Risk |
| BPA | Bulk Purchase Annuities |
| bps | Basis Points (1 bp = 0.01%) |
| BSP | Basic State Pension |
| CA | Citizens Advice |
| CAB | Central Annuity Bureau |
| CARE | Career Average Revalued Earnings |
| CBI | Confederation of British Industry |
| CETV | Cash Equivalent Transfer Value |
| CFL | Capacity for Loss |
| CIDC | Collective Individual Defined Contribution Schemes |
| CIPs | Centralised Investment Propositions |
| CIRG | Capital and Investment Return Guarantees |
| CIS | Collective Investment Schemes |
| CMI | Continuous Mortality Investigation |
| COBS | Conduct of Business Sourcebook |
| COLA | Cost-of-Living Adjustments |
| CPI | Consumer Price Index |
| CPP | Canada Pension Plan |
| CQRF | Common Quote Request Form |
| CRM | Client Relationship Management |
| D2C | Direct to Consumer |
| DA | Defined Ambition |
| DB | Defined Benefit |
| DC | Defined Contribution |
| DCIF | Defined Contribution Investment Forum |
| DGF | Diversified Growth Fund |
| DIA | Deferred Income Annuity |

| | |
|---|---|
| DIM | Discretionary Investment Manager |
| DIY | Do It Yourself |
| DWP | Department for Work and Pensions |
| EET | Exempt-Exempt-Taxed |
| EIOPA | European Insurance and Occupational Pensions Authority |
| ELSA | English Longitudinal Study of Ageing |
| EMD | European Mortgage Directive |
| ERC | Equity Release Council |
| ERISA | Employee Retirement Income Security Act of 1974 |
| ESMA | European Securities and Markets Authority |
| ETF | Exchange Traded Fund |
| ETV | Enhanced Transfer Value |
| FAD | Flexi-Access Drawdown |
| FAMR | Financial Advice Market Review |
| FCA | Financial Conduct Authority |
| FMF | Fund Management Fee |
| FOI | Freedom of Information |
| FOS | Financial Ombudsman Service |
| FPW | Free Partial Withdrawal |
| FRN | Firm Reference Number |
| FSCS | Financial Services Compensation Scheme |
| FTA | Fixed Term Annuity |
| GAA | Governance Advisory Arrangement |
| GAD | Government Actuary's Department |
| GAR | Guaranteed Annuity Rates |
| GMAB | Guaranteed Minimum Accumulation Benefit |
| GMDB | Guaranteed Minimum Death Benefit |
| GMIB | Guaranteed Minimum Income Benefit |
| GMSB | Guaranteed Minimum Surrender Benefit |
| GMWB | Guaranteed Minimum Withdrawal Benefit |
| GPP | Group Personal Pension |
| HMRC | Her Majesty's Revenue And Customs |
| HNW | High Net Worth |
| HR | Human Resources |
| IA | Investment Association |
| IBA | Investment-Backed Annuity |
| ICAEW | Institute of Chartered Accountants of England and Wales |
| ICO | Information Commissioner's Office |
| IFA | Independent Financial Adviser |
| IFISA | Innovative Finance ISA |
| IFoA | Institute and Faculty of Actuaries |

| | |
|---|---|
| IFS | Institute for Fiscal Studies |
| IGC | Independent Governance Committee |
| IHT | Inheritance Tax |
| ILA | Index-Linked Annuity |
| IORP | Institutions for Occupational Retirement Provision |
| IRA | Independent Retirement Account |
| ISA | Independent Savings Account |
| ISO | International Standards Organization |
| KFD | Key Features Document |
| KIID | Key Investor Information Document |
| LIA | Longevity Insurance Annuity |
| LPA | Lasting Power of Attorney |
| LPC | Low Pay Commission |
| LPI | Limited Price Indexation |
| LTA | Life-Time Annuity |
| LTB | Last-Time Buyer |
| LTC | Long-Term Care |
| MAF | Master Trust Assurance Framework |
| MAS | Money Advice Service |
| MBG | Money Back Guarantee |
| MIFID | Markets In Financial Instruments Directive (Directive 2004/39/EC) |
| MIR | Minimum Income Requirement |
| MPAA | Money Purchase Annual Allowance |
| MPC | Monetary Policy Committee |
| MPT | Modern Portfolio Theory |
| MVA | Market Value Adjustment |
| MW | Money's Worth |
| NAPF | National Association of Pension Funds |
| NDPB | Non-Departmental Public Body |
| NEST | National Employment Savings Trust |
| NICs | National Insurance Contributions |
| NS&I | National Savings & Investment |
| NURS | Non-UCITS Retail Scheme |
| OBR | Office for Budget Responsibility |
| OCF | Ongoing Charges Figure |
| OFT | Office of Fair Trading |
| OIR | Office for Inter-Generational Responsibility |
| OMO | Open Market Option |
| ONS | Office for National Statistics |
| P2P | Peer-to-Peer |
| PAYG | Pay-As-You-Go |

| | |
|---|---|
| PHSO | Parliamentary and Health Services Ombudsman |
| PIB | Pension Income Builder |
| PIE | Pension Increase Exchange |
| PLA | Purchased Life Annuity |
| PLSA | Pensions and Lifetime Savings Association |
| PO | Pensions Ombudsman |
| PPI | Pensions Policy Institute or Payment Protection Insurance |
| PRA | Prudential Regulatory Authority |
| PRIIPs | Packaged Retail and Insurance-Based Investment Products |
| PTS | Pension Transfer Specialist |
| QPP | Quebec Pension Plan |
| QROPS | Qualifying Recognised Overseas Pension Scheme |
| RAO | Regulated Activities Order |
| RAS | Resource Allocation System |
| RCLA | Ruin-Contingent Life Annuity |
| RDR | Retail Distribution Review |
| RII | Retirement Income Insurance |
| RPI | Retail Price Index |
| RSA | Royal Society of Arts |
| RSS | Retirement Saver Service |
| S2P | Second State Pension |
| SAFE | Secure, Accessible, Flexible, and Efficient |
| SAYE | Save As You Earn |
| SERPS | State Earnings-Related Pension Scheme |
| SHIP | Safe Home Income Plan |
| SIPP | Self-Invested Personal Pension Scheme |
| SPA | State Pension Age |
| SRPP | Shared-Risk Pension Plan |
| SSC | Strategic Society Centre |
| SWR | Safe (Sensible or Sustainable) Withdrawal Rate |
| TB | Target Benefit |
| TCF | Treating Customers Fairly |
| TDF | Target Date Fund |
| TEE | Taxed-Exempt-Exempt |
| TER | Total Expense Ratio |
| TIPS | Treasury Inflation-Protected Securities |
| TISA | Tax Incentivised Savings Association |
| TPA | Third-Party Administrator |
| TPAS | The Pension Advisory Service |
| TPR | The Pensions Regulator |
| TSIP | The Savings and Investments Policy Project |

| | |
|---|---|
| TUC | Trades Union Congress |
| TV | Transfer Value |
| UC | Universal Credit |
| UCIS | Unregulated Collective Investment Scheme |
| UCITS | Undertakings for the Collective Investment of Transferable Securities |
| UFPLS | Uncrystallised Fund Pension Lump Sum |
| VA | Variable Annuity |
| WGA | Whole of Government Accounts |
| WPAs | With-Profits Annuities |

## Recommendations of the Independent Review of Retirement income

### Chapter 1. Introduction

***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.*

***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.*

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

***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.*

***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 in the case of Solvency II, product designers would be free to use an 'internal model', so long as they explained the differences between this and the standard model.

***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.*

**Chapter 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**

***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 a ssets 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).

**Chapter 4. How savers can be helped to manage longevity risk**

***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 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; inter-generational equity; the practicalities of issuing longevity bonds, such as the construction of reference longevity indices, potential demand, pricing, liquidity and taxation

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

***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.

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

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

*We recommend that the Government looks at the feasibility of establishing collective individual defined contribution schemes.*

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.

**Chapter 7. Conclusion: Developing a National Narrative**

***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.*

***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.*

# 1. Introduction

> *'When I use a word', Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean—neither more nor less'.*
>
> Lewis Carroll (1871) *Through the Looking-Glass, and What Alice Found There*

This Chapter is a scene-setter for the remainder of the Report. We begin by considering how pension schemes have traditionally been used and also how they are likely to be used in future following the introduction of the pension reforms announced in the 2014 Budget. These reforms furnish us with an opportunity to ask anew what a 'good' pension scheme should aim to achieve. There are also risks involved in the provision of pensions and we discuss the key ones. Unfortunately, widespread evidence shows that many if not most pension scheme members do not understand these risks and are unlikely ever to do so, however much guidance or education they receive. This will make it difficult for many of them to make informed choices about how they spend their retirement savings that takes these risks into account. This, in turn, raises the question about whether scheme members should be nudged (or even defaulted) into a well-designed decumulation product that has dealt with these risks in the most efficient and cost-effective ways possible – with the option to opt out, as in the case of auto-enrolment. We then consider the different types of pension member affected by the reforms. Finally, we discuss the attitudes of employers, consultants, providers, investment managers, and trade unions to the reforms.

## *1.1 Pension schemes – uses and risks*

### 1.1.1 Uses

The primary purpose of a pension scheme is to provide life-long retirement income security for however long the scheme member lives.[2] This Report will examine retirement income in private-sector pension schemes, principally workplace schemes set up by employers for their employees. There are currently two types of such schemes in the UK – defined benefit (DB) and defined contribution (DC) schemes. DB schemes – which aim to deliver a pre-defined pension in retirement, typically linked to average or final salary, together with the option of a tax-free cash lump sum – are in decline in the UK private sector and are being replaced by DC schemes – which specify what goes into the scheme in terms of contributions, but not what comes out in terms of the size of the pension. The Report will therefore concentrate on DC schemes, the type of scheme most people will have in the

[2] This definition of a pension scheme as providing insurance against outliving one's resources is well established in the academic literature, see, e.g., Zvi Bodie (1990) Pensions as Retirement Income Insurance, *Journal of Economic Literature*, 28, 28-49; and Nicholas Barr and Peter Diamond (2008) *Reforming Pensions: Principles and Policy Choices*, Oxford University Press, New York and Oxford.

future, although it will also look at transfers from DB to DC schemes. 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.[3]

*Table 1.1 Criteria for a good DC pension scheme*

- Delivers adequate and sustainable pensions;[4] 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
- If individuals are constructing their own pension scheme, they should use products that are effective and easy to understand[5]

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. On the basis of our analysis and feedback

[3] H M Treasury (2014) *Freedom and Choice in Pensions*, Cm 8835 (Session 2013-14), 19 March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/294795/freedom_and_choice_in_pensions_web_210314.pdf.

[4] European Commission (2003), *Adequate and Sustainable Pensions*, Publication Office, Luxembourg.

[5] In a similar way as was imposed on default funds in the accumulation phase. See Department for Work and Pensions (2014) *Better Workplace Pensions: Further Measures For Savers*, Cm 8840, March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

from our various discussions, we believe that a good DC pension scheme will meet the criteria set out in Table 1.1.[6,7,8]

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.[9] Further, the 2014 Taxation of Pensions Act abolished the so-called 'death tax', the 55% tax charge on pension death benefits if the member dies before 75, so that the nominated beneficiary can inherit the residual pension fund without paying any tax. If the member dies after 75, the nominated beneficiary pays tax on the residual pension fund at their marginal tax rate. Given the generally low level of pension savings in DC schemes in this country, this outcome is likely to only be of real benefit to a relatively small number of well-off pensioners.[10] But the consequences will be much more widespread. The inheritability of the pension fund became possible because the Chancellor removed the requirement to annuitise the assets in the pension scheme.[11] At a stroke, the Chancellor converted all pension schemes in the UK – including DB schemes – into savings schemes, with no essential difference between them and other savings schemes, such as independent savings accounts (ISAs). However, the Chancellor *cannot* change the definition of a pension scheme which is to pay a pension until the member dies. Nevertheless, a key implication of his decision is that the risks involved in retirement income provision – in particular longevity risk – have been almost entirely individualised. The benefits from any form of collective risk sharing have been removed.

---

[6] The criteria listed in Table 1.1 will need quantifying for the table to be operationally useful.

[7] The Pensions Regulator has identified the following 6 elements necessary to achieve the good member outcome of an adequate income in retirement in DC schemes:

- Appropriate contribution decisions
- Appropriate investment decisions
- Efficient and effective administration
- Protection of assets
- Value for money
- Appropriate decumulation decisions.

See The Pensions Regulator (2011) *Enabling Good Member Outcomes In Work-Based Pension Provision*, Discussion Paper, January; http://www.thepensionsregulator.gov.uk/docs/dc-discussion-paper-2011.pdf

[8] Note that following 'freedom and choice', it might well be the case that a 'good' pension scheme is no longer provided by a single organisation: there might be one organisation providing the accumulation stage and another providing the decumulation stage. Table 1.1 would have to be modified to reflect this.

[9] David Cameron MP, the Prime Minister, said: 'we want to make sure we complete this great revolution where we're giving people much more power to save, to access their pension and pass their pension on to their children' (reported in Steven Swinford and Dan Hyde (2015) Crackdown on banks that deny loans to the elderly, Daily Telegraph, 18 April).

[10] Very few people will have amassed a significant sum in their pension pot by age 55.

[11] The Chancellor, George Osborne MP, announced in the Budget: 'Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, any time they want. No caps. No drawdown limit. Let me be clear. No one will have to buy an annuity … People who have worked hard and saved hard all their lives, and done the right thing, should be trusted with their own finances'.

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. Strong supporters of the new pension regime are banks and building societies with customers with interest-only mortgages who earmarked no specific savings arrangements to pay back the mortgage loan. If these customers have pension schemes, the mortgage lender can now invite them to exercise their pension 'freedom' and pay off the mortgage.[12]

### 1.1.2 Risks

It is important to be aware of the risks involved in the generation of retirement income from pension savings. The key risks are listed in Table 1.2. Following 'freedom and choice', these risks are now borne directly by DC scheme members.

*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 |

[12] But at the risk of ending up with an inadequate retirement income and the potential cost to tax payers of additional welfare benefits.

| | |
|---|---|
| Longevity risk | The risk that the 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 |

There are a number of ways of dealing with such risks in general:

- The risks can be assumed or 'run' – this might be deliberate (e.g., in the case where a scheme member increases the level of investment risk in their pension fund in the hope of achieving a higher investment return and, hence, a higher anticipated pension[13]) or unavoidable (e.g., in the case of contribution, political or regulatory risk)
- The risks can be regulated against – effective regulation can reduce cost and market conduct risk, for example
- The risks can be explained – by informing people well in advance the importance of giving providers reliable signals of when and how the pension pot will be accessed, or explaining behavioural biases and nudging people towards making optimal decisions

[13] An early example of investment risk following the introduction of the pension reforms was the Chinese stock market crash in August 2015 (dubbed the Great Fall of China), which elicited the following headlines in the Daily Mail (above to an article by Louise Eccles published on 25 August):

> *Don't risk cashing in your pension: Retirees warned they could cause 'irreparable damage' if they withdraw lump sums from their pots at such a volatile time*
>
> - *The top 100 companies in the UK – in which many pensions are invested – have had £170billion wiped off their value in the past two weeks*
> - *FTSE 100 down by almost 10% triggered by Chinese stock market crash*
> - *Fall means pensions invested in market have also plunged by up to 10%*
> - *Britons warned to hold fire on big decisions until markets have stabilised*

- The risks can be reduced – by careful design of the scheme. For example, by careful design of the investment strategy and by making the most of diversification, investment risk can be reduced
- The risks can be pooled amongst members of a given cohort (known as intra-generational risk pooling) – idiosyncratic longevity risk can be pooled and hence made more stable and predictable, but this, in turn, requires scale (i.e., only large pension schemes can do this)
- The risks can be shared between members of different cohorts (known as inter-generational risk sharing) – investment returns can be smoothed across different cohorts using a smoothing fund
- The risks can be hedged if there are suitable hedging instruments – e.g., inflation and interest rate risk can be hedged using inflation and interest rate derivatives, but systematic longevity risk cannot currently be hedged due to the absence of longevity bonds and indexed longevity swaps
- The risks can be managed within a carefully designed default plan into which the members are auto-enrolled. When someone first starts work, this will be a default accumulation plan with a default contribution rate and investment strategy. When someone retires, this could be a default retirement expenditure plan. The onset of a mental impairment, such as dementia, needs to be identified early and carefully managed
- Finally and most worryingly, the risks can be ignored.

Unfortunately, many people do not understand the risks in Table 1.2, especially longevity risk, although they are unavoidable aspects of building up pension savings over a 40-year (or longer) working life and then running down those savings over a retirement period that could last 30 years or more. Even with improved financial education,[14] it is unlikely that many people will fully understand some 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 only 45 minutes of guidance under the 'guidance guarantee' to cover all these issues.[15]

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

[14] The Government has encouraged improvements in financial education for years now, athough there is little evidence that this has been effective. See, e.g., H M Treasury (2008) *Thoresen Review of Generic Financial Advice: Final Report*, March;
webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/media/8/3/thoresenreview_final.pdf

[15] Provided by Pension Wise – see Chapter 3.

expected to manage these risks themselves.[16] 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.

One of the principal lessons of finance theory is that some risks can be reduced through diversification, that is, by pooling or sharing risks. Diversification has been called 'the only free lunch in finance'. As mentioned above, two key risks that can be reduced in this way are investment and longevity risk. This is one of the key benefits of saving for a pension in a large pension scheme. By individualising the risks listed in Table 1.2, the 2014 Budget encourages pension scheme members to give up their free lunch. The inevitable consequence will be that workers with similar salary histories and pension contributions will end up with very different pension outcomes: while some outcomes will be very good, others will undoubtedly be very poor. Many people would regard this as undesirable. We will examine how diversification benefits can be recaptured either in large schemes like NEST (National Employment Savings Trust) or with new types of collective pension schemes.

### *1.2 Pension scheme members*

#### 1.2.1 Who will be affected by the pension reforms?

One of the principal arguments of economic theory is that competition and market forces can deliver good outcomes for consumers. However, the Office of Fair Trading's (OFT) *Defined Contribution Workplace Pension Market Study*[17] in 2013 provided evidence that competition and market forces are not working effectively when it comes to pensions and that the market for buyers is 'one of the weakest that the OFT has analysed in recent years'. This is because 'most employees do not engage with or understand their pensions. Pensions are complicated products, the benefits of which occur, for many people, a long time in the future'.

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

[16] One of the reasons why pension schemes were first set up was because people did not understand and did not manage well these risks.

[17] http://webarchive.nationalarchives.gov.uk/20131101164215/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505

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. Our main emphasis will be on the first group, although we will consider how DB-to-DC transferees, the self-employed and those with employment contracts that do not qualify them for auto-enrolment can also be helped.

### 1.2.2 The impact of the pension reforms on welfare benefits

If things do go badly for members of some of these groups and they run out of money before they die or invest unwisely and end up in poverty in old age, this will be a tragedy for them individually. But it will not be costless for the rest of society. This is because such people can claim certain means-tested welfare benefits which are funded by local and national taxation. The main local benefit is council tax support (previously council tax benefit, but now localised).

In March 2015, the Department for Work and Pensions (DWP) issued a factsheet[18] showing the qualification rules for the following income-related means-tested welfare benefits that will apply in respect of the new flexibilities for accessing pension pots after 6 April 2015:

- Employment and Support Allowance (income-related)
- Housing Benefit
- Income Support
- Jobseeker's Allowance (income-based)
- Pension Credit
- Universal Credit.

The rules are extremely complicated. For those below the qualifying age for a state pension, withdrawals from a pension pot will be treated as either income or capital, depending on certain factors, such as how regular the withdrawals are. If no money has been taken from the pot, it will not be taken into account when calculating benefit. For those over the qualifying age who choose not to buy an annuity, the DWP will assume they have 'notional income' equivalent to that of an annuity, based on 100% of GAD rates.[19] Notional income must be reviewed: after every drawdown of capital; after every drawdown of income which

[18] *Pension Flexibilities and DWP Benefits*; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417473/pension-flexibilities-dwp-benefits.pdf.

[19] These are the maximum withdrawal rates periodically set by the Government Actuary's Department for capped drawdown (which caps the level of income that can be withdrawn to reduce the risk the fund will run out – see Chapter 2); https://www.gov.uk/government/publications/drawdown-pension-tables.

exceeds the notional income level; and at the claimant's request. If people take an income from their pension pot, it will be treated as the actual income if it amounts to more than the notional income.

People who take a cash lump sum will have this treated as a capital withdrawal. Ad hoc withdrawals will be regarded as capital (despite potentially being entirely taxed as income). If the claimant has savings or investments of an amount greater than the 'capital disregard' (currently £10,000), the excess will be deemed to provide an assumed weekly income, currently £1 for every £500 (or part) of the excess.

Pension income may affect entitlement to contributory benefits. For Employment and Support Allowance (contribution-based), all pension income over £85 per week, and, for Jobseekers Allowance (contribution-based), all pension income over £50 per week will be taken into account. Uncrystallised benefits[20] will not impact upon contributory benefits.

Individuals are warned to avoid 'deliberate deprivation'. The factsheet explains the 'deprivation rule' which states that if an eligible individual spends, transfers or gives away any money taken from their pension pot, the DWP will consider whether they had deliberately deprived themselves of that money in order to secure (or increase) entitlement to benefits. If it is decided that the individual has deliberately deprived themselves, they will be treated as still having that money and it will be taken into account as income or capital when any benefit entitlement is worked out.

However, the factsheet does not make clear how the DWP will decide whether someone has deliberately deprived themselves. Commentators have questioned whether people who have made poor investment decisions or been a victim of pension fraudsters would be caught out by this. For example, Neil Lovatt, director at Scottish Friendly, said: 'The Government is promoting the right of the individual to have control of their pension, while reserving the right to decide whether they have used that money wisely. [If a pensioner spends their pot on a Lamborghini, the DWP is likely to take a dim view of this], but if a pensioner loses money after investing in a buy-to-let property, will that be considered reckless? [The rules need to be much clearer about this], otherwise we [will] have bureaucrats making judgments on pensioners with the benefit of hindsight'.[21]

Entitlement to means-tested benefits is also likely to be influenced by the introduction of the new single-tier state pension for future pensioners on 6 April 2016.[22,23] This is to be set

[20] These relate to that part of the pension pot which has not been accessed in any way – see Chapter 2.
[21] Quoted in Harvey Jones (2015) Pension reform may lead to poverty: State will not support spenders with benefits, Daily Express, 1 April.
[22] The following is based on a note from Djuna Thurley, House of Commons Library, 27 March 2015 (1503-243). The new single-tier state pension will replace the basic state pension, the state earnings-related pension (SERPS) and the state pension (S2P).
[23] Pensions Act 2014, s1.

at £155.65, just above the level of the basic means-tested guarantee (i.e., £155.60 per week in 2016-17).[24] Thirty-five qualifying years will be needed to be entitled to the full amount. People with fewer qualifying years will be entitled to a proportionate amount, provided they have at least ten qualifying years.[25] The new state pension is expected to reduce eligibility for Pension Credit, with the main driver for this being the abolition of Savings Credit.

Pensioners with relatively low incomes may qualify for means-tested support through the Pension Credit. This currently has two elements:

- The Guarantee Credit tops up weekly income to a 'standard minimum guarantee' (£151.20 for a single person in 2015-16). Additional amounts are payable in respect of severe disability, certain caring responsibilities and housing costs.
- The Savings Credit aims to provide an additional amount for those aged 65 or over who have made some provision for their retirement. The maximum Savings Credit for a single person is £14.82 in 2015-16. However, Savings Credit is to be abolished for future pensioners from 6 April 2016.[26]

Pensioners with housing assets could also be affected by the Care Act 2014. This introduced new measures for both financing and limiting the costs of long-term residential or nursing care which affects around 150,000 people per year.[27] First, it established a mandatory local-authority-run 'universal deferred payment scheme' from April 2015, which means that people might not need to sell their home in their lifetime to pay for their care costs. Instead, if a local resident meets the eligibility criteria, the local authority pays certain care costs and a debt is established against the local resident's main home. This is a loan against the value of the property which is repaid on the local resident's death. The Department of Health states that most people can use 'around 80% to 90% of the equity available in their home. The limit on equity is to protect you from not having enough money to pay sales costs of the property - like solicitors' fees - and to protect the council against a drop in housing prices and the risk that it may not get all of the money back'. Councils can charge interest linked to the cost of government borrowing, up a current maximum of 2.65% p.a.

Second, the Act establishes a £72,000 cap on care costs. The original plan was to introduce the cap in April 2016, but, in July 2015, the Government announced that this would be delayed until 2020. The cap will be means-tested. Those with assets of less than

---

[24] The Prime Minister, David Cameron MP, claims the single-tier pension will be adequate to live on (reported in Michael Klimes (2014) David Cameron claims single-tier pension is adequate safety net, Professional Pensions, 20 October).

[25] Pensions Act 2014, s2. In July 2015, the DWP announced that only 37% (222,000 out of 600,000) of pensioners will be able to claim the full amount in 2016. This is expected to rise to 50% by 2020 and to 84% by 2035.

[26] Pensions Act 2014, s23 and Sch 12 Part 3.

[27] http://www.local.gov.uk/care-support-reform/-/journal_content/56/10180/6522542/ARTICLE

£17,500 receive free care. There is then a sliding scale of state support up to a threshold of £123,000. Those with assets (including pension assets) above £123,000 will receive no help towards the cap. In addition, the cap covers only the cost of personal care (help with washing, dressing, eating and mobility) and medical care (requiring nursing supervision), but not 'hotel costs' such as food and accommodation. Each council will use a 'resource allocation system' (RAS) to determine the notional cost of care in its area, with costs capped at £230 a week. One council, for example, might determine the cost is £200 a week and, if total care costs are £700 a week, then the resident is responsible for paying the remaining £500 per week. What all this means is that a cap of £72,000 on personal spending on care is likely to be a severe underestimate of the true cost of long-term care. According to Partnership, a care cost funding provider, the true cost could be double the £72,000 cap.

When the means test is applied, different sources of income and capital are assessed in different ways. In the case of pension or annuity income, 50% of this is disregarded if the claimant has a partner. In the case of flexi-drawdown,[28] the entire drawdown fund will be treated as a capital asset, with an income tariff, equivalent to a single life, non-escalating annuity, applied to it. This could mean that the care resident needs to make a greater personal contribution in the case of drawdown than in the case of an annuity.

### 1.2.3 Pension adequacy and pension inheritance

We note that one of the good outcomes of a DC pension scheme was an 'adequate' pension. But this will largely depend on the level of contributions made to the scheme and the investment returns on these prior to retirement. It is generally not possible – due to the risks involved – to achieve this objective from low levels of pension savings that rely on unrealistically high real rates of investment return being realised over extended periods. Since our Report is about retirement income, we will be looking at good outcomes, conditional on the contributions made during the accumulation phase. We have not been asked to address the question of the adequacy of pensions or the adequacy of pension savings.

Nevertheless, we note that, as a society, we are collectively not saving enough for our pensions.[29] Amongst 'baby boomers' in the 55 to 74 age range, 40% have not yet begun to save for a pension, according to a recent Blackrock Investor Pulse survey.[30] Of those with savings, 63% hold them in cash which has lost 15% of its purchasing power over the last 5 years due to inflation. At the other end of the age range, saving is also a very low priority for 'millennials' – those born after 1980 – according to recent research by BNY Mellon.[31] Yet for

[28] This is discussed in Chapter 2.

[29] See the Appendix to this Chapter for a review of some recent studies investigating this proposition.

[30] Natasha Browne (2015), Research - 40% of baby boomers not saving for retirement, Professional Pensions, 27 January.

[31] Paul Traynor (2015), The Generation Game – Savings for the New Millennial;

living standards to grow, we need to invest in increasing the economy's capital stock and the only sustainable source of long-term investment is long-term savings.[32, 33]

Aegon has reported research which shows that people have difficulty in calculating how much they need to save for retirement, since they are not clear what they will get from the state pension scheme in future. A man aged 65 would need approximately a £200,000 pension pot to buy a £150-a-week income (roughly the same as the new single-tier state pension from April 2016). Duncan Jarrett, of Aegon UK, said: 'This is significantly more than the £63,815 those approaching retirement have on average in their private pension, highlighting just how fundamental the state pension is to people's retirement plans'.[34] In 2014, the Joseph Rowntree Foundation published research which suggests that the minimum income needed in retirement is £13,500.[35] Since the new single-tier state pension is approximately £8,000 p.a., then someone needs a minimum of £5,500 in annuity income. At age 65, this costs £103,000 for a level annuity and £145,000 for an index-linked annuity. If someone delays the annuity purchase until age 75, the costs are £76,000 and £102,000, respectively.[36] Even these minimum amounts are well in excess of what most people currently have in their DC pot.

A couple of surveys were published in April 2015 on attitudes to inheritance of the pension fund after the member's death. The first was a survey sponsored by Zurich of 1,000 people aged over 50 with DC pensions. Although 79% valued the reforms, 55% said they would have no effect on how they spend or save in retirement, while 35% reported that they did not expect to leave much of the pension fund to pass on to their family. Only 5% said they would change their behaviour, knowing their beneficiaries would inherit more of the pension following the removal of the 55% 'death tax'.[37] The second was a survey sponsored by HSBC, and contained in a report called *Choices for Later Life* which found that 26% of UK respondents said retirees should spend all their money, while just 5% thought they should save as much as possible for their inheritors. The 'spend versus save gap' of 21 percentage

---

http://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/performancemagazine/articles/lu-generation-game-savings-millenial-012015.pdf

[32] No society can indefinitely borrow to invest.

[33] There is, of course, an alternative to saving for retirement and that is not retiring at all. It was not many generations ago that this is what happened in the UK and elsewhere, one worked until one dropped. This is some evidence that this is returning to the UK: there are some people who simply cannot afford to retire. Around 12% of the UK population over statutory retirement age still work (Labour Market Statistics, Office for National Statistics, March 2015).

[34] Reported in Amy Frizell (2015) Pension system changes are putting people off saving for their retirement, experts warn, Independent, 24 August.

[35] Abigail Davis, Donald Hirsch, and Matt Padley (2014) *A Minimum Income Standard for the UK in 2014*, Joseph Rowntree Foundation, June; http://www.jrf.org.uk/publications/minimum-income-standard-2014.

[36] http://www.sharingpensions.co.uk/annuity_rates.htm#text5

[37] Reported in 'Death tax cut fails to sway savers' plans – study', Professional Adviser, 30 April 2015.

points was higher than for any of the other 15 countries involved in the survey; the overall average was 8 percentage points.[38] Despite these findings, there has been a significant increase in the demand for advice about pensions and inheritance tax planning since the Budget announcements, according to a survey of accountants by Investec Wealth & Investment.[39]

### *1.3 Employers and consultants*

We held a number of meetings with employers, as sponsors of occupational pension schemes, and their consultants between January and April 2015. One example was a meeting with members of the CBI's pensions panel on 25 February 2015 and another was with the Society of Pension Professionals on 6 January 2015. There were also many separate face-to-face meetings. We discussed a broad range of issues which we summarise under the following headings.

What are the attitudes of employers in general to 'freedom and choice'?

A typical response from a consultant was this: 'We know that employers are absolutely disenchanted with Government pension policy about "freedom and choice". In particular, it does not help them with retirement management now that employees can take their pot as cash from age 55 and continue working for as long as they want/need to. So, for employers, the DC scheme is no longer a key feature of the reward structure – if they want to improve attraction/reward, they do this through a share scheme, for example'.

Overwhelmingly, employers called for a period of stability in pensions policy. They noted that the 2014 Budget was completely unexpected, massive in impact, and the reforms were introduced without any consultation. Employers need stability from a business perspective – they are still dealing with a whole range of major issues, including auto-enrolment (AE), the ending of contracting out, DB funding issues, etc. Business systems take time to adapt in response to major changes. Employers believed it was essential that policy makers really made an effort to understand how the pensions market works in practice and how it works for different types of employers. Currently, this is not the case: 'How can ministers and civil servants understand if they are remote from the real world and if they were auto-enrolled into a gold-plated, tax-payer-funded DB scheme when they started employment?' In view of this, some employers were keen to explore the idea of a permanent pensions commission.

[38] http://www.hsbc.com/news-and-insight/2015/easing-into-retirement

[39] Reported in Carmen Reichman (2015) Pensions and IHT behind 'sharp rise in demand for financial advice', Professional Adviser, 24 April. This is likely to mainly from those with above-average incomes and/or savings.

## Do employers differ in their responses to 'freedom and choice'?

Employers are grouped along a spectrum. At one end are those employers and their advisers who want to encourage their scheme members to transfer out of the DB scheme in order to de-risk it. Some employers expected 50% of their members to transfer and are promoting/advertising transfer values (TV):

- using all communications channels
- actively targeting those above age 50
- TV information in retirement packs
- TV information in annual benefit statement.

At the other end are large long-established employers running a single trust-based DC scheme which was set up when the DB scheme was closed down. Such employers:

- are more paternalistic partly by nature or history and partly because they have a reputation to protect
- feel the need to do *something* to protect employees from themselves; they want current and future employees to know that they look after their staff at the point of retirement and beyond
- are not commercial – they are not trying to sell anything
- are big, compared with new AE schemes – some go back more than 20 years.

Other employers in this second group include the outsourcing industry, facilities management, former-public-sector companies, etc. They have a very high staff turnover rate for a lot of workers, but also a significant number of long-service employees – and they need to be able to retire them efficiently.

## Employers' attitudes on value for money for scheme members

One employer told us that having paid 16% p.a. into employees' pension pots, he wanted to ensure members secured value for money in drawdown. This type of employer is likely to ensure members get the right sort of help. This might not be just because they are altruistic, it is also because it makes good business sense, since efficient retirement solutions avoid the HR log-jam.

When addressing the needs of the majority of auto-enrolled members, the employers that we interviewed recognised the importance of caution when assessing the pot size. The pensions industry (providers and advisers) tends to assume that £80,000 is a large sum, even though this buys a relative small annuity of only around £4,000 p.a. Employers were concerned that the industry would focus more on the fee/commission/profit that can be made than on the solutions it could provide. Many thought that retail drawdown products were expensive.

However, the OFT's *Defined Contribution Workplace Pension Market Study* cited earlier also pointed out that 'many employers may not have the capability or the incentive to drive competition on the key elements of value for money in the interests of scheme members…Employers may also seek to prioritise the interests of scheme members that are current employees, over those scheme members that are former employees'. The last point is likely to be very important when it comes to retirement income in the new pensions environment: we were told on numerous occasions that many employers will just want to see the their retired employees off their books and will have little interest in how they spend their pension pot.

## Value for money for employers

Employers also told us they are keen to secure value for money in return for company pension contributions. The benefit to the employer of running a scheme has changed significantly since the hey-day of final-salary schemes. The extent to which employers 'care' about employees' pensions is closely linked to staff turnover and age. Many employers still use the pension scheme for traditional recruitment/retention purposes, e.g., they offer a 2-for-1 match (so if the employee puts in 5%, the employer will put in 10%, giving a total contribution of 15%). Some employers still have low staff turnover (one employer told us this was just 2% in his company) and so being able to provide an adequate secure retirement income is a very important benefit and really valued by employees. Attitudes will be different in the case of a call centre with 200% annual staff turnover of mainly young employees. In such businesses, the cost of a pension scheme above the legal minimum is disproportionate to the benefit to the business.

The 2014 Budget combined with the loss of the right to retire employees at a specific age (as a result of age discrimination legislation) means that, for employers, the pension scheme 'has fallen apart' as the key tool in retirement management. So pensions are deferred pay, but key questions employers are asking are (a) to what age is pay deferred? and (b) how long does our commitment last after that? The Budget changes actually push some decisions out to an older age than ever before. If employers offer scheme drawdown, they need to know when to annuitise and this will be at a much older age than employers are used to dealing with. Employers will have a long-term risk on their books, especially in relation to the cognitive issues many of their older former employees will face – this is very worrying for employers.

Employers are very keen to regain control of human resource management in their businesses. Even HR managers – generally the strongest supporters of a pension scheme in any business – are beginning to think that the cost of the scheme does not represent value for money for the business. Finance directors – traditionally amongst those in a business who are the least interested in the company pension scheme – have become very focused on this and are increasingly convinced that even a DC scheme is not a worthwhile business

cost – especially given the level of contribution needed to deliver an adequate pension and the risk that employees can no longer afford to retire.

Furthermore, we were told that the following attitude was common amongst trustees: 'Trustees really, *really* don't want a pensioner category added to the existing active and deferred member categories. In fact, they don't even want deferred members and get rid of them whenever they can.' The treatment of deferred members gives us an indication of what is likely to happen to retirees in some trust-based DC schemes. We understand that trustees usually have the right to force annuitisation by default. We were told that many trustees conduct an annual 'sweep up' exercise and transfer deferred members to contract-based arrangements. Since this is likely to be the existing provider's personal pension (rather than an aggregator contract-based DC scheme), it is quite possible that the annual charge would be higher (some trustees insist on no increase; others do not). We were told that many trustees will take this same approach to retired members, which means that unless the member has already taken action, he or she will be transferred into a contract-based DC pension within the first year. We understand that trustees have the right to do this without seeking the member's permission.

The implication of this trend, if the 'sweep up' practice becomes extensive and if retirees are transferred from trust- to contract-based arrangements, is that the trust-based model for auto-enrolment could unravel. Employers – the buyers of schemes – will decide that it is much easier to use a contract-based scheme from the outset.

So the future of private sector pension provision in the UK might well be very different from the past as a result of recent policy changes, and not just because of 'freedom and choice', but also because of the reductions in the annual allowance and the lifetime allowance and possible changes to the system of pension tax relief. These latter changes and potential changes significantly reduce the value of directors' pension benefits – so why should directors be interested in pensions for their employees? In future, firms might provide just the minimum level of contributions to an AE scheme and offer some other employee benefits (e.g., SAYE), but also set up non-pension corporate trust or custody accounts for certain high valued employees. The aim would be to use a non-pension route to maintain corporate control over when employees can afford to retire.

### *1.4 Providers and investment managers*

We participated in a number of meetings and events between January and March 2015 with providers – mainly insurance companies – and their representative body, the ABI. We also met a selection of investment managers and their representative body, the Investment Association. This section summarises the various views expressed by individuals representing these organisations under the following headings.

## What are the attitudes of providers and investment managers in general to 'freedom and choice'?

The following points emerged from our discussions:

- 'The 2014 Budget changes were introduced without consultation with industry: "once the genie is out of the bottle, it's very hard to put it back in"'
- 'There has been no stability in pensions policy since the 1988 Income and Corporation Taxes Act introduced personal pensions to replace retirement annuity contracts and Section 226 policies from 1 July 1988'
- 'The only policy success in recent years has been auto-enrolment. There has been no success in increasing engagement, or in financial education, or in getting people to understand the risks they face. Safeguards only work if people are engaged and understand these risks'
- 'No further quick changes. We may need change, but it must be done slowly and carefully. Any further changes need to take account of existing policy changes'
- Insurers (including those with investment management arms) need to address the lack of consumer trust. An interviewee – from a provider – told us: 'Currently, provider self-interest drives outcomes'
- 'The various mis-selling scandals over the last 25 years are "open sores". Insurers are trusted less than banks and estate agents'
- 'Insurers need to reform to meet the entire set of needs in decumulation, which comprise not only insurance products, but also investment management. They need to adapt to survive'
- Insurers accept that it is the clients' money and that the clients can do what they like with it –'we don't want to be in the press saying we wouldn't give it to them'
- 'A key issue which we cannot duck is the inadequacy of savings. The best decumulation market in the world cannot compensate for this'
- 'Another key challenge is the younger generation which will rely entirely on DC. One in three babies born in 2015 will live beyond age 100'
- 'Innovation is essential. In other sectors, providers offer automatic upgrades in terms of tariffs and products (e.g., mobile phone). There was no reason why the pension industry should not do the same. Existing customers should be offered the latest products and pricing. Old products should be decommissioned without penalties to existing customers'
- 'Retirement will no longer be a point-in-time event'
- '"Freedom and choice" has not changed customers' needs'.

## What is a 'good' pension scheme trying to achieve?

A good pension scheme needs to deliver a minimum of three things:

- Accessibility

- Inflation protection via investment performance
- Longevity insurance.

Good outcomes for a pension scheme will be:

- A sustainable income
- The flexibility to take into account personal circumstances
- Customers do not want to be surprised by what could happen in 10 years' time, i.e., running out of money.

However:

- 'Good' is not defined in policy or regulation
- It is difficult to construct a definition because needs vary
- We must also decide if 'good' means the individual gets what they need, rather than what they want.

What are the biggest challenges to achieving these objectives?

The biggest challenge is to stop people from self-harm in terms of tax, charges, investment risk, etc. The biggest risks relate to:

- Tax: if people withdraw too much in a single tax year, they could put themselves into a higher tax bracket for that year
- Charges: the impact of charges relative to returns
- Market volatility risk: taking income after the market has fallen. One provider told us: 'We manage volatility by balancing the source of withdrawals between capital growth and dividends – dividends are important because they still tend to be paid even if the market falls significantly'.
- Composure risk: people need to avoid over-reacting to market volatility – the risk is that if the market 'tanks', people will sell at the bottom; this mainly affects non-advised customers
- Underspending: many people are scared of running out of money, so a big risk is that they under-draw and therefore do not enjoy the retirement they could afford; this is common behaviour in the US.

Another challenge relates to the issue of multiple pension pots. People might have a different pension pot for every job. This fragmentation of DC pots makes it difficult to aggregate. This is compounded by the fact that back books are often sold and resold. One implication is that 'pot size is a terrible proxy for wealth – people could have secure DB pensions and might need a bridging pension for a few years'. There was support for the

concept of a 'pension dashboard' which shows the state pension, any DB pension and up to three DC pension pots. This would need HMRC and state pension calculators to plug in.[40]

### *1.5 Trade unions*

A panel of trade unionists and TUC officials (together with two consumer group participants) met with us on 12 January 2015 to address the following questions.

What should be the primary aims of a 'good' DC scheme?

The view of the panel members was that the primary aim of a good DC scheme should be to provide a lifelong index-linked income in retirement. This is because there is a 'lack of longevity risk awareness' and because there is 'little merit in a predictable income that is declining in real terms'. One participant said: 'People do not understand inflation or longevity very well. I think the answer is that we need to have good defaults so people are nudged into having some kind of inflation-linked income. Why is the only choice level or RPI-linked annuities? Is there not a sense that people spend more in their early retirement? However, not everybody has a predictable U-shaped expenditure need; spending more in early retirement then becoming frailer. These are the sorts of things we might think about in a default strategy'. However, the same participant conceded that: 'It is rational to take out a level annuity if you have a small pot. Most of your income is from the state pension. This suggests that there should be some inflation linking but not quite the expense of RPI'.

Another participant said: 'There is also the issue of who pays for social care. This is crucial for knowing what is an adequate pension. Could it be something like a 50% target replacement ratio? Similarly, who is paying the pension contributions? What is the employer's role in that? Historically, employers have paid much more in contributions into DB schemes. Are we still expecting good DC schemes to replicate the proportion of income that DB does? It doesn't do that. Good DC only comes about with adequate contributions'.

How do you assess value for money?

We next asked about value for money as a primary aim of a good scheme which led to the following discussion:

- 'It is difficult to define value for money. It is impossible when you do not know what the charges are. No-one knows the full extent of hidden charges'
- 'For accumulation, NEST provides some sort of target or benchmark for other schemes regarding their charges. A NEST-like vehicle in decumulation might echo that by providing a standard others could match'
- 'If you think how difficult shopping around for an annuity is, it's going to be even more difficult in future under drawdown. There will be investment charges,

[40] These would have to deal with the different inflation uprating rules for the different schemes.

administration charges, platform charges, even before you get into the transaction costs. It is going to be very difficult for people to compare'

- 'Given that we know retired people will not be rational consumers in a market place, how do we get institutional arrangements that have trust-based decumulation vehicles of sufficient size and scale to negotiate good value contracts? In the same way NEST has done well to secure low charges from fund managers because they know pots will get much bigger in future; and People's and NOW probably have got charges down too. We need a limited number of large trust-based schemes that can really push the investment managers down to the lowest possible charges'.

What are the longer term consequences of 'freedom and choice'?

One participant said: 'An unintended consequence might be that companies switch to contract-based schemes. I think it is unrealistic to expect an employer-sponsored trust-based DC scheme to be to be looking after their pensioners too – as well as current workers. I wonder whether there should be a way for occupational trust-based single-employer schemes to pass on assets to a trust-based decumulation vehicle. It could be NEST. We need to learn the lesson of auto-enrolment which is that the market failed, particularly, low and middle income earners. You need to have a new public policy-based, trust-based decumulation vehicle. It would provide an option for schemes that do not want to carry on doing that. I am worried about what small contract-based providers can offer in terms of decumulation. I am also worried about the expense of advice. For small pots, guidance is probably sufficient. Members with large pots have more need for advice, but are also more capable of paying for that usually. I think there is a vested interest in the pensions industry for making everything as complicated as possible. For low and middle income earners, it should be a commodity product. Only a minority of employers will want to operate decumulation options for their workforce. It is easy to get wrong. The advantages to the employer are minimal'.

Another participant agreed: 'Employers might be keen to look after current contributors, but not so when they have left their employment. Few employers make good contributions to DC schemes. What does that tell you about their likely enthusiasm for providing decumulation products?'. Yet another said: 'If an employer is putting in extra into pensions, they will want it to go as a benefit to existing staff, not those who have left. There is no point providing benefits at that stage'.

### *1.6 Wider issues*

The 2014 Budget changes will have wider macro-economic consequences beyond those that affect pension scheme members and sponsors. Of particular importance is what will happen to the UK bond market. The gilts market is the longest maturity bond market in the world as a result of the demand by pension schemes and insurance companies for long maturity bonds to match their pension and annuity payments. This has helped to drive down long-

term bond yields, which have been driven down further by the Government's quantitative easing programme. The corporate bond market has also benefited from this as insurers have switched to this sector in search of higher yields. However, annuity sales have fallen by 60% in the year since the Budget[41] and this has had a significant impact on the corporate bond market. According to Andreas Michalitsianos, manager of J.P. Morgan Asset Management's Sterling Corporate Bond Fund, issuance in the long-dated sterling corporate bond market has been driven to the point of extinction. He said: 'What [the pension reforms] did was take away a natural buyer of long-dated investment grade corporates. The market for annuities was £11bn p.a., and two-thirds of that made its way into the sterling corporate bond market so, in context, that means a significant slowdown….The trend is likely to be here for the long term, as future demand for annuities is unlikely to return to previous levels'.[42] The Government could also find it much harder to issue long-term bonds in the future due to reduced demand from annuity providers.

However a report from CREATE-Research and Northern Trust was more optimistic about the future of annuities. Based on interviews with 15 insurance companies and investment managers, the report stated: 'Over time annuities will make a comeback within a new hierarchy of products, with diversified income funds at the bottom and annuities at the top. In between, two new product sets will emerge: pathway funds that target retirement income in the accumulation phase (e.g., target date funds, diversified growth funds) and managed drawdown funds offering a steady income'.[43] The Budget also had a significant impact on annuity pricing. According to Billy Burrows, the annuity expert: 'The pension freedoms have played havoc with annuity pricing', with average standard annuity rates at their lowest ever level in April 2015.[44]

As a final point, we note that the ending of both private-sector defined-benefit pension provision in the UK and the requirement to annuitise private-sector DC pension pots will radically change the concentration of longevity risk in the UK. Until recently, this was shared between the state – via state pension provision – and the private sector – via company DB pensions and annuities sold by insurers. Under 'freedom and choice', individuals now bear their own idiosyncratic longevity risk. But if things go wrong and a significant proportion of these individuals outlive their pension pots, the burden for bailing them out will fall exclusively on the state – in other words, the next generation of tax payers. They might, in

[41] Reported in Hannah Smith (2015) Pensions freedom - L&G explores new business areas as annuity sales drop, Investment Week, 6 May.

[42] Reported in Alice Rigby (2015) UK long-dated credit is 'on the brink of extinction', Investment Week, 5 May.

[43] Reported in Sebastian Cheek (2015) Designing a secure retirement, meeting the evolving needs of DC schemes, portfolio international, April.

[44] Reported in Josephine Cumbo (2015) Annuity rates fall to record lows after sweeping pension reforms, Financial Times, 23 April.

turn, refuse to help out their reckless and profligate forebears, leading to intergenerational conflict.[45]

### *1.7 Responses to the consultation paper*

We will summarise the responses to the first two questions in the consultation paper here.

1. *(a) What should be the primary aims of a 'good' DC scheme? Please explain. (b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined? (c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?*

Responses to this question were quite varied (and some respondents listed many desiderata while others noted just one). However, there was surprisingly little agreement amongst pension professionals about what the aims of a good DC pension scheme should be. With this important point in mind, three themes did stand out as being important. First, the level of pension savings should be adequate. Second, pension savers need choice and flexibility. Finally, pension savers need simplicity to help them engage with the process.

2. *(a) Do you agree with the breakdown of risks listed in the Introduction? (b) Are there any important risks we have not identified?*

Ninety-five per cent of respondents agreed or largely agreed with the breakdown of risks. Additional risks (or issues) were also mentioned: health and long-term care risk; risk via shocks to a partner or family; lack of engagement by savers; sequence-of-returns risks and shocks; delays in realising that mistakes had been made and consequent delays in taking remedial action; the risk that regulation might stifle competition and raise costs.

### *1.8 Analysis*

Our discussions with representatives of employers, consultants, providers, investment managers and unions together with the feedback we received from the consultation have provided invaluable inputs into our analysis in this Report 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'.

One of the key reasons why enlightened employers established pension schemes in the nineteenth century was to manage the exit of their employees from the company when they were no longer capable of productive work, while ensuring that their former

[45] See, e.g., David Blake (2012, p.51) It's the demographics, stupid!, ai-CIO.com, May/June.

employees did not live in poverty in old age. In those days, retirement was a single event, while today it is a process. This, in turn, has meant that age management has become an increasingly important aspect of human resource management, especially in large organisations. However, this becomes considerably more difficult following the 2014 Budget. If employees over the age of 55 spend their pension pot unwisely, they may not be able to retire as planned and may be forced to stay in post, often with little or no notice given to the company. Our interviews revealed that employers are not at all happy with this prospect. Inevitably, it will lead to many of them questioning why they now need to have a pension scheme. They are, of course, required to provide their employees with access to a pension scheme at the AE minimum, but many will begin to wonder why they even need to do that, given that many of their employees do not appear to value pension benefits and that recent governments have massively reduced the incentives for company directors to accrue pension benefits for themselves.

We might well look back at the 2014 Budget as the event that marked the end of private-sector employer commitment to providing any pension provision above the legal required minimum. Naturally, we would regard that as little short of tragic. This is because: (a) we find it hard to see what alternative cost-effective age management tools are available to employers, (b) we find it hard to see what other vehicles will enable employees to save enough to provide a decent life-long standard of living after they retire, and (c) we believe it will put great pressure on governments to raise the value of the minimum safety net provided by the state pension or to increase the state pension age even more rapidly than is currently planned. Nevertheless, our Report is about the decumulation of existing pension assets and we devote the rest of this Report to this task.[46]

Our interviews appear to show that employers are bifurcating into two groups. On the one hand, there are those employers who see 'freedom and choice' as a unique opportunity to reduce their DB pension deficits, by encouraging scheme members to transfer out into a DC scheme – when they do this, they take their share of the deficit with them. How often is an employer given the opportunity to cut their workers' (deferred) pay[47] by 15% or more and the workers believe they are better off as a result?

On the other hand, there are paternalistic employers who want the best for their former employees, but who are terrified of being sued if things go wrong. An interesting message from our interviews is that 'freedom and choice' has increased risk aversion on the part of employers. Some employers would like to provide advice for their soon-to-be former employees, but are reluctant to do so in case it later backfires. Some employers are even considering scheme drawdown, e.g., by offering decumulation defaults that involve drawdown with automatic annuitisation triggers if the fund falls below a certain level to

[46] There is, however, a brief discussion of the adequacy of pension savings in the appendix to this Chapter.
[47] Pensions are deferred pay under EU legislation.

protect against longevity risk. Yet, we are not aware of any employers that have actually gone ahead with this idea and it is clear that many employers would be uncomfortable with any sort of scheme defaults due to the associated long-term liability associated with poor outcomes.

### *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 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.**

### *1.10 The remainder of the Report*

Chapters 2-6 will address the following issues and make recommendations:

- How to ensure that the workplace pension retirement products available to people are those best suited to ensure they have security and confidence in retirement
- The support savers need to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment
- How savers can be helped to manage longevity risk
- The role of the National Employment Savings Trust in helping savers to access good quality retirement products
- The role of collective pension schemes and how these could be introduced in the UK.

Chapter 7 will conclude the Report and present our overarching recommendations.

### *Appendix: Studies on the adequacy of pension savings*

Most studies going back over a number of years show that the level of pension savings in the UK is not adequate to produce a reasonable standard of living in retirement:

- Aegon and the Association of Independent Financial Advisers (2010) *Saving Britain: A White Paper on Rebuilding Britain's Savings Culture*
- Aviva (2010) *Mind The Gap: Quantifying The Pensions Gap In The UK*
- Aviva (2011) *Big Picture Thinking – Towards Sustainable Savings*
- Aviva (2012) *Tackling the Savings Gap: Engagement and Empowerment*
- Chartered Insurance Institute (2011) *An Age-old Problem: Developing Solutions for Funding Retirement*

- Chatham House (2011) *Squeezed in Retirement: The Future of Middle Britain*
- Strategic Society Centre (2011) *Who Saves for Retirement?*

More recently, in March 2015, the Savings and Investments Policy Project (TSIP), managed by the Tax Incentivised Savings Association (TISA), published a report, *Our Financial Future,* found that:

- The average pension pot size at retirement is £28,000, but at least £230,000 is needed for the average household to retire on two thirds of pre-retirement income
- Two thirds of adults recognise they are not saving enough, one fifth do not save anything
- More than half of people would like to save more but cannot afford to
- One third of the population has less than £250 in savings
- Fewer than half (45%) of people of working age are saving for retirement.

The report found that inadequate financial education and a lack of trust in financial services had created a savings gap, which will lead to 'crisis point' in 2035 when the 'auto-enrolment generation' begins to retire. TSIP wants to establish a forum, comprising industry, Government and the Financial Conduct Authority, to agree on a common approach to financial education. It wants to simplify pension taxation so that the benefits of pension saving are made clearer and it wants to see the abolition of the lifetime allowance which acts as a disincentive to save. It also wants pension contributions to increase slowly to around 15%.

In September 2015, the Office for National Statistics published the results of its *Occupational Pension Schemes Survey 2014*. Active membership of occupational DC pension schemes has increased by two million since 2013 to 3.2 million, as a result of auto-enrolment, but average contributions have halved from 9.1% of earnings to 4.7%, because most of these members will have been auto-enrolled on the minimum contribution rate.[48] In December 2015, the ONS revealed that 69% of employees in occupational DC schemes had employer contributions of less than 4%.[49]

A study by PwC, also published in September 2015, reported the results of a survey of 1,200 working adults. It found that 60% have put off saving more into their pension scheme because they are so confused about the current pensions system, with women and younger workers particularly unlikely to put money aside. The survey respondents are only saving an average of 5% of their salary towards their retirement, independent of age. Only 5% are saving more than 10% of their salary and this is mostly those earning over £100,000 a year.

[48] Reported in Michael Klimes (2015) ONS: DC membership jumps by 2m but contributions halved, Professional Pensions, 24 September. Active membership of private sector defined benefit schemes is only 0.6 million.

[49] Office for National Statistics (2015) *Active Members of Occupational Pensions-Employer Contribution Rates*, December.

Average employer contributions are 6%. Philip Smith, head of defined contribution pensions at PwC, said: 'Efforts need to focus on improving saver awareness, increasing auto-enrolment contribution levels and improving financial education, so people can plan for the retirement they hope for'.[50]

Another study published in September 2015 was commissioned by Royal London and conducted by the Centre for Economics and Business Research. This again found that millions of young people are not saving enough for their retirement, yet will face much higher expenses when they retire than the current generation of pensioners. The study estimates that 8.3 million people aged between 30 and 40 are not saving for a pension, but will have to spend 148 per cent more than today's pensioners to maintain living standards by 2050, with the minimum income needed of £33,000 per annum. The implication is that the average 35-year-old who is halfway to retirement in 2050 with a pension pot of just £14,000 will need a fund of at least £666,000 – not including any state pension. Today, a typical pensioner spends £1,084 a month on housing, food, heating and transport. With inflation, this will rise to £1,715 a month by 2050.[51]

In October 2015, the Association of Consulting Actuaries (ACA) published the results of a survey of contributions to auto-enrolment schemes. A total of 477 employers sponsoring over 620 pension schemes responded to the survey. Of these, 46% had reached their staging date for auto-enrolling employees into a qualifying scheme, while many of the rest had not reached their staging date and did not have an existing pension scheme. When scaled up to the level of the economy, the survey suggests that millions of workers having been enrolled into pension schemes since 2012 at the minimum level of combined employer and employee contributions of barely 2% of total earnings. This has had a dramatic effect in reducing the average contribution rate into DC schemes over the last couple of years as Table 1.3 reveals. The table shows the 2% combined minimum contribution rate into NEST, but it also shows that the combined contribution rate into trust-based DC schemes has fallen from 11.4% to 9% since 2013. This contrasts with contributions of up to 26% in DB schemes.

[50] Reported in Lauren Fedor (2015) Pension confusion is leaving British workers unprepared for retirement – PwC, City A.M., 30 September.

[51] Reported in Sarah O'Grady (2015) Poverty warning to millions in their 30s who scorn pensions, Daily Express, 29 September. Another problem is that fewer young people will be able to afford to buy their own homes in future which means that they will not be able to subsequently sell their homes to pay for long-term care. This will have a knock-on effect on future welfare payments.

*Table 1.3: Median contribution rates into pension arrangements provided by responding employers*

| | Employer | Employee |
|---|---|---|
| Group personal pension | 4%<br>(5.8%) | 3%<br>(4.2%) |
| Trust-based DC | 5%<br>(6.9%) | 4%<br>(4.5%) |
| NEST | 1%<br>(NA) | 1%<br>(NA) |
| Other multi-employer schemes | 3%<br>(NA) | 1%<br>(NA) |
| Mixed DB/DC | 11-15%<br>(NA) | 5%<br>(NA) |
| Defined benefit | 16-20%<br>(21.9%) | 6%<br>(6.1%) |

Note: Figures in brackets are 2013 mean figures from ACA (2013) *Pension Trends Survey Report*

Source: Figure 3 in ACA (2015) *Pension Trends Survey, First Report*, Table 8, page 21, and ACA (2015) *Pension Trends Survey, Second Report*, page 25

In October 2015, Equiniti published the results of a survey of 1,200 employees which showed that 27% of them were unable to save on a regular basis, despite being keen to do so. Only about a third were saving on a regular basis with savings of at least 5% of earnings. Most of the rest had made no financial provision for their future or were focused on paying off their mortgage and clearing other debts. Equiniti concluded that there is a 'long term savings gap which threatens to become a financial time bomb'.[52]

In November 2015, Scottish Widows and the Fawcett Society released a report called *Women in Retirement* which showed that only half of British women are saving enough for their retirement, while nearly a quarter are saving nothing at all. By contrast, 60% of men save adequately for retirement, and 15% do not save at all. Jackie Leiper of Scottish Widows said: 'When it comes to attitudes towards retirement saving, young men and women appear to be almost on a par, yet our research has identified an alarming divergence in the 30s which needs to be addressed. Whether it's having a family, taking a career break or

[52] Reported in Carmen Reichman (2015) Quarter of workers willing but unable to save – research, Professional Adviser, 20 October.

changing working patterns, we need to ensure that these life changes impacting women do not jeopardise their future security'.[53]

A Scottish Widows Retirement Report published in June 2015 paints a slightly more optimistic picture of the nation's retirement savings, based on a survey of 5,000 people. Whilst acknowledging that 6.2 million people (or 20% of the population) are still saving nothing for retirement and a further 19% have no savings or investments whatsoever, the report finds that 56% of the population are now making 'adequate' pension contributions which the insurer defines as 12% of earnings. This is more than twice the 2006 contribution level (6%) and a third higher than the 9% level reached in 2013.[54] A survey published by National Savings & Investments in July 2015 showed that monthly per capita savings have increased by 50% over the past decade from £68.85 in 2005 to £104.56 in 2015. However, this would not be adequate to provide a decent standard of living in retirement.[55]

Despite these encouraging glimmers, we believe, on balance, that the following assessment is more realistic: 'The DWP has warned that 11.9m UK adults are failing to save enough for an "adequate income" in later years. No wonder the Chartered Insurance Institute estimated the total savings gap – just to deliver pensions at a level most people expect for a tolerable lifestyle – at around £9 trillion'.[56] This means that there will be a 'crisis point' and it will happen much sooner than people possibly imagine. Robert Gardner, chief executive of investment consultant Redington, speaking at the 2015 NAPF annual conference, predicts that widespread social and economic unrest will be created by the UK's ageing population. Currently, one in six pensioners (1.8 million people) live in poverty. He expects this to increase to five in six pensioners over the coming decades.[57]

The 2015 Melbourne Mercer Global Pension Index places the UK pension system at the bottom of category B for good pension systems with a score of 65 out of 100, putting it in ninth position behind countries such as Denmark, the Netherlands and Australia. A key reason for this is low contribution rates. Glyn Bradley, senior associate at Mercer, said: 'Despite the introduction of auto-enrolment and record numbers of people in the UK enrolled in pension schemes, the UK is unlikely to make the A grade soon. "Having a pension" is not the same as having an adequate pension. The UK lacks the savings culture of other countries and current minimum auto-enrolment contributions are unlikely to deliver

---

[53] Reported in Rebecca Shahoud (2015), Only half of UK women saving enough for retirement, Professional Pensions, 18 November.

[54] http://www.scottishwidows.co.uk/extranet/working/about/reports/pension-report

[55] Reported in Carmen Reichman (2015) National savings up by half – is the message finally getting through?, Professional Adviser, 14 July.

[56] Quoted from KPMG (2015) 11.9 million failing to save enough for an adequate retirement income, advertorial in Financial News, 21-27 September.

[57] Reported in Andrew Pearce (2015) UK is heading towards a 'pension crisis', Financial News, 15 October 2015.

adequate retirement outcomes. [The UK is] also an aging society, with relatively high debt, and [its] public sector and state pensions are almost entirely unfunded. [Its] pensions system has a high degree of integrity by international standards, but its low scores on adequacy and sustainability are putting [it] in danger of being relegated to the 'C' league'.[58]

In September 2015, BlackRock launched a retirement income tool, called CoRI, to allow consumers to determine how much they need to save to avoid running out of money in retirement. CoRI tells people of a given age what the cost of receiving a 'pound for life' from the age of 65. For example, on 22 September 2015, a 60-year-old (who will be 65 in 2020) would have to save £23.15 for every pound they want in their retirement. Users can then take the figure of their total savings and divide it by the value the index has produced to arrive at their annual retirement income for life. Someone with a pension pot of £250,000 at age 65 would receive a lifetime income of £10,799 (i.e., £250,000/23.15). The aim of CoRI is to inform people how much they need to save during their working lives to achieve a desired standard of living in retirement. Suppose someone wanted to have a pension of £5,000 p.a. in retirement. They would need a pension pot of £115,750 (£5,000 x 23.15). With an interest rate of 5% p.a., they would need to save £958 each year for 40 years. Chip Castille, chief retirement strategist at Blackrock said: 'We have a once-in-a-generation opportunity to change people's attitudes – they need to understand with certainty whether their savings will provide a sufficient income to support their desired lifestyle in retirement'.[59]

The alternative to saving for retirement is to delay retirement, possibly indefinitely. This is the fate awaiting one in 10 Britons who are preparing to work until they drop, according to research by Baring Asset Management published in November 2015. One in three admitted they have no formal pension savings at all.[60] A report entitled *The Death of Retirement*, released by Royal London in February 2016, found that someone contributing 8% of earnings from age 22 would need to work until 85 if they want to enjoy the 'gold standard' of 67% of pre-retirement income which is then indexed to inflation and also provides a partner's pension. If they were content to live on the 'silver standard' of 50% of pre-retirement income they would have to work until 80.[61]

---

[58] Reported in Jack Jones (2015) Freedom and choice blamed for weakening UK savings system, Professional Pensions, 20 October.

[59] Reported in Carmen Reichman (2015) BlackRock launches 'future value of a pound' retirement tool, Professional Adviser, 22 September.

[60] Reported in Harvey Jones (2015) Millions of Britons are facing up to a retirement pot shortfall, Daily Express, 24 November.

[61] Reported in Rebecca Shahoud (2016) Royal London: Decent retirement might mean working until age 85, Professional Pensions, 15 February.

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

> *'I suppose I ought to eat or drink something or other; but the great question is, what?' The great question certainly was, what? Alice looked all round her at the flowers and the blades of grass, but she did not see anything that looked like the right thing to eat or drink under the circumstances.*
>
> Lewis Carroll (1865), *Alice's Adventures in Wonderland*

In the past, most members of DC pension schemes were required to buy a lifetime annuity at some point during their retirement. The Budget on 19 March 2014 has changed that requirement, as well as opened up the possibility that new types of retirement products will become available. Not all of these will be appropriate, especially if they can lead to people spending all their pension savings before they die. We will examine the new products to see which are most suitable, given the new pension flexibilities. We then consider the most effective way in which scheme members can access the best of these products. In particular, we will look at how 'longevity insurance' (e.g., in the form of an immediate or a deferred lifetime annuity) can be combined with 'scheme drawdown' to provide a cost-effective institutionally delivered retirement income solution that allows for flexibility in spending during retirement, while ensuring that savers do not run out of money before they die. We end by looking at the best way of helping people deal with stranded pots.

### *2.1 Introduction*

Until recently, the *only* purpose of a pension scheme was to provide lifetime income security. Members of defined benefits (DB) schemes received a pension for life and members of defined contribution (DC) schemes had to buy a lifetime annuity and the annuity provider purchased low-risk bonds to back the annuity payments. The annuity, in effect, died when the member died and the annuity could not be bequested (unless a joint life annuity was purchased for a surviving partner).

However, a combination of falling bond yields and increasing life expectancy resulted in a substantial reduction in annuity rates, making annuities more expensive.[62] This was one of the factors that led to the introduction of income drawdown in DC schemes in 1995 as an alternative to an annuity. The pension scheme retained an investment in growth assets during the decumulation phase and this helped to generate an average return in excess of the return on bonds, although with the risk that the value of the assets in the pension pot could fall in times of financial market turbulence.[63]

---

[62] This does not necessarily make them poorer value.

[63] It would be interesting to know, given the degree of global stock market turbulence since 2000, how many of those using drawdown have actually enjoyed a higher standard of living than they would have done had they instead bought an annuity.

When income drawdown was first introduced, it was a recommended strategy only for pot sizes above £250,000 and there was still a requirement to annuitise the remaining pot by age 75. Compulsory annuitisation ended on 6 April 2011. From that date, retirees with a minimum income requirement (MIR) of at least £20,000 from all state and DB pensions could make use of 'flexible drawdown' and access any DC pension pot without any restrictions. Anyone failing to meet the MIR was required to use 'capped drawdown' which restricted the annual amount that could be withdrawn to some multiple of the GAD rate, which was the amount from a single life level annuity as specified by the Government Actuary's Department. The multiple, which is set and changed by the Government, has varied between 100% and 150% of the GAD rate. As a result of these changes, drawdown providers lowered the minimum pot size they would accept to £75,000 – £100,000 depending on the provider. However, the median pot size at retirement is currently around £17,000, the average pot size is £28,000 and only 10% of the 350,000-400,000 people who retire each year have pot sizes of £75,000 or more.[64]

The 2014 Budget introduced a new regime of 'freedom and choice' for all DC scheme members from age 55[65] (whether retired or not).[66] The most significant of these was that no one was required to annuitise at all.[67] However, only a small number of people currently have a sufficiently large pot size to take full advantage of the new regime without risking running out of money before they die. With the success of auto-enrolment, pot sizes will, on average, be larger in future. Although pension contributions and pension adequacy are not formally part of our remit, it is worth restating the obvious point that in order to get a decent-sized pension pot for retirement, it is necessary to make adequate pension contributions (something of the order of 15% of pensionable salary,[68] shared between the

[64] ABI annuity sales statistics.

[65] To rise to 57 in 2028.

[66] The enabling legislation for the Budget proposals was the Pension Schemes Act 2015, while the consequential changes to pension tax legislation were set out in the Taxation of Pensions Act 2014.

[67] The risks associated with ending annuitisation were discussed in:

- David Blake, Edmund Cannon, and Ian Tonks (2010) *Ending Compulsory annuitisation: What are the Consequences?*, Pensions Institute; www.pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences.pdf;
- David Blake, Edmund Cannon, and Ian Tonks (2010) *Ending Compulsory Annuitisation: Quantifying the Consequences,* Pensions Institute; www.pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences2.pdf;
- David Blake (2014) *The Consequences of Not Having to Buy an Annuity*, Pensions Institute; www.pensions-institute.org/workingpapers/wp1409.pdf

[68] Lord John Hutton, former Work and Pensions Secretary, is the latest in a long line of people who have recommended that the UK adopts a national retirement savings target of 15% to avoid future pensioner poverty (reported in Ollie Smith (2015) Labour peer calls for 15% UK retirement savings target, New Model Adviser, 10 March). If people think that a 15% contribution rate is a lot, they should consider what happens in other countries. In Holland, for example, the contribution rate is around 20%. As the Dutch say, 'we work Fridays for our pension'. In Sweden and Singapore, the contribution rate is even higher.

employer and scheme member) into a pension scheme which are then invested over many years.

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:

- The investment strategy – the strategy for investing the pension pot
- The withdrawal strategy – the strategy for withdrawing cash from the pension pot to finance expenditures
- The longevity insurance strategy – the strategy for determining when longevity insurance is purchased and when it comes into effect.[69]

There are three broad classes of product for delivering the retirement financial strategy: annuities, drawdown and hybrids (which combine drawdown and annuities). These products have different advantages and disadvantages in terms of withdrawal flexibility and investment risk and we discuss these at length in this Chapter.

There are five legal forms[70] for drawing funds from a DC pension scheme from 6 April 2015, as laid out in the Taxation of Pensions Act 2014 (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'):[71]

- 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 unless they are joint life annuities or have a guarantee term. However, it is possible to buy a capital-protected LTA.
- 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' for tax

[69] A scheme without a longevity insurance strategy is NOT a pension scheme.
[70] There is technically a sixth product called 'money purchase scheme pension', but since it is currently not possible to move from a scheme pension to drawdown, it is likely that the popularity of this product will decline.
[71] For more information about these choices, see: Institute of Chartered Accountants in England & Wales (2015) *Freedom and Choice in Pensions: A Guide to the Pension Reforms*; Aon (2015) *Reward: In-depth Guide to Retirement and Pension Changes;* Staffcare and LCP (2015) *Your Essential Guide to Implementing Flexible Benefits*; Retirement Intelligence (2014) *The Retirement Advice Survival Guide* (www.mgmadviser.com/retirement-advice-survival-guide).

purposes on the death of the member, with the remainder of the fund being 'uncrystallised'.[72] 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 DB pension. Members choosing this option will have their pension fund transferred into a 'flexi-access drawdown (FAD) fund'.[73] The trigger event for a reduction in MPAA is the same as with capped drawdown.
- Uncrystallised fund pension lump sum (UFPLS).[74] 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.[75] 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.[76]

The tax treatment of death benefits with capped drawdown, flexible drawdown and UFPLS is shown in Table 2.1, following the 2014 Taxation of Pensions Act. The Taxation of Pensions Act 2014 does not apply to DB schemes.

---

[72] See below. Essentially this means that this segment of the pension fund has not been accessed by the member for inheritance tax purposes.

[73] Beneficiaries' FADs are separated into dependants' FADs, nominees' FADs and successors' FADs. Nominees are those who are not dependants on the first death, while successors comprise all beneficiaries on the second death. The successor is named not by the member, but by the nominee, unless the member nominates a trust on the first death with trustees who will reflect the member's wishes.

[74] Note this is not the same as the pension commencement lump sum which is tax free.

[75] This option is only available from uncrystallised funds. It is not available in drawdown. It can therefore be offered by schemes which do not offer flexi-access drawdown.

[76] 'Inheritance tax (IHT) rules on when a pension fund will be counted in the deceased's estate have not changed. Generally, where the scheme member can bind the trustees to pay to a specified beneficiary who is not a dependant, it will be treated as part of the deceased's estate for IHT. But where the trustees can exercise discretion, the funds will generally be outside IHT assessment. Most schemes operate on an expression of wish basis (sometimes called a 'nomination of beneficiary'), with the scheme administrator making the final decision' (Source: Institute of Chartered Accountants in England & Wales (2015, p.4) *Freedom and Choice in Pensions: A Guide to the Pension Reforms*).

*Table 2.1: Tax treatment of death benefits with capped drawdown, flexible drawdown and UFPLS*

| Age at death | Paid from benefits which are: | Benefit type | Relevant time | Tax | Subject to Life Time Allowance test? |
|---|---|---|---|---|---|
| < 75 years | Crystallised | Income | < 2 years | Tax Free | No |
| < 75 years | Crystallised | Income | > 2 years | Tax Free | No |
| < 75 years | Uncrystallised | Lump Sum | < 2 years | Tax Free | Yes |
| < 75 years | Uncrystallised | Lump Sum | > 2 years | 45% | No |
| < 75 years | Uncrystallised | Income | < 2 years | Tax Free | Yes |
| < 75 years | Uncrystallised | Income | > 2 years | Marginal | No |
| < 75 years | Crystallised | Lump Sum | < 2 years | Tax Free | No |
| < 75 years | Crystallised | Lump Sum | > 2 years | Tax Free | No |
| ≥75 years | Crystallised/Uncrystallised | Income | N/A | Marginal | No |
| ≥75 years | Crystallised/Uncrystallised | Lump Sum | N/A | 45% | No |

Source: Institute of Chartered Accountants in England & Wales (2015, p.5) *Freedom and Choice in Pensions: A Guide to the Pension Reforms*

The Pension Schemes Act 2015 allows scheme members to transfer all their DC benefits and leave their DB benefits in the scheme.[77] It seems unlikely that the trustees of a DB scheme will allow their members to exercise the new flexibilities within the scheme itself and instead will require members to transfer the value of their benefits to a DC arrangement.[78] This could be a transfer either to the sponsor's own DC scheme if it has one or to an external provider. In addition, the changes to the tax treatment of death benefits do not currently apply to DB schemes. A dependant's pension in a DB scheme is taxed at the dependant's

[77] Previously, all benefits had to be transferred.

[78] Reported in Natasha Browne (2015) Schemes likely to rebuff plans to extend freedoms directly to DB, Professional Pensions, 22 January. Simon Taylor, partner at Barnett Waddingham, said: 'From the schemes I've spoken to, there's not a lot of interest in administering these freedoms within their DB scheme. I think it falls into the 'too difficult' box. You have all sorts of admin and actuarial issues about how to calculate the benefit that's left behind. What do you do about advice and guidance?'.

marginal rate of tax irrespective of the age at which the member died. Further, death benefits can only be paid to a narrow group of dependants in DB schemes, whereas death benefits can be paid to any named beneficiary in a DC scheme.[79]

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 was between institutional and retail distribution arrangements, but a new hybrid institutional-retail distribution arrangement is being considered. Currently, most DC scheme members have 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.[80] But the retail retirement income market has 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 effective and efficient 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 at the very minimum:[81]

- 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[82]
- 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. Mark Fawcett, chief investment officer of NEST, agrees with this. He argues that 'for many members, flexibility in the early stages of retirement is key, as they will simply not know what their income needs will be….[However], as retirees get older, they need less flexibility and longevity risk becomes the most important risk. The most appropriate solution is therefore a hybrid product that blends

[79] Punter Southall (2015) *Flexiday Briefing Note Issue 10*, February.

[80] This is unlike a defined benefit scheme in which the member receives a pension directly from the scheme. The exception would be members of group personal pension schemes.

[81] This was suggested at a meeting with Ewan McCulloch and Stuart Patton Evans of Scottish Widows on 12 May 2015. Other criteria for a good pension scheme are listed in Table 1.1.

[82] This is confirmed by surveys discussed in the next Chapter.

drawdown in the early years and longevity insurance, with opt out options, in the later years'.[83]

Taking all these issues into account implies that the appropriate arrangement for providing income in the period between retirement (or more strictly the age at which the pension is first drawn) 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 (as specified in Table 1.1), it might be considered to be a 'safe harbour' product. The term comes from the US Pension Protection Act 2006 which introduced auto-enrolment in the US and created a demand for safe harbour Qualifying Default Investment Alternatives, such as target-date funds, for 401(k) savings plans. Any adviser in the US recommending such a product cannot subsequently be sued for poor advice. So far the Financial Conduct Authority (FCA) has refused to grant safe harbour status to any UK investments.

We now turn to an examination of the following issues:

- The products on offer for investing the accumulated pension pot and for providing an income in retirement
- Current and planned delivery systems for these products
- The withdrawal strategy
- The longevity insurance strategy
- Charges, charge disclosure and proposals to cap charges
- Product and provider regulation
- How to deal with stranded pots

### *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.

[83] Quoted in Amanda White (2015), Best practice de-cumulatisation - a hybrid approach, Top1000funds, 14 May.

## 2.2.1 Annuities[84]

### *2.2.1.1 Lifetime annuities (LTAs)*

Lifetime annuities (LTAs) provide a guaranteed income for life for the scheme member (single life annuity) or for the scheme member and their partner (joint life annuity). There are two variations: level (the income is fixed for the whole period) and index-linked (the income increases with inflation). For the same premium, index-linked annuities pay a lower starting value than a level annuity: around 50% lower at age 55, 44% lower at age 65 and 26% lower at age 75.[85] The Financial Services Compensation Scheme (FSCS) covers 100% of the value of an annuity in the event that the insurance company providing the annuity defaults.

LTAs have two main advantages, as Tom McPhail, head of pensions policy at Hargreaves Lansdown, points out: 'they provide a guarantee of income for the rest of an investor's life, however long that may be; they also allow investors to benefit from the "mortality cross-subsidy",[86] by sharing out some of the value of the pensions of those who die young, they increase the payments to those who live longer. This is an extremely efficient system'.[87]

LTAs also have a number of disadvantages. First, there is no flexibility to change the payments. Second, there is no residual fund with a single life annuity on the death of the annuitant, so it is not possible to bequest the annuity when the annuitant dies.[88] Third, the investment return on LTAs is related to the return on bonds. This is because annuity providers, which must be established as life assurance companies, invest the proceeds from selling the annuity (i.e., the premium) in low-risk, low-return bonds and make the annuity payments from these.[89] Further, due to the nature of the guarantees involved in providing LTAs, the life companies selling annuities face stringent capital requirements, the cost of which is inevitably borne by the annuitants. Nevertheless, the return on a LTA does increase the longer the annuity purchase is delayed, on account of the mortality premium being higher at higher ages.[90] Finally, LTAs will become more expensive in the new pensions

[84] For more details, see Billy Burrows (2015) *The Case for Annuities*, Retirement Intelligence. Prior to the 2014 Budget changes, 90% of annuities sold were level, 5% index-linked (or inflation-linked) and 5% investment-linked (ABI sales data 2014).
[85] Cazalet Consulting (2014, p. 69) *When I'm Sixty-Four*, September.
[86] The 'mortality cross-subsidy' – also called 'mortality premium', 'mortality drag', or 'mortality credit' – arises because LTAs are a longevity risk pooling mechanism, whereby those dying earlier than their life expectancy cross-subsidise those who live longer.
[87] Reported in Corporate Adviser, 29 September 2014.
[88] This is not a design fault. It is a deliberate feature of the longevity risk pooling aspects of an annuity which, unfortunately, is not well understood by consumers.
[89] The provision of annuities is not primarily an investment risk management business, rather it is a longevity risk management business.
[90] The greater the age at which the pool starts, the greater the percentage of the pool that will die every year, and hence the larger the mortality premium that goes to surviving annuitants.

environment. This is, in part, because fewer annuities will be sold in future and, as a result, scale economies and the effectiveness of risk pooling will be reduced. It will also be because of the impact of 'selection' effects: those buying LTAs in a voluntary market are likely to have higher life expectancies than those buying in a mandatory or compulsory purchase market and this will be reflected in their price.

It is also important to bear in mind the following point about adviser fees. The FCA's Retail Distribution Review (RDR) banned advisers from receiving commission from product providers and providing 'free' advice to customers in exchange. Instead, from 1 January 2013, clients must pay advisers a fee for advice. However, if annuities are sold directly to consumers via a comparison website or platform, the FCA does not stop providers paying commission (of between 1-3%) to the owners of the comparison website or platform.[91] So we have the anomaly that, on the one hand, customers using an adviser pay an advice fee but no commission, and, on the other hand, customers using a comparison website or platform indirectly pay commission but receive no advice, even though the commission might be equal to or higher than the fee might have been. Moreover, there is less consumer protection – via the FSCS – for customers who make the product choice, because, by so doing, they take responsibility for the decision.

The Market Study on annuities by the Financial Conduct Authority (2014), together with the Occasional Paper by Aquilina et al (2014), found that annuities generally provided good value for money relative to alternative withdrawal strategies if they were purchased on the open market by someone in good health for their age and an average-sized pension pot.[92] But the FCA found that the current annuity market did not serve well the following types of customer: captive (or internal or rollover) customers of an insurance company accumulation fund who did not shop around,[93] consumers in poor health who would have benefited from an enhanced annuity, and consumers with small pots. The failure of customers to shop around, despite being told about the open market option (OMO) – the right to buy an

---

[91] A platform is 'an online administration service, with a single point of contact to the investment market. It provides advisers and clients with a single view of the client's entire portfolio. A platform provides the technology for advisers to manage their client's investments more efficiently and more effectively' (Emma Ann Hughes (2012) What is a platform?, FT Adviser, 4 April). Platforms provide portfolio valuation statements and portfolio planning tools. They also need to safeguard clients' assets and disclose separate platform, adviser and fund manager fees. Platforms are typically provided by life insurance companies where they are also known as wrappers (e.g., Cofunds which was owned by Legal & General at the time of writing) and by fund supermarkets (e.g., Vantage is owned by Hargreaves Lansdown), although there are some independent platforms. See Chapter 3 for more details.

[92] Financial Conduct Authority (2014), *Retirement Income Market Study: Interim Report*, Market Study MS14/3.2, December (http://www.fca.org.uk/static/documents/market-studies/ms14-03-2.pdf); Matteo Aquilina, Robert Baker and Tommaso Majer (2014), *The Value for Money of Annuities and Other Retirement Income Strategies in the UK*, Financial Conduct Authority, Occasional Paper No. 5, December (http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-5.pdf)

[93] They were 'deterred from engaging with their options by the length and complexity of the "wake-up packs" sent out by providers' (p.6) in the period before they have to make their annuity decision.

annuity from a different insurer to the one which offered the pension savings scheme – is a serious problem. Figures from the Association of British Insurers (ABI) show that 60% of annuities sold in the first quarter of 2015 were bought from customers' existing insurers. In some cases, this will be because the annuities have valuable guarantees not available with other providers. But, in many cases, it will be because they are, according to Tom McPhail, 'disengaged from the whole shopping around process'.[94]

Even for annuities sold on the open market, annuity rates have fallen by 73% since 2000 as a result of falling interest rates and increasing longevity. A study by Moneyfacts found that, if a 65-year old man who paid £100 a month into a typical personal pension fund for 20 years and bought a level annuity in 2015, he would receive an annual income of £2,109, compared with £7,748 if he had bought it in 2000. Richard Egan, pensions editor at Moneyfacts, said: 'The days of 15 years ago have gone forever. The economic climate has worked massively against retirees. Dreams of a comfortable retirement could easily be shattered unless individuals can either make up the pension shortfall through greater contributions or accept that they may have to delay their retirement'.[95]

As a result of the high proportion of captive customers who did not get a competitive rate and negative press coverage, the value of annuities is now severely underappreciated. However, annuities are being given a makeover and we will consider some examples below. There are also attempts to rebrand them as a 'guaranteed income for life' product. In the process, their critical role in well-designed retirement income plans will need to be explained much better. Customers need to understand the difference between investment and insurance – only insurance (an annuity) can provide a perfect hedge against longevity risk.

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

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

Short-term or fixed-term annuities are written under income drawdown rules and the product is classed as an investment within a drawdown plan, and, indeed, is sometimes referred to as 'guaranteed drawdown'. This means the FTA could be either a single arrangement whereby the whole of the DC pot is used to buy a FTA or part of a drawdown portfolio that also includes investment funds. Although classed as drawdown, the product can, and usually is sold on a non-advised basis. Typical commission is about 2% of the fund.

While products vary, the conventional FTA provides income payments for a set number of years, e.g., five. Traditionally, the annual income did not exceed the GAD maximum. The

[94] Reported in Ruth Lythe (2015) Savers urged to shop around as two in three opting for an annuity take the first pension deal offered to them, Dail Mail, 1 July.
[95] Reported in Rosie Taylor and Louise Eccles (2015) 75% fall in annuity income in 15 years: Ageing population and rock bottom interest rates blamed for the fall on pension income, Daily Mail, 14 September.

premium might be invested in a short-term gilts fund, but some products link the income level to a fund or index performance. As with LTAs, most sales of FTAs are for a level single life, but the policy can be set up on a joint life basis and with a guaranteed income period or a value-protection option to provide death benefits.

At the end of the term, the insurer returns a percentage of the original premium as a maturity value, e.g., 80% after five years – the amount will depend on the number of years and the level of income chosen. The maturity value can be used to continue DC decumulation, for example, by purchasing another FTA, a LTA, or by using drawdown.

The advantages of the FTA, like income drawdown, include the deferment of the LTA purchase, while still receiving a regular income. A traditional use of the FTA was to provide a bridging pension for an individual who had a DC pot that matured at age 60 and a good DB pension that began at age 65. In this case, it made sense to take the maximum income permitted from the FTA. The 2014 Budget allowed all pension pots to be accessed from age 55 from April 2015.

The main attraction of a FTA as promoted by providers is that when the fixed term ends, annuity rates might have improved and/or the individual's health might have deteriorated, in which case he or she might qualify for a higher LTA rate than would have been the case previously. However, the opposite might also occur, so the individual needs to be aware of the risks associated with uncertain future annuity rates (interest rate risk) and the individual's future state of health (longevity risk). These are very significant risks which, from an individual's perspective, are not so much unknown as unknowable.

There is, therefore, a danger that this product confers a potentially misleading sense of psychological security. Although it keeps the capital secure for a short period, it is not 'safe' in terms of protecting future income sustainability, since it cannot guarantee the income that the maturity value will buy when it matures in, say, five years' time. This is a significant risk for low-income investors, especially if they are also conservative investors. Therefore, we would argue that fixed-term annuities might be more accurately described as short-term income drawdown. It will be important for the promotion of these products to avoid the use of the word 'guarantee', unless the precise nature of this 'guarantee' is explained clearly.

Moreover, the combination of income and return of fund can vary and we were told that some providers emphasise the higher income at the expense of maturity value. If the income taken at the outset is at the GAD maximum, the fund returned at the end of the term will be lower than if a lower income had been taken. If, at this time, interest rates are lower and less favourable mortality assumptions are being used to price new annuities, then the buyer of the FTA could end up with a lower income than if a LTA had been purchased from the start. We were informed that there needs to be a 10% increase in the prevailing annuity rate for the annuitant to break even, when compared with the purchase of a LTA from the outset. One adviser who ran a series of quotations for us showed that assuming no

changes in health, the income that could be purchased after five years is likely to be significantly lower. Reinvestment risk is therefore the main concern with this product, as well as the additional charges which include the new fee for advice or the new commission where a replacement annuity is purchased via a non-advice service.

Legal & General has introduced two FTAs that it describes as 'flexible retirement income products' which people with a larger pension pot can combine with flexible drawdown to produce the best combination of retirement income solutions for their circumstances:

- A cash-out retirement plan, which offers a guaranteed level of income over an agreed time period and also allows for tax-efficient withdrawals to stop people exceeding their tax allowance
- The fixed-term retirement plan provides a guaranteed level of income over an agreed time period with a cash lump sum at maturity.

An example of a FTA provided by a fund manager rather than an insurer is the FTSE100 Retirement Deposit Plan 1 launched by Investec Structured Products in August 2015. The product offers guaranteed income payments plus a bonus payment at maturity which is dependent on the level of the FTSE100 index at the time. The product – available only via a self-invested personal pension (SIPP) – offers fixed annual payments of either 5.25% (Option 1) or 4% (Option 2) over its six-year term. Option 1 aims to return the full deposit amount provided the FTSE100 index is greater than 90% of its start level at maturity, while Option 2 requires the index to be greater than 75% of its start level at maturity, to return the full deposit. Gary Dale, head of intermediary sales at Investec Structured Products, said: 'In today's financial environment of low interest rates and low gilt yields, it is more and more important to be able to ensure that capital lasts longer and retains its power to provide long-term income throughout the period of retirement. This new [plan] will help clients maximise income from their retirement funds at a time when the need for more competitive retirement income is clearly a priority within the post-retirement market'.[96]

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

[96] Reported in Professional Adviser (2015) Structured product for retirees launched, 19 August.

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

Annuities with more flexible payments

HM Treasury (2014, p 14-15)[97] announced that it was consulting on whether to allow annnuities to have more flexible payment terms that:

- Allow lifetime annuities to decrease, which will provide significantly more flexibility around the design of the product. This will allow providers to offer products which meet individuals' needs more closely, for example, by allowing annuity payments to reduce once an individual becomes eligible for the state pension
- Allow lump sums to be taken from lifetime annuities, on the condition that this is specified in the contract at the point of purchase. This will allow providers to structure much more flexible products that are capable of meeting specific circumstances, such as care needs
- Allow payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000. This will allow beneficiaries to receive pension payments as a lump sum if they wish, rather than having to spread these out over several years.

Another proposal is to have 'lifestyle annuities' which provide an income that depends on which stage of retirement – early, mid or late – the annuitant is in. Specific examples of these are U-shaped and J-shaped annuities.[98] A U-shaped annuity has payments that are initially high, then fall and later rise again. This is designed to match expenditure needs in the three periods of retirement: active retirement, inactive retirement and the final period of life when care costs start to impact. A J-shaped annuity is a U-shaped annuity which allows for the possibility that expenditure during the final phase of retirement might be higher than during the initial active phase.

*Annuities with more flexible payments could be classified as safe harbour products.*

[97] HM Treasury (2014) *Freedom and Choice in Pensions: Government Response to the Consultation*, Cm 8901, July 2014;
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332714/pensions_response_online.pdf

[98] Suggested by Dr Ros Altmann (2014) Pensions revolution: how a 'J-shaped annuity' could revolutionise your retirement, Daily Telegraph, 21 July;
http://www.telegraph.co.uk/finance/personalfinance/pensions/10979903/Pensions-revolution-how-a-J-shaped-annuity-could-revolutionise-your-retirement.html

## Annuities with more flexible terms

A number of suggestions have been put forward to allow annuities to have more flexible terms. These include a cooling-off period after purchase and the ability to change the type of annuity, to switch provider and to sell the annuity.

The former Pensions Minister, Steve Webb MP, had a pre-2014 Budget proposal to introduce a 12-month cooling-off period after the LTA purchase. The Government was aware of the intense pressure DC customers are under when they make their LTA purchase. The idea is that the cooling-off period would give retirees the chance to review and change what might have been a poorly informed decision. It would have the additional benefit of putting insurance companies and distributors on notice, since they would suffer if there were a mass exodus of customers in the first 12-months due to poor pricing and/or sales processes. Moreover, data on redemptions and repurchases would be very valuable for the industry and the regulators, as it would be possible to identify insurance companies that sell inappropriate products at uncompetitive rates and distributors that operate poor sales practices.

Nevertheless, there are cost implications. Insurance companies would have to hold the premium in low-interest liquid assets for a year in case annuitants asked for their money back at the end of the cooling off period. Further, the annuity would have to be re-priced at the end of the year to reflect prevailing interest rates and any revised mortality assumptions. If insurance companies were required to honour the quote made a year earlier, then this would have to be sufficiently low to account for the risks that the insurance companies are carrying in the intervening period.

Following the 2014 Budget reforms, this proposal should no longer be necessary at the point of retirement, particularly if scheme drawdown becomes the norm, since this would provide a breathing space pre- rather than post-LTA purchase. This would avoid the introduction of a potentially complex and costly process of LTA review, rebate and repurchase that the cooling-off period would entail, and the equally likely danger of a 'churn' mentality developing among insurers and distributors, since they now have an incentive to bid for these clients during the cooling off period.

Despite these concerns, the proposal still might be relevant for two reasons. First, the purchase of annuities for health/lifestyle reasons at the point of retirement might be inappropriate where the enhancements are small. It will be important to avoid annuitisation under the new regime, where the rationale is based on the availability of an enhancement without considering its merits relative to drawdown. Second, it will still be important when

DC retirees purchase a LTA in later life, since at this point it will be essential to achieve the best rate in the open market, based on the underwriting of health and lifestyle factors.[99]

Currently, people cannot switch between products, such as between a single-life and a joint-life annuity and vice versa if their circumstances change. In future, insurers could be allowed to offer policies that enabled members to switch from a joint-life to a single-life policy if their spouse or civil partner dies before them, or to make the opposite switch if they marry after purchasing a single-life annuity.

Steve Webb, also had a pre-Budget proposal that would enable members to switch annuity provider post purchase. The proposal was met with fierce criticism by insurance companies, which argued that the cost of this flexibility would reduce LTA rates by about 25%.

Insurance companies are buy-and-hold investors of the bonds used to make the LTA payments. They buy bonds with different maturities and make the annuity payments from the coupons and redemption payments on these bonds. The cash inflows from the bonds need to be received before the LTA payments are made in order to minimise the insurance companies' holdings of liquid reserves.

LTA payments typically are made monthly, but the coupon payments on the bonds are only received semi-annually. The required cash-flow matching exercise is complex and needs to be done in the most cost-effective way. Once the bonds are in place, they are held until they mature and then the redemption proceeds are used to buy new bonds at prevailing rates which might be higher or lower than the insurance company had initially predicted. This is known as reinvestment risk and insurance companies need to hold reserves to cover the possibility that interest rates are lower and therefore that the new bonds are more expensive than predicted.

Insurance companies already have to accommodate in their reserves the possibility of adverse mortality experience, i.e., that realised mortality rates turn out to be lower (annuitants live longer) than predicted. If, in addition to this, insurance companies have to allow for the possibility that annuitants can sell back their annuities at any time, then this would certainly increase costs. Insurance companies would have to hold sufficient liquid reserves to avoid the possibility of having to sell some of the bonds needed to make payments to the remaining annuitants. This proposal has, to a certain extent, been superseded by the next proposal, namely the introduction of a secondary annuities market.

*Annuities with more flexible terms could be classified as safe harbour products.*

---

[99] This is where insurers ask applicants to fill in a medical questionnaire relating to their health and lifestyle. Insurers will be aware that individuals who voluntarily purchase annuities are likely to know from their own and their family's medical history that they will have above average life expectancy and insurers need to get as accurate a fix as possible on their true life expectancy.

## Secondary (or marketable or second-hand) annuities

In the Budget on 18 March 2015, the Chancellor announced that annuitants could sell (or assign) their annuity for cash to the highest bidder (but not back to their annuity provider) from 6 April 2016.[100] The proceeds could be paid directly to the seller or paid into a drawdown account. In both cases, tax on withdrawal is payable at the individual's marginal income tax rate.[101] However, people who did this would not be allowed to claim means-tested benefits to compensate for the loss of income, and people already on means-tested benefits would not be eligible. Also the annual allowance would be reduced to £10,000 if the option were exercised. Further, the option will not be open to someone receiving a DB pension. The institution buying the annuity would receive a taxable income for as long at the annuity seller is alive. Steve Webb had raised the possibility of selling annuities in January 2015.[102] There are currently around 6 million people in the UK with annuities from their pension scheme.

In July 2015, MorganAsh, a company that provides medical information for assessing longevity for the financial services industry, announced plans to operate a 'central annuity bureau' in the second-hand annuity market, following discussions with the FCA and other interested parties. The company proposed using medical underwriting to help in the valuation of the annuities brought to market. It said four key points had emerged during its discussions on annuity resale:

- There is efficiency in undertaking the medical underwriting and other checks on the consumer just once and sharing among the various purchasers
- There is merit in having one or a few central annuity bureaux (CAB) or portals that would undertake the medical underwriting and additional checks
- There is merit in the CAB being independent from the purchaser and the seller to avoid bias
- There is benefit to having some structure and order to the medical underwriting and tendering process.

The company argues the CAB service could run as a commercial operation, rather than a government-sponsored organisation, on the grounds that:

- Commercial organisations can be flexible and quick to provide solutions
- The purchasers are likely to self-police the quality of the medical underwriting services, as they are likely to lose out if this service is poor or biased

---

[100] HM Treasury (2015) *Creating a Secondary Annuity Market*, March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413763/Creating_a_secondary_annuity_market__print_file_.pdf

[101] In addition, there would be no tax-free allowance.

[102] Tim Ross (2015) Sell your pension for cash under radical plan, Sunday Telegraph, 4 January.

- 90% of the systems and processes required already exist within commercial organisations.[103]

There was some support for the idea of a secondary annuity market. For example, Dr Ros Altmann suggested that the following would benefit:[104]

- 'People who purchased an annuity because they had no choice, but need the money now to repay debts or pay for health or care needs or other urgent spending'
- 'People who have other pensions and for whom the annuity is not an important source of their retirement income'
- 'People who purchased small annuities, for whom the small amount of ongoing income will make little difference to their standard of living in retirement. For example, someone with a £5,000 pension fund who bought an annuity at age 60 might have less than £5 a week for life, whereas having a few thousand pounds straight away could make a real difference to their lives'.

Similarly, Stephen Lowe, group external affairs and customer insight director at Just Retirement, gives qualified support for the idea:

> *As you would expect, we are passionate supporters of guaranteed income to provide simplicity and peace of mind through retirement. Yet we also support the power of innovation and choice to drive better value through individually tailored solutions. The secondary annuity market will free that small but significant minority of annuitants who could benefit by switching out of their current contract.*
>
> *So in what kind of scenarios might people benefit by trading their annuity in?*
>
> *• To reconfigure benefits – for example, to switch out of a single life annuity to provide income for a spouse, or to switch from regular income to more flexible arrangements*
>
> *• To preserve value for the next generation – trade the annuity and transfer the value into flex-access drawdown*
>
> *• To turn income into a lump sum – where people find they have sufficient income from other sources*
>
> *• To rationalise a small annuity income – to switch an annuity paying a trivial income into a worthwhile lump sum, and*
>
> *• To extract more value from pensions containing guaranteed annuity rates (GAR) for those people needing a lump sum – accept the GAR but*

[103] Reported in Jenna Towler (2015) MorganAsh reveals secondary annuity market bureau plans, Professional Adviser, 1 July.
[104] Reported in Scott Sinclair (2015) Ministers 'to discuss' radical annuities-for-cash plan, Professional Adviser, 12 March.

*then trade the annuity to generate a lump sum above the current value of the DC pension.*

*Our support for a secondary market depends on two major conditions. ..[T]here needs to be robust consumer protection in place to ensure people considering selling their annuity fully understand the consequences. There also needs to be a transparent and competitive marketplace.*[105]

A secondary annuity market could also help DB plans hedge their longevity risk. According to Adam Michaels, partner at LCP, traded contracts could be bundled and sold to DB schemes to match pensions in payment, hedging changes in long-term interest rates and longevity improvements.[106]

However, most industry insiders were not particularly enthusiastic about the proposal. A *Pensions Buzz* poll in Professional Pensions of 135 trustees, scheme managers and industry figures found that only 30% thought it was a good idea.[107] A common view was that 'It is all too easy to imagine older pensioners being bullied by their families into selling their annuities for a lump sum for their own needs, leaving the pensioner more reliant on the state… I can't imagine it would be an option we would advise taking often'.[108] Sales would need to be carefully regulated to prevent high-paying annuities bought before the fall in interest rates as result of quantitative easing being sold to unscrupulous companies for a pittance. Another negative factor is the insurance company's gross profit margin. We were told this accounts for up to 20% of the original purchase price and for the sale to be equally profitable, the annuitant will receive a 'secondary screwing'.[109] Some commentators have suggested that sales costs could be between 20% and 40% of the value of the annuity.[110] The Institute for Fiscal Studies (IFS) pointed out the complexity of the decision, especially for older people: 'Evidence suggests that at least a significant minority of annuity holders – in particular, older annuity holders – may struggle with the complex decisions required in valuing their annuity compared to an alternative lump sum. This suggests that, at the very least, individuals will need to have access to good quality financial advice and guidance in order to navigate this new market – if, indeed, such a market does spring into existence'.[111]

---

[105] Stephen Lowe (2015) Consumer protection – Words of warning on second-hand annuities, Professional Adviser, 29 June.
[106] Reported in Natasha Browne (2015) Second-hand annuities would help DB schemes hedge longevity risk, Professional Pensions, 24 June.
[107] Michael Klimes (2015) Second hand annuities: preying on the 'ignorant, desperate and feckless'?, Professional Pensions, 20 March.
[108] Jamie Smith-Thompson, managing director, Portal Financial, quoted in 'The verdict on letting pensioners cash in their annuities', Pensions Insight, 5 January 2015.
[109] According to Mark Polson, The freedom to sell your annuity (read: The freedom to get screwed), Professional Adviser, 6 January 2015.
[110] Reported in Tim Bateman and Katie Dawson (2015) Second-hand annuity market needs 'strong controls and close policing', Professional Adviser, 24 August.
[111] Quoted in Stephanie Baxter (2015) IFS warns annuity buy-backs could harm retirees, Professional Pensions, 1 April.

There would be a particular issue with joint life annuities in order to ensure that the interests of the second beneficiary were protected and that they were getting fair value for their foregone benefits.

It was also not clear that all providers would find the proposition that attractive: 'a lifetime annuity is priced on the life and medical conditions of that particular customer. So if it is sold on, the new risks and medical conditions would need to be priced in as part of the transaction'.[112] There is a clear moral hazard problem, since there is nothing to stop an annuitant who develops a life shortening illness from trying to sell the annuity without informing the provider of their new medical situation. There is also a clear adverse selection problem as the IFS recognises: 'Who is most likely to want to cash in their annuity? Someone who now knows they don't have long to live. How much will they get for their annuity? Not much'.[113]

There would also be an expensive monitoring process to ensure that the annuity payments stop when the annuitant dies if the policy were sold to a third party. The seller would have to agree to regular certification of being alive (such as a monthly phone call) with the original insurance company. Finally, there is the issue of contract law. It is hard to change existing contracts if one side does not want to. Nevertheless, Toby Strauss, then chief executive of Scottish Widows, while acknowledging the contractual problems, thought that some new providers might be interested in investing in these income streams.[114]

An obvious question is whether a second-hand annuity could be sold to a retail investor and the Government has ruled this out. A second-hand annuity would be similar to a traded life policy or life settlement. The FCA condemned these as 'high-risk, toxic products' and effectively banned them for sale to retail customers in 2014.[115] More suitable buyers might be pension funds which wanted such assets to match their pensions in payment,[116] but it is not clear how big a market this would be. A simpler solution would be to sell the annuity back to the original life company in exchange for a lump sum, subject to a medical examination, but how would a fair price be determined in this case? While it might be argued that the facility to surrender annuities would stimulate competition and prompt insurance companies to offer higher rates initially, the calculation of the 'surrender value' of

---

[112] Kate Smith, regulatory strategy manager, Aegon UK, quoted in 'The verdict on letting pensioners cash in their annuities', Pensions Insight, 5 January 2015.

[113] Quoted in Mark Atherton (2015) Pension windfall figures dismissed, The Times, 20 March.

[114] Helen Morrissey (2015) Provider's 'interested' in Webb's annuity unwinding plan', Professional Adviser, 22 January.

[115] http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/traded-life-policy-investments

[116] If their members live longer than expected, pension schemes have to pay out pensions for longer than expected, but if they buy second-hand annuities from people with a similar mortality profile as their own members, then these annuities will also pay put longer than expected.

an annuity would prove complex and potentially allow the insurer to extract additional profit.[117]

A survey by Saga of 2,000 existing annuity holders found that 20% would be willing to sell, with those with the smallest pots and hence the lowest incomes 'most likely' to do so. The main reasons are as follows: 58% said their monthly income is too small to be able to do anything meaningful with it, 30% said they would use the cash to invest in an ISA or the stock market, and 12% said they would spend the money on luxuries such as cars and holidays.[118] A survey of 1,800 retirees by Tilney Bestinvest found that 17% would consider selling their annuity, 33% said they would not sell, while 50% stated they did not know what their plans were.[119]

Another survey, this time of 1,531 over-55s conducted by YouGov and sponsored by the Institute and Faculty of Actuaries (IFoA) found that 55% of annuitants would avoid cashing in their policies on a secondary market, despite only 48% believing their policy to be good value. Only 9% said they would be tempted because they had not wanted to buy it in the first place, and an additional 10% said they were in a position to cash in their annuity because they had another source of income. Around 40% agreed there was a high risk they would end up worse off if they cashed in their contract. Gareth Connolly, chairman of the IFoA pensions board, said: 'It remains to be seen how much demand there will be in practice for buying secondary annuities once the market has developed, and whether they will be good value for pensioners. As the YouGov survey demonstrates, annuities will continue to play an important role in the pensions market as people value the certainty they provide. Access to adequate financial advice will be vital for pensioners in understanding the pros and cons, and the inherent risks, relating to the new option they will have available. Many annuitants will likely be amongst the most vulnerable in society. It is therefore crucial that the implications of choices are fully understood and that consumer safeguards are in place to reduce the risk of mis-selling'.[120]

In July 2015, the Government announced that the introduction of a secondary annuity market would be delayed until April 2017, much to the relief of industry. Huw Evans, director general of the ABI, said: 'The new timetable announced today is a very welcome move and follows strong representations from the industry that the previous timetable was

---

[117] The challenges of setting up a secondary annuity market are set out in the Government's own consultation document: HM Treasury and DWP (2015) Creating a secondary annuity market, Cm 9046 March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413764/Creating_a_secondary_annuity_market__web_file_.pdf

[118] Reported in Scott Sinclair (2015) Small pot annuitants 'most likely' to sell up, Professional Adviser, 27 March.

[119] Reported in Professional Adviser (2015) At least third of annuitants to stick with plan – poll, 21 April.

[120] Reported in Natasha Browne (2015) IFoA - Half of annuitants would resist urge to cash in contract, Professional Pensions, 23 June.

too quick. Providers want the reforms to the secondary annuity market to work for customers and it is right more time is allowed to get the right structures and regulation in place before going ahead'.[121] The same announcement also allowed the annuity to be sold back to the original annuity provider.

*Marketable annuities could be classified as safe harbour products.*

#### *2.2.1.4 Annuities with guarantees*

##### Extended guarantee annuities

HM Treasury (2014, p 14-15)[122] announced that it would remove the 10-year guarantee period limit for guaranteed annuities and allow payments to be made to beneficiaries from guaranteed annuities to continue beyond the current 10-year maximum. This will allow providers to create annuities that ensure more of an individual's fund is returned to their families in the event of their death.

However, such extended guarantee annuities are expensive to offer and it appears unlikely those over 75 would be permitted to buy them.

*Annuities with extended guarantee periods could be classified as safe harbour products.*

##### Annuities with capital protection

One way to overcome members fears of losing their capital when they die is the capital-protected (also known as the value-protected or money-back) annuity. This might be more attractive than an annuity with a 10-year guarantee period.[123]

These annuities work by gradually phasing into full annuitisation over a period of time. Only a small amount of the fund is annuitised in the first year after retirement, and then there is a gradual increase in the percentage of the fund annuitised, with full annuitisation occurring only by around age 80, after which age the entire remaining fund will be lost on death in exchange for the lifetime income guarantee.

The capital-protected annuity removes one of the single biggest consumer objections to annuities: 'If I die soon after I retire, the annuity provider will keep my fund'. The 'live or die' guarantee of the member getting their money back is very easy to explain and avoids uncertainty by allowing the member to lock into investment and longevity guarantees to provide guaranteed lifetime income.

---

[121] Quoted in Michael Klimes (2015) Industry relieved by secondary annuities market delay, Professional Pensions, 8 July.

[122] *Freedom and Choice in Pensions: Government Response to the Consultation*, Cm 8901, July.

[123] The attraction of a capital protected annuity was further increased by the abolition of a 55% tax charge from 6 April 2015.

The cost of the capital protection is around 7% for a standard healthy life and 14% for an unhealthy life. In October 2014, the best annuity rate for a standard 65-year old male with a £100,000 pension pot was £6,024 pa, while it was 7% lower for a 100% capital-protected annuity at £5,596. For a 65-year old male who survived a heart attack, the rate was £7,130, while full capital protection lowered the rate to £6,119, which is 14% lower.[124]

In April 2015, MGM Advantage introduced a capital-protected annuity which offers retirees a selection of guarantee options with improved death benefits. This is achieved through either an extended income guarantee period of up to 30 years or returning the fund balance in a lump sum. Another option is for a capital protection benefit of up to 100% of the initial purchase price, giving a lump sum on death at any age. Andrew Tully, pensions technical director at MGM, said: 'The money-back guarantee is a cost-effective option that everyone should consider, and which can be designed to suit the needs of individual customers. This gives families peace of mind that the money invested in providing a secure income won't be lost and removes the understandable sense of financial injustice that can sometimes be felt when a holder dies early. [MGM's own research showed that consumers do still want a secure income for life, so] it's important that annuities are reinvigorated so they can remain central to retirement planning in the future'.[125]

*Annuities with capital protection could be classified as safe harbour products.*

Ruin-contingent life annuities

Another type of annuity with guarantees is the ruin-contingent life annuity (RCLA) which makes payments based on two contingencies related to longevity and weak investment performance. A RCLA is an annuity that pays out only if both the pensioner is still alive at a certain date and there has been weak investment performance prior to that date. The payments are inflation protected.

*RCLAs are not currently available in the UK.*

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

This type of annuity (also known as 'investment-backed'), which accounts for 5% of total annuities sold, invests the premium in one or more funds. There are two types: with-profits annuities (WPAs) and unit-linked annuities. As the name suggests, the former invests in a with-profits fund; the latter invests in the annuitant's choice of a range of unit-linked funds, which can be actively or passively (indexed) managed. The income, which is set at the outset with reference to the prevailing annuity rate and an assumed investment return, might fluctuate significantly, depending on the choice of fund. On average over the long run, a

[124] Katie Morley (2014) The annuities that don't die when you do, Daily Telegraph, 22 November.
[125] Quoted in Jenna Towler (2015) MGM unveils 'money back' annuity guarantee, Professional Adviser, 1 April.

higher income should be achieved by an ILA which invests in growth assets compared with a LTA which invests mainly in bonds, but this is not guaranteed.

ILAs offer a similar range of features to the LTA, such as single or joint life, a guaranteed period, and different payment frequencies. We understand that enhanced terms can also apply. Some providers set a guaranteed floor below which the income will not fall, which might be around 50-55% of the LTA rate at the time of purchase. As with a standard annuity, a mortality premium is built into the return, although this is likely to be smaller than with a LTA because, in general, it is only the wealthier and healthier annuitants who buy this product.

While favoured by some experts, due to the potential for income growth, there are important considerations that might make this product unsuitable for some people:

- Standardisation – There is little standardisation in product design, which makes it very difficult to compare like with like. Nevertheless, the purpose of the ILA is to combine the best features of drawdown – maintaining an investment in growth assets in the immediate period after retirement – with the best features of an annuity – providing longevity insurance. In principle, if it were well designed and offered good value for money, the ILA would be an attractive competitor to drawdown, particularly if it included capital protection features which are currently not common. It is also more attractive than a LTA for those who would not qualify for an enhanced LTA rate and who have no partner or dependants to consider. The ILA might also represent a suitable component part of a mixed portfolio of DC decumulation products.
- Cost – Annual costs are estimated at about 2% p.a., with a higher charge in the first year to include the cost of advice. However, we were shown many examples where the costs were not easy to calculate. Nevertheless, charges are typically lower than with drawdown
- Investment risk – Investment risk and income risk are closely connected, as we show in the more detailed consideration of the with-profits annuity below. The perceived attraction of the ILA is that it will deliver a higher income over time than is possible with the LTA, therefore the fund must generate a minimum level of growth, after charges, so that the actual maximum income that can be drawn is higher than that offered by the LTA rate that was available at the date of purchase.

Example: With-profits annuities

To explore the risks of the ILA, we focus on the with-profits version. It is significant to note that the with-profits market is generally in decline, as a result of reputational damage caused by Equitable Life and with-profit mortgage endowment policies. Nevertheless, several providers – including mutual insurers – continue to offer the fund as a general investment. The important point here is that the choice of provider and its financial strength

(which indicates its ability to support future bonuses, among other factors) is crucial. Where a provider closes its with-profits book to new business, the investment strategy will become more cautious as the book matures.

With-profits funds invest in a range of asset classes, for example, bonds, equities and property. The declared annual bonus is set to provide a smoothed – generally growing – income from the fund, unlike the income from a unit-linked fund which is much more volatile since the value of the units directly reflects the value of the underlying fund. The smoothing mechanism requires the holding of a reserve, with the objective of delivering a fairly stable income even during periods where the markets are volatile and falling.

How the bonus is calculated is not at all transparent to customers. The initial income is set in accordance with basic LTA principles, but the future income in a particular year depends on the relationship between the declared bonus – which represents the actual 'return' on the fund to the annuitant in that year – and the anticipated bonus rate (ABR) – which is the projected growth rate of the fund. The annuitant – with the help of his or her adviser, where relevant – can increase the starting income by selecting a higher ABR.

The Retirement Academy describes the process as follows:

> *The ABR can currently be anywhere between 0% and 5% and effectively allows a policyholder to borrow against future income payments. At the end of the year, the anticipated bonus is subtracted from the annuity before adding the actual bonuses declared in that year. If the anticipated bonus is lower than the declared bonus, the annuity payments increase and vice versa.*
>
> *For example, if you select a 4% ABR, the starting income will be similar to a standard level annuity. This makes sense because standard annuities are priced in relation to yields on fixed interest bonds which in normal market conditions are around 4%. The ABR is effectively the yield on which the WPA is priced. Whereas the yield on the standard annuity is fixed for the term of the annuity, the annual bonuses on WPAs change every year.*
>
> *This means that, if in year two the declared WPA bonus is higher than the ABR, the WPA income will increase, whereas, if the bonus is lower the WPA, income will fall.*
>
> *Example*
>
> *Assume a WPA with an ABR of 4% pays a starting income of £ 1,000 p.a.*
>
> *If the year 2 declared bonus is 5%, the Year 2 income increases to*
>
> *£ 1,000 x [1.05 (Declared bonus) – 1.04 (ABR)] = £1,010*
>
> *However if the year 2 declared bonus is 3%, the Year 2 income decreases to*
>
> *£ 1,000 x [1.03 (Declared bonus) – 1.04 (ABR)] = £ 990*

A few insurance companies have tried to launch a product that invests part of the premium in a LTA and part in a with-profits annuity. However, we understand that these products have been withdrawn after a short period.

Despite the current poor reputation of with-profit products, there is great value to having a product which smooths out investment returns (using a smoothing fund) and provides an income for life.[126] There is therefore a strong case for 're-inventing' with-profit annuities with a new name. However, this will only be successful if there is much greater transparency over how the smoothing is done and also over costs.

*If the issues surrounding standardisation, cost and investment risk can be resolved, then ILAs (with a minimum income underpin[127]) could be classified as safe harbour products.*

#### *2.2.1.6 Deferred annuities*

With a deferred annuity, a premium is paid when the annuity is purchased, but the income received does not start for a number of years. In the case where the income does not begin until the purchaser has reached a high age such as 80 or 85, the annuity is known as an advanced life deferred annuity (ALDA). In the standard case, the premium is non-refundable if the purchaser dies before the payments begin.

A deferred annuity is potentially an ideal asset in a drawdown programme. It would, however, require investment managers to partner with insurance companies to provide ALDAs.

However, there are a number of important hurdles to cross. First and foremost is the fact that a deferred annuity market does not currently exist in the UK. There used to be a market for deferred level annuities for the self-employed, but a combination of high inflation in the 1970s and more onerous regulatory capital requirements under various EU solvency capital requirements led to its demise. Solvency II, introduced in January 2016, will not help. Second, deferred annuities would need to be medically underwriten and this will add to costs. Third, there is the reluctance of individuals to buy deferred annuities because they are concerned that they might die during the deferment period.

A key question is: 'will deferred annuities make a comeback?'. Adrian Boulding, Pension Quality Mark chairman, believes they could do. He points to the growing success of 'longevity insurance' in the US which is the US name for a deferred annuity. It works by using 10-15% of the pension pot at age 65 to buy longevity insurance. Mr Boulding believes that having to pay for longevity insurance upfront might put people off and prefers the idea of monthly instalments. Simon Chinnery, head of UK defined contribution at J.P. Morgan

---

[126] David Blake (2003) Take (Smoothed) Risks When You Are Young, Not When You Are Old: How To Get The Best From Your Pension Plan, *IMA Journal of Management Mathematics*, 14, 145-161.
[127] Such as 80% of the initial amount.

Asset Management, also believes deferred annuities will make a comeback: 'There will still a place for annuities as the primary retirement vehicle for those wanting certainty, but we're likely to see more investors incorporating partial or deferred annuities as one part of a wider investment mix'.[128]

Others doubt whether this will happen. Adrian Kennett, director at Dalriada Trustees, said: 'Who is going to voluntarily buy this product? If you are taking your DC benefit flexibly, you are doing that because you want the cash now. The only way that product will fly is if someone legislates to say you have got to buy it – and that is not going to happen because that goes against the pension freedoms'. David Harris, managing director of TOR, argues that communicating the benefits of deferred annuities would be a challenge: 'They are notoriously confusing and complicated to explain'.

Andy Cheseldine, partner at LCP, believes it is a matter or branding: 'If you asked people, "would you like to buy an annuity?", 90% of people would say "no, no, that's horrid". But, if you asked, "would you like an insured guaranteed income in retirement?", a lot of them would say "yes". It's the same thing, it's just annuities have had a bad press'. Mr Cheseldine accepts that deferred annuities could be expensive, but believes the strengths outweigh the weaknesses: 'It will look expensive no matter how you do it, but being expensive does not make it poor value. I think it would be popular if you get it right. There are some people who would not be able to afford it and just take cash. If you are going to take your income over the long term, then this is a really good safety net and does make sense. These products will then be popular because it means people are not running out of money in old age'.

Mark Stopard, head of product development at Partnership, believes that the way that deferred annuities are sold – through the retail market or packaged up as part of an integrated institutional solution – will also have an important impact: 'From the customer's point of view, it needs to be a packaged solution. As soon as you ask consumers to buy an add-on, it becomes a more complicated and difficult decision for consumers'.

*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.*

[128] Simon Chinnery (2015) Close collaboration - 'Retirement ready' clients need long-term advice, Professional Adviser, 5 May.

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

The 2014 Budget overhaul of the DC decumulation tax rules, and, in particular, the new regime after Flexiday, will – or certainly *should* – focus attention on the value of the LTA as an insurance product that provides a perfect longevity hedge for pensioners in later retirement, when insurance against living beyond their life expectancy becomes a more important consideration than investment returns. Such a focus would recognise that the real weakness in the new DC regime is the long tail of longevity risk that individuals must bear.[129]

In the US, one form of DC decumulation for those with 401(k) pension plans[130] is to split the fund, say, 85/15, between a drawdown product and a deferred annuity product. The former, known as a 'rollover' or income retirement account (IRA), operates in a similar way to income drawdown. The latter can come in one of two forms: a deferred income annuity (DIA) or, since 2014, a longevity insurance annuity (LIA). The distinction is that DIAs can start at any age, while LIAs start at advanced ages. LIAs are also known as an advanced life deferred annuities or simply as longevity insurance. 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, although they could start as early as age 70. Both types are purchased at the time of retirement.

When they are purchased through IRAs, LIAs are provided on a gender basis. LIAs are also available through employer-sponsored plans under ERISA,[131] but in this case must be provided on a unisex basis. Because annuities sold on a unisex basis disadvantage men and the extent of the disadvantage increases with age, men are reluctant to buy unisex LIAs. One of the respondents to our consultation told us: 'In my view, a market for longevity insurance annuities is not viable in the UK, because they would be offered only on a unisex basis. The difference in life expectancy by gender at older ages makes these annuities unfavourable to males, so, in principle, they would only be offered based on female mortality rates. To my knowledge, nowhere in the world is there a viable unisex longevity insurance market'.

The basic LIA is pure insurance: it only pays out if the insured individual lives until the specified age. It is possible to buy certain features, which reduce the rate, e.g.:

- Death benefit – if the annuitant dies *before* the start of payments, the insurance company returns the value of the fund and, in some cases, adds an amount for interest.

[129] This is discussed in detail in Chapter 4.

[130] A 401(k) is an employer-sponsored pension scheme ('plan' in the US), similar in some ways to a group personal pension in the UK. It is named after the section of the tax code that governs the plans, introduced in the 1980s.

[131] Employee Retirement Income Security Act 1974.

- Cash refund – if the annuitant dies *after* payments commence, the balance of the fund is paid to his or her beneficiaries.
- Early payment – this can be arranged with some providers, for example, where the annuitant has to go into a nursing home. This element is also known as a life-care or immediate needs annuity (see Section 2.2.1.8).

Only a small number of US life companies offer LIAs, notably, New York Life Insurance Company, Symetra Life Insurance Company and Northwestern Mutual Life Insurance Company. New York Life is currently the largest seller, although only 4% of the purchasers of these annuities buy a pure LIA; the rest are LIAs with death benefits. Fidelity and Vanguard sell DIAs. LIAs are also sold in Chile, but not currently in the UK.

The combination of tail-end longevity insurance (via a LIA) and drawdown potentially sounds an attractive proposition, but there are some problems. The first is the regulations on unisex annuities, although this could possibly be circumvented by individual underwriting. Second, the standard LIA is a level annuity, so the impact of inflation is likely to be significant by the time the annuitant begins to draw the income. Third, from a regulatory perspective, LIAs are capital intensive for insurers to provide in the absence of a longevity hedge.[132]

*Nevertheless, if these problems can be overcome, LIAs could be classified as safe harbour products.*[133] *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

There are two types of enhanced annuity:

- Lifestyle annuity – provides higher annuity payments to an individual who has a lower life expectancy than a typical member of that individual's cohort as a result of the individual's lifestyle. An example is an individual who smokes or is obese. A smoker can get a 10-15% higher annuity payment than a non-smoker of the same age.[134]

---

[132] The classic longevity hedge is a longevity bond, but such bonds do not currently exist. Longevity bonds are discussed in detail in Chapter 4. The same problem applies to deferred annuities, and indeed to annuities more generally.

[133] More information on LIAs can be found here: Michael Kitces' blog for 9 July 2014 entitled 'Why The New Qualifying Longevity Annuity Contract (QLAC) Regulations Don't Mean Much For Retirement Income… Yet?'; https://www.kitces.com/blog/why-the-new-qualifying-longevity-annuity-contract-qlac-rmd-regulations-for-dont-mean-much-for-retirement-income-yet/

[134] Cazalet Consulting (2014, p. 69) *When I'm Sixty-Four*, September.

- Impaired life annuity – provides higher annuity payments to an individual who has a medical impairment which lowers their life expectancy. Examples would be heart disease, high blood pressure, cancer, and Parkinson's disease. Someone with prostate cancer can get a little more than twice the amount paid to a normally healthy person of the same age.[135]

All enhanced annuities are medically underwritten: individuals applying for one need to fill in a health questionnaire and might also need to give permission to their doctor to show the insurer their medical records. If the health questionnaire contains an extensive set of questions and the insurer also makes a detailed examination of the applicant's medical records, a procedure known as full underwriting, the applicant might be offered a much higher annuity than the standard annuity, since the insurer will now have a better estimate of the applicant's reduced life expectancy. If, on the other hand, the health questionnaire is short and there is no examination of the applicant's medical records, a procedure known as light underwriting, the level of enhancement offered might be quite small compared with a standard annuity.[136]

Billy Burrows argues that enhanced annuities are hard to beat when compared to drawdown (in *The Case for Annuities*, April 2015). The annuity specialist Partnership estimates around 65% of people could qualify for an enhanced annuity.[137]

Immediate-Needs/Long-Term Care Annuities

The standard benefit from a long-term care (LTC) insurance policy is a particular type of LTA known as an immediate-needs or long-term care annuity. This will pay an income for the remainder of the policyholder's life and the income is used to fund long-term care for the policyholder.

It is important to bear in mind that, while an immediate-needs or LTC annuity is payable for life, there is no guarantee that the annuity will provide sufficient income to cover the full cost of the care required. This might be because the inflation rate in LTC provision is much higher than the general inflation rate. There are also tax benefits if the annuity is paid directly to the care or nursing home: the policyholder is not liable to income tax on the annuity payments.

It is also important to recognise the possibility that the policyholder might eventually experience dementia and that this should be prepared for by the policyholder assigning a power of attorney to a family member or solicitor who would, if necessary, take responsibility for spending the income under the annuity.

---

[135] Billy Burrows (2015, p.9) *The Case for Annuities*, Retirement Intelligence.
[136] See Retirement Health and Lifestyle Forum; http://www.retirementhealthform.co.uk/
[137] Reported in Jenna Towler (2015) Enhanced annuities - Top ten medical conditions clients should disclose, Professional Adviser, 16 July.

Tom McPhail and Patrick Gale, Defaqto non-executive chairman, have proposed that the Government allow savers to access their pension pots tax free to pay for long-term care,[138] a move supported by Dr Ros Altmann, then the Government's business champion for older workers, in her report *A New Vision for Older Workers* released in March 2015.[139]

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

#### *2.2.1.9 State annuities*

On 2 April 2014, the Government announced the details for its plan to allow pensioners and those who reach pension age before 6 April 2016 to top-up their state pension by up to £25 per week.[140] The offer, which will be available for 18 months starting in October 2015, will enable people to get a higher inflation-proofed state pension by making Class 3A Voluntary National Insurance Contributions. The cost is based on age and takes account of average life expectancy. For a 65-year-old, an extra £1 of weekly pension will cost £890; for a 75-year-old, £1 per week will cost £674. A calculator is available online.[141]

This is an interesting move on the Government's part, as, in effect, it represents a short-term entry into the retail annuity market. The Government's pricing compares very favourably with an index-lined annuity bought on the open market.

### 2.2.2 Drawdown products

#### *2.2.2.1 Issues to consider with drawdown*

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 withdawals 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. But, this is not the case with drawdown where the customer has to make an

[138] Carmen Reichman (2014) Pensions experts call for policy intervention on care funding, Professional Adviser, 12 November; Carmen Reichman (2014) Care for a tax break? Funding LTC through pension savings, Professional Adviser, 28 November.

[139] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/411420/a-new-vision-for-older-workers.pdf

[140] https://www.gov.uk/government/news/state-pension-top-ups-pensions-can-be-increased-by-up-to-25-a-week

[141] www.gov.uk/state-pension-topup

active decision to withdraw cash and the fund can run out of money before the customer dies.

Drawdown has three components:

- the product in which the pension pot is invested according to an agreed investment strategy
- the arrangement for delivering the pension (e.g., a self-invested personal pension scheme or scheme drawdown), and
- the withdrawal strategy, the programme for withdrawing funds over time to finance expenditures.

Drawdown, by itself, does not have to have a longevity insurance strategy, and, because of this, it could not be classified as either a pension scheme or a safe harbour product.

As an investment product that is classified by the FCA as potentially high-risk, the regulator used to require a fully advised process for drawdown. This is distinct from guided- or non-advice (execution-only) which is the most common method of purchasing annuities, particularly for funds worth less than £100,000. However, providers and advisers now make drawdown available for DC customers with as little as £30,000 to invest. Since, Flexiday, drawdown customers are not required to take regulated advice.[142]

The suitability of drawdown in relation to the risk-return trade-off will depend partly on the individual's risk tolerance, but also on a professional assessment of the 'Type A Critical Yield'. This is the return needed to provide and maintain an income equal to that obtainable under an equivalent immediate annuity. The calculation assumes that an income will be taken at the level of the available annuity until a specified age (usually 75) and, at that age, there will be sufficient money in the drawdown fund to purchase an annuity equal to what could be bought at the point when drawdown started. The higher the annuity rate available (for example, enhancements might apply), the higher the critical yield required.

Unfortunately, it appears that the regulations on calculating the critical yield, which were introduced in 1998, are out of date and contain dangerous loopholes. Where these loopholes are exploited, this could lead to cases of mis-selling on the basis of an understated investment risk. In particular, the rules do not specify the basis of the calculation. A revision to the rules should include the requirement to use the best OMO rates, including the best enhanced rates.

Annuity Direct gave us the following explanation:

> *This creates an issue in that the basis for the annuity is not properly defined and when Regulatory Update 55 was drafted in August 1998, the*

[142] This is discussed in more detail in Chapter 3.

*enhanced market was not as advanced as it is today. This means that providers generally use their own annuity rate to calculate the critical yield. The result will be that, where the annuity rate is not competitive, the critical yield will be lower, resulting in the risks of drawdown being understated.*

*The problem is exacerbated when a client is eligible for an enhanced annuity, because the higher the annuity rate available, the higher the yield required. Our practice, therefore, is to broke the annuity in the open market – including medical information where appropriate – and then to use the highest annuity rate to calculate the Type A Critical Yield. The following example may help:*

*A client has £61,000, which he wants to use for drawdown.*

*The quote from the [provider's name deleted] internal rates produced an annuity of £3,010 and this was used to calculate a Type A Critical Yield of 6.6% p.a.*

*We were able to obtain an enhanced annuity for the client amounting to £3,488. When we ran this rate through the critical yield quote system, the required yield increased to 7.65% p.a.*

A final issue to consider is the implication of the ageing process, as Fiona Heald, head of court of protection at Moore Blatch, points out. Drawdown, unlike an annuity, requires the person to be able to manage their financial affairs until they die. However, as individuals age, they are more likely to experience a physical or mental disability that could reduce their ability to manage their own affairs. The appropriate way to prepare for such an eventuality is through a lasting power of attorney (LPA). This is a legal document allowing the 'donor' to appoint someone (known as an 'attorney') to make decisions on their behalf, should they have become incapacitated. There are two types of LPA, one for managing a person's health and welfare, and one for managing a person's property and financial affairs.[143]

### *2.2.2.2 Examples of drawdown products*

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.

We begin with the investment funds that have been proposed for use with drawdown. The most common are multi-asset funds – in particular, diversified growth funds (DGFs) – multi-asset target return funds, and multi-asset income funds. There are also examples of multi-manager funds. In addition to the charges (for administration and fund management)

[143] Reported in Jenna Towler (2015) Why all drawdown clients need lasting power of attorney, Retirement Planner, 20 August.

reported below, 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.[144]

We came across the following examples of diversified growth funds:

- Prudential has launched a range of diversified growth funds. The five Dynamic Growth Funds were designed to reflect different member risk appetites, with the lowest risk option having a 30% weighting in equities and the highest risk option having 100% exposure. The asset allocation of the different funds is built using sub-funds, such as Blackrock's passive equity funds and M&G's active fixed interest funds. Charges fall within the 0.75% charge cap imposed on default investment funds in the accumulation stage[145]
- HSBC Global Asset Management has introduced three risk-rated multi-asset retirement funds: cautious, balanced, and dynamic. Head of UK institutional, Stuart White, said the DC investment world needed to move from a 'collectivised approach' to 'mass customisation' where savers' individual needs can be met.[146] Each portfolio will have an annual management charge of 0.25% and the ongoing charges figure (OCF) will vary between 0.46% and 0.53% depending on the underlying asset mix.
- Blackrock has introduced a dynamic diversified growth fund with a charge of 0.65%.

Similarly, some examples of target return funds:

- Pimco's multi-asset fixed income fund has a target return that is based on the average of three objectives – tracking annuity prices, outperforming cash and producing a stable income – thereby providing a compromise between the requirements of those who want an annuity and those who prefer to remain in drawdown
- Legal & General Investment Management's (LGIM) Retirement Income Multi-Asset (RIMA) Fund. This has a target return of 3.5% above the Bank of England base rate over a complete 5-7 year market cycle. Income is paid by redeeming units and LGIM

[144] The reader will notice that different companies give different names to the charges that they impose, e.g., annual management charge AMC), annual fund management charge, ongoing charges figure (OCF) and total expense ratio (TER). Further, some of the charge measures (e.g., AMC) are defined by different companies in different ways. This is potentially confusing to customers who should also note that the headline charge is not always the total charge imposed. For example: 'The ongoing charges figure (OCF) shows the drag on performance caused by operational expenses associated with a fund. Expenses which are represented by this figure include payments to the manager [annual fund management charge], the trustee, the custodian and their representatives. The figure also includes registration, regulatory, audit and legal fees, and the costs of distribution. Performance fees, transaction costs, interest on borrowing, costs associated with derivatives, entry and exit fees and soft commissions are not included in the OCF calculation, and should be factored in separately by the investor' (Source: Trustnet).

[145] Reported in Stephanie Baxter (2015) Prudential launches multi-asset funds in response to Budget freedoms, Professional Pensions, 24 April.

[146] Quoted in Professional Adviser, 4 March 2015.

believes that a drawdown rate of 6.5% is sustainable. The fund's principal investments are bonds and equities, but the fund also invests in property and alternatives, such as global real estate investment trusts, infrastructure, private equity and high yield bonds.[147] This involves a much greater diversification into long-term growth assets than traditional drawdown products, a key benefit of institutional design. But LGIM is also concerned that savers are not forced to sell assets in distressed markets and so the fund is designed to generate sufficient regular cash flows from coupons, bond redemptions, and dividends. The annual fund management charge is 0.35% p.a.[148]

- Schroder's Flexible Retirement Fund is a multi-asset fund – invested in risk-seeking assets, such as equities, and property, but also investment grade bonds – has the target of generating returns in line with the Consumer Price Index plus 2% for members over a three to five-year business cycle, with losses limited to 8% over any time frame. John McLaughlin, head of portfolio solutions, said: 'When volatility goes above 6%, we take a break. If something spooks the market, we would immediately put a quarter of the portfolio into cash – so if, for instance, stress is at 8%, they would sell out and take volatility down to 6%'.[149] The fund has sufficient liquidity to meet withdrawals. The annual fund management charge is 0.3% p.a.[150]

Multi-asset income funds aim to generate a stable income (higher than on a deposit account) with capital preservation.[151] There are three types of income funds: (a) equity income funds which invest in the equities of mature companies and utilities generating a dividend yield in excess of 3.5% per annum, (b) fixed-interest income funds which invest in corporate bonds but offer no capital growth, and (c) covered call funds which use call options to boost the 'natural' income[152] produced by the underlying assets, paid for by giving up some capital growth.

Some examples of multi-asset income funds involving equities or bonds are: Premier Multi Asset Monthly Income (estimated yield 5%), Fidelity MoneyBuilder Balanced (4%), Woodford Equity Income (4%), Artemis Global Income (3.2%), Henderson UK Property (3.4%) and Jupiter Strategic Bond (3.2%). Typical multi-asset income funds have annual fund

---

[147] David Blackman (2014) Welcome to the world of drawdown, Pensions Insight, November/December.
[148] http://www.trustnet.com/Factsheets/Factsheet.aspx?fundCode=M5FUH&univ=P
[149] Reported in Louise Farrand (2015) Five new investment innovations ahead of April 6th, Pensions Insight, 6 March.
[150] http://www.schroders.com/globalassets/staticfiles/schroders/sites/ukinstitutional/pdf/schroders-flexible-retirement-fast-facts-january-2015.pdf
[151] Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.
[152] This concept is explained in Section 2.4.

management charges of around 0.9% a year.[153] The M&G Episode Income fund has a 1% fund management charge. It aims for a 4% yield, is managed dynamically and holds between 20% to 50% in equity, 40% to 80% in fixed income (including cash), and up to 20% in other assets.

Examples of covered call funds are: Insight Equity Income Booster (estimated yield 8%), Schroder Income Maximiser (7%), Schroder Asian Income Maximiser (7%) and Fidelity Enhanced Income (6.2%).[154]

Danny Cox, head of communications at Hargreaves Lansdown, argues that income funds should be a serious consideration for customers considering income drawdown.[155] Nevertheless, Tom Becket, chief investment officer at Psigma Investment Management, has warned that, as a result of quantitative easing, it has much more difficult for income funds to generate returns without taking on more risk. He said: 'Years of monetary stimulus had turned low-risk, higher-yielding assets into high-risk, lower-yielding assets….It has never been more difficult to be a cautious investor. In fact, the term 'cautious' is now basically prehistoric as the ravaging and distorting effects of central bankers have eliminated the return potential of most traditionally cautious investment choices….Our analysis shows that some cautious funds [which traditionally invested mainly in gilts and investment grade bonds] now have around 50% of their assets in equities, mostly in income strategies'.[156]

It is also the case that UK equity income fund managers are struggling to find suitable investment opportunities in the UK and are beginning to look overseas. They are able to hold up to 20% of their assets in overseas equity markets. Some of the largest funds are nearing the 20% limit (e.g., Newton UK Income), although the average for 2015 is 13%, up from 10% in 2013. Simon Molica, senior investment consultant at Morningstar which compiles the data, said: 'If your manager is buying overseas stocks, you need to understand how the currency could add to the volatility within the fund performance, and whether the fund hedges currency exposure'.[157]

Multi-manager funds outsource investment decisions to other fund managers. These can have higher annual fund management charges up to 2%, although some are lower.[158] For example, Schroder's Multi Manager Diversity Funds have OCFs in the range 1.26 – 1.97%.[159]

---

[153] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.
[154] Kyle Caldwell (2015) Five ways to invest a £300,000 pension pot, Daily Telegraph, 17 April.
[155] Quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.
[156] Laura Dew (2015) Psigma's Becket - 'Cautious' is now a prehistoric term, Investment Week, 15 April.
[157] Reported in Anna Fedorova (2015) Yield squeeze forces UK income fund managers to look overseas, Investment Week, 16 June.
[158] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.

Hargreaves Lansdown has a multi-manager range of six funds for non-advised retail investors called Portfolio Plus. The six funds, which are rebalanced back to their original weightings every six months, are: Adventurous Income (estimated yield 3.03%), Balanced Income (estimated yield 3.03%), Conservative Income (estimated yield 2.38%), Adventurous Growth, Balanced Growth and Conservative Growth. There are no set-up charges, but the annual management charge varies between 1.34% and 1.46% and there is an additional platform (Vantage) charge of 0.45%. The portfolios are constructed from Hargreaves Lansdown's five multi-manager funds, including its Equity & Bond and Special Situations funds.[160]

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 than those used to provide an annuity (mainly bonds)
- 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[161] 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

---

[159] http://www.trustnet.com/Factsheets/Factsheet.aspx?citiCode=KR23&typeCode=FIJB2&univ=O

[160] Reported in Professional Adviser (2015) Hargreaves Lansdown unveils 'ready-made' portfolios for non-advised investors, 2 June.

[161] This is discussed in depth in Chapter 3.

returns over time.[162] 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 marketAnnuity-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.

David Trenner, technical director at Intelligent Pensions, argues that the new style multi-asset funds will fail to deliver in precisely the same way that the old style multi-asset funds failed to deliver:

> *[I]f the objective of drawdown is to provide income for life, the one keyword that seems to be absent from all of these changes [following pension freedom] is sustainability.*
>
> *Quite simply people want to ensure that their income does not expire before they do.*
>
> *Back in 1995, a number of the early drawdown plans offered by insurance companies offered with-profits investment.*
>
> *With reversionary bonus rates as high as 9% per annum, it looked simple to take the bonuses as a sensible level of income, leaving the capital intact.*
>
> *Some companies did not offer with-profits funds for drawdown, however.*
>
> *They argued that bonus rates might fall – how right they were! They also drew attention to the need for market value reductions when the underlying value of assets was below the face value of the with-profits units.*
>
> *So these companies introduced drawdown invested in managed funds.*
>
> *These invested in cash, bonds, property and equities to provide the prospects for growth, but with downside protection. But they did not solve the problem of taking income when markets were down: while the fund included cash it was still necessary to take income from all of the fund thereby capitalising any losses. …*

[162] A particularly lethal risk which drawdown customers face is 'sequence-of-returns' risk which is discussed later in the Chapter.

> *Since Mr Osborne announced the pension freedoms there have been few new products, but there has been a plethora of new fund launches. And the fund of choice seems to be the 'multi-asset fund'.*
>
> *These funds include income producing assets with income targeted at around 3% of the fund. But which client wants only 3%?*
>
> *From where I sit, multi-asset funds are just managed funds coming back with a new name, and if I am right, they will fail drawdown investors for the same reason that managed funds did.*[163]

*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. We focus on two key examples: variable annuities and guaranteed drawdown.

#### *2.2.3.1 Variable annuities*

The classic example of a hybrid product lying between lifetime annuities and drawdown is a 'variable annuity' (VA) which was invented in the US in the 1950s and was introduced in the UK around 10 years ago.[164] However, unlike a lifetime annuity or drawdown, VAs have an accumulation stage and a decumulation stage, although people are free to use only a decumulation stage VA. As such, they offer both living benefits and death benefits.

Living benefits are those which can be exercised by policyholders while they are still alive. These include:

- Guaranteed minimum accumulation benefits (GMABs)[165]
- Guaranteed minimum income benefits (GMIBs)
- Guaranteed minimum withdrawal benefits (GMWBs)[166]

---

[163] David Trenner (2015) Why multi-asset funds will fail drawdown investors, Retirement Planner, 28 May.
[164] VAs were first introduced in the US in 1952 by TIAA-CREF (Teachers Insurance and Annuity Association - College Retirement Equities Fund).
[165] GMABs include capital guarantees (e.g., a fixed maturity amount at age 75) and a guaranteed minimum return, while still permitting investments in equities, although this is really a stop-loss rather than a return guarantee.
[166] A GMWB can be interpreted as a RCLA on top of drawdown plan, implying that a RCLA is similar to a variable-annuity-style guarantee.

- Free partial withdrawals (FPWs). Under specified conditions, the policyholder can exercise the right to withdraw a proportion of the fund value without incurring a surrender charge. An example might be the option to withdraw up to a specified limit (e.g., 30%) of the expected value of the residual payments based on a mortality table at the time of purchase on a one-time only basis on a key date (e.g., the 5th, 10th or 15th anniversary) upon a 'significant non-medical loss'
- Guaranteed minimum surrender benefits (GMSBs).

Death benefits (in the form of guaranteed minimum death benefits, GMDBs) are those which accrue to contingent beneficiaries once the policyholder has died. The most common 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.

The lifetime income and investment guarantees, whereby the policyholder receives a minimum income irrespective of longevity and investment returns, are funded via an annual management charge and a restriction on maximum withdrawals in any year. The continued access to capital and higher death benefits comes at the expense of a lower income than available under a conventional lifetime annuity. The living benefits options incur higher charges as well as having the effect of reducing the death benefit paid to individuals who die at older ages, but also enable the provider to build up reserves from all policyholders up to the point of their death to help it honour the lifetime income guarantee to those who live a long time. This is the way in which the longevity bonus works with a VA.

The new flexible payment terms for standard annuities (see Section 2.2.1.3) also apply to variable annuities. Previously, while the income paid can increase if the underlying investment fund performs well, it was not possible to cut the income if the investments are performing poorly. In future, providers of variable annuities will be allowed to raise and lower the income paid depending on investment performance.

*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*

An example of a 'guaranteed drawdown product' is the Secure Income Option offered by MetLife, a US life insurance company with a presence in the UK since 2007.[167] The product offers flexible drawdown (in the form of immediate income and deferred income) with guarantees. Customers can consolidate existing DC pension pots into a pre-drawdown product and lock in a drawdown rate pre-retirement. There is a formula for uplifting the

[167] The following is based on discussions with MetLife.

drawdown rate if income is deferred. If the client chooses a secure income, this is guaranteed by MetLife. The drawdown rate is lower than an annuity by up to 30% (e.g., 4% at age 65 when the annuity rate is 5.5%), but allows more flexibility of access, a guaranteed income and death benefits. MetLife does not offer standard LTAs, but there is no maturity date with the guaranteed drawdown product which therefore potentially provides a guaranteed nominal income for life.[168]

Once purchased, the customer locks in guaranteed future income rates. If they elect not to take benefits on their initial chosen age, they have flexibility to change dates and use the guaranteed rate for new higher age, for example 4% at age 65 increasing to 4.10% at age 66. For each year the guaranteed income in delayed, MetLife will increase the guarantee base by 5%. So for a £100,000 investment, a delay in taking income by a year will increase the guarantee to £105,000. If after 12 months, the fund value is higher, e.g., increased to £107,000, then the higher fund value of £107,000 will be locked in and become the new guarantee base. In addition, if the fund has performed better than 5%, the higher value will be locked in annually.

Lump sum withdrawals above the guaranteed level of income will proportionately reduce the guaranteed income. For example, a £100,000 investment could pay a guaranteed income of £4,000 p.a. at 65. If the policyholder decides to withdraw a lump sum of £10% of the fund, the guarantee base would reduce by 10% to £90,000. Subsequently, the guaranteed income would reduce by 10% to £3,600.

The death benefit paid is the higher of:

- the initial guaranteed base minus guaranteed income taken, and
- the fund value.

So for example, suppose a policy has an initial guarantee base of £100,000. Suppose also £10,000 of guaranteed income is paid and the fund value has fallen to £85,000. The amount payable is £90,000. The policyholder's beneficiaries can take the death benefit as a lump sum or as income.

Longevity risk modelling and analysis is an important component of the design of the product and MetLife:

- Uses a standard actuarial table for mortality (not the general population table)
- Assumes a mix of males and females
- Makes adjustments to these tables to reflect MetLife's client demographics
- Allows for mortality improvements over time.

[168] There is no guaranteed income that is linked to an inflation index such as RPI/CPI. However, the product has the potential to provide increases in income in payment through good investment performance.

The product invests in unit-linked funds and involves unit-linked guarantees. The objectives of the funds chosen by policyholders are to manage volatility to a target and to seek a total return. This creates liabilities for MetLife. MetLife uses a dynamic hedging programme called constant proportion portfolio insurance (CPPI)[169] to hedge the risk to its balance sheet from offering these guarantees.[170] CPPI involves daily switching between unit-linked funds and risk-free assets (such as Treasury bills) as the value of the unit-linked funds changes. If the fund values fall, units are sold and T-bills purchased; if the fund values rises, the opposite set of transactions occurs. The goal of the hedging programme is to construct a synthetic put option to protect the portfolio from falls in the market values of the underlying assets. The effectiveness of the hedge depends on holding assets which can be readily bought and sold. This broadly means that the funds it offers will comprise equity and fixed interest assets which are listed on large stock markets. MetLife uses BlackRock (for equities) and Fidelity Worldwide Investment (for fixed income). Only small amounts of property or hedge funds are included in the portfolio as they are inherently unhedgeable asset classes.

Since no hedge is perfect, it is possible for mismatches between assets and liabilities to occur. In this case, the liability is MetLife's, so any shortfall would be met from MetLife's reserves/capital. If the hedging programme were to fail, then the shareholder capital would be used to cover any unmet policyholder liabilities. The only point at which the guarantee could fail would be if MetLife Europe Limited were to fail. In this circumstance, the customer's investment and their guarantee could be lost. However the products are covered by the FSCS.

Charges are as follows:

- Annual management charge (i.e., the charge for administration) – 0.70% for funds up to £149,999, 0.6% for funds from £150,000 to £249,999, 0.5% for funds from £250,000 to £499,999, and 0.4% for funds above £500,000
- Investment management charge (for the operation of the funds) – 0.55%
- Guarantee charge (for providing the income guarantee) – 0.60%
- Additionally, there may be an adviser charge.

[169] See, for example, André F. Perold and William Sharpe (1988) Dynamic Strategies for Asset Allocation, *Financial Analysts Journal*, January/February, 16–27; Fischer Black and André F. Perold (1992) Theory of Constant Proportion Portfolio Insurance, *Journal of Economic Dynamics and Control*, 16, 403-426; David Blake, Andrew Cairns and Kevin Dowd (2001, p.195) Pensionmetrics: Stochastic Pension Plan Design and Value-at-Risk During the Accumulation Phase, *Insurance: Mathematics & Economics*, 29, 187–215.

[170] Prior to September 2015, MetLife used over-the-counter options with a number of counter-parties to hedge this risk.

This means that the charge for a £50,000 investment by a 65-year-old would be 1.85%, excluding any adviser charge.[171]

The preferred customer is someone with a £1.5m pension pot who uses £0.5m to provide minimum core income for essential spending and puts £1m into a diversified portfolio. Next are clients with other assets who want to guarantee a legacy for their descendants with long-term capital guarantees. Next are mass affluent clients with £100,000-150,000. MetLife has now brought down the minimum to £30,000, in line with the new level of trivial commutation.

Clients come via advisers (i.e., the product is an advised solution) who help explain longevity risk and the risk of underestimating how much people need to live on using cash flow modelling software (e.g., Voyant) which inputs data on typical spending patterns of the client. According to MetLife, 'advised sales provide greater comfort as benefits and risks of our products are explained to our customers and the adviser checks for understanding. For example, MetLife believes it is important how customers understand sequence-of-returns risk and how safe drawdown overcomes this'.[172]

Another example is Aegon which has launched a drawdown product with combined access to unit-linked guarantees on its Retirement Choices platform in July 2015. David Macmillan, Aegon managing director, said: 'The ability to combine true lifelong income guarantees with drawdown on platform will provide customers and their advisers with the certainty of income they tell us they want, but also with a huge amount of flexibility, both in terms of income and in terms of their ability to switch between products'.

Zurich is also launching a guaranteed drawdown product in 2016 that combines drawdown and a protection element that converts the plan into an income for life at a certain pre-determined age. The charge is not yet known. The product was designed in response to a survey Zurich conducted which revealed that 18% of respondents were interested in drawdown, but were fearful of running out of money. The survey results were as follows:

- 10% of over-55s in DC pension schemes have dipped into their retirement savings under the new freedoms
- 69% of over-55s have not explored their options under the new freedoms (37% were 'not ready', 26% had already bought an annuity).

The main reasons for not accessing pensions after exploring options were:

- 54% were not ready to make a decision

[171] Jenna Towler (2015) MetLife unveils flexible guaranteed drawdown offering, Retirement Planner, 14 September.

[172] http://www.metlife.co.uk/uk/Sales_Aids/2015/0471_Hour_of_Maximum_Danger.pdf. 'Sequence of return' risk will be discussed shortly.

- 34% were keeping their pension funds invested and tapping into other assets first
- 18% claimed the fear of running out of money by taking a lump sum or going into drawdown was holding them back
- 7% said their pension provider did not offer the option they wanted.[173]

*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

#### *2.2.4.1 'Mix and match'*

Just Retirement has launched a range of 'mix and match' retirement income products targeted at 'Middle Britain'. Alongside LTAs, it offers UFPLS, guaranteed income products with flexible extended guarantee periods and 'drawdown-lite' which invest in a selection of moderate to low-risk passive funds. Stephen Lowe, director, said: 'The consensus of consumer research shows that people with sufficient pension savings would like the best of both worlds – a guaranteed income for life to ensure regular bills may be paid and a flexible fund that may be accessed when required for irregular expenditure and to provide a 'just in case' fund'.[174]

#### *2.2.4.2 DIY*

Some commentators have proposed a do-it-yourself approach which involves investing in assets and dipping in to them to withdraw investment returns or capital as required. Simple examples of assets suggested for this purpose are investment trusts and exchange-traded funds that focus on income generation. Typical yields lie between 3.4 and 3.8%.[175] More sophisticated approaches would involve constructing a DIY fund, in other words, a personalised multi-asset fund consisting of UK and global income funds, possibly with some diversification into property.[176]

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

---

[173] Reported in Carmen Reichman (2015) Zurich to launch protected drawdown product, Professional Adviser, 9 September.
[174] Quoted in Jenna Towler (2015) Just Retirement unveils post-pensions freedom 'mix and match' products, Professional Pensions, 25 February.
[175] Richard Evans (2015) Need income from your pension? Here are six alternatives to an annuity, Daily Telegraph, 12 May.
[176] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.

### *2.2.4.3 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. So-called 'pension bank accounts' have very high charges. The initial fee could be as high as 3% and there will be additional administration and fund management charges of 1% p.a. For example, someone setting up a SIPP with Alliance Trust with a pension pot of £20,000 will pay an arrangement fee of £300, annual administration charge of £311 plus an annual fund management charge. Ad hoc cash withdrawals could cost anywhere between £30 and £400 per withdrawal depending on the SIPP provider.

In March 2015, the FCA said it would 'look at the different types of charging structures put in place, and look at whether they are sufficiently transparent [and whether] people are aware of what charges they will face'.[177]

The charges are a lot lower in providers' schemes that allow UFPLS.[178] For example, Aviva, Scottish Widows, Standard Life and Aegon will allow such withdrawals and will not charge extra for doing so or limit the number of withdrawals, while Legal & General and LV= will not, and Prudential and Friends Life were undecided as of February 2015.[179] However, most existing workplace DC pension schemes cannot currently be used as bank accounts, since they are not set up to offer this facility.[180]

In June 2015, the Daily Telegraph reported that Friends Life was refusing to allow clients to use their pension schemes as 'bank accounts', while other companies, including NEST, were refusing to allow clients to 'dip into their funds as often as they need'. Customers faced the following restrictions depending on the provider: a minimum withdrawal of £5,000, a maximum of 3 or 4 withdrawals per year, and no flexible access if the pension pot is less than £30,000. Fidelity charged no fee for up to three withdrawals per year, while NFU

[177] Katie Morley (2014) Pension 'bank accounts': You will have to pay for cash withdrawals, Your Money, Daily Telegraph, 8 November; Professional Adviser (2015) FCA to investigate 'rip off' pensions freedom charges – reports, 30 March.

[178] This option is not available with flexi-access drawdown.

[179] Katie Morley (2015) Will your pension provider give you freedom?, Daily Telegraph, Your Money, 14 February.

[180] Michelle Cracknell, chief executive of The Pensions Advisory Service (TPAS), said: 'The majority [of our calls now] are about how to cash in pension pots and what the tax positions is, and there is a lot of misunderstanding. People are saying to us "how do I [get the money] quickly" and I think the shock will be…that they have to access another product to take out their money.' Quoted in Michelle McGagh (2015) Want pension cash from your employer? Prepare to be disappointed, City Wire, 13 February.

Mutual charged £240 per withdrawal. However, under pressure from the Daily Telegraph and other national newspapers, Friends Life reversed its decision shortly after. [181]

In July 2015, Which? published a report on drawdown charges, included those on UFPLS.[182] This again confirmed the variety of charges from different providers ranging from Charles Stanley Direct which charges £270 for the first withdrawal each year, through James Hay (£100), Barclays Stockbrokers, Halifax Sharedealing and TD Direct (all £90) to Fidelity and Hargreaves Lansdown which have no charge at all.

There is a risk that people will take their pension as a cash lump sum and leave it in a bank account. The Financial Services Compensation Scheme provides 100% protection for annuities and up to 90% of the value of other insurance products without limit. For deposits, however, it only protects up to £75,000 per person per bank or building society. FCA Consumer Panel chair Sue Lewis says: 'We are concerned that consumers with pension pots exceeding the FSCS's £75,000 limit may inadvertently lose out on protection for their money if they choose to withdraw their pot rather than buying an annuity or leaving their money invested'.[183]

*Pension bank accounts could NOT be classified as safe harbour products, since they do not hedge longevity risk.*

#### *2.2.4.4 Buy-to-let pensions*[184]

With a buy-to-let pension, part of the pension pot is used to make a deposit on a buy-to-let property. The pensioner then takes out a mortgage and uses the rest of the pension pot to cover the mortgage repayments. The rental income provides the pension which is taxable.

The attraction of buy-to-let was that the mortgage repayments attracted tax relief. However, this relief was removed in the Budget on 8 July 2015, in large measure due to the increase in pension wealth moving into buy-to-let and the distortions to the housing market this was causing, following the introduction of the pension reforms in April 2015. Instead a tax credit worth 20% of the mortgage interest will be applied. The changes will be phased in between 2017 and 2020. The Daily Telegraph provided the following before and after example to illustrate the consequences, assuming a landlord paying 40% tax:

---

[181] Dan Hyde (2015) Pension companies 'failing to move with times', says minister, Daily Telegraph, 4 June; Dan Hyde (2015) Osborne's promises rejected by most pension providers, Daily Telegraph, 6 June.

[182] http://www.which.co.uk/news/2015/07/the-true-cost-of-pension-freedom-409249/

[183] Reported in Tessa Norman (2014) Consumer bodies warn over FSCS protection and Budget reform, Money Marketing, 3 October. The compensation level was reduced from £85,000 at the beginning of 2016 and the quote from Sue Lewis has been amended to reflect this.

[184] Michelle McGagh (2015) Annuity alternatives: 5 income solutions on the cards, Citywire, 7 January.

*NOW*

*Your buy-to-let earns £20,000 a year and the interest-only mortgage costs £13,000 a year. Tax is due on the difference or profit. So you pay tax on £7,000, meaning £2,800 for HMRC and £4,200 for you.*

*2020*

*Tax is now due on your full rental income of £20,000, less a tax credit equivalent to basic-rate tax on the interest. So you pay 40% tax on £20,000 (i.e., £8,000), less the 20% credit (20% of £13,000 = £2,600), meaning £5,400 for HMRC and £1,600 for you. Your tax bill has therefore gone up by 93%.*

*Now, say Bank Rate – and in turn your mortgage rate – rises by a small fraction, lifting your mortgage cost to £15,000, while your rent remains at £20,000.*

*You will have to pay £5,000 tax in this scenario, so you make no profit at all.*[185]

In November 2015, the Government announced that purchasers of buy-to-let properties will have to pay an extra 3% in stamp duty from April 2016. There are other potential pitfalls. The mortgage lender is likely to require a deposit of 40% or more. If the pensioner draws down the pension pot to pay a mortgage of this size, this could put the pensioner into a higher income tax bracket which could make the strategy uneconomic. The net rental income after taking into account mortgage repayments, the letting agent's fee, insurance, service charges and maintenance costs might not be very large. Further any void periods, where the property is unlet, will reduce rental income. If a large number of people start to use buy-to-let, this will have the effect of lowering average rents. Also the buy-to-let property is included in the pensioner's estate for inheritance tax purposes. If the property is sold before death, capital gains tax is payable.

A survey of 1,000 over-55 year olds by Prudential in September 2015 indicated that 14% of them were planning to buy property to let as a result of the pension freedoms, while 37% said they were planning to buy property to live in themselves. The most common reason (43%) for planning a purchase was to downsize to a smaller home.[186]

*It is an open question whether a buy-to-let pension could be classified as a safe harbour product. While it potentially hedges longevity risk (assuming a sufficiently long lease) and could provide an inflation-linked income, the changes to the market announced by the*

[185] Richard Dyson (2015) The death of buy-to-let, Your Money, Daily Telegraph, 22 August. The Daily Telegraph has launched an 'Axe the buy-to-let tax grab' campaign.

[186] Reported in Marion Dakers (2015) Savers have shunned buy-to-let despite pension freedoms, Daily Telegraph, 3 September.

*Government on and after 8 July 2015 have substantially reduced the return on and increased the risk of this product.*

### *2.2.4.5 Extreme-inflation protection*

At present, due to the approximate 40% reduction in initial income, only about 5% of people who buy a LTA purchase inflation-proofing (i.e., buy an index-linked annuity). We were told that it would be possible to design a cheaper form of inflation-proofing which aims to match RPI more closely and which would provide a hedge against extreme inflation shocks (a feature described as an 'inflation-kicker').

The concept, which has yet to come to market, is based on the assumption that most retirees can tolerate a limited amount of inflation risk. Therefore, if inflation were below 3%, the annuity income might fall slightly. If it were exactly 3%, there would be no change. Above this figure, the income would increase. [187]

This is an interesting idea and quite different from the two existing methods of capping the cost of inflation protection. The first is to buy a fixed rate of escalation, e.g. 3% per annum. The problem with this is that the annuitant receives the increase irrespective of actual inflation rates, so it could be more or less than is needed to keep pace. Due to the current low-inflation environment, 3% indexation is not significantly cheaper than full RPI. The main problem with a fixed rate of escalation is that it offers no protection in the event of soaring inflation, such as that experienced in the 1970s. With quantitative easing about to unwind, it would be impossible to rule out an inflation spike over the next 20 or 30 years.

The second method is limited price indexation (LPI). This matches RPI, but only up to a limit of 2.5 or 5%. So, like fixed escalation at 3%, it does not protect against a future inflation spike.

### *2.2.4.6 Home equity release plans*

Home equity release plans (also known as reverse mortgages or lifetime mortgages) can take the form of a LTA, although this is not the most popular form. Equity release allows home owners to borrow from the equity in their homes while still living in them. This might be particularly attractive to the elderly who might have low pensions, but substantial net housing wealth.[188] According to a study by LV=, 32% of retirees live on less than the

[187] This is similar to the smoothing principle of a with-profits annuity.

[188] See Les Mayhew and David Smith (2014) *The UK Equity Bank: Towards Income Security in Old Age*, ILC-UK, June for a proposal 'to establish a state agency which helps people release income from their homes in the form of a lifelong annuity in return for selling a portion of the equity in their homes to the state in which the value of the annuity is recovered on the death of the recipient'.

minimum wage, are going without adequate food and heating, yet the majority of these have untapped housing assets.[189]

Home equity release plans started in US in the 1980s, where they are available from age 62. The most common type is the home equity conversion mortgage, which allows borrowers to take a reverse mortgage in the form of: a lump sum, a lifetime income or drawdown (in effect a line of credit). The amount that can be borrowed is negatively related to the interest rate. Interest (typically 1.50% above government bond rates) is accrued and paid on moving or death, so there is no credit risk. However, the total interest payable is capped at the sale price of the property and lenders are protected against total interest costs rising above this limit (as a result of the home owner living a very long time) by a mortgage insurance policy that the borrower is required to take out (at a cost of 2% of the amount borrowed plus 0.5% p.a.).

In the UK, home equity release plans are provided by members of SHIP (Safe Home Income Plans). SHIP members offer a range of guarantees, including the right to live in the property for life, the flexibility to move home without penalties, and never owing more than the value of the property.

The following types of plan are offered:

- Home reversion plans – The home (in whole or part) is sold in exchange for a lump sum or monthly income (or some combination). The home owner therefore becomes a tenant and when the property is eventually sold (typically following the plan member's death), the reversion company receives the value of the loan plus interest (up to the value of the property sold)
- Home income plans – The plan member takes out a mortgage against the value of the property and uses the money to buy a purchased life annuity (PLA). Interest on the mortgage is deducted from the annuity, while the capital sum borrowed to buy the annuity is generally repaid when the property is sold after the plan member's death
- Lifetime mortgages – The plan member receives a lump sum or annuity (or some combination) with the interest being rolled up into the loan. The original loan plus interest is repaid when the property is eventually sold.

The maximum initial loan increases with the plan member's age, but is generally capped at 50% of the value of the property.

Equity release has not always had a good image in the UK. There was a mis-selling scandal in the 1980s. Since then, standards have improved with the establishment of the Equity

[189] Reported in Sarah O'Grady (2015) 5m pensioners go without food and heat in cash, Daily Express, 10 September 2015.

Release Council (ERC). Membership of the ERC ensures that only qualified independent financial advisers can sell equity release products, that the value of the loan cannot exceed the value of the home, and that a homeowner cannot lose their home, since interest can be rolled up and paid on their death. However, the protection against losing the home has been put at risk by the European Mortgage Directive (EMD) which allows new 'equity release-lite' products called 'lifetime mortgages' to be sold. They can be sold without advice and require interest to be paid rather than rolled up. The requirement to pay interest means the product no longer comes under the equity release rules, but instead comes under the residential mortgage rules, which means borrowers can lose their homes if the interest is not paid.[190]

In September 2015, the ERC announced that there was £710m of equity release in the first half of 2015, the largest half-year amount on record. Homeowners over 55 were withdrawing more than £4m of housing wealth every day. The main reasons given for this are rising house prices, tougher borrowing conditions and inadequate pension provision. Table 2.2 provides details of the equity release market and shows, for example, that 65% of new plans were drawdown and 35% were lump sum.[191]

*Table 2.2: The equity release market in 2015*

| | Drawdown | Lump sum |
|---|---|---|
| Average house price | £304,340 | £242,476 |
| Average initial withdrawal | £46,958 (15.4%)* | £77,494 |
| Average drawdown reserves | £32,348 (10.6%)* | NA |
| Average loan-to-value (LTV) | 26% | 32.0% |
| Average age at purchase | 71.5 | 67.7 |

Source: ERC
Note: * % of average house price

Alex Edmans, head of retirement at Saga, said: 'The [FCA's] Mortgage Market Review has stopped many older people from accessing a traditional mortgage, this and the fact that many people are now coming to the end of their interest-only mortgage term without a full repayment plan, has meant that more are turning to equity release as a viable solution to borrowing in retirement. Indeed, Saga has seen an increase in the use of equity release to clear a mortgage. Now is a good time to consider equity release, as interest rates are at

[190] Michelle McGagh (2014) Mortgage directive revives equity release fears, Citywire, 24 November 2014.
[191] Reported in Professional Adviser (2015) Older homeowners flock to equity release, ERC data shows, 23 September.

their lowest ever levels, property prices are increasing and loan-to-values have recently increased, meaning people are able to access more of the wealth tied up in their property'.[192]

In September 2015, the FCA announced that it was considering how regulation can help foster 'more of a market' in equity release. Christopher Woolard, director of strategy and competition said: 'The average pension pot is £30,000, yet a significant number own property assets of around seven times that number or more. The ability to access some of that asset, as a restricted lump sum or as a gradual income, could make a significant difference to people's lives. Yet, in the not too distant past, equity release became a dirty word. Whilst we have seen a combination of regulation and industry-led initiatives to help clean up the market, some will argue that the costs of equity release, both up front and compounded over time, are relatively high for the individual, and that the previous image has stuck. We believe there is a debate to be had about what products and markets could exist, and whether more entrants and innovation here might benefit consumers with greater choice and improved products'.[193]

Some argue that equity release could also be used to fund long-term care. For example, Adrian Walker, retirement planning manager at Old Mutual Wealth, raised the issue when he discussed the findings from a survey his company had conducted for its *Redefining Retirement* report. The YouGov survey of 1,600 people aged 50 to 75 showed that 'while equity release was predicted to play a greater in people's retirement and long-term care planning, long-term care is still one of the great unknowns of growing old. We Brits famously don't like to talk about death and, similarly, it would seem that we also don't like to think about how and where we might spend our later days'. The survey asked people aged 50 to 75 about their provision for long-term care: 30% of respondents have some savings set aside for their long-term care, but only 1% had a care plan in place, and 2% have, or plan to have, long-term care insurance; 46% had not thought about their long-term care needs and 8% had no intention of doing so.

Mr Walker argues that 'advisers and clients must address the potential need to meet long-term care costs and come up with a plan accordingly. As property is very often the biggest asset that people hold, it makes some sense to look at how that, as an asset, could be used to help pay for a person's care costs. Housing assets are taken into account in the current system. If you have more than £23,250 in assets[194] you will be responsible for your own care costs. However, if you receive care in your own home, property assets are not considered in the calculation. As soon as you move into a care home, then your home is included and can

[192] Reported in Professional Adviser (2015) 'Perfect storm' sparks record equity release sales, 28 July.

[193] Reported in Carmen Reichman (2015) FCA to examine equity release market amid reputation concerns, Professional Adviser, 7 September.

[194] Figures differ slightly in Scotland and Wales.

be used to cover costs. In the same survey, we asked whether people would be interested in releasing value from their home and, of those who would, 34% said they would do so in order to pay for their long-term care'.

Mr Walker accepts that: '[Equity release] is already increasing in its use as a source of delivering income in retirement of which care costs would be part. It seems a logical step that people should start to consider how they access the value of their property when they are able, in order to put something aside and form a plan for later in life when they may have a requirement for care outside their home and when they may not have the luxury of time to plan'.

However, many people do not like the idea of someone else having an interest in their home, so another solution is downsizing, allowing the released equity capital to be invested to fund future long-term care, although this too has 'emotional issues attached to it'.[195] It also has cost implications, with typical moving costs in the region of £20,000.[196]

#### *2.2.4.7 ISA pensions and care ISAs*

ISA pensions have been proposed by Michael Johnson of the Centre for Policy Studies.[197] He argues that 'Many eschew pension saving, thereby missing out on tax relief, but engagement with ISAs is high. Ready access and flexibility is valued above tax relief'.

His proposals involve replacing occupational pensions with ISA-style pensions. This, in turn, would involve replacing the existing EET (exempt-exempt-taxed) pension tax system with the TEE (taxed-exempt-exempt) tax system of ISAs.[198] With EET, contributions and investment income are exempt from tax and only the pension is taxed. With TEE, contributions are taxable (i.e., paid from post-tax income), but investment income and withdrawals are exempt. Mr Johnson believes this switch would bring forward significant tax payments and reduce the deficit by 'perhaps up to £10bn'.

Early research from PwC suggests that employees would welcome switching to a system that treats pensions like ISAs, since they believe that the current tax treatment of pensions is too complex. PwC surveyed 1,197 employees and found two-thirds did not understand the current system. Around 40% said they would rather contribute out of taxed income, and enjoy tax-free money in retirement, while only 27% wanted to keep the current tax regime, and just 14% said the tax relief on offer was an incentive to save. Further, 60% said that the

---

[195] Reported in Jenna Towler (2015) Can equity release help solve the long-term care funding crisis?, Retirement Planner, 18 August.

[196] Reported in Nicole Blackmore (2015) 'Downsize? It's more costly than staying put'. Your Mpney, Daily Telegraph, 3 October.

[197] Michael Johnson (2015) , The Workplace ISA And The ISA Pension, Briefing Note, Centre for Policy Studies, 3 July; http://www.cps.org.uk/files/reports/original/150703115927-TheWorkplaceISAandtheISAPension.pdf

[198] The pension tax system is discussed in more detail in Chapter 7.

constant tinkering with the pension system had put them off saving. Philip Smith, head of defined contribution pensions at PwC, said: 'People want a once in a lifetime overhaul of how pensions are taxed to create a simple and stable system which they can understand and trust. Moving towards an ISA-style tax system would create consistency across people's savings pots and help them plan for their future with more certainty'.

Nevertheless, Raj Mody, head of pensions consulting at PwC, said the Government would still need to incentivise people to put money into retirement saving vehicles, if upfront relief was removed: 'The reality is that when it comes to tying up money for the long term, people need an incentive. Otherwise, why would you bother saving for your retirement when faced with more immediate pressures on your finances?'. A similar warning came from Jonathan Howe, UK insurance leader at PwC: 'Pensions savings are a hugely important part of the UK retirement bank. Any reform must not reduce incentives for individuals to save for the long-term and increase the risk of a future pensions hole. Upfront reliefs can be a very important element and they also help make it clear that pensions are intended to be different – for long-term saving'.[199]

Phil Loney, chief executive of Royal London, also warned that saving levels could fall significantly under the TEE framework. He also believes that many people will not trust a system which requires people to accept that a future government will not tax pension withdrawals. He said: 'This so called "ISA-style" tax treatment of pension contributions is a fundamental and far-reaching change to the principles of pension savings, which could pose considerable risk to the Government's aim of creating a savings culture in the UK. There is no evidence that the promise of tax-free income, 25-30 years into the future, would be believed by the public given the volume of changes to the pensions system over the last 25 years. Consequently, there is a real risk of a significant fall in savings, which are already too low in the UK. It would also create a parallel system which is wholly incompatible with people's existing pension arrangements, would take years to develop and would increase the overall cost of pensions. We believe that it is vital to reform the current tax relief system to make long term saving fiscally neutral for all. The incentives need to focus on those with lower incomes, to create a more realistic and lower risk way forward. This could also enable the abolition of the lifetime allowance'.[200]

In a similar vein, Dr Ros Altmann, before becoming Pensions Minister, proposed 'Care ISAs', as a vehicle for funding later life care.[201] In August 2015, the insurer LV= disclosed that, over the previous five years, more than 19,000 pensioners had to remortgage their homes with

[199] Reported in Jack Jones (2015) Savers want ISA-style pensions, PwC research claims, Retirement Planner, 11 August.
[200] Reported in Carmen Reichman (2015) Royal London chief warns of 'real risk' to saving under ISA-style pensions, Professional Adviser, 18 August. These issues are raised again in Chapter 7.
[201] Reported in Jim Pickard and Josephine Cumbo (2015) 'Workplace ISA' to shake up UK retirement saving, Financial Times, 3 July.

local authorities because they were unable to afford the cost of residential care. Many people face care bills well in excess of their pension pots because of a dramatic increase in the average time spent in a care home in recent years.[202]

*ISA pensions would NOT be classified as safe harbour products, since they do not hedge longevity risk.*

#### *2.2.4.8 Peer-to-peer loans*

Peer-to-peer (P2P) lender Zopa has launched a campaign to allow members of SIPPs to include P2P loans in their pension pots. This followed a successful campaign for P2P loans to be allowed in a new style of innovative finance ISA (IFISA) from April 2016. According to the Daily Telegraph: 'Currently, P2P loans are classed as non-standard investments, meaning that the pension provider must set aside more capital against the possibility of the loan defaulting. The result is that any SIPP provider who does allow P2P investment will charge the pensioner extra fees to cover the capital cost.

'Peer-to-peer loan firms market themselves as an alternative to banks, where savers put their money into a platform that lends it on to pre-vetted individuals or companies. However, in return for the extra interest savers must also accept a greater risk that the borrower will not repay the loan and so it is possible to lose money…[and] 57% of lending on Zopa is funded by savers aged 55 or above'.[203]

In February 2016, the FCA announced it would bring P2P loans under its investment advice rules. This would allow advisers with appropriate permissions to advise on the products and introduce a ban on commission from the products. Other types of advisers would not be expected to give advice on specific P2P loans.[204]

Also in February 2016, Lord Adair Turner, former chair of the FSA, was concerned that automated processes and a lack of good credit underwriting will mean people are bound to lose money from their investment. He said that: 'You cannot lend money to small and medium enterprises, in particular, without somebody going and doing good credit underwriting. This idea that you can just automate that on to a platform, I think it has a role to play, but I think it will end up producing big losses….The losses which will emerge from peer-to-peer lending over the next five to ten years will make the worst bankers look like absolute lending geniuses'.

---

[202] Reported in The Times (2015) Pensioners in 'pay when you die' deals, 14 August.

[203] Reported in Tim Wallace (2015) Zopa lobbies for peer-to-peer loans to go in pension pots, Daily Telegraph, 18 August.

[204] Reported in Carmen Reichman (2016) FCA excludes P2P products from independent advice rules, Professional Adviser, 3 February.

Kevin Caley, chief executive of crowdfunding platform ThinCats, confirmed that neither it nor its 'sponsors' – a network of former bank managers who write a report on what the business does, its cashflow projections, and its ability to repay the loan – give recommendations to investors. He said is was the responsibility of the financial adviser recommending a client make a P2P loan to do their own due diligence on the borrower.[205]

*Peer-to-peer loans would NOT be classified as safe harbour products.*

### *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 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 is equal to the ratio of the proportion of the annuitants aged *x* who die during a particular year (having survived to the beginning of that year, denoted $q_x$) to the proportion of the annuitants aged *x* who survive the particular year (denoted $(1 – q_x)$).[206] It can be used to enhance the annuity paid to those who live longer than their life expectancy. This can be seen from Figure 2.1 which shows that the amount paid on an annuity has three components: the return of capital or initial premium,[207] the investment return on the capital (less charges), and the mortality premium.[208] Initially the weight of the mortality premium in the total payment is

[205] Reported in Carmen Reichman (2016) Ex-FSA chairman attacks P2P in wake of industry's biggest failure, Professional Adviser, 10 February.

[206] That is, the mortality premium at age x is equal to $q_x/(1 – q_x)$, which, in turn, is equal to the odds of dying at age x. It arises because those annuitants who die below life expectancy no longer need to be paid and the payments that would otherwise be paid to them are redistributed to surviving annuitants. No other type of investment has this additional source of return and it increases significantly with age as both Figure 2.1 and Figure 2.3 show.

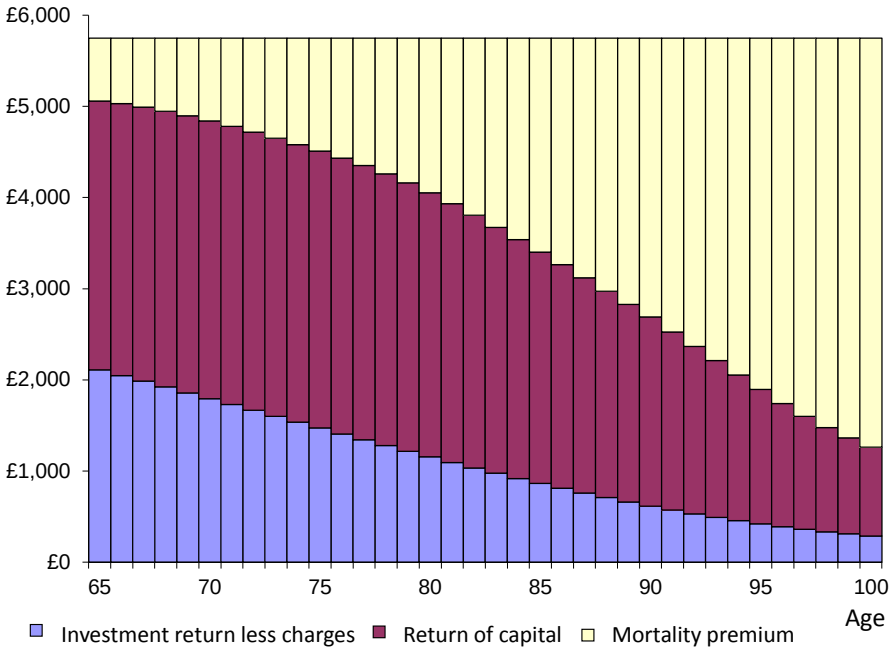
[207] The annuitant's initial investment (the premium or capital) is gradually 'returned' (or paid back) to the annuitant as part of each annuity payment.

[208] We are grateful to Tom Boardman for preparing this Figure.

quite low, since only a small proportion of the retirees die soon after retirement. By contrast, the proportions of the total payment represented by the return of capital and the investment return (net of charges) are initially quite large. Over time, these proportions decrease in size as capital is returned to the annuitant and the relative significance of the mortality premium increases.

Group annuities are the *only* financial asset ever invented to benefit from this additional source of return. Drawdown products do not benefit from the mortality premium (since they do not pool mortality risk). Unfortunately, very few people understand this.[209]

*Figure 2.1: Decomposition of annuity payments*




An international example of group self-annuitisation is the Swedish Premier Pension System (PPM).[210] Here each cohort of retirees completely 'self-annuitises' using tontine annuities.[211]

[209] For a useful explanation of the mortality premium, see Michael Kitces (2015) Understanding the Role of Mortality Credits – Why Immediate Annuities Beat Bond Ladders for Retirement Income, 1 April; https://www.kitces.com/blog/understanding-the-role-of-mortality-credits-why-immediate-annuities-beat-bond-ladders-for-retirement-income/#more-5955

[210] Edward Palmer (2000) The Swedish Pension Reform: Framework and Issues, *World Bank Pension Primer*, Washington D.C.

[211] A tontine annuity – named after a Neapolitan banker called Lorenzo Tonti (1635-1690) – is generally classified as a pooled or mutual annuity where the investment and longevity risks are borne by the members of the pool and there are no cross-subsidies with other cohorts of members. In other words, there is complete self-annuitisation within the pool. A number of subscribers contribute capital to a common investment fund and then take an annuity from the fund which depends on the fund's performance and the number of

The starting annuity rate is set on the basis of current mortality projections and interest rates. However, the annuity is rebased annually in the light of revised mortality projections and investment returns. This means that the annuity can rise and fall over time. The intention is to avoid intergenerational cross-subsidies.

In the second case, the scheme buys in annuities for its retired members from an insurance company via bulk purchase annuities (BPAs). BPAs have become common in DB schemes since 2007 and the economies of scale involved can benefit scheme members as well as the DB scheme itself (i.e., through an improvement to its funding level and its risk profile relative to liabilities). The idea is for the insurance company to underwrite the longevity risks, relative to a guaranteed lifetime income, presented by a cohort of retirees. There would be a requirement for the individual underwriting of each annuity sold by means of a medical questionnaire, but it is possible that this could be simplified if there were common characteristics in the cohort, for example, in relation to the industry in which they worked (e.g., a common occupational health risk) and/or in the area in which they lived ('postcode' or socio-economic underwriting, also known as geodemographic profiling).

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. However, it is also possible that some – indeed many – schemes might be reluctant to assume the additional liabilities associated with group self-annuitisation.

#### *2.3.1.2 Scheme drawdown*

##### How scheme drawdown works

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 members 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

---

surviving subscribers. As each subscriber dies, his or her share is divided among the survivors in proportion to their initial subscription. Depending on the mortality experience of the pool and the investment performance of the fund, the survivors will receive either an increasing or falling annuity over time. The last surviving subscriber gets the entire residual fund.

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.

The specific details about scheme drawdown offerings available are sketchy. However, Towers Watson's Fit for Retirement Survey 2015 suggested that 31% of schemes are planning to offer some form of scheme drawdown in 2016 and a further 13% are considering its introduction in 2017.[212] We were told that the maximum recommended income that a member can drawdown might still be linked to GAD rates, as was the case for retail drawdown prior to Flexiday, although it would be reviewed annually (rather than every three years) because members might wish at any point to purchase a LTA. The cap on maximum income might be set at a slightly lower level than the GAD maximum – e.g., 5-10% lower – in order to provide a 'buffer' or reserve. This would enable the fund to smooth the income payments when markets are volatile and also to return funds to members who decide the time is right to make an annuity purchase.

The income would be generated partly from the investment yield and partly from a drawdown of capital (i.e., the accumulated pension pot). For example, if the aim were to deliver a maximum income of 6%, this might comprise 3.5% from the yield and 2.5% from capital. Funds are likely to be low-risk and largely bond-based, but might also include a modest allocation to growth assets in order to help preserve the annuity-purchasing power of the funds.

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.[213]

---

[212] Jonathan Gardner (2015) Withdrawal Strategies for DC Retirees, Towers Watson Corporate and Trustee Briefing, 5 October.

[213] This is discussed in detail in Chapter 3.

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 therefore 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 fund management and 0.20% for administration of payments to individual accounts.

### Investment strategies with scheme drawdown

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.[214] 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. The similarities and differences between the TDFs and lifestyle strategies are presented in Table 2.3.

*Table 2.3: Target date funds versus life style strategies*

| Similarities |
|---|
| • Both place funds in higher-risk assets when individuals are younger and move these in to less risky assets as they approach retirement<br>• Both types are managed with a retirement date or retirement window in mind<br>• Both types have assumed, at least until recently, that individuals will with draw a 25% tax-free lump sum and purchase a level annuity |
| **Differences** |
| • Target date funds are overseen by professional fund managers who can make changes to both the strategic and tactical asset allocation in the event of changes to the markets or regulatory framework. In contrast, lifestyle strategy funds are generally pre-programmed to place funds in lower-risk assets as individuals approach retirement, and only change this approach at the discretion of trustees and pension providers<br>• Target date funds operate to a broad retirement window (e.g., 2032-34 fund) in contrast to lifestyle strategies that target a specific day, often linked to a birthday<br>• Target date funds can continue to pro-actively manage members' assets beyond their retirement date in contrast to lifestyle strategy funds that tend to 'set and forget' after reaching the assumed retirement date |
| Source: Pensions Policy Institute (2014) *DC savers' Needs under the New Pension Flexibilities*, PPI Briefing Note Number 72, October |

[214] TDFs that target a specific age or age range are known as 'to' funds, while those that maintain a significant investment in growth assets into retirement are known as 'through' funds.

TDFs have their supporters. For example, in August 2015, Mark Fawcett, chief investment officer at NEST, gave his views on why he supports the use of TDFs which he regards as inherently flexible when compared to 'mechanistic lifestyling':

> *With fewer and fewer workers knowing the exact date they'll retire, what's the point of target date funds? If savers are now going to continue investing through retirement, why de-risk as they approach state pension age? Retirement rarely happens on one day at the end of a working life anymore. It's more of a journey than an event. But this doesn't undermine the case for target date approaches to investment management, in our view.*
>
> *Rather we'd argue that target date funds represent an agile way to respond to savers' shifting needs in a world of changing retirement patterns and greater pension freedoms. People may continue investing for longer, but there'll come a point when they're no longer building up their pots and start to rely on them for income instead. Their risk capacity will change significantly in their final working years and beyond. The amount of investment risk in their pots will need to be gradually reduced, although not necessarily completely into bonds and cash, as in the days of compulsory annuitisation. They'll also need a different type of asset mix, focusing on generating an income and avoiding the risk of sharp declines in value.*
>
> *Unlike with mechanistic lifestyling, the target date fund structure is inherently flexible. This allows for sophisticated and dynamic risk management that can be implemented and adapted, efficiently and cost effectively. In traditional 'lifestyling', the re-balancing of assets happens automatically at the same rate, each year, irrespective of market conditions and the valuation of the different asset classes. By contrast, target date fund managers, like NEST, are able to analyse economic and market conditions at the time and then act accordingly to best keep members on track.*
>
> *But this isn't all. NEST's 'default fund', where members are invested if they don't make an active choice, is actually made up of around 50 single year target date funds. This unique structure means we've been able to adapt to the new landscape by implementing two significant changes to the de-risking phase of these funds.*
>
> *The first was to the shape of the glidepath into retirement following the 'freedom and choice' reforms. Many pension providers including NEST have tended to de-risk into annuity-tracking portfolios, which no longer seems appropriate. Savers are now less likely to be buying annuities straight away as many will have had to do in the past. In response, we've changed the primary objective of the consolidation phase for funds maturing after 2020. These funds will now aim to outperform CPI after all charges while progressively dampening volatility. In the run up to 2020, we believe our members' pots will still be relatively small and it's most likely*

*they'll be taken as cash. We've therefore changed the consolidation phase objective for NEST Retirement Date funds maturing up to 2020 to manage the risks associated with converting a member's pot into a cash lump sum rather than an annuity. We've used the flexibility of target date funds to set different groups of members on different glidepaths, according to their likely needs in the run up to retirement.*

*The second change was to add into the consolidation phase asset mix single-year dated gilts that mature in line with their fund's target date. For example the 2017 NEST Retirement Date Fund now invests, in part, in a 2017 gilt, the 2018 NEST Retirement Date Fund invests in a 2018 gilt, and so on. This measure is designed to get better returns than the cash we've been holding in the portfolios, without needing to worry too much about the market value of the bonds in the interim…*

*Both these changes have borrowed from concepts of 'liability-driven investment' that are more common in the defined benefit world. The aim is to align the investment horizon of a member's portfolio with their saving journey. In other words, workers should have a seamless investment experience as they move from saving up to withdrawing their pension. So far this type of 'liability aware' approach, which is possible within a target date fund structure, has not been widely applied in more traditional defined contribution strategies.*[215]

Others, however, are critical of both TDFs and lifestyle as de-risking strategies. A poll carried out by the Association of Investment Management Sales Executives (AIMSE) of its members found that 55% of respondents believed that, following 'freedom and choice', traditional life-styling would need to be radically overhauled, while 30% said it would only work if life-style de-risking also followed through to the decumulation stage. Despite the greater flexibility claimed for TDFs by their supporters, only 12% of AIMSE members – whose job is to sell TDFs – thought they would work well in the new pensions environment.[216]

Another critique is Robert C. Merton, the 1997 Nobel laureate in economics. He believes that both TDFs and lifestying focus on the wrong target: 'If the goal is income for life after age 65, the relevant risk is retirement income uncertainty, not portfolio value…The seeds of an investment crisis have been sown. The only way to avoid a catastrophe is for plan participants, professionals and regulators to shift the mindset and metrics from asset value to income'.[217] This, of course, is the opposite of what the 2014 Budget changes do.

Furthermore, de-risking glidepaths will not be effective in a world where individuals make ad hoc withdrawals from their pension pot, while leaving much of the remaining pension

[215] Mark Fawcett (2015) Coming into land: NEST's fresh approach to the retirement 'glidepath', Professional Adviser, 11 August.
[216] Reported by Stephanie Baxter in Professional Pensions, 20 February 2015.
[217] Robert C. Merton (2014) The Crisis in Retirement Planning, *Harvard Business Review*, July–August; https://hbr.org/2014/07/the-crisis-in-retirement-planning

pot invested for the long-term (i.e., where individuals use their pension pot as a bank account). According to information compiled by Hargreaves Lansdown, lifestyle funds lost an average of 9% of their value between February and June 2015. Some such as Aviva, Blackrock, Friends Life and Scottish Equitable lost more than 10%. The explanation is that the funds switched from equities into long-dated bonds at a time when long-term interest rates are anticipated to rise which led to a loss in value for these bonds. According to Alan Miller, founder of fund manager SCM Private: 'It is scandalous that losses on this scale have occurred with supposedly "safe" funds…Lifestyle funds are no longer fit for purpose'. The solution, according to Steve Patterson, managing director of Intelligent Pensions, is for people between the ages of 55 and 65 to take on more risk, via a higher equity exposure on the grounds that equities give people a better chance of inflation-beating returns which will ultimately provide more income in retirement.[218]

A report by JLT Employee Benefits published in September 2015 indicates that 56% of companies have not changed their investment strategies in the light of the new pensions freedoms, despite the fact that just 11% of employers thought members would purchase annuities. Maria Nazarova-Doyle, deputy head of defined contribution investment consulting at JLT, said: 'A fund that continues to employ a seemingly safe strategy of investing into long-dated gilts and corporate bonds to track the price of annuities more closely becomes quite risky if members do not plan to buy this type of longevity insurance...For instance, pension savers looking to withdraw cash lump sums [using] income drawdown could be left open to the adverse effects of interest rate fluctuations [which change the returns offered by bonds] without much of an upside….In addition to the actual investment risk consideration, there is now a requirement for default strategies to be relevant for the majority of pension scheme members. So, if the majority of members no longer intend to purchase an annuity, keeping the old strategy unchanged cannot be justified'.

Another study, by Towers Watson's master trust LifeSight of around 100 employers, found that two-thirds were still targeting annuity purchase in their default investment strategy. Only 43% of the employers surveyed said they planned to offer drawdown options. When asked why not, 70% said the management and implementation was too difficult, 60% cited governance problems, 53% had no desire, and 45% mentioned costs and other barriers. Fiona Matthews, managing director of LifeSight, said many employers and trustees had been slow to respond because they had been careful to balance giving people what they wanted with mitigating risk.[219]

---

[218] Reported in Katie Morley (2015) Pension Freedoms – Your investments aren't safe, either, Your Money, Daily Telegraph, 20 June.

[219] Reported in Miles Costello (2015) Employee pensions fail to keep up with pace of retirement reforms, The Times, 1 September, and Stephanie Baxter (2015) Employers are failing to adapt DC default strategies to April freedoms, Professional Pensions, 1 September.

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 funds will be withdrawn. 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. Although pension savers welcome increased flexibility, unfortunately this comes at a price.

## Examples of scheme drawdown

There are scheme drawdown offerings from investment managers, life offices and consultants. We provide some examples.

AllianceBernstein has launched a scheme drawdown product that integrates both the accumulation and decumulation stages and is suitable for the mass market.[220] The product combines AllianceBernstein's range of TDFs – which were set up for the new auto-enrolment market – with an income drawdown product called Retirement Bridge. Its first client was the BlueSky Pensions master trust. The product is aimed at scheme members up to age 75 and employs an age-related diversified investment approach with a risk-managed investment growth target, while allowing member full accessibility to their funds. The Retirement Bridge fund will be available to members from age 55. At this age, the member is invested 40% in equities. AllianceBernstein's Dynamic Asset Allocation strategy is used to gradually de-risk the investment portfolio, so that by age 75, the equity investment is reduced to 20%. AllianceBernstein also uses volatility management to make short-term adjustments to the portfolio to protect against downside risks in turbulent market conditions. The aim is to produce an income that is 20% more than that from an annuity between 55 and 75.

AllianceBernstein believes that their product would make a suitable default from age 55. According to Tim Banks, managing director of sales and client relations: 'Our extensive market research shows that 74% of 55 to 64 year olds have not decided what to do with their pension pot. We believe that providing a default solution that keeps them invested during this important time in their life, while offering full flexibility to change their mind, best meets the modern working environment'. At 75, members are expected to annuitise remaining assets. The reason for this is given by Mr Banks: 'If someone is in drawdown, even if it professionally managed, you don't really want people in products that require engagement in their late 70's', given the fall-off in cognitive abilities by that stage.[221]

BlackRock has launched the Retirement Income Account for workplace pension schemes. Paul Bucksey, head of UK defined contribution, said: 'We believe this innovation provides

[220] 'AllianceBernstein launches first work-thru-retirement default', Corporate Adviser, 15 September 2014.
[221] Quoted from David Blackman (2014) Welcome to the world of drawdown, Pensions Insight, November/December.

our members with a simple, flexible and cost-effective way of moving from the accumulation phase of workplace pension saving to decumulation'. The account allows members to choose either regular or ad-hoc income payments which are made by selling units in the funds held in the account and drawing down capital over time.

The core fund in BlackRock's suite is LifePath Flexi. This is a TDF which extends into the decumulation phase with a typical asset allocation illustrated in Figure 2.2.[222]

The de-risking glidepath used reflects the new reality following the introduction of pension flexibilities, namely 'an initial focus on growth – equities and other risky assets – and a gradual move to a more balanced asset mix where growth and volatility management are twin objectives. That move may start 20 years or so from a stated retirement date, and accelerate as the date becomes closer. It's important to remember that the expected retirement date is rarely precise – the chosen date is just a best guess for most members'.[223]

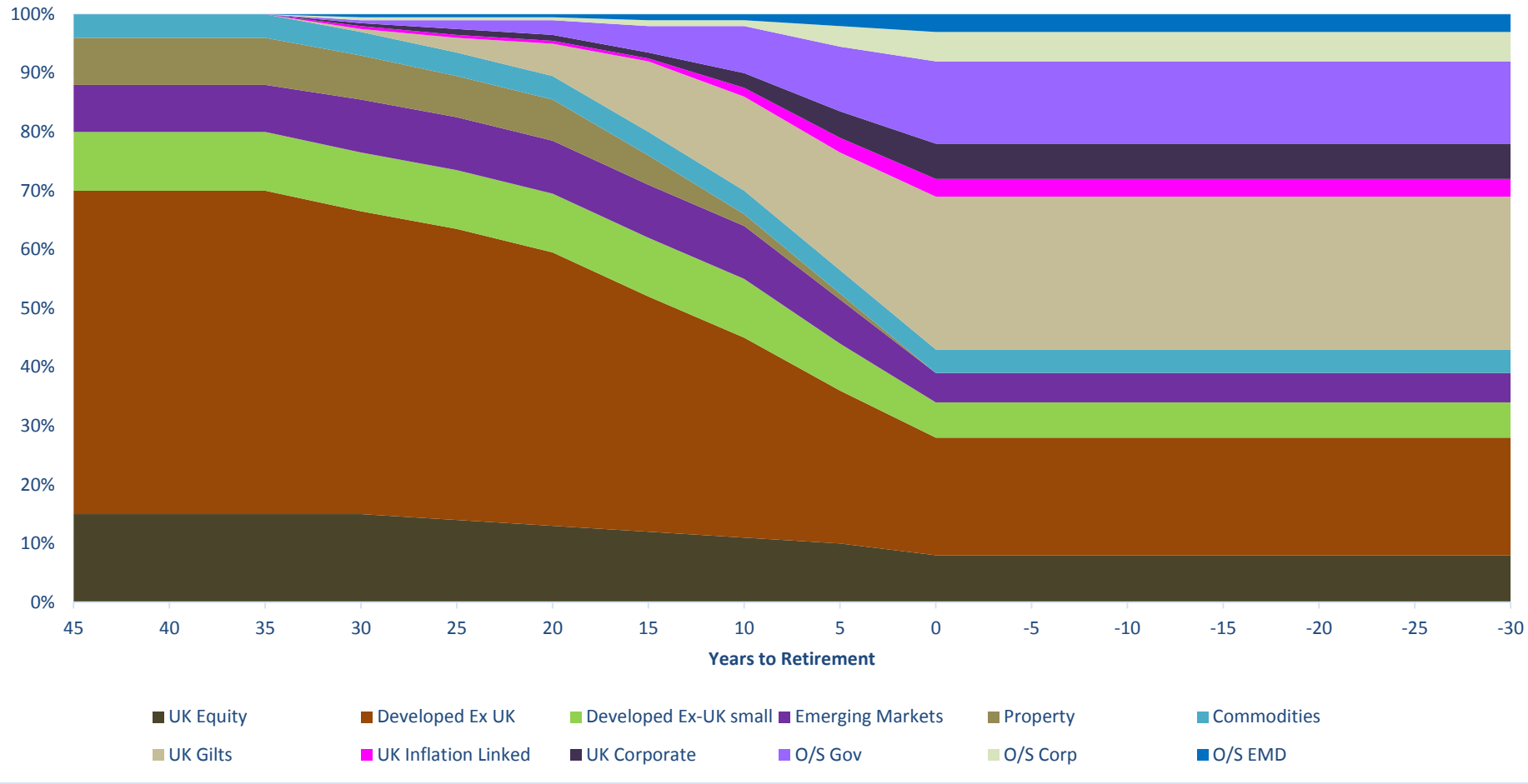
The member can also choose from another 100 investment funds from BlackRock and other fund managers. By remaining invested into retirement, members can retain the potential for future capital growth, but also alter income as required. The AMC for the LifePath Flexi fund is 0.41% which covers account administration and fund charges. There are no set up, transaction, or exit fees. There is also no charge for moving from an existing workplace scheme to the BlackRock Retirement Income Account. The minimum fund size is £50,000.[224]

Prudential's offering focuses on four lifestyle solutions: a default solution for those who have not specified a retirement preference, a solution for those planning to take their fund in cash, a solution for those planning to use drawdown, and a solution for those planning to buy an annuity. John Warburton, distribution director, said: 'The launch of the Dynamic Growth Funds, priced to sit between active and passive investments, gives our corporate customers a modern, cost-effective, default investment solution which offers diversification, flexibility and choice around the new pension freedom. The addition of further default lifestyle strategies demonstrates our commitment to offering enhanced levels of flexibility to our customers. These enhancements are part of our continuing corporate pensions proposition development to meet evolving customer needs'.[225]

---

[222] Reported in Sebastian Cheek (2015) Designing a secure retirement income: meeting the evolving needs of DC schemes, portfolio institutional, April.
[223] Alistair Byrne, senior DC consultant at State Street Global Advisers, quoted in 'Is my DC plan's default lifestyle strategy fit for purpose?', Pensions Insight, May/June 2015.
[224] Reported in Stephanie Baxter (2015) BlackRock steps into in-retirement market with drawdown launch, Professional Pensions, 27 April.
[225] Reported in Stephanie Baxter (2015) Prudential launches multi-asset funds in response to Budget freedoms, Professional Pensions, 24 April.

*Figure 2.2: An Illustrative Asset Allocation for Blackrock's LifePath 'Flexi' Fund*



Consultants, such as Aon Hewitt, Buck Consultants and Mercer, have designed a scheme drawdown product for their existing employer accumulation clients. Xafinity is planning to launch a mass-market scheme with full flexibility.

Despite all these offerings and plans, 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 to their members in practice. There are mixed views about this according to interviews with trustees and pension managers conducted by Spence and Johnson in March 2015 on behalf of the Defined Contribution Investment Forum (DCIF). Respondents in favour of scheme drawdown said this would be best delivered as all-in-one packaged solutions. Schemes that were less supportive said they were concerned about the administration difficulties and fiduciary implications. Some said scheme drawdown was more likely to be offered through master trusts than by single-employer schemes.[226]

The reluctance of many trust-based DC schemes to offer drawdown was confirmed by Adrian Boulding, then pensions strategy director at Legal & General: 'A lot of employers are reluctant to continue to be involved in a scheme providing drawdown, because it is not a "once and done" or "set and forget" solution. It requires ongoing management and monitoring, and the difficulties come between 15 and 20 years down the track when the money starts to run low. That's a step too far for a lot of them'.[227] Similarly, Nigel Aston, head of European DC at State Street Global Advisors, expects little appetite from trustees and plan sponsors to shoulder the burden of looking after members once they retire and expects them to look to master trusts and platforms instead: 'You can imagine a situation where some of the large master trusts – either the not-for-profit ones or the truly commercial ones – will say: "We'll aggregate all those individuals at retirement"'. At 65, Mr Aston believes members will leave the scheme used for accumulation and go across to NEST, NOW: Pensions, The People's Pension, or the Pensions Trust. Alternatively, they will move to 'a platform with Standard Life, Fidelity, Zurich, whoever;…. it'll be relatively seamless for the individual, but they're sort of on their own, but you still have a plan that is well governed'.[228] An additional concern of trustees is that partnering with a drawdown provider might be seen by members as giving advice.[229]

---

[226] Stephanie Baxter (2015) Reported by DC schemes want more tools for 'biggest challenge' of member engagement, Professional Pensions, 1 May.
[227] Quoted in Peter Davy (2015) Complexity and Cost will limit pensions freedom, Financial News, 16-22 March
[228] Reported in Louise Farrand (2015) Five new investment innovations ahead of April 6th, Pensions Insight, 6 March.
[229] Lydia Rowson (2015) Emerging reality on pension freedom - What can sponsors and trustees expect in the new pensions world?, Towers Watson Trustee Briefing, 8 June. The issue of advice is discussed in the Chapter 3.

### 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. We consider some examples.

Hargreaves Lansdown's SIPP is hosted on HL's Vantage platform which has an annual charge of 0.45% for pension savings up to £250,000. HL have no set up charge, but they have an exit charge of £295 + VAT if all the assets are withdrawn within 12 months. There will also be the annual fund management charge on the funds that the member chooses to invest in. This could average 1.5% pa.

LV= has launched a simplified drawdown product which charges 0.25% for funds up to £1m. It has a set up charge of £295 if the pot size is below £37,500 and £175 if the pot size is above. It also has a SIPP drawdown product with a maximum charge of 0.55% and no extra transactions costs.[230]

Intelligent Pensions has launched a fixed low-cost drawdown plan which allows DC scheme members to transfer to a SIPP and use flexi-access drawdown with ongoing advice. The SIPP is operated by James Hay. The drawdown plan has an annual charge of 0.75%, which matches the new charge cap on default funds in auto-enrolment pension schemes. The charge covers both the SIPP administration costs and the annual management charges on a wide range of investment funds. There is a set-up fee of 1% on funds above £100,000. The company believes that the minimum suitable for pension drawdown is £100,000. It also believes that flexi-access drawdown is only appropriate for people who are willing to take a 'fair degree' of ongoing risk in retirement and are also prepared to take ongoing advice. Managing director Steve Patterson said: 'Ongoing risk management is second only to initial suitability and anyone who thinks of drawdown as a DIY process is highly likely to come unstuck with potentially disastrous effects. "One size fits all" solutions are no longer appropriate – everybody's retirement will be different. To achieve the best possible retirement outcomes a far more personalised approach is needed'.[231]

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.[232] Natanje Holt, managing

[230] Reported in Carmen Reichman (2015) Providers will revisit drawdown charges after 'race to the bottom', says LV=, Professional Pensions, 10 March.
[231] Jenna Towler (2015) Intelligent Pensions launches low-cost drawdown plan, Professional Adviser, 13 March.
[232] *Better Pensions*, http://www.staticwhich.co.uk/documents/pdf/better-pensions-report---march-2015-397468.pdf ; Carmen Reichman (2015) Providers will revisit drawdown charges after 'race to the bottom', says LV=, Source: Professional Pensions, 10 March.

director at Dunstan Thomas, has identified the following types of retail drawdown charges:[233]

- Transfer out charge – for moving from one contract to another
- Transfer out charge to UK-based schemes
- Transfers out charge to overseas schemes
- Annuity purchase charge
- Tax-free cash charge (in drawdown a member might be charged several of these as they drawdown tax-free cash by stages)
- Income charge (essentially an annual usage fee)
- Crystallisation charge (as monies are drawdown)
- Pot depreciation charge (taken just before the pot balance goes to zero)
- Review charge (for those in capped drawdown where pre-April 2015 drawdown scheme members opting to be capped will remain if they do not exceed their stipulated maximum income allowance)
- Death benefit charge
- Additional designated charges, associated with phased drawdown.

In addition, the Dunstan Thomas analysis found little uniformity in terms of amounts charged. For example, based on a sample of 54 SIPP providers, the average transfer out charge was £161.70, but it varied between nothing and more than £500.

### 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, such as those considered in the previous section, but as retail customers.

This reflects the reluctance, noted in Section 2.3.1 above, of trust-based DC schemes to offer drawdown themselves. Members will have to transfer to a SIPP if they want to use drawdown. Some trust-based DC schemes used to allow up to two lump sum withdrawals per year, but no more. A key reason is cost. Jon Dean, a consultant at Altus, said: 'Even something as apparently simple as removal of drawdown limits can necessitate changing multiple interconnected IT systems, redesigning the business processes and controls they support, and communicating the changes to distribution partners'. [234]

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. For

[233] Natanje Holt (2015) It'll cost you: Can providers justify income drawdown charges?, Retirement Planner, 2 December.
[234] Quoted in Peter Davy (2015) Complexity and Cost will limit pensions freedom, Financial News, 16-22 March.

example, Scottish Widows will allow unlimited UFPLS withdrawals, but customers will have to move to another Scottish Widows scheme to use drawdown.

The costs of transferring between schemes can be high. Exiting an existing pension scheme to get a lump sum or transferring a pension scheme to another provider with a drawdown facility could involve punitive exit charges imposed by the transferring scheme and the loss of valuable benefits such as guaranteed annuity rates. This would be especially true for pension policies sold by insurance companies during the 1980s and 1990s by advisers who were paid large commissions. These commissions are spread over the life of the policy, but need to be paid whether or not the policy holder continues to pay the premiums. Exit penalties are the way in which the remaining premiums are captured. It is hard to get reliable information on the size of the exit penalties. Insurers claim they are too complex and too tailored to individual policies. However, they can range between 2-20%.[235] One example is Abbey Life which has an annual charge of 5.25% and an exit penalty of 11%.[236,237]

### *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 than is necessary) 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 level of income drawn will also be influenced by the new rules on inheritance. For those with sufficient alternative sources of savings, such as ISAs, it will be optimal to draw from those sources before drawing from the pension scheme. This is because income from ISAs is tax free, whereas pension income is taxed. Further, ISAs are subject to inheritance tax (IHT), whereas the pension fund can be passed tax free to a named beneficiary if the member dies

---

[235] Ruth Lythe (2014) Are the wheels coming off the pensions revolution? Savers who cash in their funds face charges of up to 20%, Money Mail, 27 August.

[236] Reported in Ruth Lythe (2014) Are the wheels coming off the pensions revolution? Savers who cash in their funds face charges of up to 20%, Money Mail, 27 August.

[237] The high exit charges for transferring to a scheme offering full drawdown flexibility became the subject of intense media and Government criticism in the months following the introduction of 'freedom and choice' and we consider this issue further in Chapter 3.

before age 75. If the member dies after age 75, the pension fund can go to any named beneficiary who pays income tax at their marginal rate.

The second factor is the state pension. For those with sufficient private pension savings and in good health, it pays to delay taking the state pension. Alan Higham, then head of retirement insight at Fidelity, has shown that those who reach state pension age before April 2016 would receive a 10.4% higher state pension for each year that they delayed drawing it. To illustrate, suppose someone is about to retire with a state pension of £6,000 and delays taking the pension for three years when inflation is 3%. The uplifted pension in four years' time will be £8,602 compared with £6,556 if there was no deferral, which is 31.4% higher. The three years of missing state pension payments amount to £18,922 and this has to be withdrawn from the DC pension pot. As an alternative to taking the extra state pension as an annuity, it is possible to take it as a lump sum. This would amount to £19,241. The retiree has to live 11 years for the strategy to break even, so the strategy is not suitable for those in poor health. If someone lived until 90, the total benefit would be £54,000. After April 2016, the increase in the state pension for each year of deferral falls to 5.8% which is still much better than most investments offer.[238]

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, 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.[239] For example, according to Raimond Maurer and Barabara Samova's (2009) report *Rethinking Retirement Income Strategies – How Can*

---

[238] Katie Morley (2015) How to increase your state pension by £54,000, Daily Telegraph, 22 February.

[239] Moshe Milevsky (2001) Optimal Annuitization Policies: Analysis of the Options, *North American Actuarial Journal*, 5(1), 57-69; Moshe Milevsky and Virginia Young (2002) *Optimal Asset Allocation and The Real Option to Delay Annuitization: It's Not Now-or-Never*, Discussion Paper, Schulich School of Business, York University, Toronto; David Blake, Andrew Cairns, and Kevin Dowd (2003) Pensionmetrics II: Stochastic Pension Plan Design during the Distribution Phase, *Insurance: Mathematics and Economics*, 33(1), 29-47; Andrew Cairns, David Blake, and Kevin Dowd (2006) Stochastic Lifestyling: Optimal Dynamic Asset Allocation for Defined-Contribution Pension Plans, *Journal of Economic Dynamics and Control*, 30, 843-877; Robert C. Merton (2007) The Future of Retirement Planning, in Z. Bodie. D. McLeavey and L.B. Siegel (eds) *The Future of Life-Cycle Saving & Investing*, Research Foundation of the CFA Institute; David Blake, Douglas Wright, Yumeng Zhang (2014) Age-dependent Investing: Optimal Funding and Investment Strategies in Defined Contribution Pension Plans when Members are Rational Life Cycle Financial Planners, *Journal of Economic Dynamics and Control*, 38, 105-124.

*We Secure Better Outcomes for Future Retirees?,* commissioned by the European Fund and Asset Management Association:[240]

> *[T]he modelling presented in this report [suggests that] the best investment strategy for payout solutions is to hold a significant proportion of pension assets in well-diversified equity portfolios early in retirement, and to switch to annuities and bond holdings progressively over time, taking into account individuals' specific circumstances. This strategy results in significantly higher consumption possibilities, at a relatively low risk compared to immediate full annuitisation at retirement.*
>
> *The risk of being worse off in terms of retirement income in [the] case of adverse stock [market] developments is limited for individuals adjusting their pension asset portfolio. ….The simulations of consumption levels under different financial markets conditions show that the majority of individuals (70%) can expect to enjoy up to a third of higher lifetime consumption level if they hold equity at the beginning of retirement and gradually switch to annuities over time, instead of annuitising all their wealth at the age of 65. Moreover, the consumption level of individuals ending up in the worst financial market scenarios would be less than 10% lower than under full annuitisation.*
>
> *As a consequence, compulsory full annuitisation of retirement wealth at the age of 65 results in significant costs in terms of foregone consumption. Taking into account the desire of individuals to leave money to their surviving relatives and/or build a financial buffer to cope with large and sudden expenses, the disadvantage from enforced annuitisation becomes substantially aggravated.*
>
> *The report also demonstrates that retirees can enjoy a smooth consumption pattern during retirement if they keep their retirement wealth invested in pension products featuring a switching mechanism to increase the proportion of annuities and bonds as time goes by. This result reflects the fact that short-term fluctuations in equity markets become less important over long investment horizons when the gradual reduction in equity expense limits the exposure of pension assets to market volatility.*

### 2.4.2 Is there a safe withdrawal rate?

As Abraham Okusanya argues: 'For clients in retirement, developing a sensible and sustainable withdrawal strategy is at least as important as developing a sensible investment strategy. Unless a client annuitises all or most of their retirement pot, they need to have a

[240] Raimond Maurer and Barabara Samova (2009) *Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?*, European Fund and Asset Management Association, February; http://www.efama.org/Publications/Public/Long-Term_Savings_and_Pension_Steering_Committee/Maurer_Rapport.pdf.

robust framework in place to guide their withdrawal decisions or risk running out of money'.[241]

### *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.[242] Bengen later introduced the term 'safemax' to describe the highest withdrawal rate that would allow at least 30 years' of inflation-adjusted withdrawals and showed that the safemax rate was 4.5% if the income is tax-free and 4.1% if it is taxable.[243]

The 4% rule was 'confirmed' by the so-called Trinity study in 1998. Philip L Cooley, Carl M. Hubbard, and Daniel T. Walz used Monte Carlo simulation techniques on US financial data between 1926 and 1995[244] to show that a 4% withdrawal rate from a fund invested 50% in US equities and 50% in US bonds would have a 95% chance of lasting at least 30 years (i.e., a 5% failure rate).[245]

More recently, Wade Pfau, a professor of retirement income at the American College of Financial Services, investigated the 4% rule for the UK and 16 other developed market economies.[246] He employed 109 years of financial market data (between 1900 and 2008) for each of the 17 countries. Using the same historical simulations approach as Bengen, he examined the outcomes for individuals retiring in each year of the 80 years between 1900 and 1979, allowing for a retirement period of 30 years.

---

[241] Abraham Okusanya (2015) Probability and the 4% rule: How to ensure your clients retire 'safely', Professional Adviser, 18 February.
[242] William P. Bengen (1994) Determining Withdrawal Rates Using Historical Data, *Journal of Financial Planning*, October, 14–24.
[243] William P. Bengen (2006) *Conserving Client Portfolios During Retirement*, ISBN 978-0-97534483-5.
[244] Taken from *Stocks, Bonds, Bills, and Inflation, 1996 Yearbook*, Ibbotson Associates. Over the 1926 and 1995 period, the average returns on the key asset classes were 3.7% (Treasury bills), 5.7% (long-term corporate bonds) and 10.5% (large company common stocks). The real return on a 50/50 portfolio over this period was approximately 5%.
[245] Philip L Cooley, Carl M. Hubbard, and Daniel T. Walz (1998), Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable, *AAII Journal*, 20(2), 16–21.
[246] Wade D. Pfau (2010), An International Perspective on Safe Withdrawal Rates: The Demise of the 4 Percent Rule?, *Journal of Financial Planning*, 23(12), 52–61.

| *Table 2.4: Safe withdrawal rates for UK retirees* | | | | |
|---|---|---|---|---|
| | 'Safemax' | 10th percentile | % failures (4% rate) | % failures (5% rate) |
| 'Perfect' foresight assumption | 3.77 | 4.17 | 3.8 | 27.5 |
| UK 50/50 portfolio | 3.43 | 4.01 | 9.3 | 55.6 |
| Global 50/50 portfolio | 3.26 | 3.55 | 17.9 | 31.0 |
| Source: Wade D. Pfau (2010) An International Perspective on Safe Withdrawal Rates: The Demise of the 4 Percent Rule?, *Journal of Financial Planning*, 23(12), 52–61. | | | | |

The outcomes for the UK are shown in Table 2.4. Even with perfect foresight of future asset returns and the most favourable asset mix in the light of this perfect foresight, Pfau showed that the 'safemax' 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%. Returning to Bengen's original case of a 50/50 portfolio, the 'safemax' rate is just 3.43%. With a 10% failure probability, the SWR is 4.01%, while a withdrawal rate of 5% leads to a failure rate of 55.6%. The outcome is actually worse if the individual invests in a global 50/50 portfolio (i.e., 50% in global equities and 50% in global bonds). Now the 'safemax' rate is 3.26%, the SWR rate with a 10% failure probability is 3.55%, and the failure rate with a 5% withdrawal rate is 31%.

While a fixed SWR is simple to understand, it has a number of weaknesses.

First and most importantly, it ignores longevity risk. Office for National Statistics data shows that a 65-year old couple has a 25% chance of one of them reaching 97 and a 17% chance of one of them reaching 100. A rule designed so that funds last 30 years is clearly inadequate. Moshe A. Milevsky and Huaxiong Huang (2011, Table 3) show that, for individuals who are concerned about running out of money before they die (i.e., have longevity risk aversion), it is optimal for them to use a proportion of their pension pot to buy index-linked LTAs. These authors show that lifetime consumption in retirement (as well as lifetime utility or welfare) is maximised if all pension wealth is annuitised at the time of retirement.[247] Some have argued that individuals who do not want to formally purchase an annuity because they

[247] Moshe A. Milevsky and Huaxiong Huang (2011) Spending Retirement on Planet Vulcan: The Impact of Longevity Risk Aversion on Optimal Withdrawal Rates, *Financial Analysts Journal*, March/April, 45-59.

value the flexibility of drawdown, should not actually choose a SWR above that of an annuity (i.e., 2.5% - 3%).[248]

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. Michael Finke, Wade D. Pfau, and David M. Blanchett show that if the Trinity study was repeated with real bond rates as of January 2013 (4% below the historical long-run average), then the failure rate with the 4% rule increases from 5% to 57%. If bond rates return to their historical average after 5 (10) years, the failure rate is still high at 18% (32%).[249]

Fifth, it ignores fund management charges. Maria A. Bruno, Colleen M. Jaconetti, and Yan Zilbering show that the SWR with a 50/50 US equity/bond portfolio, an 85% success rate and a 30-year spending horizon drops from 3.9% with a 0% charge, to 3.8% with a 0.25% charge, and to 3.3% with a 1.25% charge.[250]

Sixth, it ignores the dynamic nature of market and portfolio returns. Many advisers use cashflow models to help clients understand their income and expenditure needs after retirement. Included in income is the withdrawal amount from the fund, e.g., 4%. This withdrawal rate will be based on an assumed rate of return on the invested fund. The problem is that the cashflow models are deterministic and assume that the rate of return is fixed and hence ignore real world randomness. In particular, they ignore 'sequence-of-returns' risk.[251] 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.

---

[248] Jonathan Gardner (2015) Withdrawal Strategies for DC Retirees, Towers Watson Corporate and Trustee Briefing, 5 October: 'Running out of money is a possibility with the 4% rule, as it does not allow for adjustments based on poor investment performance or life expectancy'.

[249] Michael Finke, Wade D. Pfau, and David M. Blanchett (2013) The 4 Percent Rule Is Not Safe in a Low-Yield World, *Journal of Financial Planning*, 26(6), 46–55.

[250] Maria A. Bruno, Colleen M. Jaconetti, and Yan Zilbering (2012, Figure 5) Revisiting the 4% spending rule, Vanguard Research.

[251] Also known as 'pound cost ravaging': see, e.g., Simon Chinnery (2015) Navigating the dangers of pound cost ravaging, Professional Adviser, 5 June.

*Table 2.5: Sequence-of-returns risk*

| Year | Portfolio A | Portfolio B | Client age | Portfolio A | Portfolio B |
|---|---|---|---|---|---|
| 1 | -5.9 | 5.73 | 60 | 89,100 | 100,730 |
| 2 | -13.3 | 5.73 | 61 | 72,250 | 101,502 |
| 3 | -22.7 | 5.73 | 62 | 58,849 | 102,318 |
| 4 | 20.9 | 5.73 | 63 | 56,476 | 103,181 |
| 5 | 12.8 | 5.73 | 64 | 58,705 | 104,093 |
| 6 | 22.0 | 5.73 | 65 | 66,621 | 105,057 |
| 7 | 16.8 | 5.73 | 66 | 72,813 | 106,077 |
| 8 | 5.3 | 5.73 | 67 | 71,672 | 107,155 |
| 9 | -29.9 | 5.73 | 68 | 45,242 | 108,296 |
| 10 | 30.1 | 5.73 | 69 | 53,860 | 109,501 |
| 11 | 14.5 | 5.73 | 70 | 56,670 | 110,775 |
| 12 | -3.5 | 5.73 | 71 | 49,686 | 112,123 |
| 13 | 12.3 | 5.73 | 72 | 50,798 | 113,547 |
| 14 | 20.8 | 5.73 | 73 | 56,363 | 115,054 |
| 15 | -5.9 | 5.73 | 74 | 48,038 | 116,646 |
| 16 | -13.3 | 5.73 | 75 | 36,649 | 118,330 |
| 17 | -22.7 | 5.73 | 76 | 23,330 | 120,110 |
| 18 | 20.9 | 5.73 | 77 | 23,206 | 121,993 |
| 19 | 12.8 | 5.73 | 78 | 21,176 | 123,983 |
| 20 | 22 | 5.73 | 79 | 20,835 | 126,087 |
| 21 | 16.8 | 5.73 | 80 | 19,335 | 128,312 |
| 22 | 5.3 | 5.73 | 81 | 15,360 | 130,664 |
| 23 | -29.9 | 5.73 | 82 | 5,767 | 133,151 |
| 24 | 30.1 | 5.73 | 83 | 2,503 | 135,781 |
| 25 | 14.5 | 5.73 | 84 | | 138,561 |
| 26 | -3.5 | 5.73 | 85 | | 141,500 |
| 27 | 12.3 | 5.73 | 86 | | 144,608 |
| 28 | 20.8 | 5.73 | 87 | | 147,894 |
| 29 | 5.73 | 5.73 | Average | | |

Source: FinalytiQ

This can be shown using the following example.[252] Table 2.5 shows the returns from two portfolios. The second column (Portfolio A) represents a sequence of realistic annual returns, while the third (Portfolio B) represents what advisers might use in their deterministic cashflow model by assuming the average annualised return from column 2 holds for each of the 29 years in the Table. The key point is that both portfolios have the same average return, but the sequence of returns is very different.

A client withdrawing £5,000 a year from age 60 will run out of money with Portfolio A by age 83, while Portfolio B allows the customer to withdraw the same level of income indefinitely and bequest more than the initial pension pot to their descendants. The explanation for what happens to portfolio A is 'reverse pound cost averaging' or 'pound cost ravaging': the customer has to sell units at low prices to pay the required income and the portfolio can never recover from the early poor performance by later good performance, however good that subsequent performance is.[253] As Abraham Okusanya argues: 'Deterministic modelling tools hide the danger of negative sequence-of-returns, especially in the early years of retirement'.[254] Some advisers are even less complementary about cash flow models. Richard Bishop, director and principal at Premier Practice, says: 'I'm going to come out and say it: cashflow modelling is utter nonsense and is only used to justify extortionate adviser fees'.[255]

Finally, the SWR ignores the fact that the future might not be like the past: in particular, future returns might by lower and more volatile than the historical returns upon which the 4% rule was based. As mentioned by Jonathan Gardner of Towers Watson, the 4% rule was built on the particularly favourable post-World War II investment experience, and this might well not be repeated going forward.[256] A similar point has been made by Duncan Robertson, marketing director at Aegon Ireland: 'Yes, the past has a useful story to tell, and through our experiences of the past we can build models of what might happen in the future. But it would be misguided to use it blindly. Models on sustainability need to be calibrated to today's world, using today's expectations on rates of return and volatility of assets and today's expectations on an individual's longevity….. Withdrawal rates of 5%+ may be perfectly sustainable when risk-free yields are at historical higher levels, and planning to

---

[252] Taken from 'Pound Cost Ravaging: Understanding Volatility Drag, Sequencing Risk & Safe Withdrawal Rates in Retirement Portfolios', http://www.finalytiq.co.uk/pound-cost-ravaging-whitepaper/; see also Abraham Okusanya (2014) Understanding that silent portfolio killer – Sequence of return risk, Professional Adviser, 9 October; and Carmen Reichman (2015) Sequence of return risk threatens non-advised drawdown retirees – Standard Life, Professional Adviser, 1 April.

[253] See, e.g., David Blackman (2014) Welcome to the world of drawdown, Pensions Insight, November/December.

[254] Abraham Okusanya (2015) Understanding that silent portfolio killer - Sequence of return risk, Professional Adviser, 9 October.

[255] Quoted in Scott Sinclair (2014) Is advisers' love affair with cashflow modelling masking its shortcomings?, Professional Adviser, 5 June.

[256] Jonathan Gardner (2015), Withdrawal Strategies for DC Retirees, Towers Watson Corporate and Trustee Briefing, 5 October.

exhaust funds 30 years after retiring may also be okay when people weren't living so long. However, this isn't the current world'.[257]

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[258]
- 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.

Luke Delorme (2014, p.33) examined three common withdrawal strategies in terms of their 'utility scores'.[259,260] These were the original 4% rule (an inflation-adjusted percentage starting at 4% of the initial pot), a constant monetary amount (equal to 4% of the initial pot) and a constant percentage (4% of whatever the pot size is at the time of withdrawal). Based on bootstrapped simulations which draw returns randomly from the period 1928 to 2013, the author shows that the withdrawal strategy with the highest utility score in the worst-case scenario is the original 4% rule (utility score = 4.93). The strategy with the lowest score is the constant monetary amount (utility score = 2.92), while the constant percentage strategy lies in between (utility score = 4.11).

[257] Duncan Robertson (2015), Past performance: Sustainable withdrawal rates face trouble ahead, Professional Pensions, 2 December.

[258] This and the next strategy are associated with Jonathan T. Guyton (2004), Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?, *Journal of Financial Planning*, 17, 54–62; and Jonathan T. Guyton and William J Klinger (2006), Decision Rules and Maximum Initial Withdrawal Rates, *Journal of Financial Planning*, 19, 49–57.

[259] Luke Delorme (2014) *From Savings to Income: Retirement Drawdown Strategies*, American Institute for Economic Research.

[260] A utility score adjusts a monetary amount for the utility or welfare that an individual expects to experience from consuming goods and services equal in value to the monetary amount. It is particularly useful when comparing changes in monetary amounts. This is because most people experience diminishing marginal utility. This implies that doubling the monetary amount increases the utility score by less than two: eating a second ice cream is not usually as enjoyable as the first ice cream. Conversely, halving the monetary amount leads to more than a 50% reduction in the utility score.

### *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.[261]

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.[262] 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.

Ed Denbee (2008, Figures 4 and 8) examined the equivalent annuity and $1/E_x$ strategies.[263] Both strategies give similar results.[264] The pattern in the case of the median simulation for someone retiring at 65 is that the withdrawal amount is initially higher than for an equivalent index-linked annuity.[265] It increases year on year until the early 70s and then falls back, dropping below the annuity payment in the early 80s. Someone surviving to 100 would have around one quarter of the payment they would have received on the index-linked annuity.

The second is to draw only the 'natural' income from the fund. Mark Rimmer, product director for Premier's multi-asset team, defines this as the 'pay-out of dividends [coupons, rent etc] from income-generating investments'.[266] This, of course, is what equity income funds do. Since there is no cashing-in of units to pay an income, the annual income received will fluctuate from one year to the next and 'there is no tidy way of getting around this'.

The third is auto-rebalancing.[267] This involves making withdrawals from the asset classes that experienced the highest growth during the year. An extreme form would be to

---

[261] A number of the strategies below are examined in more detail in Wade Pfau and Jeremy Cooper (2014) *The Yin and Yang of Retirement Income Philosophies*, Challenger.

[262] The annuity factor is the present value of £1 per year for the remaining life of the annuitant, taking into account that at each age x, there is a probability of $q_x$ that the annuitant will die at age x and a probability of $(1 - q_x)$ that the annuitant will survive to age $(x + 1)$. The discount rate used to calculate the present value is typically related to the yield on long-term government bonds.

[263] Ed Denbee (2008) *Modelling Income Drawdown Strategies*, Investment Management Association, http://www.theinvestmentassociation.org/assets/files/press/20080311-01.pdf; see also Investment Management Association (2008) *Enabling Choice for Retirement*, Investment Management Association, http://www.theinvestmentassociation.org/assets/files/press/2008/20080311-02.pdf.

[264] And are identical when the discount rate for the annuity factor is zero (since $a_x = E_x$ under these circumstances).

[265] Except in the first year for the equivalent annuity strategy when the amounts withdrawn are the same.

[266] Mark Rimmer (2015) Is 'natural' income the answer to the sequence of return problem?, Professional Adviser, 23 March.

[267] Cazalet Consulting (2014, p. 117-9) *When I'm Sixty-Four*, September.

rebalance the portfolio annually to a constant asset mix, by selling relative winners and buying relative losers.

The fourth is to use a cashflow reserve (or bond) ladder or bucket (also called time segmentation).[268] This involves holding enough in deposits or short-maturing bonds to meet the next two years of expenditure. This means that equities do not have to be sold in a falling market to fund expenditure. The next rung of the ladder includes medium-term bonds intended to cover the next 5 to 10 years of expenditure, but which could be sold in a prolonged market downturn without too big a capital loss. At the top of the ladder are equities. With luck, by the time the client needs to sell equites to meet expenses, the market has recovered. A feature of this approach is that the portfolio becomes riskier over time, since there is no rebalancing of the portfolio as the safest and most liquid assets are sold to pay for consumption.

The fifth is the rising equity glide path proposed by Wade Pfau and the US financial planner Michael Kitces.[269] 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. Also if there has been a sequence of negative returns during the early years of retirement, the rising glide path results in the clients buying low. The approach is the exact opposite of conventional wisdom which suggests that the equity weighting in the portfolio should decrease with age (as in the common rule of thumb used by advisers that the equity weighting should equal 100 minus age).

The sixth is the floor-leverage rule.[270] 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% and the proceeds are used to increase spending. Otherwise, do nothing.

The final one is a 'least cost' or 'collared' spending strategy.[271] The designers of this strategy argue that the 4% rule leads to situations where surpluses are accumulated (and unspent) when markets outperform and where there are spending shortfalls when markets underperform. They estimate that these surpluses amount to 10%-20% of the retiree's

---

[268] See Finalytiq (2014) *Pound Cost Ravaging: Understanding Volatility Drag, Sequencing Risk & Safe Withdrawal Rates in Retirement Portfolios*, http://www.finalytiq.co.uk/pound-cost-ravaging-whitepaper; Abraham Okusanya (2014), *Chaos Theory: How to Manage Sequencing Risk in a Retirement Portfolio*, Professional Adviser, 13 November; Cazalet Consulting (2014, p. 114-5), *When I'm Sixty-Four*, September.

[269] Wade D Pfau and Michael E. Kitces (2014) Reducing Retirement Risk with a Rising Equity Glide Path, *Journal of Financial Planning*, 27(1), 38–45.

[270] Jason S Scott and John G Watson (2013) The Floor-Leverage Rule for Retirement, *Financial Analysts Journal*, 69(5), 45–60.

[271] Jason S. Scott, William F. Sharpe, and John G. Watson (2009) The 4% Rule—At What Price?, *Journal of Investment Management*, 7(3), 31–48.

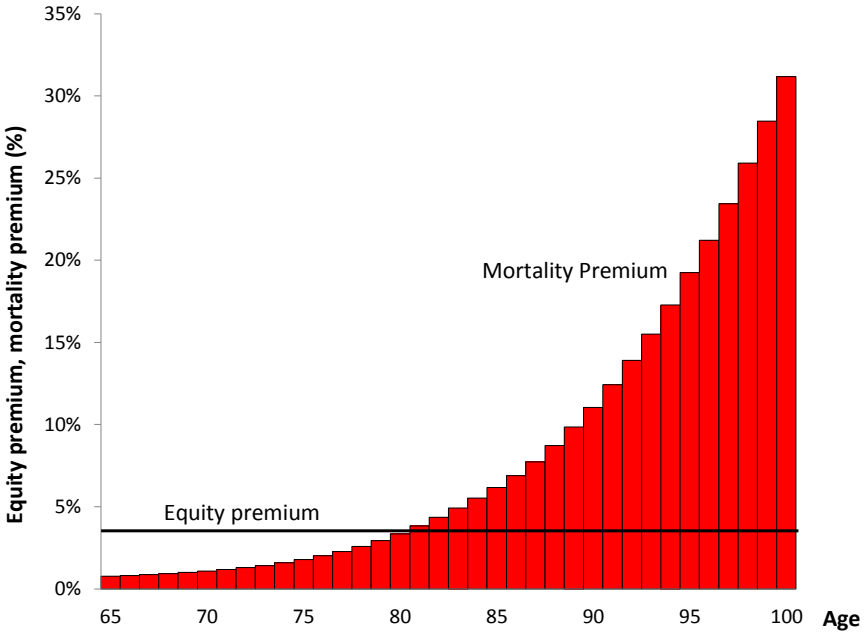
initial wealth, while the spending shortfalls are equivalent to an additional 2%-4% of initial wealth. They propose an alternative 'least cost' spending plan which eliminates the inefficiencies – amounting to 12%-24% of initial wealth – in the 4% spending plan. This involves using options to put a cap on spending when the market is underperforming and a floor on spending when the market is performing well and hence puts 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.

*Figure 2.3: The Milevsky switching rule*



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.[272] 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; it is shown by the upward sloping curved line in the Figure. 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 fixed at 3% p.a.

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.[273]

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.[274]

We make the following assumptions:

- Male retires age 65 with a pension pot of £100,000 ($F_{65}$)
- Investment strategy: 25% equites, 75% bonds
- Expected interest rate = 4%
- Volatility of interest rate = 4%
- Expected inflation rate = 2%
- Volatility of inflation rate = 4%
- Equity premium = 3%
- Volatility of equity returns = 20%

---

[272] Moshe Milevsky (1998) Optimal Asset Allocation Towards the End of the Life Cycle: To Annuitize or Not to Annuitize?, *Journal of Risk and Insurance*, 65, 401-26.

[273] This is demonstrated in David Blake, Andrew Cairns,and Kevin Dowd (2003) Pensionmetrics II: Stochastic Pension Plan Design during the Distribution Phase, *Insurance: Mathematics and Economics*, 33 (1), 29-47.

[274] We are grateful to Professor Kevin Dowd of Durham University Business School and a Fellow of the Pensions Institute for preparing these illustrations; http://www.pensionmetrics.net/

- Total expense ratio = 1%
- Annuity rate at age 65 ($a_{65}$) = 5.5%
- Age at which deferred annuity starts if purchased at age 65 = 85
- Number of simulation trials = 2,500.

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

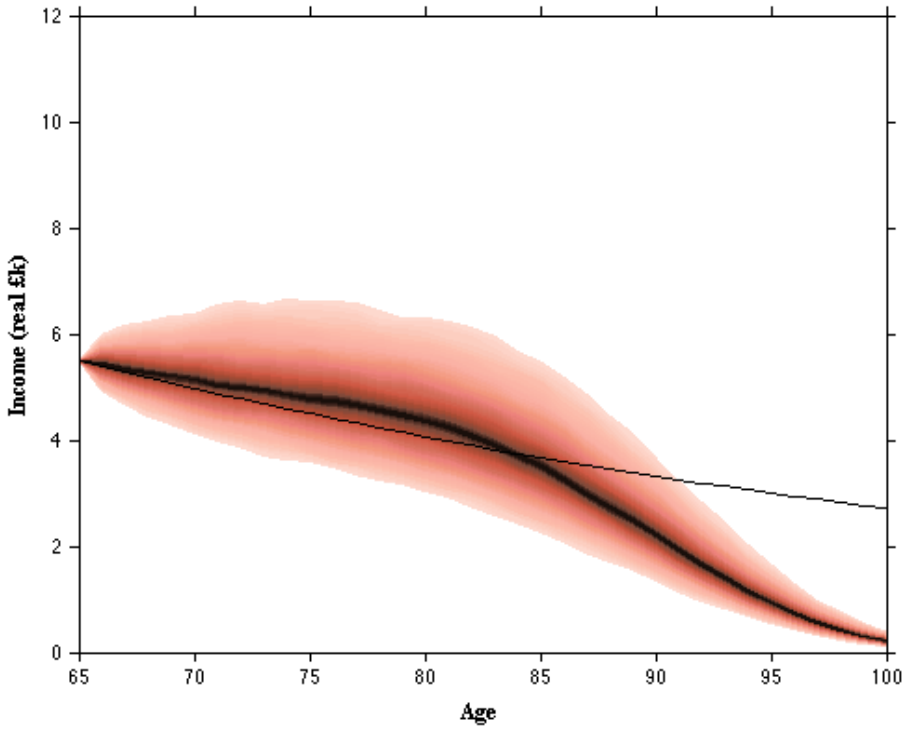



Figure 2.4 shows the distribution of real income with 100% drawdown and no deferred annuity. What is depicted is a fanchart showing the 90% prediction interval for the distribution of income from the 2,500 different scenarios. Each year, the member is assumed to withdraw the annuity equivalent of their remaining pension pot. At age 65, the member withdraws 5.5% of £100,000 (= $a_{65}$ x $F_{65}$ = £5,500), which is the same amount that could be taken from a level lifetime annuity at age 65. This means that £94,500 (=£100,000 - £5,500) is available for investment in the first year of retirement. Suppose the investment portfolio loses 5%, so the pension pot is valued at £89,775 ($F_{66}$ = £89,775) at the end of the year, and the annuity rate is 5.8% at age 66 ($a_{66}$ = 5.8%): then the income that could be withdrawn at age 66 would be £5,270 (= $a_{66}$ x $F_{66}$ = 5.8% of £89,775). Suppose instead that the investment portfolio gains 5%, so the pension pot would now be valued at £99,225 ($F_{66}$ = £99,225), and the income that could be withdrawn at age 66 would be £5,775 (= $a_{66}$ x $F_{66}$ = 5.8% of £99,225). These are two of the possible 2,500 scenarios for what might happen at age 66. The most likely outcome for what could happen between ages 65 and 100 (assuming the member survives that long) is given by the dark central band in the fanchart. We can also be 90% confident that the actual outcome will lie somewhere in the fanchart.

Also depicted in Figure 2.4 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 at the rate of 2% p.a. due to inflation. The average real value of the income that can be drawn from the drawdown programme falls each year, since more is taken out of the fund every year than the average value of the investment return (and there is also the effect of inflation). But it initially falls by less than the fall in the real value of the annuity, due to the equity premium earned by the drawdown fund. However, after around age 80, the mortality premium exceeds the equity premium. Also a higher mortality rate implies a higher annuity rate.

Since the amount taken out of the fund in a given year depends on the fund size, the annuity rate for that year and the equity premium, once the mortality premium exceeds the equity premium, the income that can be drawn from the fund falls very rapidly. This is because, while the annuity rate increases, the fund size falls at a bigger rate. But note that the pension pot never runs out, because the member never draws down more than the annuity equivalent of the remaining pension pot. Also note that the prediction interval is very wide, particularly for people in their 80s. For example, at age 80, someone could be lucky and be drawing £6,500, or they could be unlucky and only be drawing £3,000.

Figure 2.4 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 if they live that long.

Figure 2.7 shows what happens if only 80% of the annuity equivalent is withdrawn each year. In the first year, £4,400 is withdrawn. The larger sum that is retained in the pension pot to begin with means that, on average, increasing amounts can be taken out in subsequent years until the early 80s. Thereafter, the amount that can be withdrawn declines gradually and falls below that of an annuity by the late 80s.

Figure 2.8 shows what happens if a fixed amount is withdrawn each year – equal to 150% of the initial annuity amount of £5,500 (i.e., £8,250) – irrespective of the subsequent investment performance of the investment portfolio. It is clear that this is a very high-risk strategy that risks the pot being depleted completely by around age 80. Even taking only £5,500 per year is not much less risky as Figure 2.9 shows.

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

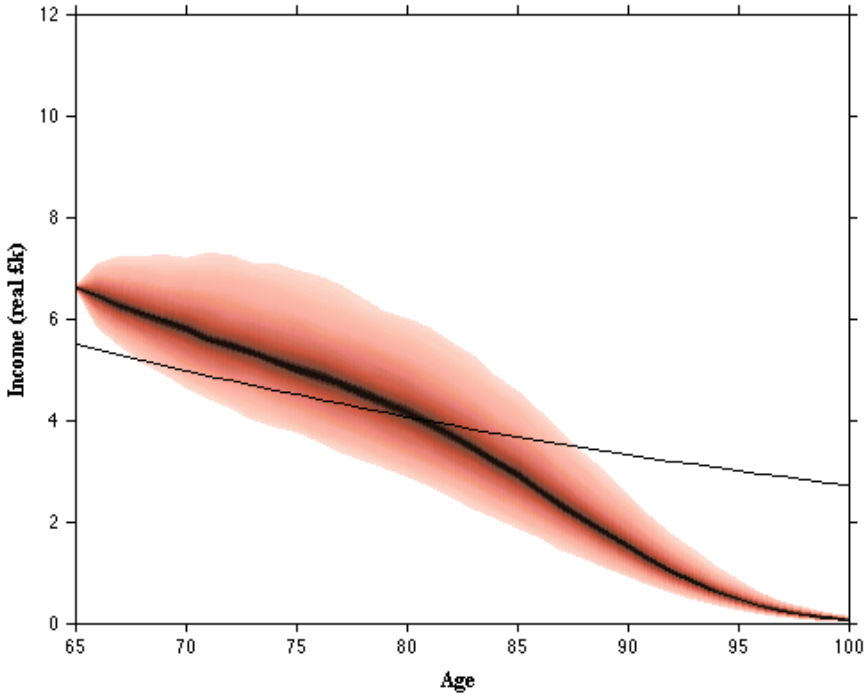



*Figure 2.6: Distribution of real income with 150% drawdown and no deferred annuity*

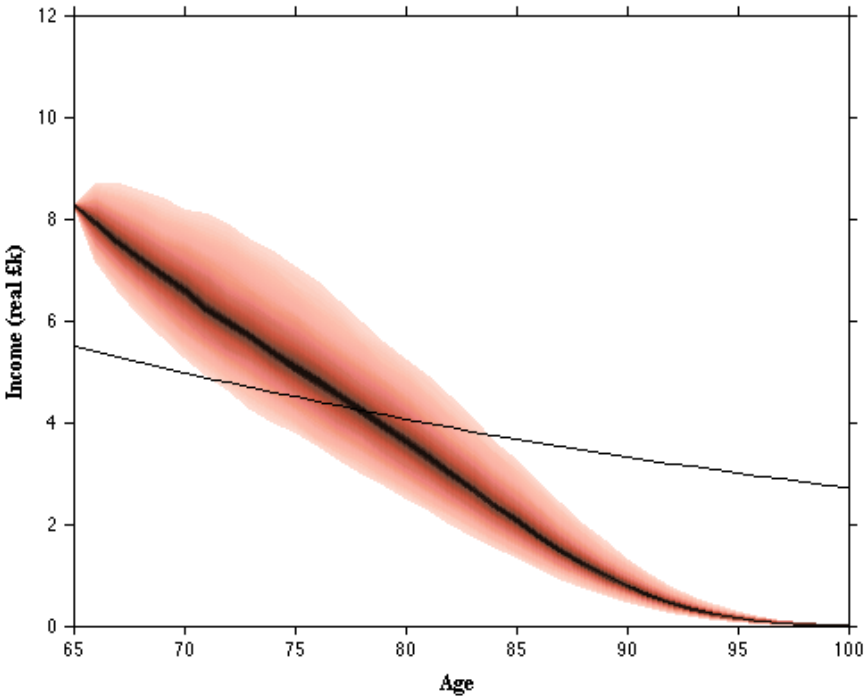


*Figure 2.7: Distribution of real income with 80% drawdown and no deferred annuity*

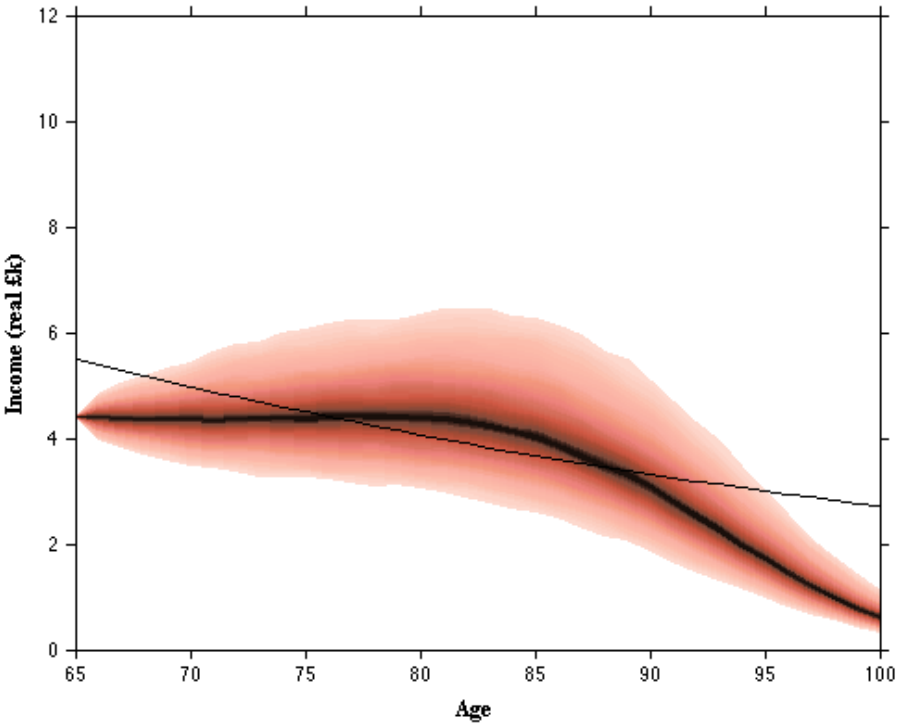



*Figure 2.8: Distribution of real income with a fixed amount withdrawn each year equal to 150% of the initial annuity amount*

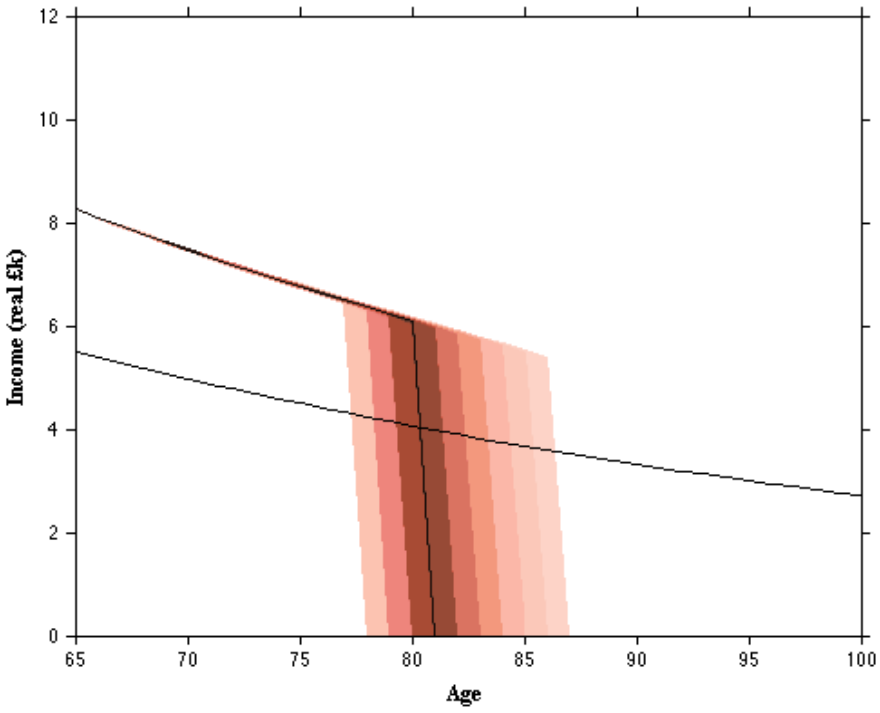
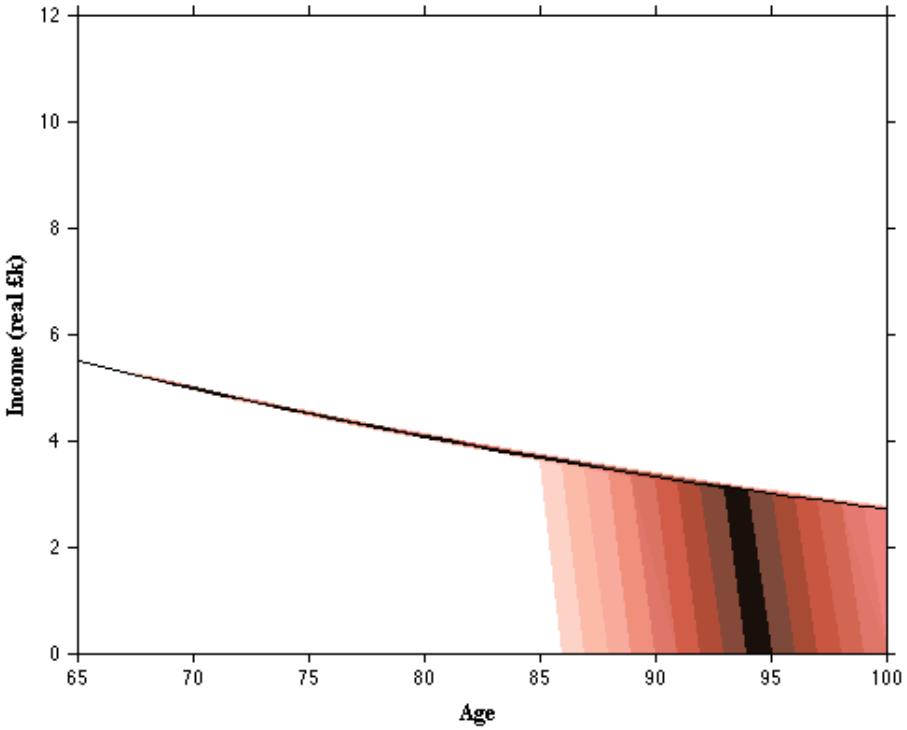


*Figure 2.9: Distribution of real income with a fixed amount withdrawn each year equal to 100% of the initial annuity amount*




The next set of Figures show what happens if part of the pension fund is used to buy a deferred annuity at age 65 which starts to pay out at age 85 if the member survives that long – the premium for the deferred annuity is lost if the member dies before 85. 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. If concerned about the fall off in income at high ages, the member could consider using 15% of the fund to buy a deferred annuity as shown in Figure 2.11. Figure 2.12 shows what happens in the case of 150% drawdown with 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85. The benefits from purchasing a deferred annuity at high ages are clear.

What these Figures strikingly demonstrate is the two key unavoidable tradeoffs people need to make in retirement: (a) a higher income earlier in retirement or 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 retirees are prepared to accept for retaining control over their assets.

*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*

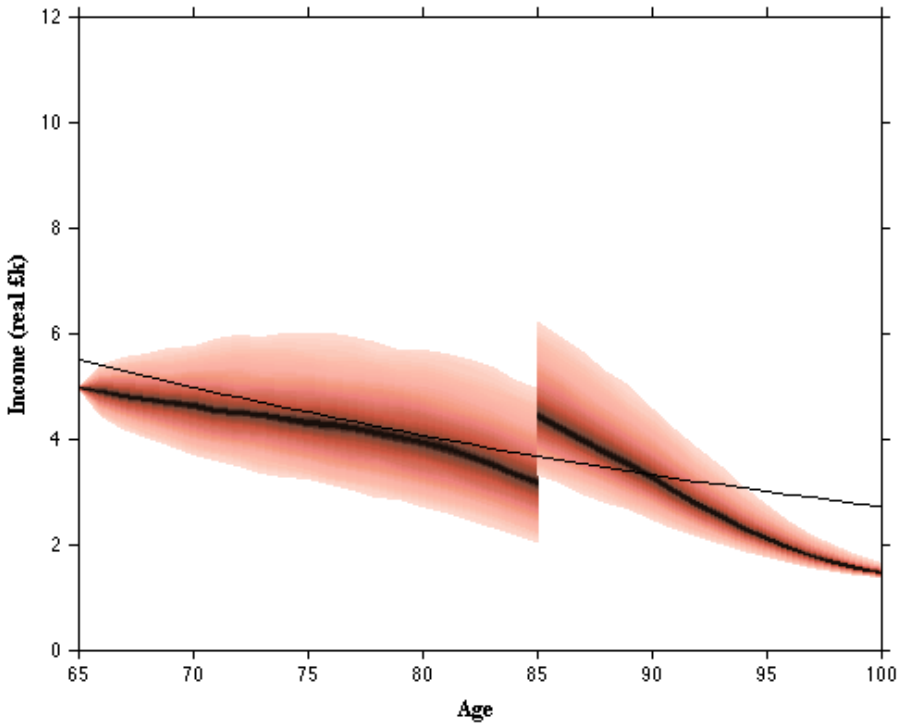



*Figure 2.11: Distribution of real income with 100% drawdown and 15% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85*

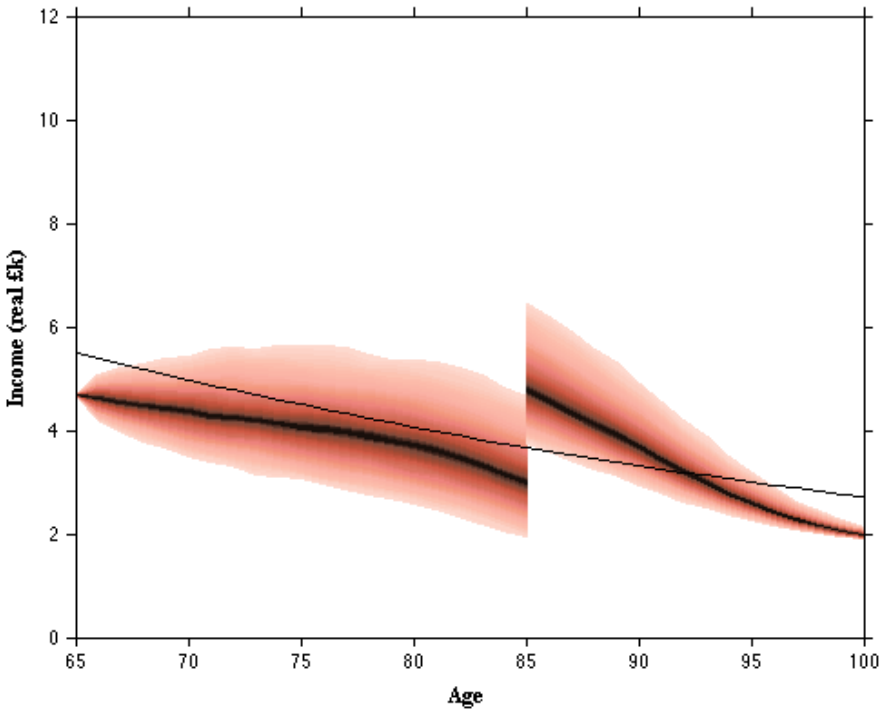
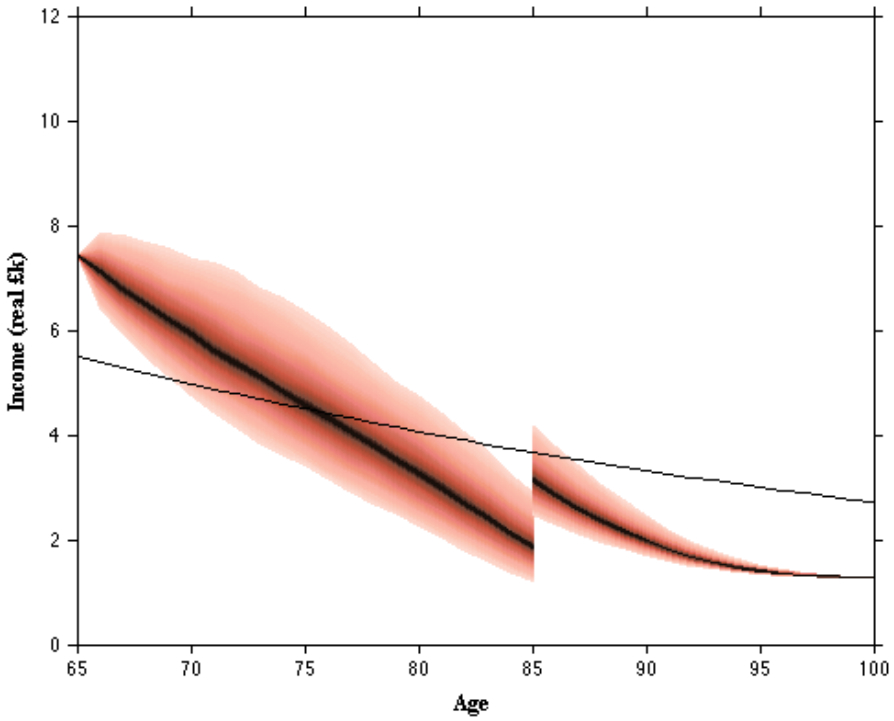


*Figure 2.12: Distribution of real income with 150% drawdown and 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85*




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

#### 2.6.1 Charges

Charges for drawdown vary considerably and have up to 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.[275]

We pool together some of the charges noted above:

- Annuities – It is hard to identify the 'charge' the annuity provider imposes for selling an annuity to a customer. The annuity provider simply sells the annuity for a price. It is possible to work out the annuity rate (which is the annuity payment divided by the purchase price), but that does not reveal anything about the charge. We do know that agents selling annuities on a non-advised basis get a one-off commission of 1-3% of the purchase price
- Short- or fixed-term annuities (FTAs) – Typical one-off commission for sales on a non-advised basis is about 2% of the fund
- Investment-linked annuities (ILAs) – Annual charges are estimated at about 2%
- Diversified growth funds – Annual charges are in the range 0.65% - 0.75%
- Multi-asset income funds – Annual charges of around 0.9%
- Multi-manager funds – Annual charges up to 2%.[276]

With current charges, drawdown products are more profitable to platforms than annuities, according to Ian Gorham, chief executive of Hargreaves Lansdown: 'we make a one-off commission if clients take out an annuity, but in the longer term we make more money on drawdown; as long as a client has a drawdown account for more than four years, it is more remunerative'.[277]

In July 2015, Which? published a comprehensive report on drawdown charges, entitled *The True Cost of Pension Freedom*.[278] For the case of a £50,000 pension pot with a 4% withdrawal rate, the difference in charges over 10 years between the most expensive provider (The Share Centre, which charged £8,100) and the cheapest (Fidelity, which charged £4,991) was around £3,000.

For someone with a £250,000 pot, withdrawing 6% a year, the cost differences over 10 years between the dearest and cheapest providers was £10,000, with Scottish Widows charging £26,490 and LV= charging £16,325. Table 2.6 shows the full set of results across the 18 companies that took part in the Which? survey.

The different companies had a variety of ways of charging: six charge to set up a drawdown plan, seven charge an annual fee for using drawdown, eight charge an annual fee if the

[275] Which? calls for additional pension reforms , 6 March 2015; http://www.which.co.uk/news/2015/03/which-calls-for-additional-pension-reforms-397246/
[276] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.
[277] Reported in Anna Fedorova (2015) Hargreaves shares slide 4pc as FSCS levy bites, Investment Week, 20 May.
[278] http://www.which.co.uk/news/2015/07/the-true-cost-of-pension-freedom-409249/

customer uses a SIPP, and seven charge a simpler single annual 'platform fee' but with additional charges for certain types of investments.

Richard Lloyd, chief executive of Which? said: 'The old annuity market failed pensioners miserably and the Government must ensure the same thing doesn't happen again with drawdown. With such big differences in cost, and confusing charges that make it difficult to compare, it's clear more needs to be done to help consumers make the most of the [pension] freedoms'.[279]

*Table 2.6: Drawdown costs*

| Company | Cost over one year | Cost over a decade |
|---|---|---|
| LV= | £1,786 | £16,325 |
| Alliance Trust Savings | £1,966 | £18,155 |
| AJ Bell YouInvest | £2,035 | £18,815 |
| Halifax Sharedealing | £2,049 | £18,957 |
| Interactive Investor | £2,069 | £19,156 |
| The Share Centre | £2,467 | £20,597 |
| James Hay | £2,410 | £21,152 |
| AXA Wealth | £2,444 | £22,081 |
| Fidelity | £2,468 | £22,284 |
| Old Mutual/Skandia | £2,491 | £22,487 |
| Charles Stanley Direct | £2,636 | £22,536 |
| Hargreaves Lansdown | £2,620 | £23,600 |
| Barclays Stockbrokers | £2,699 | £23,708 |
| TD Direct Investing | £2,724 | £24,031 |
| Bestinvest | £2,880 | £25,006 |
| Aviva | £2,820 | £25,310 |
| Prudential | £2,820 | £25,310 |
| Scottish Widows | £2,959 | £26,490 |

Note: The table calculates the costs based on a pot of £250,000, withdrawing 6% of the fund a year and pension growing by 5% per year. It also includes fund management charges. Which? used the Henderson Cautious Managed fund as the investment vehicle.

## 2.6.2 Charge disclosure

In September 2015, The People's Pension published the results of a survey of 1,256 working adults aged below 65 by YouGov which showed that 89% of scheme members did not know what charges they pay to their pension provider, while 51% said there were not aware that

[279] Reported in Michelle McGagh (2015) The £10,000 cost of getting drawdown wrong, Citywire, 21 July.

they were paying charges. Most (94%) respondents said providers should have to tell people how much they were charging them to manage their savings. Darren Philp, director of policy and market engagement at The People's Pension said: 'Our research reveals a worrying lack of awareness about pension scheme charges. At the present time, schemes can charge in very different ways which makes comparison difficult and means consumers could be being ripped off. This survey reveals a strength of public opinion that the Government, regulators and wider pensions industry cannot afford to ignore. The public have made it clear that they want to see charges explained in a way that they understand, and which allows them to easily compare products'.[280]

In response to media criticism of their charges, some providers have reduced their charges. For example, Standard Life has removed its set up charge of £208 and one-off early depletion charge of £312 in its flexible drawdown product. David Tiller, head of adviser platform propositions at Standard Life, said: 'From the feedback we've received, we know that it's the fundamentals that matter, such as: the reliability of income payments, the speed at which we can pay withdrawals on the day the client chooses and the quality of reporting to advisers and clients. It's not just about providing access, it's about providing a great service that can be relied on. The impact of the pension freedoms goes well beyond provider and adviser operational readiness. This legislation will transform the UK long-term savings market. Instead of being seen as inaccessible and opaque, pensions are about to become consumers' long-term savings vehicle of choice. Our role is to make it easy for advisers to access the flexibility, which is why we've decided to drop these additional drawdown charges. We know advisory businesses understand the opportunity arising from the new pension freedoms, but, at the same time, are concerned about increasing their capacity to deliver retirement advice while managing the obvious risks for clients living off their portfolios on a day-to-day basis. Platform technology has a clear role to play in providing an efficient and consistent way to facilitate the level of advice these clients need'.[281]

A requirement for full disclosure of all costs is currently being discussed by the industry, the regulators and the Government. MiFID II will also require product providers to disclose to clients full details of the costs and charges related to their investment, including cost aggregations, the timing of disclosure (ex-ante and ex-post) and information on the cumulative effect of costs on the investment return.

In July 2015, Martin Davis, chief executive of Kames Capital, called on the UK investment management industry to agree a common simple, transparent and understandable way to disclose fund management fees to investors. Although in 2014, he criticised the Financial Services Consumer Panel for recommending a single charge as being 'over-simplistic'.

---

[280] Reported in Michael Klimes (2015) Vast majority of scheme members in the dark over fees, Professional Pensions, 15 September.
[281] Jenna Towler (2015) Standard Life removes drawdown charges, Professional Adviser, 5 March.

The Investment Association (IA), the trade body of the investment management industry, recommends the ongoing charges figure (OCF). However, some investment managers, such as Invesco Perpetual and Legal & General Investment Management, use the term fund management fee (FMF), which is similar to OCF. Others still use the less comprehensive annual management charge (AMC). But even OCF does not include all costs such as transaction charges.

Mr Davis said: 'There is no point in certain parts of the industry getting all cleaned up and not others. It has got to be meaningful and the customer has got to understand it. I would like to see the top ten in the UK, managing the vast majority of funds, come to some sort of agreement around the best way to articulate our charges in a way that is simple and understandable. Then the Investment Association could turn that into something the rest of the industry could sign up to'.[282]

### 2.6.3 Proposals to cap charges

The Pension Schemes Act 2015 allows the Government to impose a charge cap on drawdown products in future. No figure is mentioned, but it would be probably be higher than the 0.75% charge cap on DC default investment funds in the accumulation stage from April 2015.[283]

A number of organisations have put forward proposals to cap costs in the decumulation stage, just as they have been capped on default funds in the accumulation stage. For example, in December 2014, Age UK proposed a charge cap for income drawdown products on the grounds that 'understanding and comparing the total charges for an income drawdown pension is very complicated. It will be very difficult for consumers to compare the cost of different schemes, shop around and switch to better value arrangements. The extension of the charge cap to income drawdown will help prevent consumers from paying excessive charges'.[284] Similarly, in March 2015, Which? launched a Better Pensions campaign[285] in which it calls for the introduction of a charge cap for default drawdown products.[286]

---

[282] Reported in Natalie Kenway (2015) Kames CEO calls on top UK fund houses to unite over charging, Investment Week, 27 July.

[283] Note the charge cap does not apply to investment funds offering any guarantees, say, concerning investment returns.

[284] Dominic Lindley (2014) Dashboards and Jam-Jars: Helping Consumers with Small Defined Contribution Pension Pots Make Decisions about Retirement Income, Age UK, December; http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/dashboards_and_jamjars_helping_modest_savers_December_2014.pdf?dtrk=true

[285] Which? calls for additional pension reforms, 6 March 2015; http://www.which.co.uk/news/2015/03/which-calls-for-additional-pension-reforms-397246/

[286] Along with other reforms, such as the safeguarding savings in schemes that go bust.

Futher, in the lead up to the May 2015 General Election, the Labour Party called for a cap on 'rip-off' drawdown charges on the grounds that 'people who draw money out of their hard-earned pension pot should have similar protections to when the put money in'.[287]

The Labour Party's proposals were not popular with industry practitioners. They said: 'it could be very damaging to how this market develops for customers if we saw an arbitrary cap imposed before we see how customers use their freedom or how providers innovate to meet their needs'. Further, introducing a charge cap on drawdown facilities is 'unnecessary because market forces will impose an effective cap'. A particular concern was a charge cap on drawdown products with built-in guarantees which the industry believes will be popular with customers. Steven Cameron, regulatory strategy director at Aegon, said: 'These valuable options come at a cost which may not fit within an arbitrary charge cap. This new market could be stunted before it even takes off.' Alan Higham said: 'A charge cap would be complex to implement across the range of retirement products and could stifle innovation at an early stage of development'.[288]

Speaking in the House of Lords in June 2015, Lord David Freud, Minister of State for Welfare Reform, said: 'We are going to see how the market develops. It has only been going for two months and, if it looks appropriate, we will introduce charge caps. We are meeting the industry and working with them to make sure they do produce the right level of charging and we are able to monitor that'. Lord Keith Bradley, then Labour's shadow Pensions Minister, reminded Lord Freud of Baroness Altmann's views before becoming Pensions Minister when she said that a cap on drawdown charges was important 'so that customers are not ripped off' and that 'a 2% a year charge just to keep your pension invested and to have access to it would take away much of the investment return and be a terrible deal for customers'. Lib Dem Lord Mike German asked the minister: 'My Lords, at all stages between the pension saver's pocket, the investment and back again, there are hidden charges and fees. Does my noble Lord agree that there should be transparency for pension savers and they should know what the hidden fees and charges are?' Lord Freud responded by saying: 'We already have the power to limit or ban decumulation charges and if we see that providers are charging excessive fees, we will not hesitate to act'.[289]

The Which? report published in July 2015 renewed the consumer organisation's support for a charge cap. It said it wanted the Government and FCA to work with the industry to simplify charges and to introduce a charge cap for default drawdown products.

---

[287] Reported in William Robins and Gavin Lumsden (2015) Labour joins call for cap on pension 'drawdown' fees, City Wire, 6 March.

[288] Reported in Carmen Reichman (2015) Asset managers dismiss Labour's 'unnecessary' drawdown charge cap plan, Professional Pensions, 10 March.

[289] Reported in Michael Klimes and Jenna Towler (2015) Govt to 'closely monitor' drawdown charges as market expands, Professional Adviser, 10 June; Damian Fantato (2015) Government says drawdown charge cap possible, FTAdviser, 10 June.

Again there was industry resistence to this proposal. Tom McPhail disagreed with a cost cap, saying that it would lead to savers becoming disengaged with their money. He said: 'The only sustainable answer is that we have a transparently competitive retirement market where informed investors shop around for the solutions which will suit them best. Drawdown isn't just about the price, it is also about putting investors in control of their money and giving them access to online tools and calculators to help them manage their money effectively. The risk with a price-capped "default drawdown" is that investors won't be sufficiently aware of the risks they face of investment losses or of drawing their money out too quickly. A "default" drawdown risks investors sleepwalking into unexpected investment losses. We would like to see the barriers to pension freedoms removed so that investors who have shopped around can move their money quickly and cheaply, without having to pay unreasonable exit penalties'.[290]

The Retirement Planner Inquiry for August 2015 asked advisers whether the Financial Conduct Authority (FCA) should intervene and cap charges as recently proposed by Which?. The vast majority (68%) said no regulatory intervention was needed, 20% were unsure and 12% thought it was warranted. A typical comment from an adviser supporting a cap was: 'Even at modest charges, if the client wants 5% income, this suggests a return of nearly 8% will be needed to maintain capital values. Charges in excess will just decimate the fund'.

Typical views from cap opponents were:

- 'Drawdown advice requirements are extremely varied and individual and therefore charges would vary accordingly. It always makes sense to try and look for a simple and cost-effective wrapper charge with no add-ons – the more expensive solutions will have to become cheaper over time or will disappear, anyway'.
- 'Drawdown has never been a cheap product. It is inherently risky and requires a lot more work from the provider and adviser than an annuity. In a heavily regulated environment, people need to understand that they will have to pay for this. The products that provide the best value will dominate the market in the end. Or is Which? saying they don't believe in free market economics?'.
- I don't feel regulatory action is required, but I do agree that some of the drawdown charges are excessive'.
- 'I object to any one person or group defining what is right for others. If a particularly wealthy individual with a particularly large fund is happy to pay particularly high charges, why shouldn't he? He may buy an £800 suit as opposed to one from M&S.

[290] Quoted in Jenna Towler (2015) Which? calls for FCA crackdown on 'confusing' drawdown charges, Professional Adviser, 21 July.

He may buy a BMW as opposed to a Ford. Individual choice and freedom is required'.[291]

### *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.[292] 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.

In March 2015, the FCA published the Final Report of its Retirement Income Market Study.[293] This followed a Thematic Review of annuities in February 2014 which found that the annuities market was not working well for most consumers.[294] The Final Report confirmed the FCA's provisional findings that the annuities market was still not working well for consumers. In particular:

- Many consumers are missing out by not shopping around for an annuity and switching providers, and some do not purchase the best annuity for their circumstances: for example, those with certain medical conditions or lifestyle factors had missed out by not purchasing an enhanced annuity
- Consumers are deterred from engaging with their options by the length and complexity of wake-up packs,[295] or because they do not believe the sums involved make shopping around worthwhile

---

[291] Reported in Jenna Towler (2015) RP Inquiry: Advisers on the post-April drawdown boom, Retirement Planner, 27 August.

[292] https://small-firms.fca.org.uk/fair-treatment-customers

[293] Financial Conduct Authority (2015) *Retirement Income Market Study: Final Report – Confirmed Findings and Remedies*, Market Study MS14/3.3, March; http://www.fca.org.uk/static/documents/market-studies/ms14-03-3.pdf

[294] Financial Conduct Authority (2014) *Thematic Review of Annuities*, Thematic Review TR14/2, February; https://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02

[295] The information that consumers receive from their providers in the run up to their retirement.

- Consumers' tendency to buy products from their existing provider weakens competitive discipline on incumbent firms and makes it harder for challenger firms to attract a critical mass of customers
- Consumers are highly sensitive to how options are presented to them. Savers reaching retirement will face a landscape that is more complex and will need support in making the right choices.

The FCA's solutions are:

- To require firms to provide an annuity quotation ranking so that consumers can easily identify if they could be getting a better deal by shopping around
- To require firms to redesign their wake-up packs and to consider including signposting letters and standardised pensions statements, before trialing them on consumers
- In the longer term, the creation of a pensions dashboard which will allow consumers to see all their pension pots in one place.[296]

Although the FCA said that its recommendations had received 'considerable support' from industry, some in the industry were disappointed. For example, Malcolm McLean, senior consultant at Barnett Waddingham, said: 'Most disappointing of all is the pace at which change in a market, so clearly in need of change, is drifting along. The FCA plans to consider all this further and to run another customer survey as part of a wider review of its rules in the pension and retirement area later in the summer. It will probably be another year at least before the remedies kick in, making it eight years since the regulatory probe of the market began. Both the FCA and its predecessors have shown a distinct lack of appetite for decisive action in relation to annuities. And as far as I can see from this latest lengthy report, no sanctions appear to be being proposed against those providers whom the FCA had investigated and found evidence of poor practice, particularly where providers actively discouraged people from taking up enhanced annuity products, if not widespread misselling'.[297]

In March 2015, the FCA published its Thematic Review of Structured Products.[298] Structured products are 'securities whose cash flow characteristics depend upon one or more indices or that have embedded forwards or options or securities where an investor's investment return and the issuer's payment obligations are contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows'.[299] Many

[296] This is discussed in detail in Chapter 3.

[297] Reported in Natasha Browne (2015) FCA - Annuity providers must tell customers when they are getting a bad deal, Professional Pensions, 26 March.

[298] Financial Conduct Authority (2015) *Structured Products: Thematic Review of Product Development and Governance*, Thematic Review TR15/2;http://www.fca.org.uk/static/documents/thematic-reviews/tr15-02.pdf

[299] U.S. Securities and Exchange Commission (SEC) Rule 434.

structured products involve guarantees. Examples are: capital-protected accounts which are used as a savings alternative to deposit accounts; and capital-at-risk products which are used as investment alternatives to shares or bonds. The FCA had serious concerns about the complexity and value of these products.

The FCA found that retail customers generally struggle to understand the complex features common to many structured products and they find it difficult to compare alternatives. As a result, they frequently over-estimate the products' potential returns – by almost 10% of the assumed investment amount over five years. The FCA has concluded that, not for the first time, the structured product market is not working for investors: some firms are falling below the standards the FCA expects in their approach to the design, manufacture, packaging and distribution of structured products.

The FCA argues that providers need to define at the product design stage a clear target market of end customers and identify what needs these products would serve. Structured products should have a reasonable prospect of delivering economic value to customers in the target market, which firms must be able to prove via robust stress testing – through to the end of their life cycle – as part of the product approval process. Providers also need to strengthen the monitoring of their products, including by ensuring distributors – such as financial advisers – have enough information about the product to sell it appropriately and that each product is being distributed to its identified target market. Firms need to provide customers with clear and balanced information on each product and any risks. Products that fail this process should not be manufactured nor distributed.

At the EU level, the European Securities and Markets Authority (ESMA) is in the process of finalising its rules on the implementation of MiFID II which will take effect from January 2017. Most products which are not plain vanilla shares, bonds or UCITS funds[300] will be classified as 'complex' products, since they have a ‘structure which makes it difficult for clients to understand the risks involved’. This means that many of the products that have been designed for the UK retirement income market in the new pensions environment will be classified as 'complex', since they have been structured as non-UCITS retail schemes (NURS). This, in turn, will mean that non-advised clients must take an ‘appropriateness test’ each time they purchase a NURS product.[301] The extent of the appropriateness test will depend on the complexity of the product’s underlying investments, but, in all cases, product providers would be responsible for assessing the knowledge and experience of individual retail customers before they are able to invest in the product. Product designers have used the non-UCITS route (a) to enable greater diversification than can be achieved by using

[300] UCITS (Undertakings for Collective Investment in Transferable Securities) funds are mutual funds based in the European Union which can be sold to any investor within the EU.

[301] This is discussed in more detail in Chapter 3.

UCITs and (b) because certain asset classes, such as property, cannot be invested in via UCITS.[302]

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 Platforum 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]'.[303]

### *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. Should the pension pot stay in the leaving scheme, or should it follow the member to the member's new scheme, or should it move to an aggregator scheme? Or should there be another type of solution altogether?

In Australia, scheme members tend to stay with the same scheme when they move jobs. In other words, the scheme follows the member: the member has one pot which they take with them when they change jobs. The same would hold for SAFE retirement plans in the US.[304] By contrast, the UK second pillar pension system is a workplace-based system, with schemes typically set up by individual employers, although in a small number of cases, they are established on an industry-wide basis, such as the Universities Superannuation Scheme. This means that in most cases, people have to decide what happens to their accumulated pension pot when they change employers. The default is to do nothing and leave the pot where it is (if the scheme agrees to this). The pot then becomes known as a stranded pot. If people move jobs many times over their career – and the average is 10 or 11 times – then they could end up with a large number of stranded pots. This is not only administratively inconvenient, there is the real risk that people could lose track of all their pots and, equally

---

[302] Hannah Smith (2014) ESMA unveils final guidance on MiFID II rules, Investment Week, 19 December; Laura Dew (2015) Multi-asset providers consider fund conversions on MiFID II fears, Investment Week, 13 April; Financial Conduct Authority (2015) *Developing Our Approach to Implementing Mifid II Conduct of Business and Organisational Requirements*, Discussion Paper DP15/3, March; https://www.fca.org.uk/static/documents/discussion-papers/dp15-03.pdf

[303] Reported in Carmen Reichman (2015) Providers must address 'opaque' drawdown charges or risk FCA intervention, Professional Adviser, 24 September.

[304] Examined in Chapter 6.

possible, schemes could lose track of their deferred members, which is likely to happen if people do not inform their previous schemes when they change address.

A number of solutions have been proposed for dealing with this problem.

The first is pot-follows-member. In this case, the pot, if it is below a certain size (£10,000), automatically moves to the member's new scheme when he or she changes job. If it is above this size, the member has to specifically ask for the pot to be moved, unless the leaving scheme insists that the member takes their entire pot with them. The size threshold is intended to deal with liquidity issues in the scheme. When someone moves, assets have to be sold and the cash value of the pot is transferred – it is rare for in specie transfers to take place. Schemes do not want to be in the position of having to sell illiquid assets to meet these transfers. They would prefer to do so with liquid assets which typically have lower returns than illiquid assets. So two of the key problems with pot-follows-member are switching costs and lower overall investment returns. If someone changes jobs many times, these two factors can materially reduce the value of the pension pot at retirement.

The second solution is the aggregator model. In this case, when someone changes jobs, their pot is automatically transferred to an aggregator fund which collects all the stranded pots into a single fund. A small number of funds would be authorised to offer this service. This has the benefit of introducing significant scale economies by consolidating assets in a small number of large funds, gradually moving assets away from the long tail of 200,000 mostly very small schemes. The aggregator funds would also benefit from good governance and institutional investment management if they were set up along the same lines as the National Employment Savings Trust (NEST).[305] Further, the switching costs would be lower than under pot-follows-member, since only the assets accrued in the ceding scheme need to be transferred when the member changes jobs, not the total assets accrued since the member started employment, as happens with pot-follows-member. There would be a default fund for those who make no active investment choice. A criticism of this model is that the member is unlikely to feel particularly engaged with this type of arrangement. However, the same criticism applies to the entire auto-enrolment process.

The third solution is the Australian solution of scheme-follows-the-member or what is also known as one-member, one-scheme. The employer pays contributions into the employee's chosen scheme which follows the member when they change jobs. This approach deals with the problems of switching costs and potentially lower returns. But it has the administrative inconvenience of requiring the employer to set up a direct debit for every employee's scheme. With a scheme run by the employer, the employer only needs to make a single payment covering all employees. The solution to this is to have a central clearing house into

[305] NEST is discussed in Chapter 5.

which the employer makes a single payment which is then allocated to each employee's scheme.

The one-member, one-scheme approach has been promoted by a number of industry practitioners, in particular Tom McPhail and John Lawson, head of pensions policy at Aviva. Mr McPhail argues: 'With the one-member, one-scheme approach, whenever you change jobs, you can pick up the pension and take it with you and the new employer can pay into that scheme. This would bring a sense of continuity for the member and the default position should not be to keep moving money around'.

In August 2013, the then Pensions Minister Steve Webb invited McPhail and Lawson to contact the Confederation of British Industry (CBI) to canvas support for the proposal. The CBI, while not fully endorsing the concept, accepted that that it was better for each saver to have a single well-managed pot.[306]

The technology available to execute transfers has improved significantly in recent years as a result of the introduction of Origo, an open source, e-commerce service established on a not-for-profit basis by 12 life and pension companies at the instigation of the ABI. Origo built 'Options' which does pensions transfers and reduced the transfer time from 4 months to 9 days. Version 1 does pensions-to-annuities transfers (via the OMO). Version 2 does pension transfers in accumulation (e.g., from Aviva's to Prudential's platform).

Nevertheless, this system has been criticised because the life companies involved still make it hard for consumers to switch to a new provider, according to Ben Cocks of Altus Business Systems. This is because the new provider has to get the approval of the life offices to participate in the service and pay the fees they demand. In response to this, the Tax Incentivised Savings Association and the UK Funds Market Practice Group (which sets the ISO-based open technical standards for UK financial services) have established an open transfer framework that deals with all the technical and legal aspects of transfers. Different technology companies can then offer compatible transfer services and all participating companies can have an equal say in how the service operates. This approach has been used in the ISA transfer market and has increased the level of competition between ISA providers considerably. However, Origo and the life offices have so far refused to allow open transfers for pensions, despite the Department for Work and Pensions allowing the use of open standards for automatic pension transfers.[307]

In October 2015, the Pensions Minister, Ros Altmann, announced that legislation dealing with stranded pots would be delayed in order to allow schemes to deal with other pressing

[306] Reported in Retirement Planner (2015) Pot follows member won't engage savers, warns Tom McPhail, 30 June.

[307] Reported in Ben Cocks (2015) 'Tortuously complicated'- Pension transfer system needs shaking up, Retirement Planner, 11 August.

issues, such as the completion of auto-enrolment and the introduction of both 'freedom and choice' in April 2015 and the new single-tier state pension in April 2016.

### *2.9 Feedback from our interviews and responses to the consultation paper*

#### 2.9.1 Feedback from our interviews

##### *2.9.1.1 Employers and consultants*

In our meetings with employers and their consultants, we discussed a broad range of issues concerning the products and services relevant for scheme members which we summarise under the following headings.

##### What products/services might good employers be offering?

Good employers will be looking for something that protects against the longevity risk of their former employees.

This does not necessarily have to be a separate annuity – it could be a drawdown product that has a trigger point or crash barrier so that if the fund falls below a certain level this triggers automatic annuitisation. The idea would be to default DC members in: they do not have to actively join and could opt out at any stage. If the fund was falling due to market conditions, members might be offered the choice of annuitising or stopping/reducing withdrawals for a period.

Employers are likely to be influenced by what their AE provider offers, so, as in the US, the market will be provider-led. Employers considering making drawdown available will want a fire wall between the employer and the provider, ensuring liability is transferred and there is no come-back for employers if things do not work out as well as members hoped.

Employers have not yet come to a firm conclusion about whether their drawdown offering should be a retail solution or some sort of straight-through accumulation-to-decumulation process, involving scheme drawdown. The BT scheme, for example, is moving members into SIPPs for drawdown. This is a retail product, although the employer has negotiated the terms. So, employers can use their clout to negotiate better terms with one or more providers, which is what they do with other products made available through the workplace, e.g., insurance.

Despite the lack of major launches, many respondents agreed on the merits of scheme drawdown. One said: 'Scheme pensions are more efficient in payment. Scheme drawdown is a scheme pension without pooling. It provides better governance and economies of scale but doesn't give individuals the chance to engage to the same degree'. Another said: 'The governance of scheme drawdown is crucial and must mirror that of accumulation. If the Grand old Duke of York marched his men to the top of the hill, he should march them down again'. And a third added: 'Scheme drawdown's big advantage is that it's done within a

pension fund, so it's not affected by regulatory capital requirements, which can add 1.5% to the cost, nor does it get into the grey area round advice – which is the case if a provider offers its retail drawdown product – usually a SIPP – to a member of a DC trust-based scheme. The chances are that this would – or certainly could – constitute regulated advice under FCA rules'.

The potential for scheme drawdown to offer lower charges than retail products was considered crucial:

- 'If drawdown costs more than 1%, it won't work. End of'.
- 'Scheme decumulation is likely to be the cost for accumulation plus up to 0.25% for added functionality, such as withdrawals. Retail decumulation total costs can be anything from 2% to 4%'.
- 'Retail advice adds 1% to the price. That might be OK for a one-off transaction, but what if it's a drawdown strategy with an additional 1% for advice each year?'

Another lesson from the US is that charges are regulated when members of 401k schemes roll-over into their provider's IRA.

What are the risks with drawdown?

We received the following comments:

- 'Drawdown is the most complicated of the choices that the employer/trustee might offer – there is a need to consider where to invest and how fast to draw down. The main risk with drawdown is that the income might have to be reduced. It is important for schemes to *suggest* a 'safe' level of withdrawal'.
- 'However, it is not the trustees' responsibility to *set* the withdrawal rate – this would be too risky'.
- 'Whatever the withdrawal rate suggested, it must be reviewed regularly – this cannot be set and forget – remember what happened with endowment mortgages'.
- 'It is crucial to manage the rate because, left to their own devices, individuals will panic if there is a market crash and cash out at the bottom of the market' (called composure risk by one participant).
- 'Drawdown investment strategies also need to match the annuity rate plus an additional percentage to account for the absence of the mortality cross-subsidy'.
- 'Without regulated advice, people will find it difficult to manage multiple pots'.
- 'One of the biggest risks is the interaction with means-tested benefits – this is an area that needs a massive amount of attention'.

What are the risks with annuities?

Longevity risk is the biggest concern for consultants. Deferred annuities are currently non-existent. Sales of immediate annuities have collapsed – historically most people annuitised

by age 75. Pricing an annuity for someone who is still healthy at age 85 will look like poor value to the annuitant – insurers would expect them to live an additional 12 years on average. While it is easier to price a deferred annuity at age 65, consultants are not expecting many people will want to buy one – even if the product existed – because they would fear that they would 'lose' the purchase price if they died earlier.

Insurers really do not like selling to people in their 80s because of cognitive decline.

### What will providers do?

In general, all providers are very keen to offer drawdown because this is when the DC pot is at its largest, so will provide a good fee income. Providers in the AE market will be keen to retain these assets.

Providers are likely to favour the sale of retail drawdown to retiring members – but if a major competitor offers scheme drawdown and this is seen to be better value for money, then they will do this too.

Some providers are developing a 10-year investment/drawdown period with an annuity built in, although some consultants think 80-85 is too late to annuitise, preferring age 75 (NEST is suggesting 85).[308]

### What are consultants doing?

Most consultants are focusing only on advising on drawdown. Annuitisation is too far into the future to second-guess what the market for later life annuities will look like: 'There's no point in designing a product today that tries to second-guess what a 65-year-old will need at age 75+. There will be a massive differential where medical underwriting is used at older ages – far more significant than at the point of retirement'.

Some consultants that we talked to are advising employers with single-trust schemes. Previously, they would have put in place a third-party annuity bureau service. Now they are looking at other alternatives, but they do not want to retain the responsibility/liability and do not want to run any alternative themselves.

One consultant is working on a design for drawdown to last 30 years, i.e., a 'notional income for life' product. They will use a master trust and manage the transition from accumulation to decumulation, so the investment strategy is straight-through. This is important for the stability of the strategy, but also very important because it avoids out-of-market risk. Where a DC member buys a retail drawdown plan, it would be necessary to cash out of the accumulation scheme and reinvest in the new product. The plan is to match the investment strategy of the drawdown scheme with the tail end of the default accumulation fund.

[308] Discussed in Chapter 5.

The same consultant believes that, of the drawdown funds offered by providers, very few are suitable. Income needs to be reasonably stable, but not guaranteed – i.e., needs to reflect the actual experience of the fund – so, say, a 4% of original pot size set-and-forget model is flawed. If people want a guaranteed stable income, they need an annuity.

This consultant also said that adequacy is an important issue. If people cannot afford to retire, they need to consider working longer and possibly contributing longer. The problem is that members will not know 5 years out when exactly they will retire, so planning is very tricky for both the employee and the employer.

Scheme defaults

Many employers are uncomfortable with the idea of scheme defaults. While they are concerned about the risks facing members, they appear to be equally concerned about their own risk/liability. In particular, they are concerned that *anything* they do would be perceived as advice by members. So not only are employers concerned about scheme drawdown, they would even be reluctant to support annuitisation. They realise that if things go wrong, ex-employees will be knocking on their door first.

#### *2.9.1.2 Providers and investment managers*

Our discussions with providers and investment managers is summarised here under the following headings.

What about the quality assurance of products offered via, say, a decision tree?

There was support for having the products listed in the decision tree classified as safe arbour products. This means that any adviser recommending these products cannot subsequently be sued for poor advice, after having determined their suitability for the client. So far the FCA has been reluctant to grant safe harbour status to UK investments, unlike the US. We were told: 'It is important that we try and get the FCA to approve both the decision tree and the default options at the end of the decision tree even if they are only the least worst options'.

But where do we set the bar for the products listed in the decision tree? Should the products that are listed be the 'best' or should they be just 'very good' or 'adequate'? A view offered to us is that 'they should be reasonable options, not detrimental, but not necessarily optimal, but not a bad decision. They should be "good enough"'.

However, any safe harbour products need to be carefully regulated. There needs to be a mechanism to ensure these products are indeed 'good enough', since there could be no Financial Ombudsman Service  referrals with safe harbour products (if their suitability for clients had been assessed).

Advisers, on the other hand, tend to suggest that everyone needs a perfect tailor-made solution. However, we were told that this would be an example of the case where 'the best is the enemy of the good' – and, in any event, would be too expensive for most people.

It was also pointed out that, while competition can be good, it can lead to a proliferation of essentially identical products which are marketed as being different. This leads to customer confusion.

What investment strategies are appropriate in the new pensions regime?

This turned out to be a difficult question to answer because it was not clear at the time of the interviews how consumers would behave following the introduction of 'freedom and choice'.

Many of the people we interviewed believed that 'lifestyle strategies and even TDFs are now out of date, but new investment strategies still need to deliver returns, although with reduced volatility. However, we will need to observe customer experience in decumulation before redesigning de-risking glide paths'.

It remains the case that diversification is the only low-cost way to reduce volatility. Other solutions to reduce volatility involve options and other derivatives, but these cost more than 0.75%. It was pointed out that a charge cap would reduce the scope to diversify risk and put products using derivatives to guarantee returns out of reach. It was also pointed out that the process of paying income to members is expensive, much more than the cost of collecting contributions.

In terms of new product design, investment managers and consultants are designing drawdown products with long-term (30-year) investment horizons. These would invest in fully liquid funds, so annuitisation could occur at any time, but these managers questioned whether there was any need to annuitise given the investment horizon. They pointed out that annuities were originally designed to last for 10-15 years, not 30. The success of this strategy is predicated on the assumption that an investment-based product can be as effective as insurance in terms of hedging longevity risk.

An example was JP Morgan which was designing a drawdown product with a cap on the maximum percentage of the fund that can be withdrawn, adjusted in line with fund performance, and a charge of 0.35% plus a cost per withdrawal. It would probably need to be held within a SIPP which would add an additional layer of costs. It would be offered on both an advised and non-advised basis.

What is the future of annuities?

Insurers tended to argue that the value of annuities are now underappreciated due to negative norming. It was agreed that the money's worth of annuities was high – and this was confirmed by the FCA's own research in December 2014. Annuities are the only product

that can hedge individual longevity risk. It was agreed that there was a need to reinforce the value of annuities. This could be helped by rebranding them as a 'guaranteed income for life' product.

Some felt it was hard to see how annuities could be sold without advice, due to the complexity of the decisions that need to be made: level vs inflation-linked, single life vs joint life, standard vs enhanced; the latter needs individual underwriting, but this can now be processed quickly and cheaply using the common quotation form (available since 2008).

However, this view contrasts with those who believe that these issues could be addressed using a well-designed decision tree. It was also pointed out that, before the introduction of 'freedom and choice', NEST was going to operate an annuity clearing house using a filtered form (married v single, level v indexed) and an algorithm would recommend a particular provider, say, Prudential, from a panel of providers.

### Retail v scheme drawdown

The standard drawdown product is retail. One of the biggest drawdown providers described how their company operates. Their main market is in advised drawdown. They also operate in the non-advised market (below £100,000) where they offer only 'safe' funds plus lots of guidance. They explain that if people need a guaranteed income, they should buy an annuity. Previously, this was the capped drawdown market, where the cap was a good safety net. They find there is difficulty in explaining volatility to customers and the consequential risk of overdrawing relative to the performance of the fund. They need to explain that the withdrawal rate cannot realistically be more than, say, 4-5%. But, they are conscious that another firm can always come along and say it can deliver 6%.

Charging is problematic: any fixed charge significantly outweighs a percentage charge in the £30,000-£100,000 market. Also administration is more intensive for drawdown customers – customers usually contact the provider 2-3 times p.a. – far more than under accumulation.

The same provider was also looking at scheme drawdown, but said it was hard to tell at this stage what DC scheme members will do. They said that it was virtually impossible to design a default, since there were too many 'substantial' minorities wanting different things:

- Annuity
- All cash
- Drawdown
- Drawdown plus annuity.

Some providers told us that there was a false distinction between scheme (institutional) and retail drawdown in terms of value for money. This is because it is possible to get low-cost non-advised drawdown in the retail market at all-in cost of 0.43% (e.g., Fidelity 'direct to customer') or 0.45% (e.g., Aviva). One provider said: 'We need to rethink what economies of

scale means in a drawdown market. This isn't about scheme vs. retail; it's about scale in terms of the institution managing the money'. Similarly, an investment manager told us: 'Drawdown means an individual account, so it's not necessarily cheaper to distribute via a scheme because of the need for payment into bank account'. However, we wondered how different this was from how DB administration operates in the payout stage – DB schemes exploit economies of scale and lower costs using a third-party administrator (TPA), for example.

If the client wants advice, this can raise the cost to around 2.5%. For example, MetLife's guaranteed drawdown product costs up to 1.85% to cover the cost of the guarantees and the annual management charge, and another 0.5-0.75% for advice. Further, the drawdown rate is around 70% of an equivalent single-life annuity.

We were told that there remain substantial barriers to getting employers to offer scheme drawdown:

- Employers do not want the liability
- Trustees (in single trust schemes) do not want the liability
- There is also lack of clarity about regulation and uncertainty over liability for providers.

#### *2.9.1.3 Trade unions*

A panel of trade unionists and TUC officials (together with two representatives from consumer organisations) met with us on 12 January 2015 to address the following questions.

Will longevity insurance remain an essential component of decumulation and if so why?

This question elicited the following responses:

- 'People are generally positive about longevity insurance, but there is a limit to what they will pay for it'
- 'What people really want from a pension is a secure and predictable income. I have never come across any trade union members complaining they do not have sufficient flexibility from a DB pension. Unless there is some kind of longevity protection, it is no longer a pension'
- 'Annuity products are really good. But the market has ruined them. It is the way they sold them and the way they gamed them. The public have got this perception that they are terrible'
- 'If you ask people if they want an annuity they say no. If you don't call it an annuity, but instead call it "income for life", then this is attractive'
- 'There is still going to be a role for longevity insurance, but much latter. The aim should be to start an annuity at 75, 80, or 85 at the latest. The risk of income

drawdown is that people will leave the money invested. There is the issue of investment risk in the first five years or so after retirement'

- 'We are expecting individuals to make rational decisions about different annuities, but it would be much better if schemes could do it. People want someone on their side making regular payments until they die. It makes sense for schemes to do it'
- 'There remains the problem of people's reticence to committing large amounts of money to something they may not benefit from. My grandmother resisted buying a new settee at 75 because she felt she wouldn't get use out of it. I would worry that way of thinking would be amplified with committing large sums to buying an annuity that they think they won't benefit from for very long. Perhaps it would be better if there was a way of gradually buying a longevity product over time'
- 'Denmark with ATP has just one provider. Politically that is very hard to replicate in the UK'.

What are your views on defaults?

We asked: 'Can you have a single default option?'. Participants accepted that there had to be a 'default process' which would work along the following lines: 'from what we know about you, this is what we are going to do as a default. If you want to do something different, you need to opt out'. One participant said it would have to be pot-size related. Another said: 'It would also need to be age-related. At the moment for many people with DC pots, these represent a small proportion of their pension saving. That will change over time. A solution that works for those approaching retirement now is not a solution that works in 20 or 30 years' time. We need to be mindful that 90% of people will do nothing and take the default route. Yet £20,000 saved by a low earner can be a higher proportion of their pension savings than £100,000 is for high earners. Defaults have to be mindful of that'.

Another participant took a different view on the default: 'I am listening to this – is it not the case that an actual default, in the world we regrettably find ourselves in, is that the money remains invested? I do not think there can be a default to providing income. If the member does not make a decision, it remains invested until a member makes a decision. The reason people buy level annuities is that people do not want to buy annuities at all. They didn't think they provided value'.

Another participant (from a consumer organisation) commented: 'If you default them into a product (such as drawdown), you are right squarely in the area of regulated financial advice. I think scheme trustees will be very frightened of doing that. They can do that and get regulated. I just think they will not want to be. The key problem is people who take the money and run because they do not know what else to do'. The previous speaker responded: 'If you default into an annuity, you almost guarantee that people will opt out and just take the money'. The first speaker replied: 'You should only default into an annuity once they get the benefits of longevity pooling (at age 75, 80, or 85 whatever). Until then you should stay invested so the pot has the chance to grow'.

### 2.9.2 Responses to the consultation paper

We summarise the responses to Questions 3-21 in the consultation paper.

3. *(a) Do you expect products with longevity insurance (e.g., a lifetime annuity) to remain an essential component of a well-designed retirement programme?*

All respondents agreed that some form of longevity insurance would be needed at some point in retirement. However, there was a diversity of opinion about how this should be achieved. The two most commonly suggested options were to purchase an annuity later in retirement or to purchase a deferred annuity, possibly via the payment of regular premiums. Product innovation would be needed to deliver such products in practice.

3. *(b) How should those individuals who continue to buy lifetime annuities be assisted to obtain the best value products for their circumstances?*

A quarter of respondents suggested explicitly that it would be necessary to have a combination of approaches to ensure that individuals who choose to buy annuities get value for money and purchase appropriate products. The range of suggestions from other respondents also suggested that no single option would be adequate. So to help individuals get best value from annuities, they would need a mixture of nudges, better education, better market provision and better advice/guidance.

3. *(c) If individuals do not purchase lifetime annuities, how does an individual hedge their longevity risk in retirement?*

Most respondents suggested that new products, typically some form of deferred annuity, would be necessary to help individuals hedge longevity risk if those individuals chose not to buy a conventional annuity at retirement. Without some form of annuity product, the main alternatives suggested were additional saving (and hence under-consumption) and/or reliance on family support.

4. *(a) Where annuities are purchased later in retirement, what are the most effective and efficient products for providing income in the period between retirement and the age at which the longevity insurance comes into effect? (b) Should such products have a maximum recommended level of income withdrawal? (c) If so, how should that level of income be determined?*

There was considerable agreement that drawdown was appropriate in the early period of retirement, with two-thirds saying this explicitly and the remainder suggesting approaches very similar to drawdown. Several suggested that drawdown products should or could have guarantees. There was also strong support for recommendations or guidance on the maximum that should be drawn down each year. Very few responses provided suggestions for how to calculate this maximum. There was little support for a compulsory maximum level of income drawdown.

5. *What are the advantages and disadvantages of scheme drawdown (i.e., where the scheme provides an income to the retired member prior to the purchase of an annuity)?*

There were a variety of responses to this question and very few respondents were certain whether the advantages outweighed the disadvanges. Respondents were clear that scheme drawdown might have the advantages of lowering costs through economies of scale and providing better governance. However, economies of scale might be absent for small schemes which would find it difficult to cater for the diverse needs of different members. While improved governance would be an advantage for members, some schemes might struggle to take on the additional responsibility of looking after funds in the drawdown phase, and so this was potentially a disadvantage for the trustees, especially since the regulatory framework for this is not sufficiently clear.

6. *(a) Should decumulation default products provided by, say, large-scale master trusts, be subject to the same trustee-based governance and quality standards that apply to the accumulation default fund? (b) Where decumulation products are offered by contract-based schemes, should they be included in the requirements for the new Independent Governance Committees to provide governance and quality standards and to assess value for money?*

Eighty-two per cent of responses accepted the principle of a default decumulation product, while 76% thought that the decumulation phase should be governed by the same governance standards in master trusts that apply to the accumulation default fund and should be overseen by IGCs in contract-based schemes. But a significant minority were unhappy with defaults, despite the fact that people were free to opt out of a default, and thought that IGCs were not appropriate, preferring instead to rely on existing FCA rules.

7. *(a) What could be the typical total expense ratio (TER) for a default drawdown product provided by a large-scale master trust? (b) How might this TER compare with individual drawdown products sold in the retail market? (c) Can you give any examples of TERs for retail drawdown products?*

Very few respondents were prepared to say what a typical total expense ratio should be for a default drawdown product. However, one respondent suggested that the TER should be no more than than 0.5 per cent, while another suggested it should be equal to accumulation TER plus 0.25 per cent. The small number of responses to this question noted that it is difficult to answer while new products are still being developed. Default products should be cheaper than retail products, but retail products, it was noted, can be expensive.

8. *(a) Should scheme default drawdown products be subject to the charge cap? (b) Should this be the same as for accumulation (i.e. 0.75%) or is there a case for a higher cap? If higher please explain why and what the difference might be?*

Sixty-three per cent of responses were against a charge cap on scheme default drawdown products, at least in the short run.

9. *Retail drawdown products will be sold via regulated advice and they will be purchased via non-advice (execution-only). Is there a case for: (a) Higher quality controls and consumer protection in relation to risk and costs? Explain; (b) Making retail products subject to a charge cap? Explain.*

Overwhelmingly, there was support for higher quality controls on sales of retail drawdown products, with 65 per cent of responses favouring this. However, there was virtually no support for a charge cap on retail drawdown products, on the grounds that it would stifle innovation, with two-thirds being explicitly against a cap.

10. *What is the optimal investment strategy in scheme drawdown prior to the introduction of longevity insurance?*

The strongest theme from responses to this question was that the investment strategy in scheme drawdown prior to the purchase of longevity insurance should be fairly cautious, namely to provide growth of the fund while reducing risk, with 43 per cent explicitly naming this as the appropriate strategy. However, 29 per cent of respondents noted that individuals have different needs and so there was no single strategy that would be appropriate for all individuals.

11. *What are the advantages and disadvantages of institutional annuitisation (i.e., where annuities are provided on a bulk basis either by the scheme (self annuitisation) or by an insurance company, rather on a retail basis as currently)?*

Institutional annuitisation has the obvious advantage of scale and potentially the disadvantage of not being suitable for the individual, if not individually underwritten. Another disadvantage was that the scheme would be creating DB-like liabilities and the question was raised about who would ultimately underwrite these liabilities (employer, PPF or state) if the scheme underestimated the longevity and investment risks. Some respondents were uncertain whether the advantages outweighed the disadvantages and overall there was no clear majority one way or the other.

12. *Could institutional annuitisation deal with the individual underwriting of annuities and still encourage competition from providers in the open market to maximise consumer outcomes (e.g., in the case where a retired member has a medical condition which reduces their life expectancy)?*

The overwhelming majority of responses thought that institutional annuitisation could deal with individual underwriting and still encourage competition from providers.

13. *(a) Would a market for advanced life deferred annuities be viable? (b) What is the likely demand for advanced life deferred annuities?*

Sixty per cent of respondents thought that there could be a market for advanced life deferred annuities, but it is clear that there would be significant problems to be overcome

to achieve this. To make the product more attractive, some respondents suggested it could be paid for in instalments.

14. *Is there likely to be demand for inflation protection?*

There was virtually unanimous support for the idea of inflation protection, but respondents doubted whether individuals would pay the high price needed to buy it.

15. *What are your views on the proposals by HM Treasury to allow annuities to have more flexible payment terms by: (a) allowing lifetime annuities to decrease, (b) allowing lump sums to be taken from lifetime annuities, (c) removing the ten-year guarantee period for guaranteed annuities, (d) allowing payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000?*

There was a clear majority in favour of some or all of these options to increase the flexibility of annuities' payment terms, with 68 per cent of responses supporting at least one of the options. But many respondents also raised significant concerns that such products would increase complexity and potentially confuse customers: in addition to this, many of the suggested products would only be suitable for a small component of the market. So, at best, one would say that there was qualified support.

16. *What are your views on U-shaped or J-shaped annuities?*

There were mixed views on the provision of U- or J-shaped annuities, with responses fairly evenly divided between those for and those against. A particular issued raised was where the minimum of the U should be. It was also suggested that these more complicated income streams could be achieved by more straightforward mixtures of drawdown and annuitisation.

17. *Should DC retirement products and decumulation strategies be linked to the single tier state pension? If so, how?*

Respondents disagreed on whether retirement products should be linked to the state pension. While many thought that it was a good idea in principle, there were issues about complexity of pensions in practice, which might make linking the two infeasible.

18. *What other retirement products do you expect to become available? Please provide details if possible.*

A range of products were suggested, including new (flexible) annuity products and new (guaranteed) drawdown products. Products which combined more basic products were also suggested, such as those combining drawdown and annuities. Several responses suggested products involving long-term care assurance.

19. *Is there a case for designating certain retirement products as 'safe harbour' products? Explain.*

There was a small majority of respondents in favour of designating retirement products as safe harbour products, but there were strong views both for and against.

20. *Following the impact of the Budget 2014 tax changes on annuity providers, do you have any concerns about supply-side contraction or other developments in the annuity market that might make it less competitive?*

Respondents were unanimous that the market would probably get smaller and less competitive as a result of the 2014 Budget changes.

21. *(a) What is the best way to deal with stranded pots? Explain. (b) Two approaches have been put forward to date: 'aggregator' and 'pot-follows-member'. Do you have preference for one over the other? Explain. (c) Would 'scheme-follows-member' be feasible? Explain.*

The majority of responses were in favour of pot-follows-member to deal with stranded pots, although 25 per cent favoured aggregation (with a limited number of aggregators). An alternative was a central clearing house or virtual or notional aggregation via a central database. There was little support for scheme-follows-member: a number of respondents said the issue of costs to employers was believed to be so great that it was considered infeasible, while another said that given the recent changes it is too late to be considering this.

### *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.[309]
- 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'.[310] 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.[311]

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[312] 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

---

[309] Mike Wadsworth, Alex Findlater, and Tom Boardman (2001) *Reinventing Annuities*, Staple Inn Actuarial Society, London; Tom Boardman (2006) Annuitization Lessons from the UK: Money-Back Annuities and Other Developments, *Journal of Risk and Insurance*, 73, 633-46.

[310] Quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.

[311] Quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.

[312] The 55% rate was set to recover the tax relief that a 40% tax payer received on contributions and investment returns during the accumulation phase of a pension scheme, taking account of the 25% tax free lump sum. This rate therefore made a pension scheme tax neutral over an individual's life cycle. Its abolition involves a significant transfer of wealth from the general tax payer to already well off families.

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.[313]

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'.[314]
- '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'.[315]

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.

---

[313] Annuities will become even more expensive as a result of the introduction of Solvency II in January 2016, by around 10%, according to some estimates.

[314] Lex Column (2015) UK annuities: hope in the gloom, Financial Times, 26 May.

[315] Richard Evans (2015) Need income from your pension? Here are six alternatives to an annuity, Daily Telegraph, 12 May.

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'.[316]

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:[317]

> *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.*

---

[316] Martin Gilbert (2015) Aberdeen - We are the fund managers of the (pensions) revolution, Financial Times, 17 May.

[317] Raimond Maurer and Barabara Samova (2009, p. XIII-XIV) *Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?*, European Fund and Asset Management Association, February;
http://www.efama.org/Publications/Public/Long-Term_Savings_and_Pension_Steering_Committee/Maurer_Rapport.pdf.

*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.[318]

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'.[319]

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,[320] 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.[321] 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

---

[318] Reported in Jack Jones (2014) Investment advisers fear rash of 'inappropriate products', post-Budget, Professional Adviser, 18 August.

[319] McPhail attacks 'irresponsible' Treasury reform agenda - Corporate Adviser, 29 September 2014.

[320] David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Pensions Institute Working Paper, May (http://www.pensions-institute.org/workingpapers/wp1407.pdf);
Department for Work and Pensions and Financial Conduct Authority (2015) *Transaction Costs Disclosure: Improving Transparency in Workplace Pensions*, Discussion Paper DP 15/2, March (http://www.fca.org.uk/static/documents/discussion-papers/dp15-02.pdf).

[321] Investment Association (2015) *Meaningful Disclosure of Costs and Charges*, Position Paper; http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

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.[322]

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?'.[323]

When it comes to insurers, it is evident that the insurance industry has no intention of letting 'asset managers eat their dinner'.[324] 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.[325]

---

[322] Reported in David Oakley (2015) Investment Association jettisons chief Daniel Godfrey, Financial Times, 6 October.

[323] Reported in William Robins (2015) Platform chief brands funds industry 'out of control'; High charges and poor performance still dog the retail fund sector, according to the head of investor services company Nucleus, Citywire, 6 March.

[324] According to Charlotte Moore (2015) A slow route to retirement riches, Financial News, 9 October.

[325] Reported in Charlotte Moore (2015) A slow route to retirement riches, Financial News, 9 October.

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.[326]

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.[327] In addition, annuities need to be rebranded as 'guaranteed income for life products',[328] 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

[326] Reported in Peter Walker (2015) Aegon to leave the ABI, FT Adviser, 15 September.
[327] This will be discussed in Chapter 5.
[328] A number of people have proposed this, including Nigel Waterson, the former shadow Pensions Minister in an article offering advice to Ross Altmann, the Pensions Minister appointed by the new Conservative Government in May 2015: 'The new incumbent should see a role in restoring the reputation of a guaranteed income for life (aka annuities); because for many people this will still be the best solution' (Nigel Waterson (2015) A time for consolidation – why Altmann must avoid 'initiative-itis', Professional Pensions, 27 May).

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[329]

- 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'.[330] 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.

[329] The question of advice is addressed in depth in Chapter 3.
[330] Even though they will still be in a pensions tax wrapper.

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.[331]

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

[331] Safe harbour retirement income plans combine safe harbour products with financial help or guidance (which includes confirming the suitability of the product for the client). This will be discussed in more detail in Chapter 3.

- 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.[332]

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.[333] 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'. [334]
- 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'. [335]

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.[336] Murray said the measurement of value for money must be based on 'credibility and transparency: make relevant information public;

---

[332] Value for money is discussed further in the next Section.
[333] Professional Adviser (2015) Defaqto launches pension ratings service, 1 May.
[334] The definition is in relation to public sector commissioning; http://www.nao.org.uk/successful-commissioning/general-principles/value-for-money/
[335] http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/Reg_Prop_and_VfM-November04.pdf
[336] This is discussed in Chapter 3.

avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate' (p.114). [337]

A 2014 Pensions Institute Report, *VfM: Assessing Value for Money in Defined Contribution Default Funds*, [338] 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. [339]

For annuities, the empirical evidence shows that the MW of annuities is fairly high,[340] 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

---

[337] The 2014 Final Report of the Financial System Inquiry in Australia, known as the Murray Report after its Chair, David Murray;
http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

[338] Debbie Harrison, David Blake, and Kevin Dowd (2014) *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute, January; www.pensions-institute.org/reports/ValueForMoney.pdf

[339] Edmund Cannon and Ian Tonks (2002) *Annuity Prices, Money's Worth and Replacement Ratios: UK experience 1972 – 2002*, Centre for Market and Public Organisation Working Paper No. 02/051, University of Bristol, September; http://www.bristol.ac.uk/media-library/sites/cmpo/migrated/documents/wp51.pdf

[340] Edmund Cannon and Ian Tonks (2009) *Money's Worth of Pension Annuities*, Department for Work and Pensions, Research Report 563; Matteo Aquilina, Robert Baker and Tommaso Majer (2014) *The Value for Money of Annuities and Other Retirement Income Strategies in the UK*, Occasional Paper No.5, Financial Conduct Authority, December (https://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-5.pdf)

is used to secure a competitive rate.[341] Nevertheless, many people regard the product as unattractive. This is due to a combination of the irreversible nature of the purchase,[342] 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.[343]

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

[341] The FCA now requires insurers to provide an annuity ranking table with a quotation, so individuals can see how the roll-over rate compares. The aim is to encourage more shopping around, but it is too soon to tell if this will prove effective in what has historically been a stubbornly passive purchase market.
[342] Although this will change once the secondary annuity market starts in 2017.
[343] A simple measure of this would be the size of the area under the downward sloping annuity line in Figure 3.4 relative to the total area of the fanchart.

AllianceBernstein, said: 'We need more transparency and have better benchmarking that is then down to each scheme to decide what their setting value is'.[344]

#### *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 chould 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:[345]

- 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

[344] Reported in Stephanie Baxter (2015) NAPF 2015: Schemes need better benchmarking to judge value, Professional Pensions, 15 October.
[345] See David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Pensions Institute Discussion Paper PI-1407, May; http://www.pensions-institute.org/workingpapers/wp1407.pdf

    - 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[346] and need the protection of the Food Standards Agency.[347]

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'.[348]

---

[346] https://en.wikipedia.org/wiki/2013_meat_adulteration_scandal
[347] http://www.food.gov.uk/
[348] Reported in Helen Morrissey (2015), Asset managers should be subject to retirement income regulation, Professional Pensions, 11 February.

### *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'.[349]

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.[350] 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.

---

[349] Andrew Storey (2015) Why advisers have to get under the skin of modelling tools, Professional Adviser, 27 July.

[350] Financial Conduct Authority (2015) *Pension Reforms – Proposed Changes to Our Rules and Guidance*, Consultation Paper CP15/30, October 2015; http://www.fca.org.uk/static/documents/consultation-papers/cp15-30.pdf

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.[351] 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.

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

1. The underlying assumptions in the model should be plausible, transparent and internally consistent.
2. The model's calibrations should be appropriately audited or challenged, and the model's projections should be subject to backtesting.
3. The model must be stochastic and be capable of dealing with quantifiable uncertainty.
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.
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.
6. The model should take account of key member characteristics, such as occupation, gender, and existing assets and liabilities.
7. The model should illustrate the consequences of the member's attitude to risk for

[351] 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

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

the plan's asset allocation decision. It should also show the consequences of 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'.[352] 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**

---

[352] Debbie Harrison, David Blake, and Kevin Dowd (2014) *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute, January; www.pensions-institute.org/reports/ValueForMoney.pdf. This prediction was reinforced by a subsequent report: Debbie Harrison and David Blake (2015) *The Meaning of Life: An Uncertain Future for the Traditional Life Company Business Model in the UK's Private Sector Pensions Market*, Pensions Institute, November; http://www.pensions-institute.org/reports/MeaningOfLife.pdf

**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.[353]

**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.**

[353] These issues are considered in more detail in Chapter 3.

**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.[354] 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.

[354] Board of the Pension Quality Mark (2015) *Developing a Retirement Quality Mark*, Consultation Paper, December.

**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**[355]
- **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**

[355] As in the case of Solvency II, product designers would be free to use an 'internal model', so long as they explained the differences between this and the standard model.

**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

> *'But what am I to do?' said Alice. 'Anything you like', said the Footman, and began whistling.*
>
> Lewis Carroll (1865), *Alice's Adventures in Wonderland*

We will investigate whether it is possible to design a set of good decumulation defaults and default pathways at retirement which will be suitable for most savers, in the same way that a good default investment strategy in the accumulation phase can be designed. Even if this is possible, we accept that it is likely that more people might opt for a different retirement income plan than the estimated 10% of people who reject the default accumulation fund. For example, some retirees might be in poor health and so might choose to access their funds in full at the date of retirement – or over as short a period as possible (staggered to avoid paying unnecessary income tax). Given the complexities of retirement expenditure decision making, we will examine the support in terms of guidance, help and advice that savers need in order to make the right choices for them and their family. Building on the lessons of auto-enrolment, we will examine what nudges would be useful to move people towards making decisions that are in their best long-term interests. We will also consider the barriers, especially the regulatory barriers, to implementing a default. The overriding question that we seek to answer in this Chapter is this: Is it possible to design safe harbour retirement income plans which combine safe harbour products with financial help or guidance (that confirms the suitability of the product for the client) in order to provide retirement income journeys that are good enough for most of Middle Britain?

### *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 risk 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).

In this Chapter, we examine different ways of segmenting the retirement income market. We look at different spending types, different behavioural types, and the different resources and needs of the different market segments. We propose a retirement expenditure and investment plan that helps to overcome the behavioural barriers that many

people face that prevents them making decisions that are in their best long-term interests. Next, we consider a range of defaults and default pathways that have been proposed to nudge people onto an optimal decumulation strategy. We then turn to the information, guidance and advice that are available for consumers and examine the suitability of each. We examine the role of advisers in the new pensions environment and the impact of technology on advice. Despite Government efforts to provide information to pension savers, we ask whether there is an advice gap for certain segments of the market. The different charging models used by advisers are investigated. The implications of this for a default pathway are considered. This is followed by an investigation of potential consumer vulnerability and the proposed regulatory responses to this. Access and exit charges became prominent issues in the months following the introduction of 'freedom and choice' and we consider media and Government reactions to these. We also discuss pension fraud and the questions of customer engagement and customer responsibility. Monitoring of the pension reforms will be important and we consider proposals about how to do this. The self-employed and non-eligible job holders for auto-enrolment are also examined. We end the Chapter by briefly examining the experience of other countries.

### *3.2 Understanding the retirement savings market*

We begin with some recent surveys of savers covering their attitudes and plans for retirement income.

In November 2014, the Pensions Policy Institute published an analysis, commissioned by Fidelity Worldwide Investment, of the decisions people will need to make, following the introduction of the new pension regime, when they are approaching, at the point of, and during retirement.[356] The report found that 'many of those reaching retirement with a DC [defined contribution] pension pot will have a greater number of options to choose from about how they access their savings. This could make their decisions far more complicated, pushing the burden of managing these risks further onto pension savers, and, in some cases, extending the need for ongoing decision making during retirement'. The report also found that 'decisions about accessing DC pensions are considered the most challenging of pension and retirement decisions and other major financial decisions from across the life course'. This is because people will have to understand 'complex and uncertain' factors such as inflation, investment and longevity risks (and the other risks in Table 1.2) and many people do not have the financial capability or numeracy skills to do this adequately. The report concludes that: 'those with low levels of numeracy will find decisions about accessing pension savings particularly challenging, but will be at greater risk if they also do not have

[356] Pensions Policy Institute (2014) *Transition to Retirement - How Complex are the Decisions that Pension Savers Need to Make at Retirement?*, November; http://www.pensionspolicyinstitute.org.uk/press/press-releases/t2r-how-complex-are-the-decisions-that-pension-savers-need-to-make-at-retirement

the security of being able to fall back on a secure source of private pension income in the form of an indexed DB [defined benefit] pension'.

Using data from the English Longitudinal Study of Ageing (ELSA),[357] the PPI found that people reaching state pension age (SPA) over the next ten to fifteen years vary considerably in their pension and non-pension savings. It identified the groups at greatest risk of making poor decisions when they reach SPA 'if they are not offered adequate support, either through guidance and advice or through the provision of suitable defaults'. It predicted that 700,000 people reaching SPA over the next 10-15 years (12% of the total) will be at 'high risk' of making poor decisions when they retire; this group has significant DC savings (between £19,400 and £51,300), but no additional DB pension. A further 1.6 million (29% of the total) will be at 'medium risk'; this group has £6,300 or less in DC savings and little or no additional DB pension.

In March 2015, the International Longevity Centre – UK (ILC-UK) also published a report based on an analysis of ELSA data.[358] The study analysed the outcomes of four different approaches to using DC pension wealth: (a) annuitising, (b) blowing the pot on big ticket items, (c) putting everything into a savings account, and (d) leaving the fund invested and using drawdown.

The report found that:

- Even if all those approaching retirement were to annuitise, over half of them (1.1 million people) will not be able to secure an adequate income (defined as 70% of final salary), unless they use non-pension assets or receive additional benefits on top of the state pension
- In a scenario where the DC pot is used to buy big ticket items, an additional 350,000 people (1.4 million people in total) will not be able to secure an adequate income in retirement
- Putting everything in a savings account also risks people running out of money before they die. The report predicted that average replacement rates could fall from 66% to 49%. Given that people typically underestimate their life expectancy by upwards of four years, spending savings too early is a real possibility
- Leaving the fund invested also risks people running out of money before death as well as exposing individuals to substantial income volatility. Within a balanced fund of 60% bonds and 40% equities, the report estimated that average annual income in retirement could vary between £18,000 and £12,000, depending on the fund's

[357] ELSA is the largest survey of people living in England aged between 55 and 74. In total, there are 6 million people in this age range and 2 million of them have DC pension pots and are yet to retire.
[358] *Here Today, Gone Tomorrow. How Today's Retirement Choices Could Affect Financial Resilience Over the Long Term*, 16 March 2015;
http://www.ilcuk.org.uk/images/uploads/publication-pdfs/Here_today,_gone_tomorrow_1.pdf

performance. If individuals are unprepared for such volatility, it would be akin to significant year-on-year income shocks (e.g., incomes being lower by 30% one year compared with the previous year) which could adversely impact living standards.

The prospects are even worse for the 850,000 individuals who will rely mainly on a DC pension but have low levels of financial capability. In all the four scenarios above, they will end up with replacement ratios below 40%.

The report warned that 'such income falls coming at the end of life could have disastrous implications resulting in individuals cutting back on expenditure just at a time when they may need it most, i.e., to maintain basic living standards as well as paying for long-term care'.

In January 2015, the Pensions Policy Institute published the results of a set of in-depth interviews with 55 DC pension savers aged 55 to 70.[359] The interviews were conducted by Ignition House and sponsored by State Street Global Advisors. The purpose of the interviews was to determine the preferences for how these savers would draw a retirement income, the financial trade-offs that they are willing to make, and the default products and strategies that could best support them. The new flexibilities are popular with DC savers. However 'once they begin to understand the full scale of choices and trade-offs involved in deciding how to access their DC pension pots at retirement, they can quickly become daunted. This suggests that disengagement and inertia amongst consumers from April 2015 is a key risk without the provision of effective default strategies and appropriate guidance and advice. The idea of their pension scheme or existing provider offering a default investment or drawdown option into retirement resonated with DC savers, with some believing that providers even had a "duty" to offer this – though they recognised the importance of wider individual and household circumstances and the need for there to be some element of choice for those who want it'.

The PPI identified a number of specific risks facing savers:

- Reluctance or inability to plan beyond the next few years, which means locking into a specific course of action either before or at retirement is generally unpopular
- Perceptions that there are 'safer' or 'better' investments they can use outside of pensions, which, when probed, are based on misguided beliefs or have not been properly thought through
- Poor understanding of both spending needs throughout retirement and likely 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

[359] Pensions Policy Institute (2015) *Transition to Retirement - Supporting DC members with Defaults and Choices Up To, Into, and Through Retirement: Qualitative Research with Those Approaching Retirement*, January; http://www.pensionspolicyinstitute.org.uk/publications/reports/transition-to-retirement-defaults

- Lack of engagement (even very close to retirement) – leading to the potential for consumer detriment if the defaults available are not suitable and designed in the best interest of savers.

Digging deeper into investment issues, the study found that the participants are not currently well-equipped to make investment choices. In particular, they are not confident about investing in equity-based products. The implication is that 'left to their own devices, participants would probably put their fund in "safe" investments [i.e., investments with capital protection] or leave it rolling in their pension'. Participants are generally reluctant to make up-front commitments about when they might be willing to lock their money in to a particular strategy. They are also reluctant to hand over significant sums of capital in the early years of retirement to another party. However, after some prompting, most participants would be willing to trade off more risk and indeed some flexibility for the possibility of higher returns. With further prompting, many participants would typically choose a low or medium risk portfolio.[360]

In terms of drawing from the pension pot, participants place a high value on 'ease of access and flexibility to change the amount of income': they would 'prefer to access their pension pots on an ad hoc basis or take money out of these tax efficiently, but there was confusion about how to do this'. It was likely that they would draw a level income or take more income early on.

Participants had a poor understanding of longevity risk and hence a low awareness of how long the pension pot needed to last. The concept of longevity insurance 'was understood and resonated, but a key barrier will be the cost of this'. Participants 'could see the merits of securing an income at some point in the future when they were no longer willing or able to make decisions on the pot any more. However, they were very unwilling to precommit to purchasing an annuity to do this. In addition, they would want to retain as much flexibility as possible, so were not warm to the idea of automatic conversion or rollover to a guaranteed income in later life, especially if this meant locking into an annuity. They would prefer to leave their options open for as long as possible, and are unlikely to want to commit to the option of securing an income until they are in their 70's or beyond'. Nevertheless, many participants 'were warm to the concept of a gradual payment for a longevity insurance product, with participants being able 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. The biggest barrier mentioned would be the cost, with the majority feeling that ongoing premiums of between

[360] The low-risk portfolio consisted mainly of bonds with some shares and had an expected return of 4%, just enough to beat inflation, but in a bad year could lose 10% of its value. The medium-risk portfolio consisted of 60% shares and 40% less risky assets and had an expected return of 5-6%, more than enough to beat inflation, but in a bad year could fall by 15-20%. With prompting, participants could be persuaded to move away from an all-cash portfolio, which while not falling in value in nominal terms, would generate returns of only 1-2% which would not be sufficient to keep up with inflation. However, there was a reluctance to move to a high-risk portfolio (with 80% in shares) where the expected return was 6-7%, but in a bad year could fall by 25-30%.

£500 and £1,000 per annum, starting at age 65, were not seen as an unreasonable amount to secure a lifetime income, e.g. £5,000 per annum, from age 85 onwards'.[361] But, 'after considering these costs, some still then felt that it would be too much of a "gamble" and they would prefer to take their chance on running out of money'. Death benefits are viewed as a 'nice to have', with individuals more willing to take more investment risk for their partner than their children.

The PPI believes that defaults are a good way of dealing with these problems. The two main justifications are that: (a) most participants did not know and were not interested in how their pensions were currently invested in the accumulation phase and (b) they can also be overwhelmed by the number and complexity of choices around drawing down income. They were also currently in a default through auto-enrolment. So the reason for having a default in the accumulation phase would also appear to hold for the decumulation phase: it is unlikely that people will develop the necessary skills and knowledge to manage investment choices in the decumulation phase. But despite support for the idea of defaults, participants also wanted some alternatives in recognition of the differing circumstances people face in retirement. Nevertheless it was clear that people needed support to make the trade-offs that the new world of 'freedom and choice' will bring: 'given the existing lack of understanding around the underlying investments in default funds, and what the funds are seeking to achieve, it will be important that any defaults and alternatives offered are clearly branded and communicated in terms of their objectives and risk-level'.

The PPI proposes that policy makers, regulators and the pensions industry should work together to address these issues. Alistair Byrne, senior DC strategist at State Street Global Advisors, added: 'We need to begin putting in place arrangements to implement the 'freedom and choice' reforms now, and the PPI's research provides strong evidence to build on. It's clear that default investment strategies in DC plans need to cope with uncertainty around when people will retire and how they will access their retirement savings. The industry needs to put in place well-governed retirement income defaults that provide members with value for money and flexible access to their assets, without overwhelming them with complex choices'.

The uncertainty over how retirement income will be taken is confirmed by a poll conducted by True Potential, the results of which were published in February 2015.[362] The poll of 2,000 pension savers found that 76% of those aged 55-64 did not yet know how they will take an income from their pension, rising to 82% for those over 65. Only 5% planned to buy an annuity, although 40% of respondents believed a consistent income was the most important factor in retirement. Of those of working age, 20% said they had not thought about a

[361] These premiums were generated by discussions that took place in the participant meetings, rather than being based on calculations around realistic premiums for this type of longevity insurance.
[362] Reported in Carmen Reichman (2015) Most over-55s undecided on retirement route – poll, Professional Adviser, 23 February.

pension, with higher percentages amongst the young: 29% of those aged 18-24 and 24% of those aged 25-34.

A survey conducted by Fidelity Worldwide Investment for its *Class of 2015* report published in March 2015 found that only 14% of 525 people interviewed in January 2015 who will be retiring in the next year had done any significant research about their options.[363] A further 10% were waiting to be contacted by their product provider. While most respondents (65%) felt confident about managing their finances, many had not yet considered the basic elements of a retirement income plan. One in ten thought they could make withdrawals from their scheme without needing to contact their provider to establish terms of access. A further 7% reported that they had not even thought about this. In addition, many people did not understand the tax implications of the new pensions regime, with 42% not knowing the threshold at which pension lump sums are taxed and 10% believing they can access their whole pot tax-free. While 56% of those polled said they would access their pension as a cash lump sum, with 18% planning to access more than the tax-free amount, only 4% said they would withdraw the entire pot in one go. Annuities were being considered by 22% of those not wishing to withdraw all of their pot, 25% said they would transfer to a drawdown product, 17% will leave their pension invested and defer taking it, and 13% will use a combination of a drawdown pension and an annuity. Another 20% were still undecided.

Alan Higham, then Fidelity retirement director, said: 'These decisions are complex and we would urge people to seek the appropriate expert help and advice in order to ensure they get the most from their retirement savings; be it through careful research or through an adviser…..if they are less confident. It is alarming that there is a certain hard core of people taking an approach to retirement that they would not take to their everyday life. With neither a rainy day fund, nor idea of a budget nor, indeed, an intention of establishing the best deal or checking the small print on their funds, this group is vulnerable to making a poor choice that could cost them dearly in retirement….[Further], the tax implications of accessing your pension could be the biggest issue for this set of retirees'.[364]

In September 2015, Retirement Advantage released the results of a survey, conducted by YouGov, where the over 50s were asked what they would like from their retirement income product. The findings indicate that 'the need for flexibility and the desire for certainty are valued equally by consumers, though when pressed, certainty is considered more important

---

[363] Reported in: Michael Klimes (2015) Just one in seven retiring this year have researched options, Professional Pensions, 23 March; Jack Jones (2015) One in ten retiring this year expect whole pot to be tax-free, Professional Pensions, 10 March; Carmen Reichman (2015) Fifth of near-retirees still clueless about tax on pension withdrawals, research, Professional Adviser, 10 March.

[364] Vince Smith-Hughes, head of business development at Prudential, has also warned that the majority of people accessing their pensions for the first time will be overpaying tax, particularly if they withdraw large sums of cash. This is because HMRC requires providers to apply an emergency tax code on sums withdrawn if they do not have the customer's normal income tax code. Reported in Carmen Reichman (2015) Prudential sounds emergency tax warning on pension pot withdrawals, Professional Adviser, 1 April.

than flexibility'. Around a quarter wanted absolute certainty and were reluctant to take any risk whatsoever with their pension savings, but most were happy to take some investment risk. The implication of the findings, according to Andrew Tully, pensions technical director at Retirement Advantage, is that 'consumers want it all, and as we know, neither an annuity nor a drawdown product on their own meet the need for certainty and flexibility. But a combination of both products can…. Combining annuities and drawdown into one product, offered under drawdown rules, opens up a whole new way of thinking about flexibility of income in retirement'.[365]

In March 2015, Franklin Templeton released the results of its Retirement Income Strategies and Expectations (RISE) survey of 2,000 adults.[366] It found that only 25% of respondents (mainly from the highest income groups) planned to leave some of their pension pot invested on the stock market after they retire, while 42% thought the stock market was 'too risky' as a retirement strategy, and 33% felt they did not have the knowledge to choose the right investments. The main concern was the possible decline in the value of the pension pot: 80% of respondents stated that they would be worried about a 20% decline in their pension savings, while 44% would be concerned about a 5% fall. There was a clear preference for low-risk investments: 73% said they were leaning towards a low-risk approach to their retirement investments, while 88% said stock market investing had no, or only a limited, role to play in retirement saving due to the perceived risks. The key preferred alternatives were tax-efficient vehicles, such as independent savings accounts (ISAs), favoured by 40% of respondents, while 26% thought property would be a part of their retirement portfolios.

A survey by J.P. Morgan Asset Management reported in February 2015 revealed poor investor understanding of how investments generate the income that will be needed to pay for goods and services in retirement. According to Jasper Berens, head of UK funds at JP MAM: 'Given the relentless media attention that record low interest rates have received over the past couple of years, I was genuinely flabbergasted to learn that less than half of UK investors (44%) could correctly explain the term "income investing",…It seems to be the case that, while many investors acknowledge the importance attached to generating income for their portfolios, too few actually know how to achieve this outcome'.[367] A 'worrying' 38% of respondents plan to rely on savings accounts as their 'preferred' source of income, despite the below-inflation returns that these generate.

---

[365] Andrew Tully (2015) The whole package: Annuities and drawdown side by side, Retirement Planner, 22 September.
[366] Reported in Carmen Reichman (2015) Most retirees have 'no intention' to stay invested – poll, Professional Adviser, 31 March.
[367] Jasper Berens (2015) Alarm bells: The growing income investor knowledge gap, Professional Adviser, 27 February.

A survey of 1,000 relatively well-off people aged over 55 conducted in March 2015 found the average pension pot was £87,500 and the average amount people expected to take in income each year was £9,000. Even with a growth rate of 5% per annum, this means that the average pot will only last 10 years. Half of those nearing retirement (i.e., aged 55-64) were unable to predict how long their pension income would last. Not everyone surveyed had a pension pot: almost 20% would have to rely solely on a state pension. Around one third would need to continue working to support their retirement expenditure, while 50% could rely on property and other savings.[368]

A survey held in April 2015 by website RetireEasy of 1,572 well-off pre-retirees – who are aged 58 on average, plan to retire partially at 61 and have average private pension assets of £146,000 – found that most felt well prepared for the new pensions regime, despite the fact that only 34% had been contacted by their pension provider about the changes. Despite this, 68% said they were aware of the changes and potential charges. The survey found that 28% plan to withdraw funds before they reach 65. Of those, 90% are only going to withdraw the 25% tax-free maximum lump sum. The same percentage said that they do not have plans to buy an annuity with the remainder of their fund. A similar proportion (91%) of those surveyed plan to supplement their income by working part-time in retirement. Three-quarters (78%) are either fully or partly aware of the difference between capped and flexi-access drawdown. More than one in eight (84%) think that 'freedom and choice' is a 'good idea', although 72% do not plan to take advantage of the freedoms.[369]

The above surveys covered the national population as a whole. 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 that psychologists call 'cognitive polyphasia'.

Does the picture become clearer if we segment the market more finely?

### *3.3 Segmenting the retirement income market*

When segmenting the retirement income market, we need to recognise that people differ both in their types and in their resources.

#### 3.3.1 People differ in their types

We consider two ways of segmenting the market according to type of customer.

---

[368] Reported in Carmen Reichman (2015) Retirees banking on 10% withdrawal rate 'will drain pots in a decade', Professional Adviser, 8 April.

[369] Reported in Jenna Towler (2015) Well-off retirees on top of freedoms despite 'poor provider contact', Professional Adviser, 15 April.

### *3.3.1.1 Segmentation by type of spender*

The first way is to segment DC savers according to their spending objectives. This is the approach taken in the *Aon DC Member Survey*. In December 2014, the results of a nationwide survey of over 2,000 occupational DC scheme members by YouGov was published. The survey was conducted between September and October 2014 and sponsored by Aon Hewitt and Cass Business School.[370] It identified five types of spender as shown in Table 3.1.

'Certainty seekers', who account for 35% of the total, want an annuity so that they can have a secure stable guaranteed income for life. 'Steady spenders', accounting for another 35%, want the same outcomes as certainty seekers. They want an annuity in all but name, but they intend to continue investing their money in retirement to generate a stable income: 'While there are recognised downsides to conventional annuities, with price, compulsion, lack of flexibility and no terminal value all cited as negatives in the current system, there is clearly also a continued appetite for an 'annuity-like' approach' according to the survey. Fifteen percent are classified as 'flexibility foremost'. This group will be relying on the state pension and other sources of income to meet their core expenditure needs and will draw from their DC pot as and when needed. 'Early spenders', accounting for 10% of the total, want either to draw down as soon as possible to spend or invest in assets such as property, or continue to invest their pot to generate income, while enjoying higher spending in the earlier years of retirement. The fifth group, called 'residual required', comprising 5% of the total can be subdivided into either 'care conscious' or 'bequest driven'. Both groups plan to continue investing during retirement to generate a stable income either to provide for possible care costs or to make bequests to the family.

The proportions of the population comprising these different spending types appear to be broadly confirmed by other recent surveys. For example, Aegon's *Second UK Readiness Report*,[371] published in November 2014, found that 40% of retirees want a guaranteed retirement income for life, while 30% said that they would like some combination of a guaranteed income and a cash lump sum. Just 16% said they would take their pension as a cash lump sum. Similarly, a study by ILC-UK called *Making the System Fit for Purpose*,[372] published in January 2015, found that 70% of those approaching retirement wished to use their pension pot to provide a guaranteed life-long and inflation-protected income. Just 7% reported that they would use their pot to buy a car or pay for a holiday, while 5% said they would prefer to pay off their debts.

---

[370] http://www.aon.com/unitedkingdom/defined-contribution/dc-member-survey.jsp. Also reported in Sophia Singleton (2014) What do DC scheme members really want?, Pensions Age, December.

[371] https://www.aegon.co.uk/news/media-centre/pressreleases/just-6-percent-are-on-track-for-the-retirement-they-want.html

[372] http://www.ilcuk.org.uk/index.php/publications/publication_details/making_the_system_fit_for_purpose

| *Table 3.1: Types of DC saver according to their spending objectives* | | |
|---|---|---|
| Type | Definition | % of total |
| Certainty-seeker | Want an annuity so that they can have a secure, stable, guaranteed income for life | 35 |
| Steady spender | Want the same outcomes as certainty seekers. But, they plan to continue investing their money in retirement to generate this stable income. Essentially, they want an annuity in all but name | 35 |
| Flexibility foremost | Anticipate continuing to invest and will dip into these savings as and when needed. They are likely to be planning to rely on state pension and other sources of income to support their retirement | 15 |
| Early spender | Want to take their retirement savings in one (partially taxable) lump sum, or in a series of payments soon after retirement (perhaps to reduce the tax impact) | 10 |
| Residual required | Want to ensure a significant element of pension savings towards the end of their lifetimes for long-term care or bequest to family | 5 |
| Source: *Aon DC Member Survey*, December 2014 | | |

The *Aon DC Member Survey* also provides insights into how people plan to take money from their pot. Fifty percent of those surveyed said they would use drawdown either in whole or in part. Of this sub-sample, 20% said they would like the drawdown and investments managed within their current scheme, 17% said they would like them managed by another pension provider such as an insurance company, 25% said they would manage the process themselves with the aid of an adviser, and another 25% said they would 'go it alone'.

The survey also asked about drawdown concerns and elicited the following responses to the question 'which of the following would worry you the most with regard to your drawdown pot?':

- 29% – running out of money before I die
- 26% – my money not growing as fast as I need it to in order to meet my income needs
- 25% – seeing the value of my pension fund fall in value, even temporarily, due to poor investment returns
- 11% – not being able to access my pension fund when I need to

- 7% – none of the above would worry me
- 1% – don't know.

What is concerning about these findings is that most people do not appear to be worried about running out of money before they die – even when they are explicitly asked – and this after all is the main protection a properly designed pension plan provides. The key explanation for this appears to be that death is an event too distant for many people to be concerned about. This is a behavioural problem which needs a behavioural solution.

#### *3.3.1.2 Segmentation by behavioural type*

The second way of segmenting the market is by behavioural type.[373]

Richard Thaler and Cass Sunstein in their best selling 2008 book *Nudge: Improving Decisions about Health, Wealth and Happiness* define two very different types of consumers – '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. Thaler and Sunstein believe that very few people are 'econs' and their book provides examples of how to nudge 'humans' into making optimal choices.

If people were 'econs' capable of behaving rationally and were sufficiently well informed, they could calculate the risk-return tradeoff between an annuity and drawdown and choose which was initially better for them and, more importantly, when it was optimal to switch from drawdown to an annuity to guarantee they will not outlive their resources. Econs will be very concerned about this. But most people are 'humans' who neither behave rationally, nor have the technical skills to evaluate the risk-return tradeoff, nor, indeed, many of the other risks listed in Table 1.2. Humans have behavioural biases which prevent them behaving rationally. One particular example is what economists call the 'annuity puzzle', the reluctance of many humans to buy annuities.[374]

---

[373] This Section draws on David Blake and Tom Boardman (2013) Spend More Today Safely: Using Behavioral Economics To Improve Retirement Expenditure Decisions With Speedometer Plans, *Risk Management and Insurance Review*, 17(1), 83-112.

[374] In most countries, annuitisation is voluntary as it now is the the UK. The very small number of countries with mandatory annuitisation are: Austria, Bulgaria, Finland, Greece, Iceland, Israel, Mauritius, Netherlands, Norway, Poland and Sweden.
(See European Insurance and Occupational Pensions Authority (2014) *EIOPA's Fact Finding Report on Decumulation Phase Practices*, EIOPA-BoS-14/193, October,
https://eiopa.europa.eu/Publications/Reports/EIOPA-BoS-14-193_EIOPA_s_Fact_Finding_Report_on_Decumulation_Phase_Practices.pdf;
and Dariusz Stańko and Nina Paklina (2014) *Supervising the Distribution of Annuities and other Forms of Pension Pay-Out*, IOPS Working Papers on Effective Pensions Supervision, No.21, December,
http://www.iopsweb.org/WP_21_Supervising-Distribution-Annuities-Pension%20Pay-out%20.pdf )

There are a range of behavioural reasons why retirees do not tend to voluntarily annuitise a sufficient proportion of their retirement wealth:[375]

- Aversion to planning – particularly in respect of large infrequent transactions
- Related to this is aversion to paying for advice
- Inertia and procrastination: people have to make the active decision to start a retirement expenditure plan or purchase an annuity and the default position is to do nothing
- Poor financial literacy: many, if not most, people do not recognise the importance of securing a basic understanding of retirement income provision and planning and, as a consequence, are not sufficiently competent to manage the conversion of their investments to income in old age or are unwilling to make the effort to understand unfamiliar products[376]
- This is compounded by poor estimates of life expectancy and poor understanding of the variability of actual lifetimes: in short, a poor understanding of the nature of longevity risk[377]
- Aversion to dealing with complex problems involving a sequence of choices
- Related to this is the issue of choice overload – having so many choices that you end up making no choice at all[378]
- Illusion of control: people like to feel in control of their capital, but annuitisation leads to an apparent a 'loss of control'
- Unwillingness to contemplate unpleasant events, e.g., dying and leaving behind dependants
- Overconfidence: many people underestimate how much they need to live on after retirement[379]
- Related to this is lack of self-control. A particular advantage of an annuity is that it acts as a valuable pre-commitment device (i.e., is a very valuable behavioural tool). An annuity helps control spending in retirement. Many people are unable to control their spending. A survey by Aviva in April 2014 reveals that 61% will find it difficult to

[375] A similar list of behavioural traits is given in: ideas42 (2015) *Freedom and Choice in Pensions: A Behavioural Perspective*, Association of British Insurers, February, http://www.ideas42.org/publication/view/freedom-and-choice-in-pensions-a-behavioral-perspective/; and Barclays Wealth (2015) *Humanising Pensions: Understanding the Behavioural Effects of Freedom in Pension Choice*.

[376] The Government has encouraged improvements in financial education for years now. See, e.g., HM Treasury (2008) *Thoresen Review of Generic Financial Advice: Final Report*, March.

[377] These issues are discussed in detail in Chapter 4.

[378] Sheena Iyengar and Emir Kamenica (2010) Choice Proliferation, Simplicity Seeking, and Asset Allocation, *Journal of Public Economics*, 94, 530-539; ideas42 (2015) *Freedom and Choice in Pensions: A Behavioural Perspective*, Association of British Insurers, February.

[379] Overconfidence is very common in human decision making. It is particularly common in investment decision making by both retail and institutional investors. Over-confidence can be explained by biased self-attribution, whereby individuals update their beliefs about their own ability as being attributable to skill following good outcomes, but due to bad luck after bad outcomes. They become more overconfident after good past performance, but not less confident after bad past performance.

resist spending the pension pot. They could spend their money too quickly in retirement and be reduced to living on the single tier state pension of £155.65 per week from April 2016.[380] This could involve a massive reduction in their standard of living and they will not even have a rainy day fund to fall back on. A more extreme example is people who are desperate for money at any price as the recent pay day loan and pension liberation cases show

- Too much self-control. There will also be people with the opposite set of behavioural traits, those who take excessive precautions and put everything into a rainy day fund and hence spend their money too slowly. Such people could have enjoyed a higher standard of living in their retirement had they had an annuity, taking comfort from the fact that next month another annuity payment will come in should they live that long
- Hyberbolic discounting:[381] this leads to a poor understanding of the distant future and a poor understanding of the effects of inflation in reducing purchasing power over time: economists call this latter phenomenon 'money illusion'[382]
- Mental accounting. Individuals tend to assign assets to different mental accounts such as 'assets available for current expenditure' and 'assets available for future expenditure'. In terms of the decumulation of pension assets, the pension pot at retirement is likely to be assigned by individuals using mental accounting to the first of the above mental accounts if it can be taken as a lump sum and to the second if it has to be taken as an annuity. Individuals who employ mental accounting are likely to value the annuity less than they value the lump sum
- Framing effects: retirees can be unduly influenced by the way things are communicated to them. If an annuity is explained in an investment frame ('an annuity is like a bond, but you will lose your entire investment if you die'), then people are likely to view an annuity as a highly risky investment, but if an annuity is

[380] This is the maximum: many people will not get this. It has been estimated that more than a million people will not get the full single tier pension when it is introduced on 6 April 2016. Only 45% of people retiring before 2020 will receive the full amount (Reported in Sarah O'Grady (2015) 'Nasty shock' as a MILLION people miss out on full pension, Daily Express, 13 January).

[381] Most people tend to discount (i.e., reduce the value of) future outcomes because they are impatient: one apple today is valued more than one apple tomorrow. Some people might even prefer one apple today over two apples tomorrow. At the same time, the very same people might appear to be willing to display much more patience when choices have to be made at some distance in the future. Given the choice between one apple in 100 days and two apples in 101 days, such people would choose to wait 101 days and receive the two apples. This behaviour is consistent with hyperbolic discounting: people have a high short-term discount rate and a lower long-term discount rate. Hyperbolic discounting leads to behaviour that is inconsistent over time. The apparent long-term patience disappears when the long term becomes the short term. After 100 days, people choose the one apple rather than wait one more day to get two apples. Hyperbolic discounters prefer, for example, a nominal annuity over an index linked annuity since it gives them more money up front and they discount future inflation risk.

[382] Money illusion is the tendency of people to think in nominal or money terms rather than in real terms that takes inflation into account. Many people would prefer to have a nominal rate on their bank account of 5% when inflation is 6% to a return of 2% when inflation is 1%.

explained in a consumption frame ('an annuity allows you to maintain your standard of living in retirement for however long you live'), then people are likely to have a much more favourable view of an annuity. Similarly, choices can be framed in a way that causes people to overvalue the 'large' lump sum in their pension fund at retirement and undervalue the 'small' annuity. The emphasis on the pension pot size rather than the income in retirement is very bad from a behavioural perspective. To many people, a pot size of £28,000 sounds like a lot of money, but it is not when it has to possibly last for the next 30 years or more

- Susceptibility to negative norming, e.g., concerning annuities. Annuities have a bad press in most countries. It is interesting to contrast this with the positive view of DB pension schemes which effectively auto-enrol all pensioners into an annuity. More importantly, studies show that annuities that are bought on the open market by people in good health – rather than the internal or rollover annuities bought by the existing customers of an insurance company's accumulation fund when they retire – represent good value of money.[383] Recent research by the Financial Conduct Authority (FCA) has shown that the 'money's worth'[384] of annuities between 2006 and 2014 to be very high at 94% for a 65-year old, confirming previous UK studies.[385] Further, the chance of running out of money with an annuity before you die is zero. This is not true with drawdown. The FCA study shows that a drawdown scheme that takes the same amount of money at age 65 as an annuity and has a 1% charge has an 11% chance of running out of money before age 85. But as we saw from some of the above surveys, many people heavily discount this possibility
- Related to framing and negative norming is herding or peer effects: if dominant members of a peer group, such as employees near retirement at a company, trash

[383] It is important to recognise that standard annuities do not represent good value for people in poor health. Indeed, there is evidence that as many as 600,000 people in poor health have been mis-sold an annuity. They should have been sold an enhanced annuity which took account of their health status. As a result of campaigns, such as the Daily Telegraph's Justice for Annuity Victims campaign, the Financial Ombudsman Service is considering whether insurance companies should be made to compensate victims without recourse to the courts. Compensation could vary between 20 and 50% of the original price of the annuity (Reported in Katie Morley (2015) Pension redress owed to 600,000, Daily Telegraph (Your Money), 14 March).

[384] The 'money's worth' of an annuity equals the ratio of the expected present value of the future annuity payments to the purchase price. It takes into account the life expectancy of the annuitant as well as the interest rate on assets – typically Government bonds – used to make the annuity payments. The money's worth will always be less than 100% due to administrative costs and the costs of the capital that the insurer incurs. Increasing life expectancy and falling interest rates in recent years have reduced the money's worth. The FCA shows that the increase in life expectancy between 2006 and 2014 has reduced the annuity amount by 7%, while the fall in interest rates has reduced the annuity amount by 11%.

[385] Matteo Aquilina, Robert Baker and Tommaso Majer (2014) *The Value for Money of Annuities and Other Retirement Income Strategies in the UK*, Financial Conduct Authority, Occasional Paper No. 5, December; Edmund Cannon and Ian Tonks (2008) *Annuity Markets*, Oxford University Press, Oxford; Edmund Cannon and Ian Tonks (2009) *Money's Worth of Pension Annuities*, Department for Work and Pensions, Research Report No. 563; Amy Finkelstein and James Poterba (2002) Selection Effects in the United Kingdom Annuities Market, *Economic Journal*, 112, 28-50.

annuities, then this could lead to a herd effect whereby no members of the group choose to buy annuities

- Loss aversion: many individuals wish to avoid making losses and so try not to put themselves into a position where losses might occur, even if this means foregoing large gains with a high probability. A common view is that 'annuities are a gamble'. The probability of dying very soon after purchasing an annuity is very low, but this probability is likely to be overestimated, so the 'loss' is perceived to be high: 'what dying and losing all my capital too!'. Conversely, the significant probability of outliving one's resources if one does not annuitise is underestimated, so the 'gain' is perceived to be low. Hence the 'gain' from annuitising will give only a small welfare benefit, while the 'loss' from dying early will have a large welfare loss. Loss aversion is not by itself a sign of irrational behaviour. However, the tendency to overestimate the probability of low-probability events and underestimate the probability of high-probability events is certainly irrational
- Finally, there is regret or disappointment aversion: individuals might choose to avoid making a decision because they might regret or be disappointed by the consequences of that decision. Again the decision not to buy an annuity might be the result of this type of aversion.[386]

### 3.3.2 People differ in their resources and needs

The other important way of segmenting consumers is by resources and needs. This is one of the ways in which the FCA classifies consumers into 10 types. The FCA's *Consumer Spotlight* identifies two types of consumer who are retired:[387]

---

[386] Loss aversion differs in a subtle way from regret aversion. With loss aversion, individuals are risk-seeking in the domain of losses and risk averse in the domain of gains, relative to an exogenous reference point. Regret aversion implies individuals anticipate ex-ante the regret they will feel ex-post if they made a suboptimal decision; in this case, the reference point is the best decision that could have been made and this reference point is endogenous in the decision process.

[387] Reported in Carmen Reichman (2015) FCA reveals ten types of consumer in bid to drive product design, Professional Adviser, 19 January. The remaining 8 types are: Affluent and ambitious - mostly aged between 35 and 60, they have high incomes, own their homes and work full-time. They are highly educated and financially confident, Mature and savvy - confident and well informed about financial services, has higher incomes and savings than average, and is in full-time work; Living for now - people on low incomes, most working or studying, are internet-savvy but less confident about financial matters - although they will take more risks than average consumers; Striving and supporting - mostly in work and with low incomes, more than half of this group have dependent children, risk averse but can struggle with bills or fall behind with payments; Starting out - slightly below average income, but technologically advanced with a high level of education, this group consists mostly of under 45s who are single and without children, almost all are renting; Hard pressed - on low incomes, many struggling with everyday expenses, Many also have no savings or investments, and are not confident with financial decisions; Stretched but resourceful - likely to own their home, and many have savings, investments and pensions, half have children at home and are generally confident about financial matters, but time-poor; Busy achievers - those on high household incomes, with mortgages, pensions and

- Retired with resources
    - These are mostly retired homeowners who are risk averse and rarely in debt, with high savings and a range of financial products and typically well informed on financial matters. They comprise two groups known as 'mass affluent' and 'high net worth'
- Retired on a budget
    - These are mostly over 65 with low incomes, who are careful with their money and stay loyal to providers. They have limited access to services and information. They are also known as the 'mass market'.

Many of the people surveyed in the above studies belong to this second category.

We can divide income needs into three broad categories:

- '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.

Table 3.2 shows household expenditure by gross income quintile group for those aged 65-74. We could, for example, interpret the income needs of the bottom quintile as essential. This amounts to £198 per week per household (or £167 per week per individual). This is approximately equal to the state pension and other benefits received by a recently retired couple (£191).[388] We could interpret the middle quintile as having an adequate income of £484 per week per household (or £249 per week per individual) and the top quintile as having a desired income of £920 per week per household (or £350 per week per individual).

A survey from *Which? Consumer Insight Tracker* released in March 2015 found that 66% of those aged 50-64 are concerned about how much money they will need in retirement. Further, only 41% of retired people say they are living comfortably on their pension.[389] The survey, conducted by Populus, interviewed a representative sample of 2,251 UK adults online between 17th - 18th September 2014 and 2,088 UK adults online between 16th - 18th January 2015.

---

some savings, they are in work, albeit largely part-time, with children at home, they can access information and services easily but for them time is very limited.

[388] DWP *Pensioners' Income Series*, July 2014.

[389] http://www.which.co.uk/news/2015/03/which-calls-for-additional-pension-reforms-397246/

*Table 3.2: Household expenditure by gross income quintile group where the household reference person is aged 65 to 74, 2011-2013 (£ per week, United Kingdom)*

| | | Lowest twenty per cent | Second quintile group | Third quintile group | Fourth quintile group | Highest twenty per cent | All House-holds |
|---|---|---|---|---|---|---|---|
| Lower boundary of group (£ per week)[a] | | | 265 | 462 | 696 | 1,078 | |
| Weighted average number of persons per household | | 1.2 | 1.7 | 1.9 | 2.3 | 2.6 | 1.8 |
| Commodity or service | | Average weekly household expenditure (£) | | | | | |
| 1 | Food & non-alcoholic drinks | 35.10 | 49.70 | 61.90 | 70.70 | 93.20 | 55.60 |
| 2 | Alcoholic drinks, tobacco & narcotics | 6.90 | 9.30 | 12.80 | 14.50 | 19.00 | 11.10 |
| 3 | Clothing & footwear | 7.50 | 11.90 | 21.40 | 24.80 | 41.00 | 17.30 |
| 4 | Housing(net)[b], fuel & power | 40.20 | 49.70 | 52.90 | 66.10 | 86.10 | 53.60 |
| 5 | Household goods & services | 10.60 | 23.60 | 33.30 | 39.00 | 60.10 | 27.90 |
| 6 | Health | 3.10 | 5.80 | 8.60 | 13.10 | 12.60 | 7.50 |
| 7 | Transport | 15.50 | 40.40 | 66.40 | 86.40 | 143.00 | 55.50 |
| 8 | Communication | 6.80 | 9.70 | 11.20 | 14.10 | 17.80 | 10.70 |
| 9 | Recreation & culture | 28.30 | 48.10 | 87.50 | 93.00 | 140.90 | 66.50 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 10 | Education | - | [0.30] | [0.30] | [3.00] | 11.90 | 1.60 |
| 11 | Restaurants & hotels | 11.70 | 23.90 | 38.60 | 49.20 | 80.40 | 32.80 |
| 12 | Miscellaneous goods & services | 15.60 | 23.00 | 33.90 | 45.30 | 100.60 | 33.10 |
| 1-12 | All expenditure groups | 181.20 | 295.30 | 428.70 | 519.20 | 806.80 | 372.90 |
| 13 | Other expenditure items | 16.50 | 33.20 | 55.10 | 62.10 | 113.10 | 45.30 |
| Total expenditure (£) | | 197.70 | 328.50 | 483.80 | 581.30 | 920.00 | 418.20 |
| Average weekly expenditure per person (£) | | 167.10 | 194.20 | 249.00 | 256.90 | 350.30 | 234.60 |

Notes: This table is based on a three year average.

[a] Lower boundary of 2013 gross income quintile groups (£ per week).

[b] Excluding mortgage interest payments, council tax and Northern Ireland rates.

Source: ONS, *Family Spending 2013*

The *Aon DC Member Survey* discussed earlier appears to suggest that attitudes to both the standard of living in retirement and the age at which retirement takes place are changing. The great retirement deal that the babyboomers could get, namely a pension of two-thirds of final salary from age 65, is no longer regarded as realistic. The survey suggests there is 'a welcome sense of realism among employees about their retirement prospects'. Nearly 50% of respondents expect a pension of between 21% and 50% of their final salary. Similarly, 50% expect to retire between 66 and 70, while 10% anticipate working until their 70s. While 50% still expect to fully retire from all paid work when they leave full time employment, around 40% anticipate easing into retirement by do some part-time work; however, 5% expect they will not be able to ever retire.

### 3.3.3 Implications of the market segmentation analysis

Together these surveys build up a very interesting picture about 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.[390] Much 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 they draw
- 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 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

[390] They might also have some DB pension as well, although, in due course, this source of retirement income will disappear as private-sector DB pension provision comes to an end.

- 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.

We also need to be aware that there is a difference between what people say they will do and what they actually do. The above surveys suggest that many DC savers plan to act quite rationally. They imply that life time annuities ought to remain an important feature of retirement incomes. However, the survey conducted by ILC-UK also found that people had a poor understanding of their retirement income options. Only 50% of those with a DC pension said they understood what an annuity is, only 20% understood what an enhanced annuity is, and only 35% said they understood what income drawdown is.[391]

In addition, financial advisers did not expect annuity sales to be high in future. An Aegon adviser survey[392] of 200 financial advisers found that only 2% of advisers expected annuities to be the market leading product by 2025. One in three believed that risk-managed funds would become the leading product, while 28% thought that guaranteed investment strategies would lead the product list. So there also appears to be a big disconnect between what savers say they will do and what advisers believe that savers will do. Nick Dixon, Aegon investment director, said: 'It's now clear that most [advisers] now think some form of income drawdown or phased retirement will overtake traditional annuities before long. Flexible guarantees, risk-managed funds, and income funds are all becoming central to advisers' toolkits as their clients look to take advantage of the new flexibilities'. An implication of this is that many people will not see the need for longevity insurance, because they cannot imagine the consequences of running out of money before they die. Yet, if they did run out of money before they died, it is equally likely that they would regret this and accept that the strategy that led to this unfortunate circumstance was sub-optimal in the long run.

One of the most important facts to recognise is that the alternatives to annuitisation – principally income drawdown – involve more risk, often much more. People can only get a higher return than an annuity by taking on more risk and the extra return is not guaranteed.

[391] http://www.ilcuk.org.uk/index.php/publications/publication_details/making_the_system_fit_for_purpose
[392] Reported in Professional Adviser, 7 January 2015.

Almost immediately after the Budget, scheme members were being encouraged to take on more risk.[393] Drawdown also has higher charges, in particular, fund management charges.[394] In addition, there are drawdown products that guarantee a minimum income, but long-term guarantees of this kind can be very expensive.

So we are confronted with the following potentially toxic combination: people who do not fully understand the risks that they face, being offered a wide range of retirement income products and solutions, but with 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 the risks in Table 1.2 themselves. This means that the provider must design products and solutions that effectively manage these risks.[395] Second, we need to recall that one of the important lessons from behavioural economics is that too much choice is a bad thing. This means that we should consider introducing defaults with 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.

The use of defaults in decumulation builds on the lessons of auto-enrolment in the accumulation phase of DC schemes introduced in October 2012. However, there are important differences arising from the greater complexity of decumulation decision making.

First, in the accumulation stage, a single default investment strategy could be designed that would be adequate for most people. Because people's circumstances differ, it is unlikely that we will be able to design a single ('one size fits all') default decumulation strategy that would suit most people.

---

[393] Chris Torney (2014) Savers should consider taking more risk with their pensions in light of new Government rules, express.co.uk, 23 April.

[394] Fund management charges are included in the total expense ratio (TER). But what is included in the TER are only the visible costs in fund management. There are also a significant number of hidden costs as reported in David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Pensions Institute Discussion Paper PI-1407, May. The investment management industry is now beginning to acknowledge that these hidden costs exist. Daniel Godfrey, then chief executive of the Investment Association wrote on a blog: 'We think [a full list of charges] will avert a continuation of the trap we've all fallen into over the last twenty years with disclosure [of charges] that nobody understands at best and which can be misleading at worst, with spurious assumptions of accuracy being made that could lead to real consumer detriment' (reported in Dan Hyde (2015) We misled savers for 20 years over hidden fees, says fund boss, Daily Telegraph, 11 February). In February 2015, the Investment Association issued a position paper *Meaningful Disclosure of Costs and Charges*; http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

[395] At the very minimal, the products and solutions need to have (a) accessibility, (b) investment returns in excess of inflation and (c) longevity insurance (see Chapter 2).

Second, in the accumulation stage, people could be auto-enrolled onto the DC scheme default investment strategy without the need for very much information, guidance or advice. This is clearly not the case with decumulation. The Government has introduced the 'guidance guarantee', a new service called Pension Wise that is free, impartial and aims to help individuals consider their options and make informed choices.[396] However, we need to assess whether 'guidance' – which is a non-regulated activity in the UK – is adequate for the purpose, in which case the customer can avoid the expense of taking 'advice' – which, depending on the type of advice, can be a regulated activity in the UK – from a qualified financial adviser.[397]

Third, in the accumulation stage, people are auto-enrolled at a natural point in their career, i.e., when they have made the decision to start a new job and expect to be filling in forms, etc. There is no a similar clear-cut point in decumulation, especially if people have accumulated a number of pension pots over their career. Any default would, in general, need to be triggered by the member.

We also need to overcome the behavioural barriers that people face which prevent them making decisions that are in their best long-run interests, that is, decisions that their older selves will appreciate that their younger selves made, rather than decisions they will subsequently regret. Further, in a world of 'freedom and choice' and no compulsion, we need to find ways of nudging people towards the best default for their circumstances. Finally, we need to determine whether there are any regulatory barriers that impede the effectiveness of the default, the guidance/advice or the nudging and, if there are, then they need to be identified and removed.

Before doing all this, we briefly consider initial customer reaction when 'freedom and choice' first started.

### 3.3.4 Initial customer reaction to the introduction of 'freedom and choice'

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

[396] https://www.gov.uk/Government/news/millions-guaranteed-the-right-to-free-and-impartial-guidance-on-their-new-pensions-choices. Pension Wise is discussed in more detail in Section 3.6.3.

[397] For those who choose not to use the default, advice would still be highly desirable, although cost is an important consideration, especially if the pension pot is fairly small. These issues are discussed later in the Chapter.

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.[398]

Tom McPhail, head of pensions research at Hargreaves Lansdown, said: 'It will take some time for a clear pattern to emerge in terms of how investors are looking to use the new freedoms. Initial demand has been focused on an investment income rather than buying an annuity, though we do expect this balance to swing back to some extent in the weeks to come. Relatively few people are asking to take all their money out; we'll be tracking the sums involved, however, in the main, we expect it to be at the smaller end of pension pot sizes'.[399]

| *Table 3.3: What customers telephoned Hargreaves Lansdown about on 6 April 2015* | |
|---|---|
| Topping up/opening a SIPP | 8.2% |
| Taxation (of drawing a pension) | 8.7% |
| Ad-hoc lump sum withdrawals | 16.9% |
| Drawdown | 42.1% |
| Annuities | 9.8% |
| Taking tax-free cash only | 6.6% |
| Taking all their pension pot in one go | 7.7% |

A breakdown of the calls Hargreaves Lansdown received on 6 April is shown in Table 3.3. Only 7.7% of calls concerned accessing the entire pot. Its customer preferences for products in the first two weeks following Flexiday were as follows: over 85% were about drawdown, around 6% about uncrystallised funds pension lump sums (UFPLS) and only around 7.5% were about annuity purchase.[400]

An analysis of client calls to Fidelity Worldwide Investment concerning the new pensions freedoms revealed the following:[401]

---

[398] Reported in Natasha Browne (2015) Providers pick up 60,000 calls a day after flexibilities take effect, Professional Pensions, 16 April; Lisa Bachelor (2015) Speedboats, cruises and holiday homes on pensioners' shopping lists, Guardian, 9 April; Ruth Lythe (2015) A sports car, a hot tub, a cruise on the Queen Mary: Two days into pensions revolution we ask savers what they plan to do with their nest eggs, Daily Mail, 8 April.

[399] Reported in Professional Adviser (2015) Just 8pc eye taking pension 'in one go' - drawdown dominates – research, 7 April.

[400] Email communication from Tom McPhail, 22 April 2015.

[401] Reported in Professional Adviser (2015) Advice rule irritates DB savers as pension freedom trends emerge, 19 May.

- Dominant drawdown: 61% of calls to telephony teams were from customers wanting to enter drawdown and take tax-free cash
- Drawdown deferrers: Half of drawdown customers were deferring income, with many taking the tax free cash element
- Allowance impact: More customers were seeking information around the lifetime allowance
- Overstated cash claims: Just 6% wanted to cash out, of which small pots made up half this statistic
- Annuities agenda: 'In' proved as popular as 'out', with 3% of customers enquiring about cashing in their annuity and a further 3% wanting to purchase one.

Only 1% of the clients of retirement adviser My Pension Expert chose to cash in their pensions completely. Once the tax and longevity risk implications were explained, the majority of its clients avoided the lump sum option in favour of drawdown and annuities.[402]

Within two months of Flexiday, the proportion of Scottish Widows' customers looking to take their pensions as cash had fallen from 70% to 50%. Around 85% of requests were for pots of less than £30,000, with an average withdrawal of £20,000. Robert Cochran from the company said: 'It's still too early to draw definitive conclusions about the longer term impact of pension freedoms due to the pent up demand of those who deferred until April 6th to access their money….However, our site activity data also tells us that customers are still looking for more help in making the right decisions, given the wide range of options now available to them'.[403] Blackrock reported that 1,152 over-55s had accessed their BlackRock workplace pension pots (valued at £13.4m) over the same period and 83% took all their pension saving in cash. One client withdrew £300,000, and while 25% of this was tax-free, the rest would be taxed at a marginal rate of 45%.[404]

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'.[405]

---

[402] Reported in Professional Adviser (2015) Tax hit dissuading savers from taking pensions as cash, 19 May.

[403] Reported in Natasha Browne (2015) Cash requests tail off as pension freedoms bed down, Professional Pensions, 2 June.

[404] Reported in Jenna Towler (2015) BlackRock client takes tax hit after £300k pension withdrawal, Retirement Planner, 10 August.

[405] Reported in Daniel Grote (2015) Pension Freedom - savers withdraw £1 billion, Citywire, 16 June.

The amount withdrawn in the first two months was £1.8bn according to data released by the Association of British Insurers (ABI). The details are as follows:

- Savers took out more than £1bn in 65,000 cash withdrawals from their pension pots. The average pot taken was £15,500. Most were uncrystallised funds pension lump sum (UFPLS) withdrawals
- Savers took out £800m from income drawdown policies in 170,000 withdrawals
- Savers put in £630m to buy 11,300 annuities and a further £720m to buy 10,300 income drawdown policies
- The average annuity was purchased with £55,750 and the average fund put into drawdown was £69,900.

So 52% of the total sales were annuities and 48% drawdown. This compares with 2012, the peak year for annuity sales in the UK when monthly sales were £1.2bn (90% of the total) and only £0.1m per month was put into income drawdown products (10% of the total).[406]

The amount withdrawn in the first three months was £2.5bn according to the ABI, equivalent of £27m a day.[407] The details are as follows:

- Savers took out more than £1.3bn in 65,000 cash withdrawals from their pension pots. The average pot taken was £15,000. Most were UFPLS withdrawals.
- Savers took out £1.1bn from income drawdown policies in 264,000 withdrawals, with an average payment size of nearly £4,200.
- Savers put in £990m to buy 17,800 annuities and a further £1.3bn to buy 19,600 income drawdown policies.
- The average annuity was purchased with £55,600 and the average fund put into drawdown was £68,000
- 55% of annuities were bought from the existing provider, compared with 45% of drawdown products.

The amount withdrawn in the first six months was £4.7bn according to the ABI.[408] The details are as follows:

- Cash withdrawals:
    - £2.5bn was paid out in 166,700 cash lump sum payments, with an average payment of just under £15,000

[406] Reported in Carmen Reichman (2015) Savers extract £1.8bn in first two months of pensions freedom, Investment Week, 15 July.

[407] Reported in Carmen Reichman (2015) Providers paying out £27m a day since pensions freedom, says ABI, Professional Adviser, 3 September.

[408] Reported in Professional Adviser (2015) Pension freedoms: £4.7bn paid out in first six months, says ABI, 3 November.

    - £2.2bn was paid out via 606,000 income drawdown payments, with an average payment of £3,600
    - In 95% of cases where savers accessed a cash lump sum, they withdrew the entire fund. Four in five cash lump sums were paid to those under 65, with three in five under 60
- For funds being invested:
    - £2.85bn was invested in 43,800 income drawdown products, an average fund of almost £65,000; 60% of people changed provider when buying an income drawdown policy
    - £2.17bn was invested in around 40,600 annuities, making the average fund invested nearly £53,300; 40% of customers who bought an annuity changed provider.

So 60% of sales were drawdown and 40% were annuities. ABI director for long term savings policy, Dr Yvonne Braun, said: 'Despite some ringing the death knell for annuities, this seems to have been premature. An increasing number of people are recognising the value of a guaranteed income, with annuity sales rising this quarter. There are also initial signs that the number of people accessing their pension pot as cash is beginning to settle down, with larger pots continuing to be used to buy retirement income products'.

In August 2015, Royal London discovered from a survey it conducted that 69% of people making use of the pension freedoms took their pension pot as a cash lump sum. Of these, 16% said they would use the cash to clear their mortgage or other debts, while 23% intended to put the money into a bank, building society or cash ISA account which was likely to pay a lower rate of return than their pension pot was earning. The remainder planned to use an alternative savings or investment vehicle. The company called on the FCA to increase awareness of the tax implications of cashing out a pension pot at retirement. Fiona Tait from the company said she was worried the results reflected a wider industry trend: 'Royal London does want the pension freedoms to work, but not at the financial detriment of customers. Where customers are looking to pay off debts or spend the money on a vital purchase, the tax charge may well be a price worth paying. However, if the intention is for the cash to just stay in a savings account, consumers are potentially paying a tax charge for no additional financial benefit. Having extra focus in the retirement risk warnings framework would help to ensure that customers appreciate all the options they have within their existing pension. This is particularly important for those customers who are not willing or able to access financial advice'.[409] On the other hand, a survey of Zurich's clients, also published in August 2015, found that only 9% of over-55s had accessed their pension pots. The rest were either not ready to make a decision, were keeping their pensions invested and spending other assets like cash savings first, or were worried that they could run out of

[409] Reported in Natasha Browne (2015)FCA pressed to highlight tax hit as savers cash out to put money in the bank, Professional Pensions, 20 August.

money.[410] According to calculations made by Hargreaves Lansdown for for BBC News, the Treasury will net an extra £700m in tax in 2015-2016 as a result of the cash withdrawals.[411]

Paul Green from Saga said: 'It's great to see so many people taking advantage of the new pension freedoms and that people are being savvy with savings and shopping around for the best deal. David Cameron and George Osborne were right to trust people with their own money. Treating adults like adults leads to better outcomes for society and individuals – we have happy citizens and a welcome boost for the economy'.[412]

However, others have warned warned against using amounts withdrawn as a 'measure of success' of pension freedom. For example, Adrian Walker, retirement planning manager at Old Mutual Wealth, said: 'The UK has a problem with saving, not spending, so care needs to be taken when deciding how to measure the success of the pension freedoms. I would suggest that a more appropriate measure of success will not come for many years, when those people who have withdrawn money from their pensions are still enjoying the retirement they planned and saved many years for'. Tom McPhail also pointed out that 'less than one in ten of people [are] currently choosing to buy an annuity, compared to eight or nine in 10 only a couple of years ago', implying that most people exercising their pension freedoms are not protected from outliving their resources.[413]

The *Retirement Planner Inquiry for August 2015* invited advisers to provide feedback on how their clients were using drawdown products. Only 3% of advisers reported that their clients were choosing to take income from natural yield[414] only, 15% said clients were drawing from capital, and the remainder (82%) said it was a combination of income and capital. Long-established drawdown clients tended to restrict income drawn down to no more than natural yield, while high-net worth individuals 'tend not to require a monthly income drawdown and as such the majority strip out gains from capital growth when appropriate'.

The inquiry also found that 'the popularity of multi-asset funds is set to increase as more people remain invested throughout their retirement. Many fund managers have launched or repurposed multi-asset funds to capitalise on pensions freedom'. Around 40% of advisers had increased allocations to multi-asset funds since April 2015 or were planning to do so. The main reason was to increase diversification and reduce the volatility of the fund value.

---

[410] Reported in Tim Wallace (2015) Savers reject the high life despite pension freedoms, Daily Telegraph, 31 August.

[411] Reported in Professional Adviser (2015)Treasury to net £700m in pensions freedom tax windfall, 7 July.

[412] Reported in Carmen Reichman (2015) Savers extract £1.8bn in first two months of pensions freedom, Investment Week, 15 July.

[413] Reported in Carmen Reichman (2015) Chancellor reveals £1bn cashed in since pensions freedom, Professional Adviser, 16 June.

[414] That is, the pay-out of dividends, coupons, and rent etc from income-generating investments – see Chapter 2.

Around 17% of advisers were also recommending enhanced income funds where yield could be as high as 7%, while another 50% said they were considering doing so.[415]

### 3.3.5 Initial scheme reaction to the introduction of 'freedom and choice'

A survey of 70 trustees and advisers by Linklaters in May 2015 found that nearly 20% of company DC pension schemes will offer flexible drawdown as a result of the 'freedom and choice' reforms, while 46% will offer some degree of access to the UFPLS option, though the majority preferred a one-off withdrawal. A survey from Sackers of more than 50 UK schemes also in May 2015 found that two-thirds of DC schemes were offering members some form of pension flexibility. Of these, 94% were allowing members to cash out their pots through the UFPLS, while only 14% were providing flexi access drawdown. Of the one-third of schemes not currently offering any flexibility, 54% said they were considering it, while 38% said they had no plans to do so.[416]

However, trust-based DC schemes appeared to be more conservative in their approach than contract-based schemes and were still in a 'wait-and-see mode' concerning at-retirement options, according to Nils Johnson, director of retirement at Spence Johnson. He anticipated that over the next three years, 'cash and drawdown' would become the two main options being offered.[417]

Others agreed that 'now is not the right time [for trust-based DC schemes] to offer in-house drawdown'. According to Richard Butcher, managing director of independent trustee PTL: 'They've got no commercial imperative to do this… so they were quite happy to wait and see what happens. In any event, [schemes not offering drawdown] hasn't frustrated "freedom and choice" because people have always had the right to statutory transfer'. Gregg McClymont, head of retirement savings at Aberdeen Asset Management, said: 'It's such a big change, isn't it? There are so many questions around the ongoing potential role of trustees that I don't think it's a surprise that there's not been a rapid move towards a post-retirement framework for scheme members….My own view is that it would be unfair to point the finger at trustees, because they are trying to manage a situation which has changed overnight without consultation, and something that potentially fundamentally changes the nature of a pension'.

---

[415] Reported in Jenna Towler (2015) RP Inquiry: Advisers on the post-April drawdown boom, Retirement Planner, 27 August.

[416] Reported in Natasha Browne (2015) Two-thirds of schemes offering pension freedoms, Professional Pensions, 22 May.

[417] Michael Klimes (2015) Nils Johnson: Trust-based schemes have not embraced pension reforms, Professional Pensions, 24 September.

There are five reasons why trust-based DC schemes are not currently offering drawdown to their members:[418]

1. Sponsor reluctance – enterprise risk
   Providing drawdown means trustees and sponsors will be taking on more enterprise risk (organisational risk). According to Richard Butcher: 'Their concern is for the welfare and wellbeing of their staff – not people who retired 30 years ago. I think most trustees of single-employer schemes said: "We don't need to do this, we don't particularly want to do it, there's a risk to doing it, so why should we bear that risk and cost? Let's just leave it to the commercial market". It's going to be the large schemes that do it if anybody does it. J.P. Morgan got quite well advanced with their plans on it, but then the Americans decided against it because of enterprise risk'. Steve Budge, principal DC and savings at Mercer UK, agreed: 'Clearly there's a nervousness in the market in terms of clients and schemes wanting to offer some flexibility but, because of the nature of drawdown, it exposes members to a lot more risk in terms of running out of money'.

2. Governance challenges
   In-house drawdown also creates an ongoing governance challenge for trustees. As Gregg McClymont explains: 'Generally speaking, trustees' jobs stopped at retirement and so [in-house drawdown would represent] a big shift towards the trustees having a significant role in governing options for retirement income'.

3. Lack of appetite from members
   There is little demand from members for drawdown – most retirees have been taking their DC benefits as cash, since they have very small DC pots (although they may also have a DB scheme).

4. Lack of product innovation
   Pension scheme members would like both flexibility and security of income, but as Gregg McClymont said: 'That's not straightforward to achieve, so I'm sympathetic to the challenges trustees are facing. In terms of the product side of things, asset managers are developing income products and multi-asset products, but that product innovation is at a relatively early stage, not least because those at retirement at the moment are, according to all the evidence, tending to take cash in larger quantities than investing in markets'. Steve Budge agreed: 'There's definitely a lack of product innovation. I don't think anyone's at fault here, there just hasn't been much time to put things together'.

[418] Sara Benwell (2015) Five reasons trustees should avoid providing drawdown solutions, Pensions Insight, 4 December.

5. Lack of scale

   The final issue relates to the inability of many schemes to generate sufficient scale to provide true value for money with in-house drawdown. Helen Ball, head of defined contribution at Sackers, argues that only the big master trusts or perhaps some of the very largest single-employer schemes will ever be able to achieve the necessary scale: 'Over time, it is more likely that they'll think about some of the new flexibilities, because they've the scale to provide the funding to do it'.

A way around this problem in due course would be to work with an established provider of drawdown solutions. Mr Butcher explains: 'The trust could buddy up with a commercial provider or perhaps a commercial master trust, so the individual can move across from the single-employer trust to a commercial master trust and gain access to drawdown'.

The slow response of trust-based DC schemes to 'freedom and choice' was confirmed by Willis Towers Watson's *Pensions Flexibility Study* published in January 2016. Of the 222 trust-based schemes surveyed, 61% did not provide access to any form of flexible drawdown, 7% provided flexi-access drawdown within their trust, while the rest (32%) allowed members access to a drawdown facility by transferring their assets to one or more pre-selected drawdown providers. However, 71% of the schemes allowed members access to one lump-sum payment without the member having to transfer their DC assets, while 19% allowed up to two withdrawals. Further, 62% of the trust-based schemes continued to target tax-free cash and annuity purchase as their default option for members. This contrasts with the contract-based schemes surveyed, where 80% were offering a blended strategy that aims to accommodate a range of member-retirement choices.[419]

The May 2015 Linklaters survey cited above found that around 70% of trustees and advisers agreed that DB pension scheme members should be allowed to transfer out, with 44% of employers having already been contacted by members about moving their pot.[420] However, there was little sign that DB schemes would offer such flexibilities as drawdown at this stage. In September 2015, Aon Hewitt published the results of a survey of more than 200 DB schemes. Eight out of ten have taken some action in response to the new regime. One third automatically provide retiring members with transfer quotes, and a further 20% intended to do so soon; 40% of schemes providing quotes in retirement packs also offered members access to financial advice. It was mainly the larger schemes that were doing this. Ben Roe, head of liability management at Aon Hewitt, said: 'Large schemes have generally been at the forefront of introducing risk reduction measures, so not surprisingly they have also led on

[419] Reported in Kristian Brunt-Seymour (2016) Nearly two-thirds of trust-based schemes have not embraced drawdown, Professional Pensions, 26 January.

[420] Reported in Natasha Browne (2015) One in five schemes to offer flexi drawdown, Professional Pensions, 11 May.

making changes in response to the Budget, as more than a third are planning to quote transfers in the retirement pack. This, in turn, can lead to significant savings against funding and long-term targets. There is evidence that some companies are also taking advance credit for likely liability gains in their profit and loss'. But the survey found less than 10% of schemes were making any additional support available to members at retirement. Mr Roe said: 'What is disappointing is the relatively low numbers of schemes which are offering meaningful support to members on what is now a more complex decision for them. Not only does additional support lead to better member decisions but our statistics show that this also leads to more members taking a transfer, which ultimately means more cost and risk reduction for companies'.[421]

An analysis of requests for information made by Portal Financial between September 2014 and September 2015 on behalf of its clients to their pension schemes indicated that scheme members could wait up to three months to receive the information in the case of DB schemes and up to 5 weeks in the case of DC schemes. Managing director Jamie Smith-Thompson said: 'Currently, many pension schemes are unable, or unwilling, to support the new pension flexibilities and, therefore, members of these schemes need to transfer to a provider that can. However, a transfer cannot take place until we are in receipt of the latest information and, only at that point, can we provide the necessary advice on a possible transfer. It is, therefore, incredibly important that it is provided in a timely manner. Clients simply don't understand the delays, as it just doesn't seem possible to them that their financial services providers don't have the information at the touch of a button. The delays can be very stressful and many scheme providers urgently need to improve their response times. We believe that action is necessary and pension transfers should be as simple as changing bank accounts with clear service levels and timings that need to be adhered to'.[422]

### *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.[423] The term SPEEDOMETER is used to reflect the fact that spending optimally is related to the speed with which assets are drawn down and a SPEEDOMETER is a useful device both for measuring and influencing speed.

---

[421] Reported in Jack Jones (2015) Eight in ten DB schemes adapt offering for pension freedoms, Professional Pensions, 17 September.

[422] Jenna Towler (2015) DB schemes' 'slow' response time holding back pension transfers, Professional Adviser, 12 October.

[423] David Blake and Tom Boardman (2013) Spend More Today Safely: Using Behavioral Economics To Improve Retirement Expenditure Decisions With Speedometer Plans, *Risk Management and Insurance Review*, 17(1), 83-112.

Given that most people are 'humans' rather than 'econs', we should recognise that the retirement stage of a pension plan is just too complex for most people to deal with without any outside support. We also need to recognise that retirees: have different expenditure needs during different phases of their retirement and need to pace their spending throughout retirement in order to optimise the use of their lifetime assets and income and their ability to make intended bequests. It is important to recognise that a retiree needs to work out the desired spending pattern in retirement before deciding on the appropriate investment strategy for their pension pot.

With these considerations in mind, a SPEEDOMETER plan has the following five components – and 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. Key components of the plan are budgeting and projecting expenditure. The remaining components implement the plan. Ideally, planning should occur throughout the accumulation phase. It is very important as retirees approach retirement for planning to take place to determine the optimal age for securing a guaranteed life-long income.
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. The plan uses insurance, when available and cost effective, to cover contingency events, such as repairs to white goods, central heating and car. Some expenditures in retirement will be lumpy (e.g., holidays and car purchase), so it is important to have a 'rainy day' fund of liquid assets in order to retain as much flexibility as possible with retirement assets. The lower the level of insurance used, the greater the 'rainy day' fund needs to be. Care costs are potentially the greatest spike to expenditure. There is currently a limited insurance market for care costs other than immediate-needs annuities that can be purchased when retirees enter care homes. This lack of pre-funded long-term care insurance requires the mass affluent to retain a considerable fund against this possibility.[424] For those with limited means, the state will provide care and this

[424] Psychological barriers, due to loss aversion, to buying long-term care insurance might be partially overcome through bundling the insurance with an annuity, as suggested by Christopher Murtaugh, Brenda Spillman, and

illustrates the need for retirees to be aware of how they can maximise means-tested benefits to their advantage.

4. Fourth, secure 'adequate' income. Many people will, of course, wish to secure a higher standard of living in retirement than the essential level if they have sufficient resources to meet their needs and wishes throughout retirement, including desired bequests.
5. Fifth, achieve a 'desired' standard of living and make bequests. The plan offers a simplified choice architecture for managing any residual wealth with the aim of achieving a 'desired' standard of living in retirement, while allowing part of the remaining wealth to be bequested at a time of the retiree's choosing.

A SPEEDOMETER plan deals with the behavioural traits that people face:

- Critically, the plan utilises inertia and procrastination, since, once enrolled, individuals do not tend to change their minds
- The plan accepts individuals suffer from overconfidence and have self-control problems and would benefit from using commitment devices
- If annuities are used in stages 4 and 5 of the plan, they could be capital-protected or money-back annuities, since these deal with the aversion to losing control of and the fear of loss of capital on early death. Such annuities have the following advantages:
    - They remove the single biggest consumer objection to annuities: 'If I die soon after I retire, the annuity provider will keep my fund'
    - The 'live or die' guarantee of getting your money back provides a simple underpin
    - They are very easy to explain and for consumers to understand
    - A lump sum repayment rather than the continuation of current income for a guaranteed period of 5 or 10 years is easier for people to understand and is generally more highly valued
    - The cost of the guarantee is transparent and allows consumers to make an informed choice.
    - They automatically phase pension funds into full annuitisation (up to the limit specified by the annuitant).
    - They remove a significant barrier to pre-retirement saving: people won't save voluntarily if they don't believe that it pays to save.
- The phasing of annuitisation deals with the aversion to making large transactions and possible regret about getting the timing wrong

---

Mark Warshawsky (2001) In Sickness and in Health: An Annuity Approach to Financing Long-Term Care and Retirement Income, *Journal of Risk and Insurance*, 68, 225-54.

- The plan is a universal one, although only the mass affluent will be in a position to make use of all five stages. Except for plan members who reveal themselves to be extremely risk averse, the annuity will not be the most prominent feature of the plan for the mass affluent in their early years of retirement. For most mass affluent plan members, what will be discussed first will be the management of retirement assets in accordance with the member's attitude to risk. Annuities will merely be one component of the management of retirement assets. This helps to overcome framing effects.

### *3.5 Defaults and default pathways*

In this Section, we examine some proposals for defaults and default pathways that reflect differing individual and household circumstances. In particular, we need to consider how nudging and the use of a choice architecture in decision making – ideally also combined with guidance or advice – can be used to help 'humans' make optimal solutions for themselves.

#### 3.5.1 Default and default pathways with SPEEDOMETER plans

It would clearly be better if a retirement expenditure plan like the SPEEDOMETER plan were to be adopted by a fully engaged consumer working closely with an adviser. But could someone who was not engaged or not willing to seek advice be auto-enrolled or defaulted onto the plan?

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. There needs to be a co-ordinated approach to overcome inertia and procrastination, the two key behavioural barriers to effective decision making. Similar strategies can be used to get them to start the plan as was used to get employees to start a SAVE MORE TOMORROW (or SMART) plan, e.g., sign up now for a plan that starts on the retirement date in six months' time, with the option to drop out at any time beforehand.[425] 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. The extent and timing of the annuitisation will depend on the initial assessment by the adviser and the subsequent

[425] Shlomo Benartzi and Richard Thaler (2004) Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving, *Journal of Political Economy*, 112, S164-S187. A SPEEDOMETER retirement expenditure plan is the natural counterpart to the SAVE MORE TOMORROW (SMART) plan introduced by Benartzi and Thaler to help people save more for their retirement and which was adopted by the Government when it introduced auto-enrolment in the UK in October 2012.

realised investment performance. Couples will need more flexibility than singles. High net worth retirees will need more flexibility than the mass affluent.

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 desired
- Tax position
- Risk attitude
- Risk capacity.

Given this information, the following default pathway can be established:[426]

- 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.[427] 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. The member should be aware that any cash withdrawn from the pension pot above the tax-free amount might have tax consequences

---

[426] This is similar to the 'goal segmentation' approach of Moshe A. Milevsky (2009) *Are You a Stock or a Bond? Create Your Own Pension Plan for a Secure Financial Future*, Pearson Education, Upper Saddle River, New Jersey.

[427] This proposal has industry support, see for example, Jamie Smith-Thompson, managing director at Portal Financial: 'If a client has a pot of £300,000 and needs £10,000 a year to live on, they can underpin their pot with an annuity or a guaranteed income product. This ensures they are safe and can take more risks with the rest of their pot' (quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January).

- 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, 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[428]
- 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 a process that 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 a true default which requires no action at all by the member.[429]

---

[428] As discussed in Chapter 2.

[429] See, for example, Yvonne Braun (2015) *Identifying the Challenges of a Changing World*, Association of British Insurers, February;

Ideally, the plan also involves annual reviews with the adviser covering: needs (including medical and care needs), state benefits, drawdown strategies for non-pension assets (such as housing equity release), inheritance, and tax. A key task of the adviser is to assess the initial attitude to risk of the member in order to determine the appropriate investment strategy for assets that have not been annuitised and to consider whether this has changed since the last annual review.

It is also important to take actual investment and health experience into account at each annual review. Similarly, it is important to recognise that attitudes themselves can be flexible. Attitudes to annuitisation can also change. Once a retiree has held an annuity for some time, they can appreciate better the value of annuitisation and be less averse to further annuity purchases.[430]

If the member does not have an adviser, it should still be possible for the member to choose from a set of well-designed default pathways using a decision tree.

### 3.5.2 Other default proposals

#### *3.5.2.1 Age UK proposal*

In December 2014, Age UK proposed a default plan with the following components:[431]

- Maximise state pensions and means-tested benefits
- Gain a full picture of all pension and other assets
- Consider merging small pots
- Be aware of taxation
- Consider using DC pensions to repay expensive debt
- Maximise income from other financial assets
- Decide on which retirement income product:
    - Consumers will need to decide (with or without the help of a financial adviser) whether they prefer the lower secure lifetime income from an

---

https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Pensions/Retirement%202050%20Identifying%20the%20challenges%20of%20a%20changing%20world.pdf

[430] Studies show that people with annuities are happier: they can spend their annuity payments in full each period, knowing they have full longevity risk protection (e.g., Constantijn Panis (2004) Annuities and Retirement Well-Being, in Olivia Mitchell and Stephen Utkus (eds) (2004) *Pension Design and Structure: New Lessons from Behavioral Finance*, Oxford University Press, Oxford).

[431] Dominic Lindley (2014) *Dashboards and Jam-jars: Helping Consumers with Small Defined Contribution Pension Pots make Decisions about Retirement Income*, Age UK, December;
http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/dashboards_and_jamjars_helping_modest_savers_December_2014.pdf?dtrk=true

annuity or take the risk that entering an income drawdown plan could see them having to reduce their income or run out of money. For some, they may want to choose a mixture of these two options or enter income drawdown with a view to buying an annuity at a later date

- Take difficult decisions about income drawdown:
    - Consumers should try and avoid high-charging income drawdown products and understand how their pension should be invested and how much they want to withdraw each year to avoid running out of money. They should think about what income they would live on if their DC pension ran out. These decisions will be difficult for them to undertake on their own
- Shop around for an annuity and declare medical details to qualify for a higher rate
- Integrate decisions about small DC pots with decisions about state pensions: It is essential that decisions about how to access small DC pension pots are aligned and integrated with decisions about when to access state pensions and whether to use some or all of their DC pot to buy additional state pension.[432]

#### *3.5.2.2 The Strategic Society Centre (SSC)*

In a report published in March 2015, *Default Reform: Preventing Low Incomes with an Automatic Income Plan*, the SSC proposes a default 'automatic income plan' that would deliver 'predictable, secure (guaranteed) and good-value income' in retirement.[433] It believes that this is necessary to protect savers who have little experience of investment. The SSC's own research found that only a quarter of 55- to 65-year-olds keeps track of the stock market, while only one in three say they are aware of inflation levels. Furthermore, only 12% of low-income pensioners have an investment product and 34% do not even have a savings account. James Lloyd, SSC director and author of the report, say: 'The results of the Government's April pensions revolution will ultimately depend on the financial capability and decision-making of millions of UK workers. However, this detailed research on the financial capability of DC pension savers approaching retirement shows worrying levels of financial disengagement, raising questions as to how effective people will be in seeking

[432] The Age UK report also discussed the following proposals:

- Pensions Dashboard: Consumers should be provided with a Pensions Dashboard which should be able to gather data electronically from all their schemes. The Dashboard should display details of all of the consumer's DB and DC schemes in one place alongside their state pension entitlement.
- Pensions Jam-Jars: Pension providers should develop new tools to help people budget, control their spending and set aside money for future goals. These could also help them manage the inevitable trade-offs and conflicts which exist when taking a retirement income. These tools could help consumers decide how much money to take out of their pension each year. Once consumers have made a plan, specific alerts can be used if consumers are departing from it or at risk of running out of money or triggering a higher rate tax charge.

[433] James Lloyd (2015) *Default Reform: Preventing Low Incomes with an Automatic Income Plan*, Strategic Society Centre, March; http://strategicsociety.org.uk/wp-content/uploads/2015/03/Default-Reform-Preventing-low-incomes-with-an-automatic-income-plan.pdf

good-value, appropriate products throughout retirement, that protect them from changes in inflation and investment risk….Our research suggests the Government's pension freedoms could repeat the experience of countries like Australia, where 'freedom and choice' for retirees has ultimately resulted in lower incomes and growing calls for reform'. The report warns that there is a 'significant risk that the April 2015 changes to DC pension taxation will result in an increase in pensioner poverty' with many pensioners running out of money before they die.

#### *3.5.2.3 Adrian Boulding's three step proposal*[434]

In January 2015, Adrian Boulding, chairman of the Pension Quality Mark, proposed a default that uses McKinsey's 3 x 3 rule:

- Give people a set of three choices
- Then another set of three choices (based on the first choice)
- Followed by no more than a set of three choices.

In a retirement income context, savers are given the following three choices about their pension pot:

- Take it all at once
- Leave it all invested and draw a regular income
- Give it to an insurance company and get an income for life.

If the saver chooses the second option, the next set of choices relate to the type of investment fund they want to use:

- Low risk, drawing 4% a year
- Medium risk, drawing 5% a year
- High risk, drawing 6% a year.

The third set of choices relate to protecting against the pension pot running out before the member dies:

- Make a single payment of £5000 to an insurance company, which will guarantee payments of £200 per month starting at the age of 85
- Regular payments of £25 a month to an insurance company, which will again guarantee payments of £200 per month starting at the age of 85
- Do nothing and rely on other sources of income

Mr Boulding also proposes minimum standards for flexible drawdown products:

---

[434] Laura MacPhee (2015) Three steps to navigating pensions freedoms, Pensions Insight, 27 January; http://www.pensions-insight.co.uk/Story.aspx?storyCode=1474426&source=Adestra

- A simple fund range
- Low charges
- A suggested withdrawal rate
- A slick operation for changing monthly payments or taking one-off lump sums
- Ongoing reviews
- Strong governance.

#### *3.5.2.4 Retirement Security Project proposal: Automatic Trial Income*[435]

A study from the Retirement Security Project in Washington DC in 2008 proposes that 'When they retire, individuals would have a proportion of their DC pot allocated to a two-year trial annuity unless they opted out. After two years, the annuity would convert to a permanent one, unless members dropped out. Employers would choose both the annuity provider and negotitate a group annuity rate. They would also choose the type of annuity, such as level or index linked'.

#### *3.5.2.5 Michael Johnson's auto-protection proposal*

Michael Johnson from the Centre for Policy Studies published *Auto-protection at 55* in February 2015. The proposal – which could also be called auto-annuitisation – is for a default option for people approaching private retirement age whereby their pension pot would be automatically enrolled in a not-for-profit national auction house for index-linked annuities, the same model that is used in Chile. This would stop them running down their savings too quickly.

Mr Johnson argues that: 'There are legitimate concerns that some people may fail to purchase suitable retirement income products. People approaching retirement need to be encouraged to purchase retirement income products that limit downside risks, notably longevity, investment and inflation risks that almost all of us are incapable of managing by ourselves. People would either opt-out or find themselves with a deferred lifetime annuity, which would be a joint-life policy if they are married. That is exactly what goes on in several other countries, places like Singapore and Switzerland. All aspiring annuity providers, which could include the state, would be required to participate [in the auction]. Initially only a limited number of standardised single and joint-life, inflation-protected lifetime and deferred annuity contracts would be listed. Pre-auction aggregation of small pots by the house would encourage stronger bids'.[436]

---

[435] William G. Gale, J. Mark Iwry, David C. John and Lina Walker (2008) *Increasing Annuitization in 401(k) Plans with Automatic Trial Income*, Discussion Paper № 2008-2, The Retirement Security Project, Washington DC.

[436] Quoted in Sam Brodbeck (2015) Govt urged to default savers into deferred annuities, Money Marketing, 20 February.

There was little industry support for this proposal. A *Pensions Buzz* poll in Professional Pensions showed that only 25% of respondents supported the idea of defaulting people into an index-linked annuity.[437]

Supporters of the proposal made the following comments:

- Although they will need to understand what this means for them (and their spouse) assuming it's a single life annuity?
- As long as the default includes a market listing of the available annuities and the default is the best value after they have completed a health assessment
- But we have seen how politics can override good sense
- Freedom of choice is important, but a sensible default option that works for most is even more important
- I would also remove the option to take any tax-free cash and the op-out option! Maybe this would encourage them to remain in contact with administrators
- It is surprising this was not introduced in 1997, when limited price indexation (LPI) became compulsory for DB Schemes
- Something is better than nothing even if it is a very small growth
- There is a need for a great deal of education here
- Yes there should be a default option. For most ordinary working people, the new 'freedoms' will present a horrifying dilemma about financial matters that they just do not understand.

Opponents of the proposal made the following comments:

- A thousand times no! Inflation-linked annuities would be appalling value for money, and would lead to more pensioner poverty than just leaving them to use their own common-sense (and their computer)
- And they should be required to make a calculated decision on something as important as this. This default option is unlikely to be the best one
- Annuity rates – especially if inflation linked are very poor value
- As that is definitely not what most people want or need, it is a daft idea
- Definitely not. These are apt to be particularly poor value for money
- Depends on individual circumstances. A default approach would encourage lack of involvement in a vital decision
- Few members are likely to purchase an annuity on reaching retirement age
- Firstly, index linked annuities are of questionable value. Secondly, there is no need for a default at retirement. People will have to make a choice, otherwise they get

[437] Michael Klimes (2015) Industry figures reject inflation-linked annuity default, Professional Pensions, 26 February.

nothing, and I would favour forcing a choice rather than drifting into an unsuitable option. Why have 'freedom and choice' if you are going to do otherwise?

- In a world where the mantra has long been 'freedom of individual choice' this is possible the most ridiculous and repellent suggestion yet
- Individuals need time to decide what benefits are right for them – defaulting them into an arrangement which may not be appropriate for them, and difficult/impossible to get out of
- Inflation linked annuities are poor value. You have to live for about 15 years to break even. What about ill-health, lifestyle, joint? Who chooses the provider? There should be no defaults. We need to encourage engagement. If people are ready, or don't want to receive a retirement income, it shouldn't be forced on them. Would trustees take on the liability for making financial decisions for members, which turn out to be wrong? They had better increase their liability insurance PDQ. MADNESS
- It is bad enough that the majority get lumped into a default fund that someone has decided is best for them!
- Make them do something if they want to take money
- Members have to make a choice at this point, even if their understanding is not great
- Surely the Budget 2014 changes have overtaken this approach?
- The annuity should be flat rate
- The bewildering landscape of pensions along with jargon and policies of big pension providers will be such that savers are bamboozled into following a route they did not wish to. Only by the time they realise it will be too late to reverse
- The choice should be between capped drawdown and an annuity, with the pot remaining invested if the member fails to make a choice
- There should be no default option; whilst it is just about supportable from an investment angle, the retirement choice has to be individual. The decision is too important – at some point the individual has to take ownership for their future
- They must show the options and let the member choose
- They need to be forced to decide or the pension system will get the blame when they feel they have lost out in some way, don't decide then nothing comes your way in retirement, that should get the message through
- This is a backwards step and unlikely to be the best option for members. Inflation-linking is a gambol [sic] and the provider is the bookmaker
- This seems reasonable enough, but great care must be taken to ensure that the default is always one of the best value annuities available on the market, otherwise there'll be tears
- This would be far too prescriptive
- Why? It is better if they make an active choice with the right advice.

In the light of these criticisms, on 6 March 2015, Mr Johnson changed his default from an annuity to drawdown, whereby 5% of the pension pot is drawn down each year from the age of 55, unless the member instructs otherwise. His justification for the change was that he had given insufficient weight to the value of flexibility. The revised proposal could have automatic annuitisation later in retirement.[438]

Supporters of layering plans, such as the SPEEDOMETER retirement expenditure plan, would argue that both of Mr Johnson's proposals were in fact sensible, but for different segments of retirement expenditure. The proposal to default into an index-linked annuity is sensible for essential expenditure. As previously mentioned, if 'essential' means what it says, then there is no real flexibility in how to meet it. Further, if essential expenditure is inflation linked, as it will be and is required for as long as the member lives, then there is no real alternative to buying an an index-linked annuity, however 'expensive' this may be, or a guaranteed drawdown product offering inflation uprating. Just because something is 'expensive', does not mean that it is bad value. Flexibility, on the other hand, is valuable when it comes to meeting adequate and desirable expenditure and contingent expenditure such as a repair bill. However, there would probably be disagreement with one aspect of the proposal and that is about the starting time. It would not make sense to begin the decumulation process at age 55 regardless of the wishes of the member. It should start when the member wants it to start.

#### *3.5.2.6 Automatic deferred annuitisation*

With this proposal, starting at some age, typically in the 40s, an increasing share of pension contributions would go to purchasing units of a deferred annuity that would be received when the person retired and started receiving benefits.[439]

The idea comes from the US and the first company in the US to introduce it – with the name Lifetime Income Strategy – was United Technologies (UT), an aerospace and building technology company with around 200,000 employees.[440] UT automatically enrolls employees into the strategy, which was designed by AllianceBernstein, unless they choose to remain in their existing equity, bond or target-date mutual fund until they retire at an assumed age of 65. At age 48, the employee's savings are gradually moved into variable annuities with a guaranteed minimum level of lifetime income for life from age 65. The

[438] Jack Jones (2015) Johnson backtracks on default annuity proposal, Professional Pensions, 6 March.

[439] The proposal was introduced in J. Mark Iwry and John A. Turner (2009) New Behavioral Strategies for Expanding Lifetime Income in 401(k)s, in William G. Gale, J. Mark Iwry, David John, and Lina Walker (eds) *Automatic: Changing the Way America Saves*, Brookings Institution Press, Washington, DC.

[440] Reported in Tara Siegel Bernard (2012) A 401(k) That Promises Never to Run Dry, New York Times, 13 November;
http://www.nytimes.com/2012/11/14/your-money/a-401-k-that-promises-income-for-life.html?pagewanted=all&_r=0

variable annuities continue to invest in equities and bonds – although in decreasing amounts – but also guarantee that employees can withdraw a minimum sum each year, even if the market crashes. By the time the employees reach 60, all the investments have been switched into a secure income fund.

The annual income is a fixed percentage of the market value of the secure income fund. For example, if the fund was valued at $200,000 and the payout rate was set at 5% – which is based on the average rate at which the deferred annuities are acquired by UT over time – a 65-year old retiree could withdraw $10,000 annually for the remainder of their life, irrespective of market conditions, including the case where the account becomes depleted. The level of guaranteed income is recalculated annually on the employee's birthday or when new contributions are made. Three insurers – Prudential (US), Lincoln Financial and Nationwide (US) – bid every quarter for UT's annuity business and the annuities are insured up to a cap by state guaranty associations. Employees can choose a joint benefit to cover a partner, in exchange for a lower payout rate. Further, any residual fund on death can be bequested.

The fees are lower than for standard variable annuities whose fees have been described as 'notorious'. Workers below age 48 pay 0.13% p.a. charges on the underlying index funds. The insurance cover provided in the secure income fund costs 1% p.a. So total costs, including investment and insurance fees, are 0.21% of the fund value at age 48, rising to 1.24% at age 60 and above. Fees of this size take a substantial amount out of the value of the pension pot when compounded over a 30 year retirement, but it would be worse if the retiree took out a large lump sum part of the way through retirement since they would be paying for a longevity protection guarantee that they never used.

Although UT was the first US company to use automatic deferred annuitisation, it is not the first to combine target-date funds and annuities. Prudential (US) has offered this combination under its IncomeFlex plan since 2008. In this case, the fixed minimum payout is 5% p.a. irrespective of market conditions. This guarantee costs 1% on top of fund management fees. More than 73,000 employees in more than 7,000 pension schemes participate in the plan, with some now being auto-enrolled. According to a survey of more than 500 large US employers conducted by Aon Hewitt in 2012, 16% offer products within their 401(k) plans, such as annuities, that allow retirees to receive a lifelong income stream. The survey revealed that more employers would offer such insurance-related options if US regulators made it easier for them to do so. Employers are concerned about breaching their fiduciary duties to employees, given the much higher probability of insurance company insolvency in the US than in the UK.

The success of automatic deferred annuitisation in the US is very encouraging and suggests that, if it can work in the US, it can also work in the UK.

### *3.5.2.7 The Murray Report's proposal for a comprehensive income product for retirement*

In November 2014, the Australian Government published the Final Report of the Financial System Inquiry,[441] known as the Murray Report after its Chair, David Murray. The Report proposes a default pathway for both the accumulation and decumulation stages – see Figure 3.1.

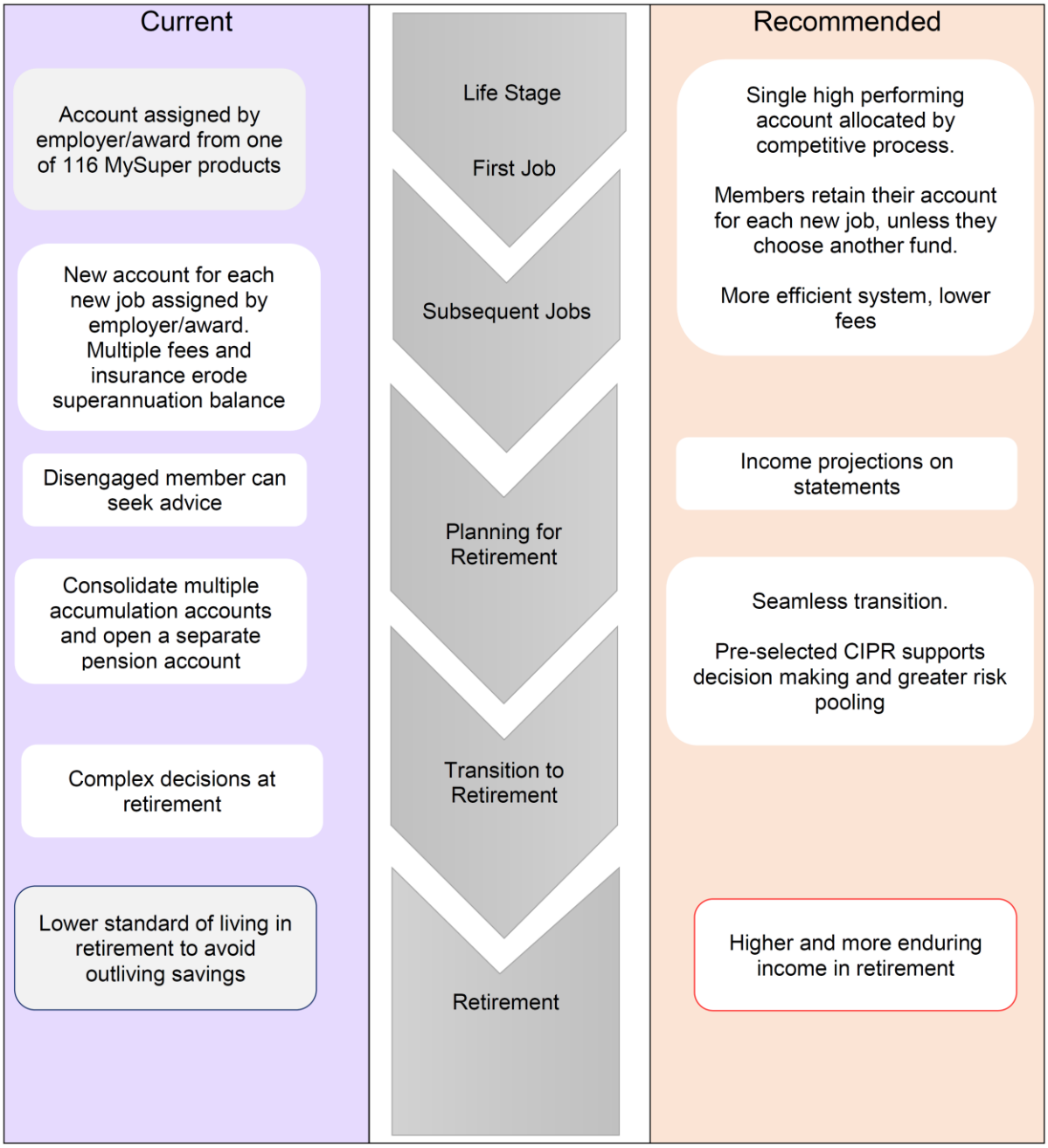
The Report argues (p.91) that:

> *Greater use of risk pooling could significantly increase retirement incomes generated from accumulated balances. This could allow individuals to allocate consumption throughout their lives better (greater dynamic efficiency) by reducing the savings required to achieve a target level of income in retirement. This could be achieved by:*
>
> *Removing barriers to new product development.*
>
> *Using behavioural biases to encourage rather than discourage the use of products that provide longevity risk protection.*
>
> *This recommendation would involve trustees pre-selecting a comprehensive income product for retirement (CIPR) option for their members. Pre-selected options have been demonstrated to influence behaviour but do not limit personal choice and freedom. They would bring the policy philosophy at retirement closer to that of the accumulation phase.*
>
> *Managing longevity risk through effective pooling in a CIPR could significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement, while still allowing them to retain some flexibility to meet unexpected expenses. An enduring income stream would give retirees the confidence to spend in retirement, which would help to sustain economic growth as the population ages and reduce the extent to which longevity risk falls on the taxpayer.*

The Murray Report proposal is an attempt to reverse the experience in Australia of 50% of Australians taking a lump sum at retirement and 25% of these running out of funds before they reach 70.

[441] http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

*Figure 3.1: A default pathway for Australian pension scheme members*[442]




[442] Source: Figure 6: The superannuation system for default fund members

In October 2015, the Australian Government accepted most of the Murray Report's recommendations, in particular:[443]

> *Inquiry Recommendation 11 — The retirement phase of superannuation*
>
> *Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.*
>
> *The Government agrees to support the development of comprehensive income products for retirement and will facilitate trustees pre-selecting these products for members.*
>
> *Trustees' pre-selection of such products will help guide members at retirement. Comprehensive income products for retirement could improve outcomes for retirees, including through increased private retirement incomes, increased choice and better protection against longevity and other risks.*
>
> *The range of products available at retirement is currently narrow and does not always meet individuals' needs and preferences.*
>
> *We will continue work to remove impediments to retirement income product development.*
>
> *Further consultation is required to develop a principles-based framework for pre-selection of a comprehensive retirement income product by superannuation trustees. This framework will be developed with regard to the outcomes of the Tax White Paper process and the Retirement Income Streams Review.*

David Murray said he was pleased the Government had agreed to remove impediments to the development of annuity and annuity-like products, as well as mandate that all pension schemes 'soft default' members into a CIPR when they stop working instead of offering them a lump sum. The proposals were also supported by Challenger, Australia's largest provider of annuities. Its chief executive Brian Benari said: 'CIPRs will help people manage complex decisions at retirement by allowing retirees to opt-in to a retirement solution, which suits their circumstances including a stable income stream, flexibility and longevity risk protection'. David Knox, senior actuary at Mercer, said mandating CIPRs was 'one of the most important steps' the Government could take to improve the system. However, David Whiteley, Industry Super Australia chief executive, said it would be 'absolutely critical' that

---

[443] Australian Government (2015) *Improving Australia's Financial System: Government Response to the Financial System Inquiry*; http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/Government%20response%20to%20the%20Financial%20System%20Inquiry/Downloads/PDF/Government_response_to_FSI_2015.ashx

there be strong oversight to ensure default-account-based pensions are designed to be in the best interest of retirees rather than market providers.[444]

### 3.5.3 Support for a default

Academic behavioural economists have supported defaults for a long time.[445] Think tanks and wide segments of industry also support the use of defaults.

#### *3.5.3.1 Pensions Policy Institute*[446]

The PPI argues that industry needs to put in place well-governed retirement income defaults that provide members with value for money and flexible access to their assets, without overwhelming them with complex choices. The interviews it conducted with DC savers found that many were 'daunted' by the array of choices on offer and want providers to offer them a default investment or drawdown choice, alongside appropriate guidance and advice. Indeed, many thought that providers had a 'duty' to offer a default, although they also recognised the need for some element of choice for those who want it.

The PPI's proposed default had the following key features:

- Simplicity – defaults should aim to broadly meet a range of needs for most of the people most of the time
- Value – 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
- Freedom to opt out – default arrangements should not lock individuals in, but flexibility may be more of a priority in the earlier years of retirement than it is in the later years
- Clear choice architecture – the default is one option located within a set of straightforward alternatives that won't overwhelm savers.

It also identified six principles to inform the design of default retirement solutions:

---

[444] Reported in Sally Rose (2015) Annuities and private pensions to replace lump sums as default for retirees, Sydney Morning Herald, 20 October.

[445] See, for example, John Beshears, James Choi, David Laibson, and Brigitte Madrian (2008) The importance of default options for retirement saving outcomes: Evidence from the United States, in Stephen J. Kay and Tapen Sinha (eds.) *Lessons from Pension Reform in the Americas*, Oxford University Press, Oxford.

[446] Pensions Policy Institute (2015) *Transition to Retirement - Supporting DC Members with Defaults and Choices up to, into, and through Retirement: Qualitative Research with those Approaching Retirement*, January; http://www.pensionspolicyinstitute.org.uk/publications/reports/transition-to-retirement-defaults

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.

#### *3.5.3.2 The International Longevity Centre – UK*

The ILC-UK supports a default strategy with annuities playing a key role:[447]

> *In the face of complexity, many individuals are likely to do nothing which means that their retirement incomes will be dependent on whatever happens to the fund. We would argue that for a significant number of people, and especially for those who have high DC wealth concentrations, buying an annuity is still the right option and should form the backbone of any default strategy. However, annuitising is likely to remain an irreversible decision, so individuals need to be given appropriate warning that they will have part of their fund annuitised (perhaps 75% of the fund so as to retain some flexibility) if they do nothing. For this reason, consumers must be given a year's warning, and the default must not kick in before they reach their respective State Pension Age. Up until this age, the pension fund should be invested in a balanced portfolio of safe and risky assets to allow for continual growth in the fund.*

However, it recommends that annuities must be rebranded as 'safe guaranteed income for life' products.

#### *3.5.3.3 The Strategic Society Centre (SSC)*

The March 2015 report of the SSC discussed above was followed up by an empirical study published in July 2015 which showed that the level of wellbeing experienced in retirement was related to the level of guaranteed income they enjoyed in retirement.[448] The SSC analysed data from the English Longitudinal Study of Ageing on over 2,000 retirees in England in receipt of a private pension. The analysis found statistically significant positive

---

[447] The International Longevity Centre – UK (2015) *Here Today, Gone Tomorrow. How Today's Retirement Choices Could Affect Financial Resilience Over The Long Term*, 16 March; http://www.ilcuk.org.uk/images/uploads/publication-pdfs/Here_today,_gone_tomorrow_1.pdf

[448] Will Parry and James Lloyd (2015) Income Security and a Good Retirement, Strategic Society Centre, 14 July; http://strategicsociety.org.uk/income-security-and-a-good-retirement/#.Vaasr60w-70

relationships between an individual's level of private pension income and a range of retirement outcomes such as:

- Spending habits (such as being able to go to the cinema or own a mobile phone)
- Sense of autonomy and control
- Life satisfaction
- Participation in community and civic society.

However, the analysis also found that the level of financial wealth was not associated with any of these outcomes.

At the same time, the SSC published a policy paper which considered the implications of the research for UK private pension policy and for the Government's position of neutrality regarding how individuals use their DC pension savings.[449] The paper argues that by adopting a position of neutrality, the Government may oversee reductions in the wellbeing of the older population as a result of the April 2015 changes to rules on DC pension savings.

The main policy recommendation is that the Government should ensure that a decent guaranteed income is the default option for DC pension savers. Other recommendations include:

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

Stephen Lowe, group communications director at Just Retirement, said: 'This report provides unprecedented insights into how people derive wellbeing from guaranteed income throughout their retirement. With so much attention being focused on the option to access pension savings as cash, the findings demonstrate the real benefits of treating pension savings as just that – a source of guaranteed pension income for life'.[450]

---

[449] James Lloyd (2015) *Income, Security and Wellbeing: Helping savers choose a good retirement*, Strategic Society Centre, 14 July; http://strategicsociety.org.uk/wp-content/uploads/2015/07/Income-Security-and-Wellbeing.pdf

[450] Quoted in Helen Morrissey (2015) Think tank calls for guaranteed income DC retirement default, Professional Pensions, 14 July.

### *3.5.3.4 National Association of Pension Funds (NAPF)*

A report published by the NAPF in January 2015 as part of its Understanding Retirement Research Programme concluded: 'To give savers the best possible chance of managing their money, we will need to give them three things:

- Clear pathways that are easy-to-understand and provide access to good-value solutions
- Visible and easy-to-obtain guidance that makes savers aware of their options, and
- High-quality products designed to meet the needs of savers.

The NAPF's own research showed that '82% of the retired and 78% of the working people in this group said they would rather have a secure income for retirement than a pot to dip into', implying that 'lifetime annuities remain the most obvious mechanism for achieving this'.[451] Graham Vidler, director of external affairs at the NAPF, concludes that 'what's really needed is a default retirement pathway'.[452]

We participated in a NAPF seminar on 27 January 2015 which discussed the above report. We list the key comments made at the seminar:

- Government talk is about 'freedom and choice', but the pensions industry (schemes, employers, providers) believes that there is a pressing need for default solutions that combine drawdown with longevity insurance
- The mass market is the group with the most urgent need for default solutions
- There is a real danger that if people are not nudged/defaulted, they will withdraw all of their pot because they believe that they can 'do better' themselves and also because they do not trust pension providers. The biggest danger is that they will fall victim to scams
- The idea is to establish a simple set of default pathways. Possibly three options. But many will choose the middle option, which in effect becomes the default-default
- There needs to be realism about the extent of member engagement. The reality is that most are defaulters – they will not engage. Fiduciaries (trustees and investment governance committees (IGCs)[453]) will have to choose the default. This will be low-risk because they will be worried about liability

---

[451] National Association of Pension Funds (2015) *The Unpredictability of Retirement, Understanding Retirement: An NAPF Research Programme*, January (http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0425_understanding_retirement_first_report.pdf);
Jackie Wells (2015) Uncertainty ahead for DC members, Engaged Investor, 9 February 2015 (http://www.engagedinvestor.co.uk/uncertainty-ahead-for-dc-members/1474457.article)

[452] Graham Vidler (2015) Helping hand: Why ordinary savers will need more than Pension Wise, Professional Adviser, 1 April.

[453] Discussed later in the Chapter.

- We need to decide what 'good' looks like. It has to be good for the majority, it cannot be good for everyone. It needs to be well understood (in term of risks, guarantees, etc), demonstrate value for money and have clear guidelines on the maximum percentage of the fund that can be withdrawn. So the default-default might be capped drawdown plus longevity insurance
- The NAPF research shows that consumers in mass market want a secure lifetime income, but this is made more difficult by the 'freedom and choice' regime, the lack of affordable regulated advice, and the lack of suitable products
- Consumers do not understand the implications of marginal tax rates or longevity risk (the dispersion around the average). So the Government message 'it's your money' requires a complicated caveat '… but subject to marginal tax rates and to how long you will live' etc. Guidance is not enough – people need clear and simple to understand solutions; most will not engage
- There is no need for policy intervention to allow defaults, as schemes can do this now (according to a pensions lawyer present)
- Many employers/schemes will not want responsibility for default products – they need a third-party solution, i.e., to make the default a transfer to an outside scheme – most likely a master trust
- Governance is crucial. There is a vital role for DC scheme trustees and IGCs. There also needs to be strong backing from regulators and policy-makers. We need to build on the NAPF's quality mark. However, there are serious challenges:
    - Putting the right governance in place will be challenging – the governance issues are far more complicated than with accumulation
    - Who is responsible for governance? Employers unlikely to want this liability; trustees/IGCs will be worried about liability too
    - The NAPF's quality mark involves a charge cap, yet there is widespread provider/adviser opposition to a charge cap in decumulation
- It was noted that there is very little sign of product innovation. This was put down to first-mover disadvantage in a completely new landscape
- There was general view that longevity insurance needs to be sorted out at the point of retirement/drawdown, with around 10% of the pot being used for a deferred annuity
- There needs to be a minimum degree of engagement with members, since schemes do not know members' bank account details because contributions come via the employer's payroll system
- Camilla Barry, partner at Macfarlanes, argued that a default option would help to remove the risk that trustees and employers face in terms of making decisions and giving advice: 'It may be useful to think about having a default as well as pathways. People that don't make choices would be tipped into the default option which may be capped drawdown with the purchase of deferred annuity – a model product that will work for most people'. Patrick Heath Lay, chief executive officer at B&CE, said

'while trustees would need to ask people which route they would want to do down, they would also have to pick a centralised route with an element of risk removed'.[454]

#### *3.5.3.5 National Employment Savings Trust (NEST) Consultation*

Further support for a default option was contained in response to a NEST consultation released in March 2015.[455] Paul Todd, assistant director of investments at NEST, said: 'There is a remarkable consensus for big groups of people who have been automatically enrolled for some straightforward choice architecture and not too much confusing choice and definitely, in large groups, the need for default pathways… I think the two main things which have come out are the need for flexibility in the early years of retirement and the point that people at some point in their accumulation phase need to get some insurance for living longer than expected. I think the emerging consensus was that at some point you need to protect people from longevity risk'.

#### *3.5.3.6 Steve Webb*

While Steve Webb, the former Pensions Minister, dismissed the idea of creating an at-retirement default withdrawal system, he has conceded that this might be appropriate at a later time in retirement: 'It is good to give people financial flexibility in their early 60s, but the question is whether we want people to have to make active financial decisions throughout what could be a 30-year retirement'.[456]

### 3.5.4 Opposition to a default

A *Pensions Buzz* poll in Professional Pensions in March 2015 showed that a significant minority opposed a default retirement option.[457] In response to the question 'Should there be a default for DC members when they reach retirement age?', 49% answered 'yes', while 46% said 'no', with the rest undecided. The main reason given for supporting the default was the recognition that many people, while needing an income product, did not want to or were not able to manage their investments, particularly as they got older: 'As an industry, we must be able to design an "annuity plus" product', but 'the default should exist as a safety net, as a last resort'. Typical reasons for opposing the default were: 'Default option absolves individuals of responsibility. Who takes ownership and deals with problems caused

[454] Reported in Stephanie Baxter (2015) Default option for decumulation 'is crucial but challenging', Professional Pensions, 27 January.

[455] Reported in Michael Klimes (2015) Industry supports DC retirement default says NEST, Professional Pensions, 16 March.

[456] Reported in Taha Lokhandwala (2015) Defined ambition not just an 'academic exercise' – Steve Webb, Investments & Pensions Europe, 8 June.

[457] Reported in Michael Klimes (2015) Industry questions value of at-retirement default option, Professional Pensions, 13 March.

by lack of understanding?' and 'A one-size-fits all approach would disadvantage a large minority of retirees'.

The poll also showed strong opposition to a default retirement option that was not initiated by the scheme member. Responses to the question 'If there were such a default, what should it be?' were:

- 64% – stay invested until member makes an active decision
- 13% – index-linked annuity
- 9% – capped drawdown followed by annuitisation at 75
- 9% – flat annuity
- 4% – capped drawdown
- 2% – cash/cash-like fund.

The general view was that peoples' circumstances were too varied and complex to create a comprehensive default suitable for everyone.

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

An important feature of the success of any retirement expenditure plan will be the information, advice and guidance received by the member. While this would appear to be obvious, there are important regulatory distinctions between information, advice and guidance in the UK. It is possible that customers will get confused by the distinctions.

#### 3.6.1 The distinction between information and advice

The FCA's guidance consultation *Retail Investment Advice: Clarifying the Boundaries and Exploring the Barriers to Market Development*[458] in July 2014 defined the 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. The provision of information, such as facts about the performance of investments, the terms and conditions of investment contracts, or the price of investments, does not constitute giving regulated advice if the investor alone decides whether to act on the basis of this information. Regulated advice, on the other hand, involves recommending a course of action or giving an opinion or making a judgement on the merits of, say, buying or selling an investment. If information is provided in a way that seeks to influence or persuade, then it may be classified as regulated advice. For example, if the provision of information about the price of an investment is given at the same time that the firm is indicating that it is a good time to buy, then this may constitute regulated advice.

[458] Financial Conduct Authority (2014) *Retail Investment Advice: Clarifying the Boundaries and Exploring the Barriers to Market Development*, Guidance Consultation GC14/3, July; http://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf

Two additional criteria need to be taken into account before deciding whether or not information is classified as regulated advice: 'suitability' and 'appropriateness':

- If, based on a consideration of a person's circumstances – which would cover their knowledge and experience in the investment field, their financial situation, including ability to bear losses, and their investment objectives, including risk tolerance – an investment is presented as being 'suitable', then this may still constitute a personal recommendation and, hence, regulated advice, even if the firm has a clear, prominent and understandable disclaimer stating that no advice or recommendation is being given. A suitability report needs to consist of three elements at a minimum: the client's objectives, why the advice is suitable, and what could be the disadvantages. The suitability test also applies to a firm that sells and manages investment products
- Whether a product is considered 'appropriate' for a customer will depend solely on their knowledge and experience in the relevant investment field. Customers might have to demonstrate that they have sufficient knowledge and experience to understand the risks attached to any product they are considering buying.

*Table 3.4: Pre-sale suitability and appropriateness assessments under MiFID II*

| Type of sale | Type of product | Test required | Factors to be considered |
|---|---|---|---|
| Advised | Complex | Suitability | Knowledge and experience in the investment field<br><br>Financial situation, including ability to bear losses<br><br>Investment objectives, including risk tolerance |
| | Non-complex | | |
| Non-advised | Complex | Appropriateness | Knowledge and experience in the investment field |
| | Non-complex | None | None |

Source: Financial Services Consumer Panel (2015)

Although assessing product suitability for a particular client does not constitute advice, it will still be necessary to do this to determine whether a firm is able to recommend the purchase of a 'complex' MiFID (Markets in Financial Instruments Directive) product. Under MiFID II, which is due to come into force in January 2018, it is expected that many pension

products, such as drawdown, will be classified as ‘complex’ which means that they cannot be sold on a non-advised (i.e., execution-only) basis to inexperienced investors. Instead, providers will have to conduct an ‘appropriateness test’ to assess whether the customer is in the position to make an informed decision about the product. But the test will not determine whether the product is suitable for their particular circumstances. Table 3.4 summarises these requirements. The only ‘non-complex’ products once MiFID II comes into effect will be plain vanilla shares, bonds and unit trusts.

According to Matt Connell, head of regulatory developments at Zurich UK Life, advisers could be required to assist providers in their appropriateness testing. Advisers who offer both non-advised and fully advised services could be asked to help providers with some of the information gathering about customers. He said: ‘The idea is if you have a [pension] wrapper that includes guaranteed returns, it is a bit like a derivative. Products that are more expensive, but with less volatility, might be less risky for consumers, but the question is do consumers understand them. It's bringing the whole channel closer together. There will be more requirements on product providers and advisers to talk to each other on a non-advised basis. Consumers will enter conversations with providers over appropriateness not with the adviser, but then may have to go back to the adviser if the provider says 'no'. Advisers should think about how they collect information and send it to providers. They may have to capture information for which they do not yet have the right systems in place’. The practical consequence of this is that, once MiFID II comes into force, most customers might not be able to buy a drawdown or other complex product without first taking advice.

According to the FCA: ‘Pensions liberalisation could give rise to new risks of inappropriate sales of insurance-based investments to consumers, as well as MiFID II investments’.[459] The Tax Incentivised Savings Association (TISA) is concerned about how MiFID II will operate in practice, particularly in terms of appropriateness, suitability and product governance. It said it would establish guidelines on how advisers and providers should address these issues. In particular it will look at:

- The definition of complex versus non-complex products
- What does best practice look like for product governance?
- What does it mean by target market? What will it look like?
- Information flows between manufacturer (i.e., provider) and distributor?
- How can technology be used and what will the impact be?
- What is the impact on execution-only closed-end funds?
- What will appropriateness look like in practice?
- What are the implications for clients?

[459] Reported in Carmen Reichman (2015) Advisers could be caught in MiFID II 'appropriateness' testing, Professional Adviser, 13 May.

Jeffrey Mushens, technical director at TISA, said: 'The directive makes it very clear that firms, which manufacture or distribute a product, will also be expected to have appropriate organisational arrangements that specifically address the issue of product governance. Whilst there has always been a requirement to understand the products under advice, this is now required to be more organised and formal, thus, the directive increases expectations on existing systems and controls'.[460]

The FCA has a long-standing concern about the failure of the industry to meet suitability requirements. In 2011, it issued a 'Dear CEO' letter to wealth management firms, following a previous suitability review. Its 2015-16 business plan released in March 2015 announced a thematic review of 'improvements in suitability standards across wealth management', focusing on managed portfolios and their suitability in respect of clients' risk profiles, attitudes to risk, and capacity for loss.

The FCA is particularly concerned that the proliferation of new complex retirement products could confuse older consumers who have little experience in taking decisions about their income and who typically underestimate their longevity: 'Firms may develop decumulation products or services that could highlight certain product features or the price at the expense of other important information, or be difficult to compare due to hidden costs and fees and include barriers to exiting, There is also a risk that these could result in increasingly complex products or a mix of products that require ongoing servicing and potentially higher costs, which some financial advisers may recommend in a bid to generate higher fees'. According to Neil Walkling, from regulatory consultancy Bovill: 'The FCA is still finding some firms have not done much to improve suitability standards and the way they gather information from clients. There is the sense [the FCA has] run out of patience'.[461]

In December 2015, the FCA published the findings from its thematic review of the suitability of retail investment portfolios provided by wealth management and private banking firms.[462] Although a number of firms had taken steps to demonstrate that their clients' portfolios are suitable, the FCA found that, in 60% of the sample portfolios they investigated, the composition of the portfolios they managed did not truly reflect the investment needs and risk appetite of their customers, especially those who have a limited capacity for, or desire to expose themselves to the risk of, capital loss. Many firms also still have to make substantial improvements in gathering, recording and regularly updating customer information to support the investment portfolios they manage for customers. The

[460] Reported in Carmen Reichman (2015) TISA to hammer out clear MiFID II guidelines, Professional Adviser, 30 June.

[461] Reported in Dan Jones (2015) Wealth managers risk enforcement actions as FCA 'runs out of patience', Investment Week, 30 March.

[462] Financial Conduct Authority (2015) *Wealth Management Firms and Private Banks: Suitability of Investment Portfolios*, Thematic Review, TR15/12, December; https://www.fca.org.uk/your-fca/documents/thematic-reviews/tr15-12

FCA also warned firms that they need to ensure that their governance, monitoring and assessment arrangements are sufficient to meet their regulatory responsibilities in relation to suitability.

The FCA investigated 150 files from 15 firms. It found that:

- 23% indicated a high risk of unsuitability
- 37% were unclear
- 41% showed a low risk of unsuitability.

Megan Butler, FCA director of supervision, investment, wholesale and specialists, said: 'Getting suitability right is fundamental to providing a portfolio management service that meets customers' needs'.[463]

The FCA has five key tests for investment advice:

1. Does the service being offered constitute a recommendation?
2. Is the recommendation in relation to one or more transactions in financial instruments?
3. Is the recommendation at least one of the following:
    a. presented as suitable
    b. based on the consideration of the person's circumstances
4. Is the recommendation issued otherwise than exclusively through distribution channels or to the public?
5. Is the recommendation made to a person in his capacity as one of the following:
    a. an investor or potential investor
    b. an agent for an investor or potential investor.

If the answers to all these questions is 'yes', then it is investment advice.

In January 2015, the FCA released a complete list of its definitions of advice.[464] These are listed in Table 3.5.[465] Between the clear and unambiguous extremes of execution-only and personal recommendation/regulated advice come generic advice or information, focused advice (which is requested by the customer) and simplified advice (a service specified by the

[463] Reported in Laura Miller (2015) FCA finds 60% of wealth managers' portfolios close to unsuitable, Professional Adviser, 9 December.

[464] Financial Conduct Authority (2015) *Retail Investment Advice: Clarifying the Boundaries and Exploring the Barriers to Market Development*, Finalised Guidance FG15/1, January; http://www.fca.org.uk/static/documents/finalised-guidance/fg15-01.pdf

[465] The Table reflects differences in the definitions of regulated advice at the EU level under the Markets in Financial Instruments Directive and the Regulated Activities Order (RAO), The FCA applies both in the UK, but the former requires regulated advice to be a personal recommendation (otherwise, it is generic advice), while the latter does not.

firm, but falling short of regulated advice although might involve a personal recommendation).

| *Table 3.5: Financial Conduct Authority's definitions of advice* | | |
|---|---|---|
| 1 | Execution-only | A service consisting of the execution and/or reception and transmission of client orders relating to particular financial instruments at the client's initiative. The firm does not give any advice on investments or assess appropriateness. |
| 2 | Generic advice | Advice or information that does not relate to a particular investment or does not otherwise meet one of the characteristics of regulated advice. |
| 3 | Focused advice or limited advice | Advice focused on the provision of personal recommendations relating to a specific need, designated investment, or certain assets. As requested by the customer. |
| 4 | Simplified advice | Advice focused on the provision of personal recommendations relating to a specific need, designated investment, or certain assets. The firm sets out the boundaries of the service it provides and uses streamlined and/or automated advice processes to provide customers with a personal recommendation, based upon their personal and financial circumstances. |
| 5 | Personal recommendation | A recommendation relating to taking certain steps in respect of a particular investment, made to a person in their capacity as an investor or potential investor (or their agent), which is presented as suitable based on a consideration of the person's circumstances. |
| 6 | Regulated advice | Advice relating to a particular investment given to a person in their capacity as an investor or potential investor (or their agent) and relates to the merits of them buying, selling, subscribing for, or underwriting (or exercising rights to acquire, dispose of, or underwrite) the investment. |
| Source: Derived from FCA Finalised Guidance 15/1 (2015, pp. 2-3) | | |

### 3.6.2 Generic advice

In 2007, the Treasury conducted an experiment on the effectiveness of generic financial advice as part of Otto Thoresen's review of generic financial advice.[466] Around 5,000 people took part in a 12-week trial involving a free, impartial generic financial advice service

[466] H M Treasury (2008) *Thoresen Review of Generic Financial Advice: Final Report*, March.

providing information and guidance on money matters. The service was offered by A4e (as Money Fitness) and Consumer Direct (in partnership with Citizens Advice). The preliminary findings revealed that many people lack the confidence to buy savings and investment products without advice, and do not have a clear idea of which products would suit them. However, generic financial advice can act as a prompt for people to take action. Within a week of using the service, 80% of the people who took part in the experiment had taken at least one follow-up action, with 20% contacting a new supplier of financial products.

The results of the exercise indicate that generic financial advice is potentially beneficial to all demegraphics, not just low-income groups.[467]

### 3.6.3 Guidance

'Guidance' is not specifically listed in Table 3.5. The Government is offering a free 'guidance guarantee', called Pension Wise, to all those about to draw on their pension pot.[468] The guidance offered by Pension Wise will involve taking stock of people's assets and liabilities and explaining the options available to them. This is achieved through a six-step process which 'help you understand how to turn your pension pot into income for your retirement':

1. Check the value of your pension pot
2. Understand what you can do with your pension pot
3. Plan how long your money needs to last
4. Work out how much money you'll have in retirement
5. Watch out for tax
6. Shop around for the best deal.[469]

---

[467] Reported in Professional Adviser (2007) Generic Financial Advice would work – survey, 24 December.

[468] https://www.pensionwise.gov.uk. Pension Wise was set up by HM Treasury, but in September 2015, the Government announced that the Department for Work and Pensions (DWP) would take over responsibility for Pension Wise.

[469] Initial comments about the Pension Wise website expressed disappointment. For example, Katie Morley argued that 'It is deluded to think that people with such basic literacy abilities could be expected to read Pension Wise, process the information, and relate it to their own personal pension circumstances. Knowing how complex the rules are, how opaque providers are about their products, and that the average person now has 11 different pension pots, most people's arrangements are likely to be anything but simple to sort out. To make it easier for people to relate to, the website needs to present information in a much more personal way. What use is reading up on the intricacies of income drawdown – if you don't know how the rules apply to you, for example? Pension Wise is also in desperate need of some basic useful tools. Ones which would allow people to enter their personal details to produce meaningful figures. Numbers go over people's heads unless they related directly to them and their money. Core calculators missing from the site include showing people how long they're likely to live, how much tax they will pay on their pension, and how much income they can afford to take from their pension per year. There is no way someone can begin to properly plan their pension without these basic ingredients.' (quoted from 'I tried Pension Wise - and this is why it won't work', Daily Telegraph, 23 February 2015).

In terms of content, a guidance session will:[470]

- inform consumers of the scope, purpose and limitations of the session
- inform consumers about the pension entitlement and other personal and financial information that the designated guidance provider may request from them during the session
- request information from the consumer about their accumulated pension pots
- request information about the consumer's financial and personal circumstances that is relevant to their retirement options
- alert the consumer to other sources of information and advice as appropriate and at relevant points during the session
- identify for the consumer and provide them with information about:
    - the options relevant to the consumer
    - to the extent that they are relevant to the consumer's options
    - the potential tax implications or debt obligations
- set out the next steps for the consumer
- provide consumers with a record of their guidance session.

The Pension Wise service is run by two designated guidance providers The Pensions Advisory Service (TPAS) which offers phone-based guidance and Citizens Advice (CA) which offers face to face guidance sessions,[471] each lasting 45 minutes. The FCA has introduced the following standards for designated guidance providers:[472]

- ensure that the guidance is impartial, consistent, of good quality and engaging across the range of delivery channels
- create consumer trust and confidence in the designated guidance providers and content of the guidance so that consumers actively use the service
- ensure that the framework works for both contract-based and trust-based pension schemes
- deliver helpful guidance for consumers that considers their retirement options and refers them to specialist advice or information where appropriate.

[470] HM Treasury (2015) *Delivering Pensions Guidance: January 2015 Update*, 12 January; https://www.gov.uk/Government/publications/delivering-pensions-guidance-january-2015-update/delivering-pensions-guidance-january-2015-update

[471] From more than 500 locations in England and Wales.

[472] Financial Conduct Authority (2014) *Retirement Reforms and the Guidance Guarantee*, Policy Statement PS14/17, November, http://www.fca.org.uk/static/documents/policy-statements/ps14-17.pdf

Individuals delivering the guidance must:

- have the skills, knowledge and expertise necessary for the discharge of their responsibilities – including good interpersonal skills (including listening skills and verbal communication skills) – and have knowledge that includes the following:
    - the different types of pension schemes
    - the impact of fees and charges for both accumulation and decumulation pension products
    - the options available to consumers when accessing their pension savings
    - the factors relevant to the selection of options when accessing pension savings, including the impact of guarantees, special features, restrictions or conditions, protected rights, and exit charges
    - the tax treatment of pensions and income generally
    - the circumstances when a consumer may require further specialist help, for example debt advice, or regulated advice
- cover other issues that are relevant to consumers considering their retirement options, for example, long-term care needs, sustainability of income in retirement and life expectancy, and
- understand the conduct that a designated guidance provider may engage in.

Consumers must have access to a complaint management system that is fair, consistent and prompt. The Parliamentary and Health Services Ombudsman (PHSO) will handle any complaints about Pension Wise as a last resort. Initially, there was no recourse for people who receive guidance from TPAS or CA, since neither guidance nor the designated guidance providers are regulated by the FCA.[473] However, in July 2015, the FCA – which has been made responsible by the Treasury for setting standards for the delivery and for monitoring the delivery of the guidance – clarified the issue by stating that where redress is due, it will be paid by TPAS or CA. The FCA said it can 'make recommendations' to the Treasury and the PHSO to order guidance providers to pay out: 'We expect a recommendation to make redress to be comparatively rare. We would expect such a recommendation to follow our general process for making recommendations with the calculation of the level of redress based on the size of detriment experienced. Where a consumer has already received adequate redress, as set by the Parliamentary and Health Service Ombudsman, we would not require it to be paid again as a result of our recommendation'.[474]

In July 2015, the FCA announced that it would, for the first time, distinguish between advice and guidance in the way it records complaints. Previously, the FCA categorised complaints against financial services firms under the headings 'misleading advice/guidance', 'arranging',

[473] Complaints involving financial advice are handled by Financial Ombudman Service.

[474] Reported in Carmen Reichman (2015) FCA - Pension Wise providers liable for guidance guarantee redress, Professional Adviser, 3 July.

or 'inappropriate sales technique'. Going forward, it said it would categorise complaints as either 'unsuitable advice' or 'unclear guidance/arrangement'. This will give the regulator a clearer picture about how many complaints were made specifically about regulated financial advice and how many related to guidance, Christopher Woolard, director of strategy and competition at the FCA, said: 'Our rules will help deliver the quicker, easier and fairer resolution to complaints that consumers want. Getting this right is also vital for firms. A properly resolved complaint can keep a customer happy, and protect the firm's reputation. But, more than that, effective complaints handling systems can act as an early warning system for firms'.[475]

Early evidence suggests that affluent investors were not using Pension Wise. A survey by Suffolk Life of its own relatively well-off clients who started a drawdown programme during April and May 2015 found that only 2% contacted Pension Wise. Three quarters took advice, while the rest acted without seeking advice. The average fund size of a Suffolk Life SIPP is around £330,000.[476]

In July 2015, the Treasury announced that Pension Wise had delivered 18,000 guidance appointments since its launch. It also reported that 925,000 visitors had visited the Pension Wise website. However, this was only 15% of the total appointments available. Hargreaves Lansdown has previously said that only one in seven of its customers were using the service.[477] Also in July 2015, the Government announced that the minimum age for accessing Pension Wise was being reduced from 55 to 50.[478]

A survey of 700 companies by Close Brothers Asset Management in August 2015 found a third did not have a clear understanding about Pension Wise or how it could help retirees, while 13% did not feel confident recommending the service. Only 9% said it has been a huge support in offering help to employees. Jeanette Makings, head of financial education services at Close Brothers, said: 'Four months after the pension reforms were introduced, it's clear that there is still some confusion. It's crucial that if employers are directing their staff towards Pension Wise, they really understand the support it can provide and that the guidance it gives is not advice and so should sit alongside financial advice rather than competing with it'. On the other hand, the survey also found that 20% of companies were actively trying to improve their support network for staff approaching retirement, while 37% said the reforms had encouraged them to play a greater role in financially educating their employees. Ms Makings said: 'Options at retirement have become all the more complex, and education is the key to helping employees navigate their new freedoms. A financial education programme – whether this is through seminars, clinics or one-to-one advice – can

[475] Reported in Carmen Reichman (2015) FCA splits advice from guidance in new complaints rules, Professional Adviser, 23 July.
[476] Michael Klimes (2015) Affluent investors not using Pension Wise, Professional Pensions, 8 June.
[477] Ollie Smith (2015) Pension Wise has delivered 18,000 guidance sessions since launch, Citywire, 23 July.
[478] Reported in Professional Adviser (2015) Pension Wise access extended to begin from age 50, 8 July.

help to build up understanding and engagement and can lead to them taking action to improve their financial wellbeing'.[479]

Research published by the NAPF in October 2015 revealed that only 10% of people considering their retirement options had turned to Pension Wise, although 20% of people who had accessed their pension pot had used the service. The research was based on a focus group of people who had accessed some or all of their pot, and had used Pension Wise. According to Graham Vidler, NAPF director of external affairs: 'The problem is not one of quality of service, because late on in the process we started nudging people towards Pension Wise, and when they went and investigated, they liked what they saw. The problem is one of awareness and knowing the service is there and can be used. We really need to crack through because at the moment there's a service out there that is not being used by people who in most cases could do with some expert guidance and support'. Instead, people were using informal sources of support such as the media, family, and friends. There is a big group of people who are looking at their options and they do not know what to do. One of our responders, June from Bristol, was typical – she said she felt "paralysed" by the choices on offer'.[480]

In September 2015, TPAS reported that those who used the service recently were most concerned about avoiding tax, accessing pension freedoms, and the lifetime allowance. They were also considering their options more carefully than those who approached TPAS at the beginning of 'freedom and choice' in April 2015 and were looking to access their money as quickly as possible. Charlotte Jackson, head of information and guidance, said: 'What we are seeing now is that people are more considered and taking their time. Around 20% of people are saying to us they want a combination, the security of an annuity and a degree of flexibility'.[481]

In December 2015, the Government announced that Pension Wise guidance was costing £496 per client to deliver. The cost of the service in 2015-16 was £39.4m, with advisers contributing £4.7m. Steven Levin, chief executive of Old Mutual Wealth's investment platform, said this represented 'poor value' compared with full personalised advice, which cost around £175 per hour. He said the industry needed to see better value for the £4.7m it is being asked to contribute.[482]

---

[479] Reported in Stephanie Baxter (2015) Many employers failing to engage with retirement processes, Professional Pensions, 19 August.

[480] Reported in Jack Jones (2015) Only 10% exploring retirement options turning to Pension Wise, Professional Adviser, 15 October; and Mark Cobley (2015) Three-way split on 'pension freedoms', Financial News, 15 October.

[481] Reported in Michael Klimes (2015) TPAS: Tax, LTA and accessing freedoms top concerns for members, Professional Pensions, 23 September.

[482] Reported in Carmen Reichman (2015) Pension wise session cost branded 'poor value', Professional Pensions, 18 December.

Steve Webb, now policy director at Royal London, believes that the resources put into Pension Wise would have been better used giving retirees vouchers for financial advice: 'Given the tens of millions that have been spent on Pension Wise, maybe that money should have been spent on £500 advice vouchers, so you can access financial advice and start to understand the value of the service. That might be the direction the Government should be going in'.[483] In January 2016, the FCA said it would support a move for Pension Wise to provide a more personalised service for its clients.[484]

### 3.6.4 The implications for members of DC schemes

The *Aon DC Member Survey,* published in December 2014, of 2,000 occupational DC scheme members made the following predictions (which turned out to be a fairly accurate indicator of what actually happened in the first few months after Flexiday):[485]

- Only 12% of the respondents to the survey said that they would make use of a 'web-based Government guidance service'.
- One third of the survey respondents intend to make important decisions about their retirement on their own, or with the help of friends and family. But the very high proportion of DC members that currently invest in their default DC investment option probably indicates that members do not engage much with the investment process prior to retirement.
- Another quarter of the respondents said that they would seek the help of an independent financial adviser (IFA).

According to Keith Churchouse, director of Chapters Financial, it is very likely that 'for some, this guidance [from Pension Wise] will be extremely useful, for others it will be like receiving the instructions for a flat pack furniture unit'.[486] According to financial solutions firm LEBC, the guidance guarantee will do little more than deter people from 'doing stupid things' with their pension pots, it will not help them plan for their retirement.[487]

---

[483] Reported in Rebecca Shahoud (2015) Webb: Pension wise was not worth the money, Professional Pensions, 5 November.

[484] Reported in Carmen Reichman (2016) FCA backs Pension Wise move to 'personalised guidance', Professional Adviser, 8 January.

[485] Reported in Sophia Singleton (2014) What do DC scheme members really want?, Pensions Age, December. http://www.aon.com/unitedkingdom/defined-contribution/dc-member-survey.jsp

[486] Keith Churchouse (2014) Why this adviser thinks pensions 'guidance' is the IKEA wardrobe of financial services, Professional Adviser, 22 July.

[487] Reported in Carmen Reichman (2014) Guidance guarantee plans not good enough, LEBC warns, Professional Adviser, 30 July.

TISA, in an initiative supported by 50 firms and trade bodies, wants the FCA to introduce a 'common sense' standard for the delivery of guidance to consumers.[488] This is because the rules around simplified advice and the boundary between guidance and advice are 'just not clear'. The initiative, part of the Savings and Investments Policy Project (TSIP), wants the FCA to establish a set of 'kitemarks', using, for example, decision trees, which will help advisers guide consumers based on what 'people like you' should do. Currently, advisers are 'too afraid' to guide consumers unless it is part of full regulated advice.

In May 2015, MGM Advantage released the results of a survey conducted by ComRes of 1,000 UK residents aged 55 and over who are not retired. The survey found that 65% thought that financial advice at the point of retirement should be compulsory. Only 11% said they were 'very comfortable' managing their pension in retirement, while 35% said they were not comfortable doing this and indicated they needed on-going advice. Andrew Tully, pensions technical director at MGM Advantage, said: 'People are making difficult, life-changing decisions, made all the more complex by the new pension rules. We're seeing the majority of people recognise that without financial advice they may fail to realise the full implications and make decisions that end up costing them dearly. The Pension Wise guidance service is a good starting point for people. The service can help people understand the options available, but it may not be enough to help them make the choice that's right for their personal circumstances…We need to continue to work hard to promote the benefits of people actually taking the next step and getting proper regulated financial advice. This is the only way we can remove the status quo, ensure we improve the outcomes for people at-retirement and make sure the new rules benefit as many of them as possible'.[489]

In May 2015, IFA software provider Intelliflo published the results of a survey of 1,000 adults earning at least £40,000 on their attitude to regulated financial advice. Around 39% said they would need a pension pot of at least £100,000 before they would consider seeking regulated financial advice, while 24% said between £50,000 and £100,000, 11% between £25,000 and £50,000, 11% between £10,000 and £25,000, and 14% if they had less than £10,000. However, 43% of respondents said they intended to manage their pension pot themselves.[490]

---

[488] Reported in Carmen Reichman (2015) FCA under pressure to agree on 'common sense' guidance principles, Professional Adviser, 11 March.

[489] Reported in Professional Adviser (2015) Advice at retirement 'should be compulsory', say over 55s, Professional Adviser, 5 May.

[490] Reported in Professional Adviser (2015) Retirees set advice threshold at £100k savings, Professional Adviser, 22 May.

### 3.6.5 The implications for members of DB schemes transferring to DC schemes

The Pension Schemes Act 2015 distinguishes between 'flexible' or 'safeguarded' benefits.[491] Flexible benefits comprise DC and cash balance benefits, while safeguarded benefits are DB benefits. The Act gives members a statutory right to transfer each category of benefit from their current scheme to another scheme. Members with DB benefits must have ceased accrual and made an application to transfer those benefits (following receipt of the statement of entitlement). Schemes do not have to provide the new flexibilities themselves. Further, existing scheme rules may not permit them. To enjoy the new flexibilities, members might have to transfer their benefits to another provider. However, if trustees do wish to offer the new options, they can now amend the scheme rules by resolution (with employer consent) or use a statutory override of the scheme rules.

Trustees are required to give the following information to members with DC benefits at least four months before their retirement date: [492]

- A statement of the options available to the member under the scheme rules
- A statement that they have the opportunity to transfer flexible benefits to one or more different pension providers
- A statement that different pension providers offer different options in relation to what the member can do with the flexible benefits, including the option to select an annuity
- A statement that different options have different features, different rates of payment, different charges and different tax implications
- A copy of the guidance that explains the characteristic features of the options that has been prepared or approved by the regulator
- An estimate of the value (or cash equivalent transfer value (CETV) if relevant) of the affected member's flexible benefits (if the benefits are 'transferrable rights' in accordance with the disclosure regulations), the date that this was calculated, an explanation that this is not guaranteed and information about any guarantees or features, restrictions or conditions that could affect the value, and
- A statement that there may be tax implications associated with accessing flexible benefits, that income from a pension is taxable and that the rate at which income from a pension is taxable depends on the amount of income that the member receives from their pension and other sources.

---

[491] See The Pensions Regulator (2015) *Regulatory Guidance: DB to DC Transfers and Conversions*, April; http://www.thepensionsregulator.gov.uk/docs/db-dc-transfers-conversions-regulatory-guidance.pdf

[492] *The Occupational and Personal Pension Schemes (Disclosure of Information) (Amendment) Regulations 2015* (https://www.gov.uk/Government/uploads/system/uploads/attachment_data/file/405622/occupational-and-personal-pension-disclosure-of-information-draft-amendment-regulations-2015.pdf); The Pensions Regulator (2015) *Communicating with Members about Pension Flexibilities*, March (http://www.thepensionsregulator.gov.uk/docs/draft-essential-guide-pension-flexibilities-march-2015.pdf)

In the case of DB benefits, trustees are required to inform members that they have the right to DB benefits and how they can access information about them. Trustees must also direct members to Pension Wise on the options available to them, provide them with generic risk warnings on each option, and inform them that they should consider taking independent advice to help them decide which option is most suitable for them if they have flexible benefits, and must do so if they have safeguarded benefits.

A poll of consultants to DB schemes conducted by Towers Watson showed that many members want to know what their transfer value is. Trustees should therefore consider the most cost-effective way of doing this, such as adding transfer values to all retirement letters rather than responding to individual requests. The poll indicated that around 20% of schemes had decided to automatically quote transfer values at retirement, 40% had decided not to, and around 40% were still undecided.[493]

Fidelity's Retirement Service announced in October 2015 that there had been a 'significant increase' in interest in DB-to-DC transfers since April 2015, although the take-up had been small so far: 12% of its calls were about this topic. Richard Parkin, head of retirement at Fidelity International, expected partial transfers to become more popular than full transfers: 'If you have £25,000 [in DB benefits] and you trade in £5,000 for a pot of money, it's much easier to have conversations about that, because you're not giving up your guaranteed income'. Some customers were concerned about the tax treatment of their DB benefits when they die, believing that it would be better to transfer to DC. Others just wanted to get their hands on the cash. But overall, there has also been a general increase in interest in pension planning since April. Mr Parkin went on to say: 'One thing I've started to think about recently is that, as an industry, we're very nervous about DB-to-DC transfers because of what's happened in the past. We've tended to say that we can't do it – but that doesn't mean we shouldn't check. Are trustees or sponsors of DB plans really serving members properly by not looking at whether a transfer value makes sense? For example, if members are single or sick – or both – then DB may not be giving them value. We should be giving DB members much better retirement help rather than just saying "you've got a gold-plated pension, so you're lucky". DB is great quality, but you can't just make the assumption that that's always the case. Plan sponsors have an interest in doing that, because if they can reduce their liabilities in a way that also works for the members, then it's good for both sides'.[494]

Matthew Arends, partner at Aon Hewitt, speaking at the NAPF annual conference in October 2015, said that while transfer quote requests had risen since Flexiday, fewer than

[493] Reported in Lydia Rowson (2015) Emerging reality on pension freedom - What can sponsors and trustees expect in the new pensions world?, Towers Watson Trustee Briefing, 8 June.

[494] Reported in Stephanie Baxter (2015)DB to DC transfer enquiries double in just one month, Professional Pensions, 3 November.

1% of members had actually taken up the option. He questioned whether only 1% of people are better off by transferring out of their DB scheme. He argued that DB schemes needed to employ different communications methods – such as telephone and online chat facilities as well as online modellers – if members are to understand options such as transfers to DC schemes. He pointed out that 40% of schemes that provide CETVs to members also provide access to independent financial advice, but despite this, take up of this advice remains low.[495] However, in December 2015, Xafinity reported that the number of people transferring out of DB pension schemes each month had doubled since January.[496]

The FCA's review of enhanced transfer values (ETVs) published in July 2014 found that advisers had failed to assess whether the transfer was suitable for customers for a number of reasons including:

- generic templates which were inadequately 'tailored' so the advice did not reflect specific member circumstances or give sufficient priority to the members' own requirements
- advice where the outcome focused solely on critical yield analysis[497] without full consideration of wider member circumstances
- not establishing adequately the level of risk a member is willing and able to take
- fund recommendations which did not match the assessed risk profile of the member
- the use of default receiving schemes (in some cases, with uncompetitive charging structures) and limited consideration of the suitability of a member's other existing pension arrangements, and
- limited consideration of the tax and, in a small number of cases, means-tested benefit implications of accepting the offer.[498]

There were also failures concerning disclosure, such as:

- incomplete record keeping
- the 'annuity risk' of transfer from DB to DC not being fully explained
- over-emphasis on the possible 'flexibility' under a DC scheme in undertaking the transfer analysis

---

[495] Reported in Helen Morrissey (2015) NAPF 2015: New communication approach needed for DB-DC transfers, Professional Pensions, 16 October.

[496] Reported in Professional Pensions (2015) Defined benefit transfers double since January, 3 December.

[497] The critical yield is the investment return which is required in the new arrangement to match the existing scheme benefits. The analysis also makes a number of assumptions about factors which will impact on both the pension received from the DB scheme and the cost of matching the benefits. This will include assumptions made about the various indices which will impact on the revaluation of the pension and also factors such as gilt yields which will impact on the conversion of the pension fund to an income.

[498] Financial Conduct Authority (2014) *Enhanced Transfer Value Pension Transfers*, Thematic Review TR14/12, July.

- offers being structured against a reduced transfer value and therefore appearing artificially generous, and
- no consideration of the members' additional voluntary contribution (AVC) funds as part of the advice process.

Clive Adamson, director of supervision at the FCA, said: 'Transferring from a DB to a DC scheme is an important decision for consumers. It is disappointing that our review saw failings in the advice given, particularly when incentives [such as a direct cash offer[499]] have been provided to transfer. All firms active in this complex area of pension transfer activity should think very carefully about the quality of the advice process and assurance framework required to deliver fair customer outcomes'.[500]

The same FCA review found that 59% of members who accepted an ETV from a DB scheme did so as an 'insistent client' against their adviser's recommendation.[501] The FCA wants advisers to ensure they have recorded the client's reasons for wanting to transfer out of the scheme and have discussed the risks involved as well as alternative options.

Those who want to transfer pension pots worth less than £30,000 are not required to take advice. While this would lead to cost savings for trustees, it was not without risk for scheme members. According to Stephen Green, senior consultant at Towers Watson: 'The fact that advice isn't required for small pensions does not mean that this is a decision to be taken lightly – especially where people have little else besides their state pension to fall back on. But if someone's other final salary pensions will provide them with a good income in any case, their desire to swap a small pension for a pot of capital that they can access as they like may have overridden any financial advice not to do so.'[502]

The situation could be even worse for people living abroad who want to transfer their UK pension scheme. According to a FCA rule update published in July 2015, they might have to pay twice for advice. This is the interpretation given by Intelligent Pensions technical director, David Trenner: 'While most focus has been on the definition of safeguarded benefits and the need for a pension transfer specialist, there is a small section in the FCA feedback document which seems to have passed without comment. This is the section dealing with overseas residents and that they may end up having to pay for two advisers and therefore paying twice'. This is because there are two stages in the advice process: (a) is a transfer suitable? and (b), if it is, where should the money be transferred to? The FCA points out that UK-authorised advisers may not have knowledge of local tax regimes and

[499] The practice of offering cash has now been outlawed.

[500] Reported in Laura Miller (2014) FCA probe slams ETV pension transfer advice, Professional Pensions, 24 July.

[501] An 'insistent client' is someone who acts against some element of the advice received. Typically the advice was to remain in the DB scheme, but the member transferred despite this recommendation.

[502] Quoted in Natasha Browne (2015) FCA introduces emergency rules to prevent mis-selling from April, Professional Pensions, 26 January 2015.

pension rules, and says that it is in discussion with the DWP to consider whether amendments should be made to the rules for non-UK residents. Mr Trenner added: 'While we can have some sympathy with clients needing to pay two advisers, it is absolutely essential that the requirement for a UK-registered transfer specialist is retained. We have in the past seen overseas advisers transferring DB values into QROPS [Qualifying Recognised Overseas Pension Scheme] with no benefit comparison and the only "reason why" given being that they are no longer in the UK, so they would not want their pension to remain in the UK. A professional firm will set up an arrangement with offshore specialists to ensure that the UK adviser understands all of the relevant aspects of the overseas jurisdiction, and the resulting team will be stronger than the sum of the two parts'. The key reason was to protect consumers: 'We were approached by a couple who had emigrated to Dubai, but decided it was not right for them. They were only in Dubai for two years, but this was long enough for a local adviser to transfer benefits from two DB schemes (one the NHS Pension Scheme), and to deduct 12% in hidden charges. It is essential that the rules are not watered down in any way'.[503]

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.[504]

Also in July 2015, The Pensions Regulator (TPR) announced that it was considering bringing its guidance to pension scheme trustees on communicating the new retirement flexibilities into line with the FCA rules. Previous TPR guidance was to give members only generic information if they were considering accessing their pension pot, while the FCA rules say providers of contract-based products must give tailored risk warnings. The reason for the initial difference was that trustees were concerned about 'straying too close to giving financial advice' which could be avoided by giving only generic warnings. Going forward, particularly for large DC schemes and master trusts that plan to offer the full suite of drawdown options to members, TPR will discuss with the DWP and the FCA whether trustees 'should also be able to offer specific risk warnings which would be as similar as possible to the FCA's second line of defence for providers'. TPR believes it is 'important for regulators to work together to make sure there was no regulatory gap'.[505]

---

[503] Reported in Jenna Towler (2015) Overseas residents hit with double pension transfer advice charge, Professional Adviser, 2 July.

[504] Reported in Scott Sinclair (2015) Govt says savers in a muddle over mandatory advice rules, Professional Adviser, 30 July. The Treasury consultation is discussed later.

[505] Reported in Jack Jones (2015) PBUK 2015 -TPR explores aligning 'freedom and choice' risk warnings with FCA rules, Professional Pensions, 1 July.

### *3.7 Opportunities for advisers*

The new pensions environment was seen by some as a 'huge opportunity' for advisers. Not the least of these was Steve Webb when he was Pensions Minister. Speaking at the Retirement Planner Forum and Awards 2014,[506] Mr Webb said 'the guidance guarantee would only get people to the starting line, giving them just a basic understanding of what their options are and issues such as taxation and longevity. [T]here was only so much that could be covered in such a limited conversation, which would only equip them with the very basics of retirement planning. There are some in the advice community who see this as a threat. I see it as a huge opportunity. I liken the guidance guarantee to wine tasting and you, the advisers, are a vintage wine. When people realise what choices they have; when there is innovation in product, which I am sure there will be; when people start to consider all their retirement wealth and income and all their partner's retirement wealth and income and all the different permeations of the new freedoms they have got, I think many people will want to talk further to someone who can help and that seems to me to be an adviser…who can give them personal tailored advice'.[507]

#### 3.7.1 Opportunities for advisers in regulated advice

Others agree and see an important role for regulated advice going forward. For example, Duncan Jarrett, retail managing director at Aegon, said: 'There's a massive opportunity for advisers, as 65% of people don't understand the pension reforms and even those who do are likely to require support selecting the right combination of income products. Advice has never been so important and to help advisers we've introduced Your Retirement Planner to bring customer options to life and the tool responds based on the combination of income options they select. We expect advised customers will want to take full advantage of the new flexibilities and combine a range of different income options'. Aegon said consumers using the site direct would be more likely to seek regulated advice afterwards.[508]

Similarly, Richard Nuttall, head of compliance policy at SimplyBiz Group, said: 'It is expected that one of the main outcomes for these individuals [from the guidance guarantee] will be to obtain regulated financial advice. For those firms wishing to engage in this activity, it represents a great opportunity. Where individuals require, or are guided towards, regulated

[506] Which was well before evidence of the low usage of Pension Wise emerged.
[507] Quoted in Jonathan Stapleton (2014) Webb: Guidance guarantee will fuel appetite for the vintage wine of independent advice, Professional Adviser, 11 June.
[508] Quoted in Jenna Towler (2015) Aegon launches pensions freedom website and modelling tool, Professional Adviser, 4 March.

financial advice, the Money Advice Service will have a directory of advisers for the individual to access'.[509]

Standard Life's head of platform and wealth propositions, David Tiller, also believes that pensions freedom has handed advisers their biggest business opportunity ever on account of 'the fact that pensions can now be fantastic for wealth transfer and supporting the next generation on their retirement savings is a compelling opportunity to open clients' eyes to the art of financial planning'.[510] According to Mr Tiller, retirement planning has become much more complex, but it is filled with opportunity for three reasons:

1. Baby boomers reaching retirement means demand will remain at an all-time high for some time.
2. These people are the wealthiest retirees this country has ever had.
3. For many, choices are now so complex they may find it challenging to get good outcomes by themselves.

Mr Tiller estimates that drawdown was about 5% of adviser business in 2014, but by 2024, it could be 80% of adviser business. He believes that the key to coping with this increase in demand is what he calls a 'centralised retirement proposition', which will cover:

- Tax advice policy – having established client needs around income and wealth transfer, working out the best tax wrapper to take this from. Subject to using tax allowances, this is often going to mean taking from the pension last (turning previous advice on its head)
- Cashflow modelling – how much income can they take given total assets and any goals on wealth transfer. With the removal of GAD limits, many advisers are using GAD as a proxy, but we are seeing different standardised approaches to projecting assets and sustainability of income
- Investment advice – creating an investment strategy for clients who may live off their portfolio for 30 years is a sophisticated multi-goal investment challenge. Many advisers have already developed disciplined CIP [centralised investment proposition] processes around accumulation; it is now about doing the same thing for decumulation
- Accessing investment solutions – creating a decumulation CIP will inevitably demand accessing new investment solutions that manage volatility and sequence-of-returns risk in retirement (pound cost ravaging)[511]

---

[509] Richard Nuttall (2015) Everything advisers need to know about Pension Wise, Professional Adviser, 23 January; see Appendix.

[510] David Tiller (2015) Has pensions freedom given advisers their biggest opportunity yet?, Retirement Planner, 25 June.

[511] Sequence-of-returns risk is explained in Chapter 2.

- Withdrawal policy – setting clear customer expectations of how their income will change over time – streamlining annual reviews as expectations already set and avoiding difficult conversations when significant changes happen as the customer expectations set.

The new pension freedoms have encouraged a number of advisers to extend the range of services they offer to well-off clients, with a new focus on wealth management and financial planning. There had already been a major change in advisers' business models following the introduction of the Retail Distribution Review (RDR)[512] in 2013, with a move to discretionary services and away from the low end of the advised market. Examples include:

- Brewin Dolphin expands financial planning business (May 2014)
- Rathbone launches private office (February 2015) and acquires independent financial advice network Vision Group (October 2015)
- Charles Stanley refocuses business entirely on wealth management (April 2015)
- Investec Wealth launches private office for 'under-served' investors with a minimum of £10m (April 2015).

By contrast, life assurers – which traditionally had a dominant role in providing retirement income solutions – have responded to the new pension environment by offering a 'vertically integrated' service that has been put together through acquisitions. Examples include:

- Old Mutual acquires the Intrinsic network (July 2014) and launches national advice business called Old Mutual Wealth Private Client Advisers (October 2015)
- Standard Life buys adviser Pearson Jones with the aim of building up a face-to-face advisory service in addition to telephone and online advisory services. The new service will be called 1825 (February 2015).[513]

In November 2015, Tilney Bestinvest and Saga introduced a financial planning and investment service offering regulated advice, guidance and execution-only services to the over-50s. The service is aimed at the estimated 12.5 million people who have made no financial plan for retirement. Customers can 'do it on their own' with free online and telephone support, take one-off guidance, or have a longer-term relationship with a professional adviser. Initial adviser charges range from between 1% and 3% – depending on complexity – plus ongoing fees of between 0.75% and 1.25% per year. Nici Audhlam-Gardiner, Saga Investment Services managing director, said: 'By combining Tilney Bestinvest's investment expertise with Saga's 60-year history of improving the lives of the over-50s, we have created a service that will help make investment easier to understand

[512] RDR ended the practice of advisers being paid by commission from product providers and replaced it with customer-agreed adviser charging from the beginning of 2013.

[513] Reported in Anna Fedorova (2015) Wealth firms step up 'full service' offerings as client demand grows, Investment Week, 28 April.

and more accessible, particularly for those who have been underserved by the financial services industry in the past'. Customers will also have access to flexi-access drawdown.[514]

Another trend that is developing is increasing collaboration between advisers and accountants as the demand for tax planning increases following the introduction of 'freedom and choice'. These findings came from a poll of 120 advisers conducted by Prudential in August 2015. Vince Smith-Hughes, director of business development at Prudential, said: 'Pension freedom has underlined the importance of independent financial advice….Markets which might have been closed before are potentially opening up, but there is a realisation that advisers may need additional expertise. Working with the ICAEW [Institute of Chartered Accountants of England and Wales] financial services faculty, we hope to explore the opportunities presented by pension freedom legislation for advisers and accountants'.[515]

### 3.7.2 Opportunities for advisers in simplified advice

John Porteous, head of client proposition at Towry, argues that 'simplified advice is a clear missing link between guidance and full advice, but there are numerous challenges, 'validation' [or suitability] among them…. [T] technology-led innovation around the principle of simplified advice creates an opportunity for firms to reach out to different client segments'.[516]

The greater use of existing IT and computer-generated advice is critical to the success of simplified advice,[517] not least because of the significant decline in advisers post-RDR to around 22,500.[518] The FCA has offered help to advisers to build simplified advice models, by giving them an 'informal steer' on, for example, how to clarify the boundary between guidance and advice. This is part of its Project Innovate and will be managed through Innovation Hub, launched in October 2014. Innovation Hub was set up both to help firms negotiate the regulatory landscape and to allow the FCA to assess what it can do to promote

[514] Reported in Scott Sinclair (2015) Financial planning service for over-50s launched, Professional Adviser, 9 November.

[515] Reported in Carmen Reichman (2015) Advisers align with accountants as tax planning demand rises, Retirement Planner, 19 October.

[516] John Porteous (2015) The unavoidable challenges facing simplified advice, Professional Adviser, 5 February.

[517] This is discussed in the next Section.

[518] Reported in Brendan Llewellyn (2014) Standard Life's O'Dwyer: Increase advisers' productivity to narrow advice gap, Professional Adviser, 31 July.

innovation in financial services.[519] This is in response to advisers' fears about possible 'systematic mis-selling' using simplified advice models.[520]

At the lower end of the market, companies, such as Scottish Widows, have established online guidance and a call centre to help those who want to transfer, but do not have a financial adviser. Peter Glancy, head of corporate propositions at Scottish Widows, said: 'Traditionally, it has been people with hundreds of thousands of pounds who really know what they are doing [using drawdown]. Now we are going to be working with people who just want to get some money out and may be putting it into drawdown by default without realising the tax implications. We need to make sure we're engaging with them more intuitively and not allowing them to do anything silly'.[521]

As discussed in Chapter 2, Prudential has launched a non-advised drawdown product for customers who want to take advantage of pensions freedom, but choose not to consult an adviser. Its Pension Choices Plan offers access to its PruFunds range, its Dynamic Portfolios, and its cash fund. The minimum investment is £25,000.[522] Similarly, Zurich has launched a non-advised drawdown product with a minimum investment of £30,000, as has Blackrock.[523] Aegon's online Retirement Choices platform has a drawdown option which requires customers to take advice, but the firm is planning to introduce a simplified non-advised version.

Just Retirement has launched a simplified telephone-based advice service for providers to offer to their clients when they retire. Stephen Lowe, group external affairs director, said: 'The service is designed for clients with simple, straight-forward needs and savings of between £30,000 to £40,000. It's aimed at life companies that want to ensure their pension savers are more actively engaged in the decision-making process at retirement, while passing on the responsibility for the regulated advice. Charging structures for the service will be agreed with the individual life companies and will be charged separately from other products, but clients will only have to pay if they act on the recommendation. Clients opting for the service will receive personal recommendations about how to use their pension savings to generate income or access lump sums. The advice will also look at whether clients should keep funds invested based on their attitude to risk and capacity for loss or whether they should defer taking benefits. Simplified advice is set to be a cost-effective way of giving

[519] Reported in Carmen Reichman (2014) FCA offers advisers 'informal steer' on simplified advice, Professional Adviser , 28 October 2014.

[520] Jenny Towler (2014) Advisers raise 'systematic mis-selling' risk of simplified advice models, Professional Adviser, 11 July.

[521] Quoted in Peter Davy (2015) Complexity and Cost will limit pensions freedom, Financial News, 16-22 March.

[522] Reported in Jenna Towler (2015) Prudential enters non-advised drawdown market, Professional Adviser, 30 September.

[523] Jenna Towler (2015) Zurich rolls out non-advised drawdown for workplace savers, Retirement Planner, 1 December.

retirees, who usually wouldn't choose to engage in accessing advice, the helping hand they are going to need in the future. The majority of these Middle Britain pension savers won't have complex requirements, so a simplified advice service should be a good option'.[524]

Hargreaves Lansdown has introduced a restricted advice service which has allowed it to simplify its fee tariff and remove the minimum portfolio size for advice. It will now advise clients over the telephone, regardless of the size of their portfolio, for a minimum fee of £495. Face-to-face advice costs a minimum of £1,495.[525]

AllianceBernstein's Retirement Bridge product, which covers members between age 55 and 75, includes 'embedded advice'. Tim Banks, managing director of the Pensions Strategies Group, said: 'You can take out any amount of money you like as cash any time, but the impact of you taking additional lump sums is clear, because you sell 'units' in the fund and can see what income you are swapping for cash.' [526]

### 3.7.3 The frequency of advice

There is also a question about how often advice is needed. Many advisers felt that there is more to retirement planning than can be covered in a single meeting. For example, Buck Consultants said: 'The implication…that the guidance…can be delivered on one occasion, at which the member will take decisions on all aspects of their retirement planning, is not credible - even if the expected outcome, in most cases, is that the member will choose to select a packaged solution. [Employers could hold] regular informal discussions with groups of employees on pensions matters [so when specific situations arise, individuals can take professional advice which can be] focused and kept to a minimum, [thereby reducing costs]'.[527]

Clients apparently want to receive communications from their advisers 11 times a year, according to a survey of client satisfaction conducted by NPG Wealth Management, SEI and Scorpio Partnership in which 3,113 investors globally were questioned. Clients who only see their relationship manager 6 times a year gave a poor satisfaction score. On the other hand, more than 13 annual contacts was considered too much. Most 'heavily invested' clients preferred to deal directly with their adviser, while those with less than a quarter of their assets with a wealth management firm prefer to contact product specialists or use a digital

[524] Carmen Reichman (2015) Just Retirement launches simplified advice for life company customers, Professional Adviser, 13 April.

[525] Reported in Laura Miller (2015) Hargreaves Lansdown dumps independent advice; overhauls charges, Professional Adviser, 1 October.

[526] Quoted in Peter Davy (2015) Complexity and Cost will limit pensions freedom, Financial News, 16-22 March.

[527] Quoted in Carmen Reichman (2014) Revealed: What advisers told the Treasury about pensions 'guidance', Professional Adviser, 12 August.

service. The two main reasons for a contact were to discuss overall progress and to consider relevant portfolio changes.[528]

Others suggest less frequent contact is acceptable if this is what the client wants. According to Paul Harrison, head of business consultancy at Prudential, advisers should tailor their ongoing services to their clients and do not need to see all of them annually to satisfy an unwritten rule about treating active customers fairly. While the core service a firm offers should be consistent – and have the charging structure for it – advisers should think about modifying how often they see their clients and through which channels in order to free up capacity. For instance, some clients may not require annual check-ups and could be seen every two or three years. Others could be serviced over the phone or online to supplement face-to-face meetings. Nevertheless, many advisers are concerned about the FCA's attitude to adviser charging for ongoing advice. In its reviews of the implementation of RDR in April and December 2014, the FCA found evidence of firms receiving an ongoing adviser charge, while not providing a genuine service in return. It said that the value of an ongoing advice service acted as an 'important motivator' in consumers' decisions to pay for financial advice in the first place.[529]

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

Technology was at the heart of affordable advice, according to a poll of advisers conducted during a Professional Adviser web-seminar on 6 October 2015. Around 91% of advisers polled thought technology was important or extremely important when trying to provide affordable advice. Just 3% thought it was unimportant and the rest were non-committal.[530]

#### 3.8.1 Platforms

'Platforms will be the primary facilitator for many pensioners and advisers in managing retirement funds', according to Alistair Wilson, head of retail platform strategy at Zurich. Advisers need to be aware of the functionality of different providers' platforms in terms of:

- Access to income through flexible access drawdown, some may also offer annuities
- Taking the whole pot as a cash lump sum
- Partial (ad-hoc) lump sums without crystallising the pot
- Existing capped drawdown plans on their platform going forward
- Transfers of existing capped drawdown plans on to their platform

[528] Reported in Carmen Reichman (2015) Clients want contact 11 times a year – survey, Professional Adviser , 4 June. The results are dominated by US customers.

[529] Reported in Carmen Reichman (2015) Advisers don't need to see every client every year - Prudential's Harrison, Professional Adviser, 16 July.

[530] Reported in Jenna Towler (2015) Technology at heart of 'affordable advice', adviser poll reveals, Professional Adviser, 7 October.

Mr Wilson adds: 'Where a client wants to have a fixed monthly payment, this should be relatively simple, but where the payments may include ad hoc requests, the dynamics become very complex. Understanding what at first glance appears to be a piece of trading functionality becomes ever more important. And so, it is important to look in detail at the challenges relating to platform functionality and associated costs when taking an income, especially if these costs change if income is stopped, reduced or restarted. Add to this, understanding the "in-flight" events such as corporate actions and the impact these can have on income, there is an increasing amount to be considered…Providing clients faster access to their cash, or at the very least, not imposing processes that delay access, comes to the fore. Clients don't expect technology to slow down access and, for some platforms which don't prefund some transactions, this is exactly what can happen….The problem is further compounded by the fact that many clients will be expecting to stagger their entry into retirement, such that, at the same time as withdrawing funds as efficiently as possible across tax wrappers, they may also still be making contributions. It goes without saying clients are not going to be happy to have to pay extra and wait longer for their cash if they could also face a scenario where there is insufficient cash to pay income on time….Those platforms that support cash management automation will come into their own with pension freedoms, providing clients and advisers with an additional safety net'. The following costs also need to be taken into account: setting up and management of pension income, ongoing fees for effectively 'payroll' administration, ad-hoc payments, and additional costs when releasing individual pots.[531]

Richard Budnyj, director of Platform Action, considers the pricing challenges facing platforms in the post-RDR world. The client needs to pay for the services offered by the adviser (if the client is advised), the investment manager and the product provider's platform. Mr Budnyj discusses these in turn:

- Advisers:
    - Pre-RDR, advisers typically received 50bps in commission from the product provider. Post-RDR, though many advisers have fared well by adapting their business models and segmenting their clients to focus on those who believe in the service value they bring, not enough clients have been willing to pay directly for advice. As a result, we have seen a rationalisation of advisers. We are also left with a great swathe of clients who, due to the size of their investment pots, are not a viable proposition for advisers anymore, but who do need advice. Yes, there are people out there who can 'DIY', but a large population have been left in limbo, leading many providers to see this as an opportunity and set up direct-to-consumer (D2C) propositions

[531] Reported in Retirement Planner (2015) New world - How platforms are adapting to pensions freedom, April 14.

- Investment managers:
    - The investment managers have had to deliver new fund classes, but overall one could argue they have not had to cut their cloth to the same extent as providers are having to. I suspect they'll argue they are about value and that the net return given to investors is the most important thing. As an investor, I am happy to pay the value premium
- Product providers
    - The product provider level is where we are seeing significant pressure for reductions in price, with some calling it a race to the bottom. But for how long can they sustain this position? We currently have a number of smaller independent wrap platforms who arguably have the right business model but are struggling to make profit because they don't yet have the required scale. To succeed long-term, they need to increase assets under management and their low-cost base means the break even point is far lower than platforms with a life company heritage. But, given the huge influx of assets onto platforms in recent years, successful independent platforms are likely to be those which can now attract assets transferred from other platforms. For the platforms which have grown out of traditional life companies, although they have the scale in terms of assets, they also have the high costs associated with servicing legacy business and so are also struggling to make a profit. These companies are under greater pressure to scale further as their breakeven point is much more challenging.

Mr Budnyj believes that updated technology alone cannot create long-term profitability for many platforms and he proposes two solutions: greater operational efficiency within the life companies (with new digital technology at the core) and consolidation with the smaller players, through mergers and acquisitions.[532]

Standard Life's David Tiller also predicts a contraction of the platform market from 25 to about 15 platforms by 2018, but only around six of these will cater to advisers. He warns advisers to avoid being trapped in dying platforms which may find it hard to find a buyer. This is because rival platforms would find it difficult to integrate systems and so would only be interested in the assets not the rest of the business. Adviser platforms would therefore have to switch to a D2C or workplace model or become 'zombies', closing to new business but limping on as has happened in Australia. Advisers who become trapped in such platforms risk falling behind their competitors which have their clients' assets invested on more modern platforms. Mr Tiller argues that there are nine things advisers should be looking for in their platforms:

[532] Richard Budnyj (2015) Platforms - Why the old life company model just doesn't work, Professional Adviser, 18 May.

1. The advisers using the platform have progressive business models, are successful, compliant and are growing ahead of the market
2. Operating a successful UK adviser platform is core to the business strategy and commercial model of the platform owner
3. The platform has access to capital funding from committed long-term owners
4. The platform has seen sustained new business growth from advisers, as opposed to direct or workplace assets
5. The platform has a stable pricing position and business strategy
6. The platform has maintained a consistent level of service and support for advisers as it has grown
7. There is a track record of continuous enhancement of the platform, such as by investment in the underlying technology
8. The platform has a clear business plan and roadmap of further development for advisers
9. The platform has proactively embraced the RDR and helped advisers adapt to it.[533]

Average platform costs have fallen by 18% over the last five years, according to a study published in July 2015 by Steve Nelson and Terry Huddart called *Platform Pricing Prophecies: Past, Present and Phuture*.[534] For an average sized portfolio of £200,000, the annual platform cost has fallen since 2011 from 0.38% to 0.31%, or by £140. The main explanations for this are: RDR, competitive pressure, a focus on due diligence among advisers, and a significant migration of assets to platforms enabling scale economies to be passed on to customers.

Nevertheless, it is hard for advisers to compare platform costs and this could help to explain why cost appears to be low on advisers list of priorities when recommending a platform, with the study finding 'no real evidence pointing to a disproportionate amount of assets flowing into cheaper propositions'. Instead, advisers choose platforms based on factors other than price, such as suitability to their clients and their own business requirements. The study predicts that the price falls seen in recent years will come to an end as platforms fail to see them translating into more business. On the other hand, the study argues that the asset management charge is an item to look at if the cost to the customer is to be reduced further: 'let's be honest, there is more fat to cut here'.[535]

As a result of price pressures, poor back-office systems, and outdated front-end technologies, some even predict that platforms in their current form are finished. This is the view of the lang cat consultancy in its report *Platforms are Dead* published in October 2015.

[533] Reported in Carmen Reichman (2105) Standard Life urges advisers to check platform deals to dodge 'zombies', Professional Adviser, 18 September.
[534] http://langcatfinancial.co.uk/blog/price-only-important-in-the-absence-of-clear-value/
[535] Reported in Laura Miller (2015) Platform pricing report: Average costs cut by 18% vs. pre-RDR, Professional Adviser, 13 July.

Mike Barrett, consultancy director at the lang cat, said: 'We're convinced that platforms – at least in the guise that we've known them for the last decade and a half – are dead. With most of the sector's 25 platforms now operating for at least a decade, more should be running at a profit and with clear strategic objectives and charging structures. There's an urgent need for platforms to improve back-office systems and processes to reduce costs, and to improve their online offerings. In several cases, a platform's customer portal requires you to use a PC with Internet Explorer, and even then you can only get a valuation. That's just crazy. In a digital world, customers expect much more and a number of direct platforms are starting to address this'. Mr Barrett also agrees that future platform consolidation is limited by technology: 'With six main suppliers providing the necessary systems for most platforms – Bravura, FNZ, GBST, IFDS, JHC Figaro and SEI – and with re-platforming between providers operating different systems so difficult, this could affect consolidation'. He does, however, believe that an increasing demand for advice following Flexiday have thrown a lifeline to platforms: 'Those platforms that enable advisers to deliver their advice proposition in a manner befitting the digital age will flourish'.[536]

An example of an online platform launched to give scheme members access to 'freedom and choice' is Bigblue Touch 4life from Aon Employee Benefits. The following services will be offered to those reaching retirement: an annuity broking service to compare prices and select the provider and annuity which matches their needs; flexible drawdown, access to cash and a range of investment funds and strategies; online modelling tools; and access to advice if needed. Debbie Falvey, head of DC proposition, said: 'With increased freedoms since April this year, there is now a great deal, more choice, but this needs to be supported and guided responsibly. Bigblue Touch 4life helps members make sense of their options. It allows them to make fully informed decisions and to structure their retirement savings in a way that has previously been impossible'.[537]

In January 2016, Zurich reported the results of a survey of 120 advisers which found that 64% of them were reassessing their platforms as a result of concerns over functionality and the range of products on offer. Pension freedoms have put greater demand on providers for additional services, such as automated processing of funds and being able to split funds over different risk profiles. Advisers want the platform they use:

- To offer the full range of drawdown options (flexi-access/ capped / UFPLS) – Advisers are most worried about whether or not their platform offers all products accessible through pension freedom. Legally all products do not have to be provided, so some platforms have decided to offer a selection only, However, advisers seem to mind, as

[536] Reported in Scott Sinclair (2015) Platforms are finished, hard-hitting report to suggest, Professional Adviser, 22 October.

[537] Reported in Michael Klimes (2015) Aon launches online retirement platform to deliver freedoms, Professional Pensions, 14 September.

45% thought this issue was very important, compared with only 6% who said this was unimportant

- To allow the adviser to amend income levels online – Equally important for advisers is whether they can make adjustments to their clients' income levels online. For 18%, it was of utmost importance.
- To allow the adviser to select more than one model investment portfolio[538] for an individual client – Pension planning can involve a range of different risk profiles, as it combines long and short-term planning. Advisers wanted to be able to have multiple portfolios on the go. The majority of advisers were concerned about this, while 8% thought it very important.[539]

### 3.8.2 Robo-advice

'Robo-advice' is portfolio management advice, typically derived from Modern Portfolio Theory (MPT),[540] with the following characteristics:[541]

- Automated with little, or no, human intervention
- Delivered online
- Self-service
- Use algorithms to match portfolios to clients, based on assessed risk tolerance and other factors such as age, and
- Confined to relatively simple portfolio construction matters.

It therefore operates without the features of traditional face-to-face advice, namely questioning, explaining, reassuring and guiding clients. However, some believe that the term robo-advice is a misnomer. An example is Adam Jones, senior consultant at Altus Consulting, who believes that it should be separated into two components, 'automated advice' and 'automated investing'. According to Mr Jones, 'the first of these is the automated or partly automated delivery of the advice process. Many of the solutions still involve real advisers to some extent, but aim to take the steps of the advice process that we know and love, and execute them automatically. This is creating propositions which are cheaper to operate for firms and thus cheaper to procure for customers….Importantly, this type of service is most definitely regulated financial advice. It results in a personal recommendation and carries with it all of the liability associated with that…. [The] second type of proposition is a service where the customer picks a goal, a timeframe and a risk rating. The customer is then presented with a suggested portfolio (usually from a range of pre-packaged investment

[538] See Section 3.11.
[539] Reported in Carmen Reichman (2016) Worries flare over pension product range on platforms, Professional Adviser, 18 January.
[540] In MPT, investment portfolios are constructed to reflect the risk preferences of investors in a way that minimises risk (through efficient diversification) for a given target expected return.
[541] Source: Finametrica.

solutions) and a proposed investment amount. If the investor chooses to go ahead, their contributions are invested into the selected portfolio and it is managed for them in line with the agreed investment strategy, rebalancing as required. Importantly, clients using these services do not provide lots of information about themselves, and the companies providing these services usually argue that they do not constitute regulated advice, as they are not providing a personal recommendation'.[542]

Robo-advice has been used in the US since around 2005. The key US providers are Financial Engines[543] with assets of $104bn and an annual charge of $150 per year, Guided Choice with assets of $12bn and an annual charge of $500, Vanguard's Personal Advisor Services with assets of $10bn and a charge of 30bps, and Wealthfront with assets of $2bn and a charge of 25bps. In the case of Vanguard, clients need a minimum of $50,000. Vanguard also offers more human intervention than the existing offerings: clients with more than $500,000 will have a dedicated adviser, while those with less have a team to draw on. Advisers will design a financial plan for the client based on attitude to risk, objectives and investment horizon. Clients can monitor their portfolio's performance and will receive a quarterly report. Fund management charges are in addition and, the case of the Vanguard funds, range from 5bps to 19bps.

In May 2015, the US financial regulators – the Securities and Exchange Commission and Financial Industry Regulatory Authority – issued a warning to investors and advisers to beware the limitations of automated investment tools:[544]

- Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation. For example, an automated investment tool may be programmed to use economic assumptions that will not react to shifts in the market
- Which questions the tool asks and how they are framed may limit or influence the information you provide. Be aware that a tool may ask questions that are over-generalised, ambiguous, misleading, or designed to fit you into the tool's predetermined options
- An automated investment tool may not assess all of your particular circumstances, such as your age, financial situation and needs, investment experience, other holdings, tax situation, willingness to risk losing your investment money for potentially higher investment returns, time horizon for investing, need for cash, and investment goals.

Pauline Vamos, CEO of the Association of Superannuation Funds of Australia, speaking at the NAPF annual conference in October 2014, said that Australians had already moved

[542] Quoted in Adam Jones (2015) Is this a better name for robo-advice?, Professional Adviser, 5 November.
[543] Started by Professor William Sharpe, one of the founders of MPT.
[544] Reported in Professional Adviser (2015) Robo-advice alert issued in the US, 18 May.

towards self-service pension advice models. She warned that internet-based comparison sites were driving decisions, rather than third-party advisers: 'You don't know who the organisation is behind the comparator….Unless you capture the member early in terms of giving them simple advice services, simple tools that they will use, they will soon be able to get those sorts of services outside. And that may not be in the best interests of the members'.[545]

Robo-advice is not yet common in the UK, although a number of companies have set up in recent years to offer simplified advice. We report the following developments:

- Nutmeg was the first to launch in 2011-12
- Wealth Horizon started in 2014 with a portfolio structuring service on the Parmenion platform on the basis of simplified advice for clients with assets between £10,000 and £150,000, with a charge of 0.75% annually (plus a 0.25% set-up fee in year one). Advice is delivered online and, where required, over-the-phone by CF30 registered advisers
- Wealth Wizard. In August 2015, insurer LV= bought a majority stake. It said it would inject additional capital to assist with its plans to develop a 'white-label' automated advice platform and expand its own CORA (clear online retirement advice) service. Richard Rowney, managing director for life and pensions at LV=, said: 'The way people fund their retirement is changing and so is the way that people access their savings. This deal is a great opportunity for us to support the development of digital solutions to meet the evolving demands of retiring consumers'[546]
- Saidso, owned by Chapters Financial, offers an online, three-stage financial planning service charging £299 for a full report which records users' circumstances, objectives, attitudes to investment risk and tolerance to loss before suggesting solutions. It caters for retirement, investment and protection needs
- Postcard Planning which has a minimum charge of £149 for investment, retirement or regular savings advice, and a maximum charge of around £5,000 for wealthier clients
- Echelon Wealthcare's Fiver-a-Day which charges an upfront fee of 0.5% plus an ongoing flat rate of 0.7% (0.25% of which represents the cost of advice)[547]
- In August 2015, BlackRock announced that it had bought a San Francisco-based robo-adviser which it will use to give mass affluent clients 'holistic' personalised advice on their investment and pension accounts and the management of taxes

[545] Natasha Browne (2014) Rise of self-service advice 'poses threat to UK pensioners', Professional Pensions, 16 October.

[546] Reported in Jenna Towler (2015) LV= steps into robo-advice with Wealth Wizards stake, Professional Adviser, 3 August.

[547] Reported in Scott Sinclair (2015) Four advice gap pioneers the Government must speak to, Professional Adviser, 3 August.

accrued in their portfolios. It will recommend BlackRock's multi-asset model portfolios and investment products, as well as the products of other asset managers. FutureAdvisor will operate within BlackRock Solutions, BlackRock's technology and risk business. Tom Fortin, head of retail technology, said: 'As demand for digital wealth management grows, we believe that our combined offering will accelerate our partner firms' abilities to serve the mass affluent in a convenient, scalable way'. The nascent robo-advice market in the UK is typically associated with giving simplified advice, but BlackRock believes that the acquisition of FutureAdvisor is consistent with its 'mission to help clients solve their most complex investment challenges through technology'[548]

- Intelliflo plans to launch a simplified advice service for advisers which will be embedded in its existing Personal Finance Portal (PFP). This will enable advisers to service a broad base of clients, regardless of the size of their assets. The service will use investment risk profiling tools and several pre-defined investment portfolios. It will also allow the construction of bespoke risk-rated portfolios by advisers for their individual clients. The tool will 'red flag' clients with high value assets or requirements that are not straight-forward, automatically directing them to their adviser to seek more personal advice. Nick Eatock, Intelliflo's executive chairman, said: 'It's a form of robo-advice that keeps the adviser central to the process'[549]
- Towry is launching online services for clients, to supplement its existing face-to-face restricted advice service. Clients will be able to make transactions electronically. Rob Devey, chief executive, said: 'We, like many other wealth managers, have been a face-to-face driven service. The whole of the services industry is changing, people's expectations are changing. The iPad has changed everything. We need to respond to that'[550]
- Charles Stanley is also investigating the possibility of introducing a low-cost automated advice service[551] as is Investec Wealth & Investment
- In January 2016, Royal Bank of Scotland, Lloyds and Santander UK announced that they were entering the robo-advice market in an attempt to reconnect with the lower value mass market customers they dropped following the Retail Distribution Review.[552]
- FinaMetrica has launched a robo-advice toolkit targeting investors with under £100,000 to invest. Investor Profiler creates investor scores which link to a range of

[548] Reported in Carmen Reichman (2015) BlackRock US acquires robo-adviser, Professional Adviser, 27 August.

[549] Reported in Laura Miller (2015) Intelliflo to launch simplified robo-advice service, Professional Adviser, 14 October.

[550] Quoted in Professional Adviser (2015)Towry eyes online services for iPad generation, 20 April.

[551] Reported in Scott Sinclair (2015) Does this extraordinary list of robo-advisers show there's a market for automated 'advice'?, Professional Adviser, 14 April; Professional Adviser (2015) Vanguard launches 30bps 'robo' advice service for £33k clients, 7 May.

[552] Nicola Brittain (2016) Banks muscle in on robo-advice market, Professional Adviser, 25 January.

multi-asset portfolios. The tool is intended for advisers who have clients with simple investment goals, or for use by directly consumers. It bases its investor scores on a 12-question scientific risk tolerance test and questionnaire, which takes into account investors' time horizons, capacity for loss, risk tolerance, knowledge of investments and investment experience.[553]

There are very mixed views about the value and future of rob-advice in the UK. We now consider these.

Mark Loosmore, executive general manager (wealth) at technology group IRESS, argues that most consumers are now very comfortable with accessing information online and with using price comparison websites. An IRESS report entitled *Data, Disruption and the Digital Consumer* found that 80% of consumers now carry out research online before making a significant purchase or investment decision, 39% said it makes interacting with firms more convenient, 21% said it speeded the process up, and almost a quarter said they wanted to view their financial world – bank accounts, mortgages, investments, insurance – in one place. The report found that consumer appetite for both conducting financial activity online and seeking financial advice varies depending on wealth and the type of transaction: 25% of respondents across all income groups are willing to pay for financial advice, while this figure rises to 42% in the case of those with a household income above £60,000. Mr Loosmore believes 'there is an opportunity for advisers here: as well as harnessing the benefits of digital in their own work, they can also shape their proposition to help efficiently deliver this style of advice to a wider audience…[D]igital or 'robo' advice can be implemented as part of a 'menu' of options, with the ability to switch channels as required…Personal input will always be necessary, but this could then be focused on taking the time to develop relationships with the client'.[554]

Andrew Storey, technical sales director at eValue, believes that advisers who harness the power of technology will outpace their rivals:

> *The good news is that the robo-adviser can be harnessed to work for flesh-and-blood adviser, rather than against it. In fact, used correctly, technology-based solutions can be a valuable tool for segmenting an adviser's customer base and servicing legacy clients. Forward-looking advisers will be able to white-label simplified advice propositions offered by networks, platforms and providers, and will be able to offer customers simplified advice for between £150 and £250.*
>
> *By partnering with an organisation that has already done the due diligence on the algorithms and messages under the bonnet of the system, advisers*

[553] Reported in Carmen Reichman (2015) FinaMetrica launches robo-advice tool for sub £100k investors, Professional Adviser, 21 September.

[554] Mark Loosmore (2015) Robo-advice can't be avoided but it can be assimilated, Professional Adviser, 1 July.

*can be comforted they are not exposing themselves to unnecessary regulatory risk.*

*Not only can robo-advice provide an adviser with a revenue source in itself, but it should also be a way to filter large volumes of individuals – whether direct clients or those engaged with through the workplace – and identify those nuggets that can be turned into valuable full advice clients.*

*Simplified robo-advice systems will present anyone with complex affairs or large portfolios towards messages telling them need to speak to a financial adviser. The workplace, in particular, could prove to be a rich seam of new business for advisers that adapt to this new technology.*[555]

Bruce Moss, strategy director at eValue, believes that robo-advice could help to solve the pensions freedom advice/guidance conundrum:

*Robo-advice has frequently been seen as a threat to advisers, or as sub-standard and gimmicky. This is wrong and seriously misses the important point that robo-advice is a complement to traditional advice. Robo-advice not only caters for clients who have traditionally been financially inefficient for advisers to serve, it also allows adviser firms to deal with volumes that are way beyond their existing capacity.*

*The phase the UK is currently in is similar to that which happened in the US some seven years ago. When robo-advice started in the US, it mostly focused on investing new money without reviewing existing investments. In the main, robo-advice in the US has been targeted at the younger investor as a low cost pre-packaged investment option, but even if advisers use the technology to reach the masses, it is still far from a threat to advisers on either side of the Atlantic.*

*The robo-advice process is simple and short. A few simple questions and a risk assessment questionnaire, a stochastic forecast to help investors understand what the outcome might be, and a recommendation of a model portfolio of mostly ETFs [exchange traded funds] to keep the costs down.*

*It is a process that is not exactly rocket science and can be easily applied in the UK….Firstly, it is not very difficult to create an investment robo-advice process which ticks all the regulatory boxes. Secondly, it is only really necessary because the dividing line between information/guidance and advice is unclear. Essentially, the more help given to the consumer, the more likely it is that the line between guidance and advice may be crossed. In spite of the FCA's attempts to clarify the distinction between guidance and advice, it remains a grey area which may ultimately be decided by the*

[555] Andrew Storey (2015) Advisers must harness robo-advice and 'make it work for them', Professional Adviser, 15 July.

*courts. The distinction between online guidance and robo-advice needs legal clarity as the market develops.*

*Robo investment advice is undoubtedly useful as a means of resolving an area of regulatory uncertainty and providing a source of income for adviser firms from consumers who it would otherwise be uneconomic to serve…*

*To understand the real potential of robo-advice, we need to understand what it can do to meet the biggest challenge facing the financial services industry today in the UK – that of pensions freedom. Every year more than 300,000 people retire with defined contribution (DC) pensions. Many have comparatively small funds of circa £50,000. With a typical fee of over £1,200 plus VAT for conventional "at-retirement" advice, the fee aversion of most consumers at present seems very understandable.*

*Beyond being able to reduce the cost of advice dramatically to around £150, robo-advice has the capability to handle hundreds of thousands of cases a year – a feat which would be impossible by conventional means. The numbers needing robo-advice will grow rapidly because all those retirees who don't buy an annuity at outset will potentially need ongoing advice on how to invest and drawdown their retirement savings over the rest of their lives. This combination of high volume and low cost is the real advantage of robo-advice.*

*As with almost all innovations, there are some potential downsides, but they can all be managed. Robo-advice cannot handle complex cases, but it can handle the majority. In those complex cases, conventional advice can be offered with a substantial discount as a considerable amount of information captured by the robo-advice process can be made available to a human adviser.*

*The process must be very well-designed and a good model is vital, for any weaknesses in the model will continue to be replicated. Validation checks and monitoring are essential with borderline cases being identified and reviewed. There is also the risk that consumers may struggle to understand and use robo-advice, but innovative design and gamification techniques*[556] *can help to engage consumers.*

*Robo-advice is important because it helps address the greatest challenge faced by our industry – helping consumers make wise retirement choices.*[557]

---

[556] Gamification techniques apply 'game-design elements and game principles in non-game contexts..[and] strive to leverage people's natural desires for socialising, learning, mastery, competition, achievement, status, self-expression, altruism, or closure. [They] use rewards for [those] who accomplish desired tasks' (https://en.wikipedia.org/wiki/Gamification).

[557] Quoted in Bruce Moss (2015) Untapped potential: Understanding the real power of robo-advice, Professional Adviser, 12 October.

Jamie Fiveash, chief operating officer at The People's Pension, believes that there is no reason why pension scheme members could not receive advice for less than £100 per head: 'I am surprised trustees are not thinking around advice….We see no reason why you cannot get advice to your members for less than a £100 each. So we are committed to looking at how we can do that and are looking at digital advice as a solution'. He said that the pensions industry was behind other sections of the financial sector in its use of modern technology and could learn from the US: 'I think we will see a lot emerge from the market into this space and there is a lot of learning from the US where they use robo-advice a lot. We think that you can get the cost of advice down through some digital solutions'.[558]

In November 2015, Vanguard released the results of a survey of 70 UK wealth managers. Around 40% viewed robo-advice as a threat, while a similar 40% viewed it as an opportunity to increase efficiency and attract new clients. The rest said the impact would be minimal. Janine Menasakanian, head of wealth for Vanguard UK, said: 'The advent of the robo-advice age is creating significant hype and so it is not surprising that wealth managers are considering the impact over the long-term. What we do know is that technology is here to stay, so wealth managers will need to consider how to embrace the advantages of technology whilst still emphasising the personal, trust and relationship-based parts of their value proposition'.[559]

Also in November 2015, Finametrica published a report entitled *The Robo Revolution*. The report argued that rob-advice is 'paradigm changing' and 'the most significant development in the delivery of financial advice in the past three decades'. However, it noted that the biggest obstacle facing robo-advisers is the same one facing the entire financial services sector, namely the cost of acquiring new clients. This is estimated to be £200 per client in the UK, a sum which is 'beyond the means' of many advisory firms and explains their slow growth. The way around this, according to the report, lies in the white label market via channels that target communities, such as corporations, community groups, and even bloggers: 'The cost of acquiring a customer within a community is a fraction [of the cost] of going to the wider market. We all know this to be true – it is why financial advisers join the golf club….Imagine, for a moment, the impact of Apple offering financial services through a robo embedded into the operating system of its iPhones and iPads'.

Another big challenge in the UK are the regulatory hurdles. The report states that the automated models that do exist operate at the 'lowest levels' of restricted, focused, or simplified advice and are 'basically transactional machines': 'Robo-advisers aspiring to rise any further up the ladder towards more sophisticated advice which includes a portfolio

[558] Reported in Michael Klimes (2015) People's Pension: Robo-advice can be delivered for less than £100 per head, Professional Pensions, 25 September.

[559] Laura Dew (2015) Almost half UK wealth managers call robo-advice a 'threat', Investment Week, 24 November.

recommendation become caught in a strange clash of regulatory and compliance regimes'. These include not only the FCA and the Financial Ombudsman Service (FOS), but also EU legislation, such as MiFID II which has expanded the extent of its 'appropriateness' test. Nevertheless, the report sees robo-advisers as the solution to the advice gap 'as they have scalability and can service customers at low cost' and can help to 'democratise' financial advice.[560]

Chris Woolard said the FCA, via its Project Innovate, is keen for firms to come to market with robo-advice models, so that firms are able to deliver regulated advice 'more cheaply, efficiently and effectively' by employing a 'mixture of technology and human beings'. However, Mr Woolard did accept that financial services firms were reluctant to introduce new advice models because of 'nervousness' about the boundaries separating advice and information. He said the FCA was seeking to clarify its definitions of 'regulated advice' and 'personal recommendations' to help firms develop new, lower cost, distribution models with confidence.[561]

The FCA hosted a forum on robo-advice at the end of September 2015. The FCA said it wanted the industry to provide more people with access to financial 'help', whether advice or guidance. It was therefore planning future policy work around both simplified advice and simplified regulation to make it easier for firms to develop solutions.

The following issues emerged at the forum: [562]

- The Government is keen to support fintech (financial technology)
    - Harriett Baldwin, the Economic Secretary to the Treasury, said the Government recognises 'fintech is good news for all concerned' and will support innovation in the sector 'in any way we can'. The Government recognises that too many consumers are put off by the cost of advice and hopes to find ways to deliver financial help more cheaply through the use of technology
- Safe haven for product testing
    - The Government and FCA want to create a 'safe haven' for firms to test new products on consumers without the regulatory backlash if something goes wrong. The FCA wants to hear ideas built with the intention to act in the best interest of the consumer and will vet the ideas it allows in

[560] Reported in Scott Sinclair (2015) Robo-advice: Report detects 'elephant in the room', Professional Adviser, 5 November.

[561] Reported in Scott Sinclair (2015) FCA: We're primed for robo-advice, Professional Adviser, 22 May.

[562] Reported in Carmen Reichman (2015) Five lessons on robo-advice from day one of the FCA's forum, Professional Adviser, 1 October; Carmen Reichman (2015) PFS CEO Keith Richards: Time to focus on quantity not just quality, Professional Adviser, 1 October; and Carmen Reichman (2015) Fintech expert calls for urgent reform of '20th century FOS', Professional Adviser, 1 October.

- Do people need advice or guidance?
    - The Government is looking at how guidance providers, such as the Money Advice Service and Pension Wise, can be made more effective for consumers. People who fall into the advice gap may not actually need advice, instead they might need guidance
- Is there a role for pure robo-advice?
    - Delegates agreed robo-advice was needs-based, making it suitable for people with a well-defined need. However, most forms of automated advice currently in the market are a combination of an online process and human interaction. They use hurdle questions to identify clients with complex needs and refer them to a human adviser. Some delegates thought certain areas of advice, such as DB-to-DC transfers, could never be automated as they are too complex
- What type of consumers love robo-advice?
    - According to Charlie Nicholls, managing partner of Money on Toast, there are four types of consumer groups: self-directed, validators, delegaters, and avoiders. Self-directed and avoider types do not need or cannot be helped, respectively. Validators and delegaters are interested in to varying degrees but may be confused about their finances. They want help and as such are the target group for robo-advice. Mr Nicholls said: 'Robo-advice is needs-based. It's suitable for low- and high-value investment. Just because HNWs [high net worth investors] are served well by the traditional financial advice market doesn't mean robo can't go into that market and take a large market share'
- Bridging the affordability and accessibility gap
    - Keith Richards, chief executive of the Personal Finance Society, believes that automated services will form a key part in bridging the affordability and accessibility gap created after advisers moved upmarket following the RDR. He also believes that robo-advice is 'complimentary rather than a threat [to regulated advice]. We have seen a number of regulated firms have integrated robo or automated solutions into their processes. Simplified advice was put into RDR as [a means] to bridge the advice gap. We do have challenges we have to address including perception, affordability and accessibility [for which] we need different mechanisms'
- Role of the FOS
    - Ian McKenna, director of the Finance and Technology Research Centre, argued that the FOS needs to be reformed if robo-advice is to stand a chance of flourishing in the UK. He said it was operating a '20th century mandate in the 21st century' and needs to be reformed to allow low-cost advice solutions to enter the UK market. The only thing preventing the growth of robo-advice in the UK is stringent regulatory standards around consumer

protection, in particular, around 'assessing suitability, pension switching and self-defeating transactions'.

Delegates at an Intelliflo conference in June 2015 were warned that advisers who fail to embrace technology, and do all their business face-to-face and via paper, will lose out to more tech-savvy firms which better serve pensions freedom clients. Jane Hodges, chief operating officer at Alexander House Financial Services, also said that the sheer number of people who will need retirement income advice following the introduction of pensions freedom means advisers need to think differently about how to use their skill set to help the maximum number of clients.[563]

This view was shared by participants at a round table on robo-advice hosted by eValue in November 2015. Jason Chapman, managing director of Willis Owen, argued that robo-advice does not pose a threat to face-to-face. Instead, what could pose a threat is advisers' lack of skills in using technology, particularly around building consumer friendly websites and a creating a better digital experience. He added that advisers could embrace technology better than they do today: 'What we need to worry about is the huge sway of individuals who have no access to any advice or any product solution and create the journeys that will enable them to use technology and have a choice of the way that they purchase'. Samantha Seaton, CEO of eValue, said: 'We are always going to have a tension whereby a traditional adviser is probably going to feel alienated and threatened by robo-advice and I think that's perfectly natural. But I don't think that will stop robo-advice from happening'. Others agreed robo-advice was an opportunity to increase the overall size of the market: 'It seems to be an opportunity to expand the market rather than cap the market you've already got. It's to build a whole new group of consumers, who if they may not pay so much to begin with, they use your pipeline and they are paying something'.[564]

Some, on the other hand, believe robo advice will only have a limited future in the UK. For example, Numis doubts whether consumers will ever truly 'entrust their life savings to a computer'.[565] Sheriar Bradbury, managing director of Bradbury Hamilton, does not believe that robo-advice 'will fully replace skilled, professional advisers. I appreciate that tools offering automated solutions are sought by the DIY investor but, in the main, our clients are discerning and want to be challenged. They actively seek the value of strategically and tactically thought-through advice which only a human can provide…There will be aspects of advice that an algorithm is unlikely to replace. Holistic advice involving financial planning for more complex areas of, for example, inheritance tax, retirement, investment planning and the taxation interplay, is unlikely to be replaced by an algorithm any time soon. The

[563] Reported in Jenna Towler (2015) Tech averse advisers risk 'losing pension freedom market share', Retirement Planner, 23 June.

[564] Reported in Carmen Reichman (2015) Adviser tech real threat not robo-advice, specialist warns, Professional Adviser, 19 November.

[565] Reported in Dan Jones (2015) Will robo-advice take off in the UK?, Investment Week, 14 May.

question is which wealth management firms will be on the right side of that technology? These are the firms which will survive extinction'.[566]

Steve Hagues, founder of Retiring IFA, believes that 'nothing beats comprehensive personal service…The challenges that high net worth individuals face in managing their wealth range from the complexity of investing to working with multiple providers – banks, asset managers, accountants, lawyers, insurance agents and so on – to the complications of estate and tax planning…[There] is a benefit for forward-thinking firms to improve their focus and free up resource which can be achieved through tie-ups with other professional service companies, such as lawyers and accountants… [As] the advice market becomes more intricate, raising the value and scope of the service offered to clients is more than likely going to be key to professional services firms' success in the future'.[567]

Chris Williams, chief executive of Wealth Horizon, argues that robo-advice could well push out generalist advisers: 'A generalist adviser who is just really managing portfolios of funds for people has got a problem because fees are going to come down. Investment management and portfolio management are easy to automate. There's an abundance of information out there. People will question the fees they are paying. But where there is real complexity, where an individual doesn't really understand what's happening people are happy to pay for it in that space. That is where we will see fees increase because there is a real need for advice and for getting it right…Robo can go a very long way towards meeting financial advice. What it can't do is replicate the emotional, the empathetic [element] of having a human work with you. It's simply a choice whether they want that or whether they are happy to do it online'.[568]

The Finametrica report *The Robo Revolution* cited earlier considers 10 ways in which robo-advisers will affect human advisers:[569]

- Robos are big
    - You're going to hear a lot about them and they will impact on your life. We believe that the impact will be overwhelmingly positive! Don't believe the gloom that says robos will replace human advisers. They won't
- Robos will be everywhere

[566] Sheriar Bradbury (2015) Robo-advice: 'Some conversations an algorithm can never replicate', Professional Adviser, 8 October.
[567] Steve Hagues (2015) Client satisfaction: Why professional tie-ups trump robo-advice, Professional Adviser, 13 November.
[568] Carmen Reichman (2015) Wealth Horizon CEO: Robo-advice will push out generalist advisers, Professional Adviser, 10 August.
[569] Reported in Scott Sinclair (2015) Ten ways robo-advisers will impact human advisers, Professional Adviser, 5 November.

    - Everyone in the financial services supply chain will have a robo, either as a direct-to-consumer offering or as a tool for financial advisers to use
- Your client base may be under threat
    - Robos will be everywhere and your clients will be courted by them. Your new competitor might be a club or a community based organisation or affiliate – any organisation with a large membership could soon be in the market for a while-label robo
- There will be many different robos for different purposes
    - You will have a choice of robos, which will not all be the same. If you plan on working with any one you will need to assess it carefully to ensure it will be fit for your purpose
- Early-movers don't necessarily win
    - Better to make a considered decision and use proven technology and processes
- Robos will have to adopt suitability standards
    - To flourish, robos will have to meet the same suitability standards as human advisers. It is unimaginable that an advice business would want the same client getting a different recommendation depending on whether they used robo or human advice. A business built on a multi-factor assessment of risk tolerance, risk capacity and risk needed will, of course, expect those same standards in a robo
- Dealing with non-assigned clients and other relationships
    - Robos are quick and accurate at process work, like collecting data. And they make things fast – an investment recommendation can be on the table moments after the data is collected. It will, of course, be expected that robos must integrate with your business practices
- Low-cost, multi-asset portfolios are here
    - Robos deal in very low-cost investment structures and that is going to challenge current thinking, current practice and profitability. Like ripples in a pond, over time the effect becomes unpredictable even when it started out very structured
- You will have to prove your value proposition
    - Advisers are professionals who add value to their clients' financial lives. Be ready to prove that, because you will have to be able to supply that proof to charge higher fees than a robo
- Fees may come under pressure
    - Just as low-cost airlines lowered airfare costs, robos are likely to bring down the base-cost of advice. But, just as with the airlines, some people will not want to fly with the cheapest; some will be happy to pay full economy and some will want the silver-service that comes with first-class. The more holistic and detailed you are, the more you will win. Robos are not currently good at

> complex matters, such tax or estate planning or insurance. Possibly, we will see traditional advice operating to create the financial plan, with robos dealing with ongoing transactional needs

Finally, UBS predicts direct advice and simplified advice's share of the UK retail savings market will rise from 21% to 29% by 2025, although it does not identify how much of this will be robo-advice. It also predicts workplace advice's share will increase from 19% to 31% by 2025.[570] McKinsey believes the market for virtual wealth management advice has the potential to generate annual revenues of $66 billion.[571]

### 3.8.3 RetirementSaverService

The RetirementSaverService is a proposal made by Mark Hoban in January 2015 when he was MP for Fareham:[572]

> *The RetirementSaverService (RSS) would facilitate better retirement planning by supporting savers to see how their current savings might translate into income in retirement and what this means for how much they save, how long they plan to work and their appetite for risk. The service would do this by bringing together the multiple strands of information about an individual's assets and sources of income on a user-friendly online service. The RetirementSaverService would also provide tailored guidance to people approaching retirement. It would bridge the gap between the limited guidance currently provided and regulated advice, which remains unaffordable for most people. The service would help them choose suitable approaches and avoid unsuitable products through a narrowing of choices. The service would be independent and provided in the first instance by the Money Advice Service, building on its existing operations in this space….*
>
> *The RetirementSaverService is targeted at meeting [two] needs: guidance to support savers and a focal point of drawing together savings information. It would be a digital service providing guidance for users. It would be a self-directed service; offering tailored guidance driven by answers given by users to a series of questions. Although focused on retirement planning, it will use data about pensions and other assets alongside personal information to produce tailored guidance. It will not produce personal recommendations but will present a series of choices to users with the user making the final decision.*

---

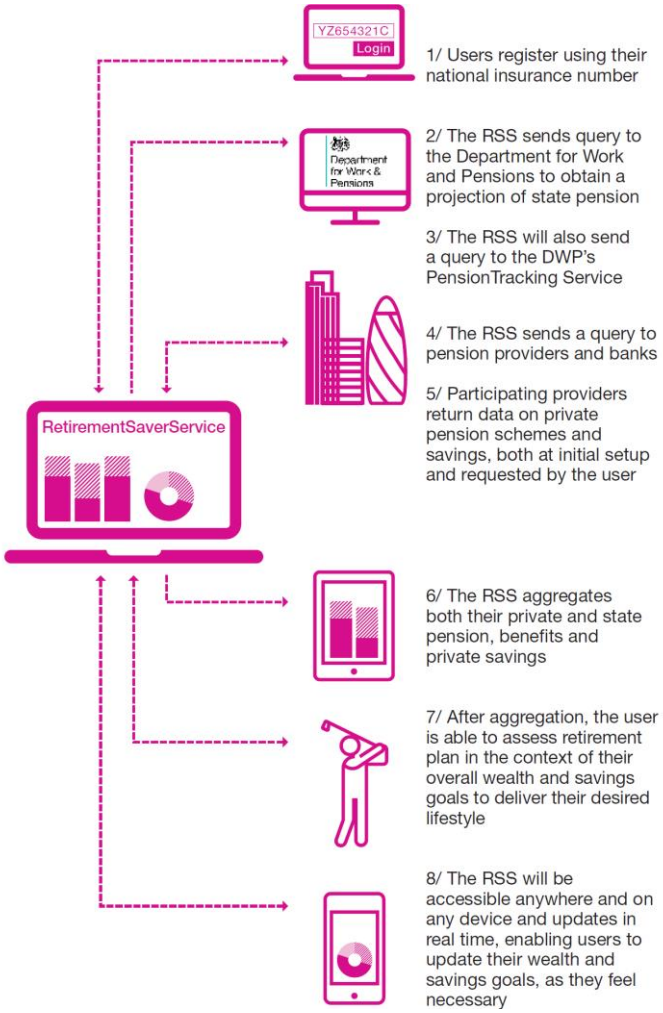
[570] Reported in Dan Jones (2015) Will robo-advice take off in the UK?, Investment Week, 14 May.

[571] Sarah Krouse (2015) Virtual financial advice set to soar, efinancialnews, 1 June.

[572] Mark Hoban (2015) RetirementSaverService, Reform, January; http://www.reform.uk/wp-content/uploads/2015/01/RetirementSaverService.pdf

Figure 3.2 shows a network map which illustrates how data could be shared and aggregated across the RetirementSaverService, while Figure 3.3 shows how users might interact with RSS from joining to retirement.[573]

*Figure 3.2: RetirementSaverService network map*




[573] Respectively, Figures 6 and 7 in Mark Hoban (2015) *RetirementSaverService*, Reform, January.

*Figure 3.3: Lifecycle of the RetirementSaverService*




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

#### 3.9.1 A number of advice gaps have emerged

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 fully 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 full 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. According to Robert Cochran from Scottish Widows: 'The 'guidance guarantee' offered via Pension Wise will offer savers access to information, but early indications suggest this is being sorely under-utilised, with barely 15% of the available appointments being used. For those who do reach the door of the Pension Wise offices, they will find it only gives a certain level of support, and for those who want a recommendation appropriate for their circumstances, they're likely to struggle finding it at a "reasonable" cost. The clincher is that this new segment may not even be aware they need advice. For those who've been saving for a few years and are now approaching retirement with a modest pot, they have a plethora of choice and little understanding of what the options are, or what the tax implications could be. Some 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'.

Arguments such as these have led to the view that an advice gap has developed in the UK. Mr Cochran believes 'there's a growing number of people with relatively modest pension savings, and it's becoming apparent that there's a gap in the market for advice aimed at people with smaller drawdown pots. This gap stands to widen as the effects of auto-enrolment start to unfold, and the full potential of the new freedoms truly hit home. … Advice may well be perceived as a luxury for richer clients, but what many consumers won't realise is how much of that fee could be offset as a result of the advice they receive'. He then provided an example to demonstrate the point. The individual has a £45,000 pot which they want to take as cash. Their marginal tax rate is 40%, so will pay £13,500 in tax. But if advised to split the amount taken over two years , the individual could save up to £8,870 in tax, offsetting the £1,500 cost of advice.

Mr Cochran also appeals to providers to help: 'Some providers apply a charge per withdrawal when people take encashment, which eats into the capital which could be used to pay for an adviser. By making products simpler and limiting or removing charges from encashment, it would make it easier to sell into employees with smaller pots, enabling them to seek out paid-for advice without eroding their modest savings'.[574]

Stuart Wilson, managing partner at Later Life Academy, goes further than Mr Cochran and argues that advisers should offer Pension Wise retirees free regulated advice up to a limit. He believes that 'guidance represents an untapped opportunity which, if executed correctly, could deliver a large number of new clients with varying later life advice needs, plus of course, the referrals that naturally come with any satisfied individual…. [This follows

[574] Robert Cochran (2015) What can be done about the advice gap?, Professional Adviser, 23 July.

because Pension Wise] is a long way away from tailored advice which delivers a clear route-map and recommendations for what to do next….[F]or advisers interested in these clients, the important part is developing a proposition which takes these individuals on the next stage of the client journey…By that I mean advisers are probably going to have to offer up some "free" time and advice in order to move the client on – this means taking the information provided by Pension Wise and making it much more specific, it means highlighting options and areas which guidance will not have covered, it will mean a discussion of pension options, but also offering some clear idea of what that may mean for tax burdens and benefit entitlement…And this should be offered free of charge because a client leaving Pension Wise may well recognise their need for financial advice, but they may not yet be in the headspace which means they are willing to pay for it. After this initial session however, the adviser will be able to make clear that any next steps come with a charge'.[575]

Some argue that any controversy over a widening gulf between those who need financial advice and those who can actually afford to pay for it is not actually the advisers' problem. For example, Geoff Mills, founding director of Rayner Spencer Mills Research, says 'The role of the [advice] industry is to educate those who can pay for [advice] about the benefits of it. Yes there is an advice gap but that's not for advisers to solve. That is for the Government to worry about, not businesses'.[576]

The Association of Professional Financial Advisers (APFA) has pressed for advisers' contributions to funding Pension Wise to be reduced because they are not winning sufficient follow-on advice business.[577] Nevertheless, APFA reported that by September 2015, 90% of advisers had received an average of eight new enquiries about getting financial advice on accessing pensions. Around half the advisers surveyed said the request for advice was on how to transfer out of a DB scheme. Although not all enquiries resulted in a transaction, the survey suggests that up to 150,000 people had contacted an IFA. This compares with the 400,000 people who reach retirement age each year. It is recognised that many people fail to take advice because they say that they cannot afford it, resulting in an 'advice affordability gap'. APFA agreed that more needed to be done to lower the price of advice and for Pension Wise to explain the value of regulated financial advice.[578]

It is also becoming clear that a different type of advice gap has emerged – the inability of some segments of the market to find advisers even when they want advice. Whatever the

---

[575] Reported in Jenna Towler (2015) Why IFAs should offer Pension Wise retirees free regulated advice, Retirement Planner, 14 July.

[576] Reported in Laura Miller (2015) Advice gap branded 'not advisers' problem', Professional Adviser , 31 July.

[577] Reported in Scott Sinclair (2015) Advisers not winning clients via Pension Wise, says APFA, Professional Adviser, 20 May.

[578] Reported in Carmen Reichman (2015) APFA: Almost all advisers see pension freedom enquiries, Professional Adviser, 1 September.

merits of using advisers, some believe that customers with small pension pots will struggle to find advisers who will take them on. According to Graham Bowser, a certified financial planner at QS Financial Planning: 'In practice, most IFAs will not be willing to engage with these "extra" low value retirees who might want to extract funds or use drawdown because the regulatory/compliance risk will be so much higher than is the case when dealing with people in the traditional drawdown market (those with £100,000-plus in pensions and have other savings/investments)'.[579] Chris Smallwood, chief executive of 2plan, said 2plan advisers have been instructed to turn away clients wanting to cash in their pots or move into drawdown when the amount is between £30,000 and £100,000. The firm would only recommend drawdown for pots above £100,000 if it believed it was a suitable product after giving full advice. For many others, an annuity is 'still the right option'.[580]

A related issue is the shortage of advisers following the implementation of RDR which significantly reduced the number of advisers in the market. David Thompson, managing director of business development and proposition at AXA Wealth, has looked at the number of advisers in different countries in relation to population size. Hong Kong, which had an RDR-style reform in 2015, has a one financial adviser for every 156 people. In the US and Australia, there is one adviser for every 1,400 people, while in Canada, there is one adviser for every 1,900 people. By contrast, in the UK, there is one adviser for every 2,700 people.[581] Mr Thompson believes 'we run the risk that people will go looking for advisers and there's going to be no one there to answer the call'.[582]

Steve Hagues of Retiring IFA expects more consolidation of the adviser market via mergers over the next couple of years as a consequence of increased competition from simplified and online advice. He said: 'Advice firms need to be on the ball to make sure they don't lose clients….Do you remember when garages sold fuel and not much else? Most are mini-supermarkets now….Accountants are increasingly interested in investment advice, while financial advisers are beginning to understand the power of doing a client's tax return and probate. The advantage of servicing clients' needs across the board is slowly starting to gain acceptance in the advice industry…As the decade progresses, if you don't ring fence your clients, you will be faced with having to defend them relentlessly from the other professions. Those who move across the professions are likely to succeed at the biggest client land grab wins due to the principle of first mover advantage. As the industry develops, it's clear the lack of a linked up or overarching strategy across different professional service

[579] Quoted in Jenna Towler (2014) Will platforms struggle to cope with pension freedom?, Retirement Planner, 9 December.

[580] Reported in Carmen Reichman (2015) National IFA 2plan won't offer small pot drawdown advice, Professional Adviser, 3 March.

[581] The total number of financial advisers in the UK in 2015 was 22,500 (working in 4,500 firms) down from 26,000 in 2011 (Reported in Carmen Reichman (2015) Adviser numbers up 5%, official figures show, Professional Adviser, 18 November).

[582] David Thompson (2015) Are advisers becoming an endangered species?, Professional Adviser, 23 July.

offerings could be a missed opportunity. At the moment, everyone is doing their job, but no one actually owns the client's overall real outcome'.[583]

The issues of mass access to advice and people being priced out of advice has been an increasing concern of the FCA since RDR. As we mentioned earlier, 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.[584]

The FCA is working on a middle-ground category where advice is offered but not a personal recommendation.[585]

> *We have therefore been discussing with our stakeholders the options for low-cost, simpler ways of recommending retail investment products, particularly for customers with relatively modest amounts to invest and relatively straightforward investment needs. It is clear that there has been some reluctance on the part of firms to develop these models and we are keen to understand more about the barriers firms believe they face.*
>
> *We are also aware that firms offering retail investments without personal recommendations want greater clarity on how they can support customers in making informed decisions – increasingly via technology-rich solutions – without stepping over the boundary into providing a personal recommendation.*[586]

### 3.9.2 The Financial Advice Market Review

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.

Its terms of reference are to examine:[587]

- the advice gap for those people who want to work hard, do the right thing and get on in life but do not have significant wealth
- the regulatory or other barriers firms may face in giving advice and how to overcome them
- how to give firms the regulatory clarity and create the right environment for them to innovate and grow

---

[583] Steve Hagues (2015) Consolidation- The changing shape of adviser mergers, Professional Adviser, 28 May.

[584] Reported in Laura Miller (2015) Advice gap branded 'not advisers' problem', Professional Adviser , 31 July.

[585] Financial Conduct Authority (2014) *Retail Investment Advice: Clarifying the Boundaries and Exploring the Barriers to Market Development*, Guidance consultation GC14/03, July;
https://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf

[586] Note that MiFID II goes further and would class this type of advice as regulated.

[587] https://www.gov.uk/Government/publications/financial-advice-market-review-terms-of-reference

- the opportunities and challenges presented by new and emerging technologies to provide cost effective, efficient and user friendly advice services, and
- how to encourage a healthy demand side for financial advice, including addressing barriers which put consumers off seeking 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 review will also consider the interplay between the regulatory framework for advice and the role of the FOS and the Financial Services Compensation Scheme (FSCS) in redress. The initial evidence gathering will have a broad scope before narrowing down to consider those areas where the so called advice gap may be most acute. The initial evidence gathering will request examples of problems in obtaining advice in the following markets:

- investments, savings, pensions, and retirement income products (including annuities)
- mortgages (including Help to Buy and equity release) and consumer credit
- general insurance.

The review will also examine evidence from consumers about the barriers they face in seeking advice, the value they place on it and how easy it is to understand where advice can be found and what it means.

While focusing on consumer financial services and products, the review will also look at the provision and effectiveness of advice across retail markets to assess whether differences in regulatory requirements around advice lead to unintended consequences for consumers and firms.

Finally, the review will come forward with:

- a package of reforms to:
    - empower and equip all UK consumers to make effective decisions about their finances
    - facilitate the establishment of a broad-based market for the provision of financial advice to all consumers
    - create a regulatory environment which give firms the clarity they need to compete and innovate to fill the advice gap
- a set of principles to govern the operation of financial advice
- measures to ensure standards of behaviour for firms within all types of financial advice market are in accordance with those principles
- proposals as to whether the regulatory perimeter for financial advice should be amended, taking into account European legislation

- an examination of the role that might be played by regulatory carve-outs, such as a so called safe-harbour
- a consideration of the proportionality of rules and their impact on affordability and availability of financial advice and products
- indications of
    - the resources needed for implementation of these proposals
    - a framework for evaluating how successful reforms have been in closing the advice gap, post implementation.

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. However, it was unlikely the FCA would consider removing liability for 'simple' advice solutions altogether. Speaking at a Work and Pensions Select Committee hearing on 16 September 2015, Christopher Woolard said: 'There is a further jump…to create a safe harbour where if you give someone advice and charge for that in some way and yet not take responsibility for that advice given – that feels like a step too far. But there is a lot we can do listening to those concerns to come up with something to help consumers and the advice community'.[588]

The Treasury (represented by Charles Roxburgh, director general of financial services at the Treasury) and the FCA (represented by Tracey McDermott, acting FCA chief executive) will lead the review with an advisory panel of industry and consumer experts, chaired by Nick Prettejohn, chairman of Scottish Widows. The Treasury said it wanted to make sure people can access high-quality, affordable, tailored guidance and advice to help them make informed financial decisions. Harriett Baldwin said: 'Making sure that our financial services sector supports working people at every stage of their lives is a key part of our long-term plan. That's why we've launched a major new review to explore what more can be done to make sure consumers can access high quality and affordable advice so they can make informed decisions with their hard-earned money'.

Huw Evans, director general of the ABI, said: 'This is a welcome step which comes at a good time. The new pension freedoms have highlighted how important it is that proper advice is accessible to all, not just those that can afford it'.

Chris Hannant, director general of the Association of Professional Financial Advisers (APFA), said: 'We welcome Government recognition of the need to examine the legislative barriers to accessing affordable financial advice. We believe there needs to be a fundamental rethink of the current regulatory environment, particularly around liability' and listed, as examples,

[588] Reported in Carmen Reichman (2015) FCA: We understand advisers' concerns about simplified advice liability, Professional Adviser, 16 September.

the lack of a long-stop [i.e., an open-ended liability] for advisers, the levy approach of the FSCS which penalises regulated advisers for those unregulated investments which go wrong, as well as imposing an unpredictable and seemingly ever-increasing fee burden, and concerns that the Financial Ombudsman Service faces 'systematic problems' in its decision-making. He said: 'Consumers need to understand that investments can never be 100% risk-free. We look forward to continuing to work with HM Treasury and the FCA as part of this review and elsewhere to ensure liability is assigned more fairly and that steps are taken to minimise the cost of regulation for professional financial advisers'.[589] In evidence to a Work and Pensions Select Committee hearing in September 2015, Mr Hannant said: 'There had been incidents where an adviser had, for example, set up a self-invested personal pension, the client had then undertaken their own investments but the adviser had still been held responsible. There is no time limit on which a complaint can be brought to the ombudsman. There are long tail liabilities. The way the FSCS is funded needed a fundamental hard looking at…. [Further], many advisers can foresee problems further down the line as pensions freedom beds in over the coming years. Everyone is saying things have gone reasonably well, they haven't fallen over. But the biggest concern among my members is that they foresee problems further down the track. We won't know until five or ten years down the track [if the reforms have been a success]'.[590]

In October 2015, the FCA announced that it was considering five options for re-introducing a complaints long-stop for advisers:

- Maintaining the current regime – not putting in place a long-stop
- Introducing a single long-stop – for example, a longstop of 15 years (such as that applying to certain causes of action under the Limitation Act 1980), or using a different time period recognising the long life of financial services products
- Introducing varied limitation periods linked to the terms of products – for example, differential time limits which reflect the nature of products or advice, so that liability extends for a longer period when it relates to longer-term products (for example, 25 years for a mortgage)
- Enhanced professional indemnity insurance (PII) – strengthening PII for firms so that it includes cover sufficient to meet claims relating to long-term advice, whether the firm is still in business or not
- A compensation fund – setting up a compensation fund which would pay out in the event of a justified claim older than 15 years against an individual firm, which all

[589] Reported in Jenna Towler (2015) Govt and FCA launch major review of financial advice market, Professional Adviser, 3 August.

[590] Reported in Jenna Towler (2015) APFA: Long-stop is missing piece to mass-market advice puzzle, Professional Adviser, 8 September.

firms would contribute to, but which would not require the firm concerned to be insolvent before paying.[591]

The review was also welcomed by advisers. For example, Keith Churchouse of Chapters Financial and Saidso, said: 'There are millions of people who are just not engaged in the financial advice process who should be. There is a mass market, we are talking millions of people, who are totally disenfranchised from financial advice but not through either their own choice or their own knowledge….The reality is that unless people are guided towards taking advice they will carry on probably doing not a lot and missing out on great opportunities to make their money work harder….There are always those who think that everything in life should be free, but I do not think they will get the answers that they want. However, I do think there is a middle market who are prepared to pay a nominal fee for good quality guidance and advice. To say "this is what you should be doing, this is who you should be doing it with". It is those [people] who need to be dealt with. The question is how much is a nominal fee? At Saidso it is £299. I am not saying that is the answer, but it is an answer. I am sure there will be competitors across the market'. Mr Churchouse also believes financial advice aggregator sites will come to the fore over the course of the next ten years. Such sites would compete for business to guide investors towards individual recommendations. This is a different concept from robo-advice which he believed would also become popular: 'Robo-advice might be another low-cost solution, people might be prepared to pay less for that. They are a bit like tracker funds – they are very cheap but run by a computer to keep costs low. Some people might want that, [but] some people might want a bit more of a personal approach'. He does not believe either of these initiatives will be a threat high quality financial advice: 'The reason why this review is going through is that these people are not being serviced at all. Even when internet services come into place, they still won't be a financial adviser's target market'.[592]

Similarly, Wealth Horizon's Chris Williams believes the introduction of safe harbour legislation for financial advisers would be a welcome step towards rebalancing liability between advisers and clients. Safe harbour legislation exists in both the US and Australia. In the US, it means employers cannot be sued if they followed certain steps when arranging employees' pension investments that later underperform; in Australia, it sets out the steps financial planners need to take to ensure they meet a statutory obligation to act in clients' best interests. Mr Williams believes safe harbour legislation could bring about a regulatory environment that recognises caveat emptor, or buyer beware: 'There has to be a view that consumers are able to make their own decisions based on relevant information. Trying to

[591] Reported in Scott Sinclair (2015)A complaints long-stop: Five options on the table, Investment Week, 12 October.

[592] Reported in Jenna Towler (2015) Millions of 'disenfranchised' savers could benefit from advice review, Professional Adviser, 3 August .

instil that level of responsibility and determination for consumers would be really important'.[593]

In October 2015, the FCA reported that it had identified eight main reasons which prevented people from seeking financial advice, and hence created an advice gap. The FCA defines an advice gap as 'any situation where consumers cannot get the form of advice that they want on a need they have, at a price they are prepared to pay'.

The eight reasons are:

1. Price

   Consumers may view the price for advice, particularly for professional, face-to-face advice, to be too high. A survey by unbiased.co.uk found that consumers are paying an average hourly rate of £150 for professional, regulated advice (though this represents a 14% drop compared to 2013). Some consumers may also find it hard to judge the value of advice because the benefits are usually deferred over time and more intangible than for purchases of non-financial products.

2. Lack of trust

   Consumers may not trust firms in the financial services market to act in their best interests, or be able to identify which firms are trustworthy and could provide valuable service.

3. Lack of knowledge

   Consumers might not recognise the need for advice or be aware of it. They also may not understand how to obtain it. As many people engage only infrequently in the market, this is not an area where people can easily gain experience to inform future decisions. In addition, consumers may lack confidence about the process, feel embarrassed about their lack of knowledge or concerned they may be judged for previous decisions – this may cause consumers to make non-advised financial decisions with poor outcomes. For example, a Mintel report showed that there might be a sizeable group of consumers who lack a basic understanding of what professional advice involves and how to obtain it. Of the consumers surveyed, 44% believe it is too complicated to understand how financial services firms can help them manage their finances, and 34% do not believe that professional advice is geared towards them. Moreover, 14% of consumers said they would not know where to begin looking for a financial adviser.

[593] Reported in Scott Sinclair (2015) Call for 'safe harbour' for advisers as rules reviewed, Professional Adviser, 4 August.

4. Engagement

Consumers who are disengaged with financial services generally are unlikely to engage with the process of seeking advice. Others may not recognise the complexity of their financial needs, e.g., longevity, tax, long-term care, benefits and investment returns may be relevant to a decision about retirement planning. Still others may feel they need financial advice but never be prompted sufficiently to seek it.

5. Overconfidence

Some consumers might believe they are as competent as a professional adviser, even though they could benefit from using one. As a result, consumers might not seek professional advice or, if they do, not follow the advice.

6. Access to face-to-face advice

Depending on their location, some consumers may not have easy access to advisers, and others may not wish to make the time to meet with an adviser.

7. Access to the internet and concerns with sharing data online

Where advice is available via the internet (for example, in the form of information, generic advice or an automated online advice service), lack of ability to use such channels and tools may prevent some consumers from getting advice in this way. Consumers may also have concerns about sharing sensitive personal data online.

8. Advice not necessary

Consumers may make a rational and reasonable decision that they do not need advice and are capable of making a decision themselves. This could be the case, for example, where the situation and options are simple and the risk is low, or where the effort or cost of seeking advice is disproportionate to the benefits.[594]

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 intimated 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

[594] Reported in Laura Miller (2015) Eight reasons people don't seek financial advice, Professional Adviser, 12 October; and Carmen Reichman (2015) FCA advice gap focus turns to income thresholds, Professional Adviser, 12 October.

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.[595] 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.

David Brooks, technical director at corporate advice firm Broadstone, explained the results of this survey in terms of the 'Dunning-Kruger effect', described by David Dunning as follows: '...incompetent people do not recognise – scratch that, cannot recognise – just how incompetent they are…What's curious is that, in many cases, incompetence does not leave people disorientated, perplexed or cautious. Instead, the incompetent are often blessed with an inappropriate confidence, buoyed by something that feels to them like knowledge'. While competent individuals tend to underestimate their ability, the opposite is true for incompetent people.[596]

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. The benefits perceived by customers from taking advice were the potential to grow their investments (42% of respondents), peace of mind that they have been advised by an expert (34%), and the feeling that they had made the best decision for their circumstances (28%).

Commenting on the findings, Duncan Jarrett, Aegon UK managing director, retail, said: 'There is a significant gap between what consumers believe they need to have saved before they seek advice, and the amount advisers believe is required to make advice worthwhile. The Government's consultation on methods of extending advice needs to look at ways of reframing consumer thinking. Take a household example, as a car gets older many people opt for an annual service which can spot potential problems early. While it involves a regular cost, it could pay you back many times over if it prevents a major expense at a later date.

---

[595] Reported in Laura Miller (2015) The reasons over-55s don't want your advice, Professional Adviser, 17 August.

[596] David Brooks (2015) Blog: Understanding why people don't want your advice, Professional Adviser, 18 August; Justin Kruger and David Dunning (1999) Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self-Assessments, *Journal of Personality and Social Psychology*, 77(6), 1121–34.

The same is true of advice. When people understand that the cost is potentially securing them a much more comfortable retirement or removing a major worry, then the value becomes apparent'.[597]

In October 2015, Citizens Advice released a report called *The Four Advice Gaps*.[598] The report concludes that more than 5 million people would be willing to seek out and pay for regulated advice, but are not prepared to pay current prices. The report also argues that there is not a single advice gap, affecting those who want advice but cannot afford it. Rather, there are four gaps which lead to a range of people missing out on the benefits of advice and the security that it affords. The results are based on responses from more than 2,000 individuals and 'scaled up' based on the 2011 population total of 48.3 million.

The four advice gaps are:

1. The affordable advice gap affects consumers who are willing to pay for advice, but not at current prices. According to Citizens Advice research, up to 5.4 million additional people would consider paying for advice if it cost less. While 20% of the population would consider paying for advice when making an investment, just 6% would pay £500 or more for simple investment advice.
2. The free advice gap affects people who want advice, but who are unable to pay for it. Citizens Advice said up to 14.5 million people who think they would benefit from free advice haven't taken any in the past two years. This includes some 735,000 people who have apparently tried to access free advice but have been unable to due to a lack of supply.
3. The awareness and referral gap affects people who are not aware that advice exists, or where to get that advice. As many as ten million people who think they would benefit from free advice are not aware of public financial guidance, according to the Citizens Advice report.
4. The preventative advice gap affects those who need financial guidance at key points in their lives, but do not take it because it is not marketed properly, or do not get the required breadth of help they need when they do.

In addressing these advice gaps, the FCA has announced it seeks to explore how access to advice can be 'radically improved'. It has therefore announced, as part of FAMR, an advice consultation which will focus on the following questions:

- What kind of financial advice do consumers want?

---

[597] Reported in Jenna Towler (2015) The magic number: Consumers see £121k as advice tipping point, Professional Adviser, 23 November.

[598] Reported in Professional Adviser (2015) Five million more would pay for advice (if it cost less) – report, 15 October.

- Are there gaps between the financial advice that consumers want, and the financial advice that they can access and afford?
- How can these gaps be closed?
- What role could technology, such as robo-advice, play in improving access to financial advice?

There will be a simultaneous guidance consultation which will consider how the Government should structure the provision of free, impartial guidance, including that given by the Money Advice Service (MAS) and Pension Wise, to give consumers the information they need, either to make financial decisions directly or to seek the right additional advice to help them do so. The two reviews will provide a complementary and comprehensive analysis of the advice landscape.[599]

While recognising that the advice gap exists, firms could be opening themselves to risks further down the line if they rush to fill it, according to Simon Laird, a partner at law firm RPC. Addressing an audience of financial advisers at the Wealth Management Association's Investment Conference 2015, he said that 'ordinary people need to make crucial decisions about how to invest their money to last them for 30 years or more….The reality is if firms get tempted into that advice gap [by offering simplified or flat-fee products] without some sort of thought-out structure behind it, then they might only be wanting to help, but if it goes wrong, they're going to be turned on and people are going to lay criticism at their door later down the line… If people do start taking shortcuts to keep costs down, they could fall foul of the regulator'.[600]

The FAMR consultation drew the following responses:

- Thomas Miller Investment has called on the Government to extend a tax exemption for employers who arrange financial advice for employees. The HMRC exemption from an employee benefits tax charge for regulated advice costing an employer up to £150 per person per year should be increased to as much as £1,000 per individual. This would confront the 'inconvenient truth' that 'the only way to ensure people make good decisions is to ensure they get good, sound advice from highly-qualified, highly-regulated advisers'. Matthew Phillips, managing director, said that the Government must face up to 'where the country finds itself. The reality is that retirees' choices are varied, older pension schemes are complex and a 45-minute guidance session will offer nowhere near the level of assistance that most people need to make an informed decision. Sorting out the regulatory befuddlement between advice and guidance is welcome, as is anything that reduces the jargon of

[599] Reported in Carmen Reichman (2015) FCA and Treasury launch 'advice gap' consultations, Investment Week, 12 October.
[600] Reported in Sara Benwell (2015) Firms should be wary of filling the advice gap, Pensions Insight, 5 October.

the financial services industry, but here is the catch: it rather misses the point. The only way to help people is for them to receive advice, and the reality is that with advice there are no half measures. If you have a regulated advice community, it is binary - it either gives advice, for which it is liable, based on an individual's full position, or it does not. It is a tailored solution and tailored solutions come at a price…An increase in the HMRC tax exemption is the best and most practical solution, actively encouraging the use of professional regulated advisers'.[601]

- The Financial Inclusion Centre has called for the establishment of a funded national advice network to help bridge the advice gap, with the funding provided either by industry or the Government. The network would 'provide advice, guidance, and information to consumers who are not commercially viable for the for-profit financial services industry. This must involve some form of cross-subsidy either from the public purse or from the industry. Closing the advice gap means focusing on making the financial services industry more efficient, so it can extend its reach to more consumers and providing alternative provision for consumers who are not commercially viable for the for-profit advice sector'.[602]
- The ILC-UK has called for a new type of advice for older retirees that would sit between the non-advised and advised categories and be cheaper to deliver than full regulated advice. In a report published in December 2015 and entitled *Understanding Retirement Journeys: Expectations vs Reality*, the ILC-UK said: 'Bringing financial advice to the mass market – whether face to face, over the phone or on the internet – is long overdue and we call on the Financial Advice Market Review to facilitate real change in this area'. Using data from the Living Costs and Food Survey and the English Longitudinal Study of Ageing, the report found evidence of under-consumption among the older population who hold the majority of their savings in low interest current accounts. Further, people typically started reducing their consumption around the age of 70, so their saving levels start to rise, thereby creating a drag on economic growth. Much of the decline in consumption came from reduced spending on non-essential items, such as holidays and eating out, whereas spending on essential items such as food remained flat. Some of the reduced spending could be explained by consumers becoming more uncertain about their income. To circumvent this, consumers should be actively re-engaged in the planning process at this point by being offered regular full financial health checks, through

[601] Reported in Professional Adviser (2015) Call for £1k pensions advice tax exemption for employers, 20 October.

[602] Reported in Carmen Reichman (2015) Think tank calls for state-funded national advice network, Professional Adviser, 21 October.

both Pension Wise and the proposed new type of advice. That advice would mention the importance of buying a lifetime annuity to provide security of income.[603]

- The Pensions and Lifetime Savings Association (PLSA) called on the Government to replace the environment where savers are left largely in the dark about the specific options open to them to one where they are signposted to quality-assured retirement income solutions: 'While leaving savers with the right to decide how to use their own retirement pot, this would ensure that the path of least resistance is much more conducive to good outcomes than today's effective default of taking cash'. Although wider access to advice would help ('but only for the few not the many'), the reality is that most people are not inclined to seek advice and are reluctant to pay for it. The PLSA's own research showed that, among those who have already accessed their pension, only 39% sought out financial advice and only 21% had used Pension Wise (mostly using the website only).[604]

### *3.10 Adviser charging*

It is clear from the previous Section that RDR, which required advisers IFAs to move to a fee-based and away from a commission-based charging model, has made the cost of regulated advice more explicit to the consumer. To illustrate, prior to RDR, a typical annual management charge (AMC) of 1% was split 50/50 between the provider (e.g., an insurance company) and the adviser. The insurer provided the administration, premium collection and the investment funds, while the adviser provided advice to both the employer and the scheme members.[605] Following RDR, the adviser has to charge the customer directly for advice. Furthermore, from April 2016, the FCA also banned trail commission on products sold after 31 December 2012, although it still allows trail commission on legacy products that were sold before 2013. This could make the advice business unsustainable for between 20-40% of current advisers, according to some estimates.[606] To reduce adviser costs, in particular regulatory costs, the advisers' trade body, the Personal Finance Society (PFS) has called for the introduction of a product levy – an explicit fee on investments and policies – to be paid for by the client. [607]

---

[603] Reported in Carmen Reichman (2015) New category of advice needed to get over 70s spending – report, Professional Adviser, 2 December.

[604] Reported in Stephanie Baxter (2015) Industry urges new approach to freedoms as advice is 'not enough', Professional Pensions, 22 December.

[605] Reported Laura Miller (2015) Point, counterpoint: Henry Tapper responds to pension adviser's charge cap gripe, Professional Adviser, 20 August.

[606] Heath Report, February 2015. Reported in Carmen Reichman (2015) New adviser body backs commission-like charges, Professional Adviser, 18 May.

[607] Carmen Reichman (2015) PFS joins calls for policy levy to combat 'unsustainable' adviser fees, Professional Adviser, 3 June.

In the lead-up to the new pensions regime, there was a debate amongst advisers, conducted in Professional Adviser, concerning the most appropriate charging model going forward. The main choice is between a fixed fee (based on an hourly rate) and a percentage-of-assets (or ad valorem) model.[608] The debate was inititated by Alan Smith, who argued that fixed fees was the 'modern, professional way' to charge, and Clive Waller, who supports a tiered percentage-of-assets model (e.g. 1% to 250,000, 0.75% to £500,000 etc...), with only specific pieces of work, such as an inheritance tax report, charged on a fixed-price basis.[609]

Keith Robertson, managing director at Armstrong Financial, said that the debate exposed a worrying element of conflict: advisers appeared uncertain whether their profits or their clients' outcomes should be the main focus. He added: 'As always, it pays to look through the clients' eyes… The only time ad valorem charging is rational (and therefore likely to be considered reasonable in principle by clients) is if the practitioner is providing genuine investment management advice. If this amounts to no more than passing the client to a discretionary investment manager (DIM), a client could, and should, question what additional skill you add for receiving a kick back on the fees; the DIM does all the work'. Instead, Mr Robertson recommends performance-related fees: 'according to research, it turns out that investors would pay reasonably generous performance-related fees - perhaps 20-25% of all gains above an agreed benchmark. However, this is only the case if the investment manager also participated in the bad years by giving something back. So perhaps this sort of remuneration would have to be on some sort of rolling basis, with a portion of fees held in escrow against possible future negative returns'. His specific suggestion was as follows: 'Say one set a target annual return of an inflation benchmark plus, maybe, 4%. If that return was achieved, an ad valorem fee of, say, a standard 1% would be payable. If the return was higher, the adviser/manager would receive 25% of the excess and the investor 75%. The problem is what happens if the target return is not achieved. Perhaps a sliding scale from 1% at the target down to close-to-zero if no return were generated and, if the return went negative, the adviser to give back some proportion of previously paid fees. Making adviser-managers liable for losses (to a limited extent), as well as gains, would change their behaviour and investment strategies; an interesting thought indeed. Non-investment work is obviously a matter of fixed or time-charged fee, negotiated with the client prior to starting the work, exactly as prescribed by the Retail Distribution Review'.[610]

Simplified advice firm Wealth Horizon argues that advisers should set charges according to the service their client wants, rather than offering a full service that charges 'for everything rather than what is required'. The firm argues that 'significant changes' are required to

---

[608] In February 2014, *Which? Magazine* published the results of a survey of fees charged by independent financial advisers (IFAs). It found that 81% charged an upfront fee of 3% on assets. For others who charge on an hourly basis, the average hourly rate was £164.

[609] Scott Sinclair (2015) Percentage charging is 'relic of bygone era', Professional Adviser, 27 April.

[610] Reported in Professional Adviser (2015) The charging model one IFA says will petrify advisers, 6 May.

make the industry more accessible for consumers in the light of the new pension flexibilities. Advisers need to avoid expensive packaged bank account-style add-ons that are designed for 'pandering to the wealthy'. CEO Chris Williams said that customers with less than £100,000 in the bank 'simply don't know where to turn'.[611]

In May 2015, a new association of directly authorised advisers called Libertatem was established with the aim of introducing a type of service for which commission-like payments will be payable. Libertatem would also set fixed fees for certain work, which would allow people currently unable to access advice to get that advice. The new organisation is led by Garry Heath, former IFA Association director general.[612]

The May 2015 survey published by Intelliflo discussed earlier also asked respondents how they would be prepared to pay for advice: 35% preferred a fixed pre-agreed hourly rate, while 12% preferred a fee based on a percentage of assets, with 10% preferring a combination of the two. In terms of what was considered to be a reasonable hourly rate for a fully qualified IFA, a third said less than £50 per hour, a third said between £50 and £100, 18% said between £100 and £150, 10% between £150 and £200, and 4% said between £200 and £300 per hour.[613]

A survey by APFA found that around 60% of advisers had turned away clients seeking pension advice in 2014 because they were concerned that the advice was too expensive, given the clients' needs and circumstances. Chris Hannant called on the FCA to relax regulation to allow advisers to come up with simpler, cheaper processes.[614]

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

[611] Reported in Carmen Reichman (2015) Call to end 'pandering to the wealthy' one-size fits all adviser charging, Professional Adviser, 27 April.

[612] Reported in Carmen Reichman (2015) New adviser body backs commission-like charges, Professional Adviser, 18 May.

[613] Reported in Professional Adviser (2015) Retirees set advice threshold at £100k savings, Professional Adviser, 22 May.

[614] Reported in Carmen Reichman (2015) APFA: Cost top reason two thirds of advisers reject clients, Professional Adviser, 4 March.

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'.[615]

According to a study by Which? in January 2014, more than half of the advisers surveyed did not reveal their charges until they had met with customers to see what they wanted.[616] In June 2015, only five of the 50 largest financial advice firms published their fees on their websites, according to research by low-cost adviser Candid Financial Advice. These are Hargreaves Lansdown, ranked second largest with gross sales of £6.6bn 2014, Brewin Dolphin, ranked third with sales of £2.5bn, Investec Wealth & Investment, ranked tenth with sales of £1.3bn, Saunderson House, ranked 23rd with sales of £620m, and Vestra Wealth, ranked 37th with sales of £370m. Most advisers refuse to be transparent about their fees because they say it is too difficult to assess how much their advice will cost without fully knowing a potential client's circumstances. However, this is making life difficult for customers, according to Justin Modray, founder of Candid Financial Advice, who said: 'While the commission ban forces advisers to tell clients how much they charge, it seems the vast majority will only do so when you agree to speak to or meet with an adviser. This makes shopping around for a fair deal very tiresome and in my experience too many clients feel compelled to use an adviser after meeting them, even if their fees are high… I would be very wary of financial advisers who do not publicly disclose their fees, as in my experience it's often because they are expensive'.[617]

In October 2015, Which? renewed its call for advisers to display their fees and charges online. But, it now wants the FCA to act and make displays mandatory. Again, there were mixed views amongst advisers about the issue of greater disclosure, but there was little support for making this mandatory.

Supporters of greater disclosure argue that the move would promote transparency, clarity, and certainty. For example, Al Rush, founder of Echelon Wealthcare and online adviser Fiver-a-Day, said that showing prospective clients how much a service will cost gives clients what they want: greater transparency. To illustrate, the website 'will tell clients that, if they want XYZ, in 85% of cases it will cost you x. This will only increase if the work gets too complicated or there is more work involved'. He did not accept the argument that it is impossible to display generic charges due to the 'bespoke nature' of their service: 'Some of our clients might be bespoke with old pensions and trusts all over the place, but for most people, if they want to consolidate a pension, start investing, re-investing, we know straight away how much it's going to cost. I know within half an hour. The reality is lots of our clients

[615] Reported in Anna Fedorova (2015) Schroders adviser survey: 75bps 'new norm' as smaller investors lose out, Investment Week, 4 December.

[616] Reported in Carmen Reichman (2014) Advice needs to be 'commoditised' to attract consumers – Unbiased, Professional Adviser, 16 December. When it analysed the websites of 500 adviser firms, Which? found 349 did not publish their fees online, while few others 'clearly' displayed their fees or used illustrative examples.

[617] Laura Miller (2015) Five advice giants break away from rivals on fees, Professional Adviser, 3 June.

are not bespoke; they've got pretty similar needs and circumstances. We are not tying ourselves to anything. We give an estimate, which is subject to change'. But while 'it makes good business sense to do it', Mr Rush did not want to see charges disclosure become mandatory.

Those against greater disclosure argue that the focus on cost is 'misleading'. According to Chris Budd, managing director of Ovation Finance, clients should be focusing on services, not fees, and leading them to think otherwise is misguided: 'I don't think Which? calling for the FCA to make it mandatory is helping anybody. Clients need to get the right type of service for them, not focus on costs. A list of possible fees is not going to tell anybody what type of service they will receive. Which? should be telling people to focus on shopping around for the service that's right for them. Cost is secondary. People focus on the wrong thing because they are being misguided by Which?'.[618]

The fee charged by advisers also covers the cost of regulation, which includes fees levied by the FCA and the FSCS. APFA surveyed its member firms in 2014 and found that regulatory costs – which included 'indirect' costs such as case-checking and general compliance – could be as high as 12% of turnover. The FCA and FSCS levies comprise around 0.5% and 4% of turnover, respectively. Sam Caunt, director of Future Life FP, says: 'The real cost of regulation is covering your backside. The fees and levies are just headline noise. The real cost is sitting down with the client, finding out their needs and objectives, doing the research and, on the back of that, the compliance it demands. We spend three times as much on IT and compliance as we do on FSCS. Most of our cost is labour: doing the job, documenting it all and doing the IT'.[619]

A study by consultancy Investment Trends of the Australian advisory market showed that profit margins have narrowed following the introduction of regulatory reforms in 2013 similar to the RDR which banned commission on products. The average profit margin has fallen to 1.2% for upfront advice (defined as 'the total cost of providing full advice to the typical client') and 3.2% for ongoing annual advice (defined as 'maintaining a client file, including periodic reviews'), compared with corresponding UK margins of 4% for both upfront and ongoing advice.

The two markets responded in different ways to the reforms. The UK switched mainly to percentage-of-assets charging (or 'explicit commission') and focused on high net worth clients. This allowed UK advisers to earn higher fees per client, although the client base was smaller. In contrast, Australian advisers moved more to fixed fees, because clients told advisers 'we don't want to pay asset-based fees'.

---

[618] Reported in Carmen Reichman (2015) For and against: Should adviser fees be displayed online?, Professional Adviser, 26 October.

[619] Reported in Carmen Reichman (2015) Talking Heads: Should advisers include 'cost of regulation' in fees breakdown?, Professional Adviser, 21 August.

Investment Trends' research shows the average Australian adviser earned 21% of its income from fixed fees in 2011, compared with 22% from asset-based fees and 54% from commission. This grew to 33% via fixed fees in 2014 and is projected to grow further, to 42% by 2017. In the UK, the average firm earned 14% from fixed fees, 20% from percentage fees and 65% from commissions in 2011. This changed to 21% fixed fees and 52% asset-based fees in 2014 and is projected to change to 25% fixed fees and 56% asset-based fees in 2017.

Australian advisers also started to compete more directly with each other – there are 70,000 advisers in Australia, more than thrice the number in the UK – while product providers also started offering low-cost advice and the result was to drive down prices. Investment Trends believes the UK could come under similar pricing pressure as cheaper forms of advice – such as simplified advice from providers such as Standard Life and robo-advice – enter the market to fill the 'advice gap' created by RDR.

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

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. 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'.[620] Under the current regulatory framework, this is clearly a challenge, but it suggests we should be looking at the simplified advice route.

#### 3.11.1 A default pathway with simplified advice

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

The first relates to 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 bespoke regulated advice). According to Rachel Vahey, independent pensions consultant: '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'. A particular issue was the cost of guarantees in the new range of drawdown products being offered: 'Guarantees serve a useful purpose, but can be expensive. It is important people understand

[620] Financial Conduct Authority (2014) *Developments in the Distribution of Retail Investments: Purchasing Investments without a Personal Recommendation or with Simplified Advice*, Thematic Review TR14/10, July. http://www.fca.org.uk/static/documents/thematic-reviews/tr14-10.pdf

what the costs are, what the implications are for their money management, and importantly what the alternatives are'.[621]

Joel Adams, adviser with LIFT Financial, argues that, while drawdown will become more mainstream, it will not be viable for people with smaller pots: 'Complete flexibility is a very dangerous thing, especially for those without an adviser. I anticipate that there will be a cut-off level where it is not profitable for advisers to be involved and I think it will be at about £100,000. You have to look at it realistically as to whether it is worth getting involved with small pots. There is a cut-off line where the benefit of advice will be outweighed. That is exactly why we need to see innovation from product providers to make sure advisers can offer simple solutions to clients'.[622]

The second relates to 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, according to a study by IFA Prydis in December 2014.[623]

The third relates to the quality of and trust in the advice. As mentioned above, 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. The research was conducted by consultant Ignition House as part of the FCA's Interim Report for its Retirement Income Market Study.[624] The main findings from the research are:[625]

- 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'
- providers were not communicating with clients effectively about their retirement options, and were ignoring the code of practice produced by the Association of British Insurers
- a 'strong mistrust' towards IFAs by those yet to retire and those not currently with an adviser, due to a combination of 'poor past experiences' and a belief that IFAs 'might not always work in their best interests'. Respondents were 'surprised to hear

[621] Reported in Jenna Towler (2014) 'Will the masses be hooked on non-advised drawdown?', Retirement Planner, 22 October.

[622] Reported in Jenna Towler (2014) 'Will the masses be hooked on non-advised drawdown?', Retirement Planner, 22 October.

[623] Reported in Carmen Reichman (2014) Advice needs to be 'commoditised' to attract consumers – Unbiased, Professional Adviser, 16 December.

[624] Financial Conduct Authority (2014) *Retirement Income Market Study: Interim Report*, Market Study MS14/3.2, December, http://www.fca.org.uk/static/documents/market-studies/ms14-03-2.pdf

[625] Reported in Carmen Reichman (2014) Public wants quality-of-advice benchmark, report suggests, Professional Adviser, 11 December.

that pension advice in the post-RDR environment would be paid for through an explicit fee, and that this could cost them in excess of £1,000'. This put some customers off using an IFA, especially those with small pension pots

- pre-retired advised customers were content with how much they paid their adviser and would be happy to continue the relationship post retirement.
- there were mixed views from those already retired about the value of advice, with some respondents reporting that they had sufficient information available for them to confidently make decisions on their own, while others saying that they would seek advice if they did not understand the options facing them
- many retirees using advice reported that they had no way of telling whether the service they had received was good.

The fourth hurdle relates to a 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.[626] According to Fiona Karlin, director at Momentum Partners, FCA guidelines suggest that firms should treat simplified and focused advice in the same way as full advice and this would include risk profilings. Advice firms need to protect themselves and hence should include hurdle questions to assess client suitability in online advice.[627]

The fifth relates to 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.

The final hurdle relates to how the FOS treats complaints. The 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'.[628]

---

[626] Carmen Reichman (2015), Pension provider fears 'advice' risk in FCA's retiree rules, Professional Adviser, 28 January.

[627] Quoted in Carmen Reichman (2015) Simplified advice should include 'hurdle questions', says IFA, Professional Adviser, 25 February.

[628] Reported in Carmen Reichman and Scott Sinclair (2015) FCA tweaks guidance on what constitutes 'advice', Professional Adviser , 22 January.

### 3.11.2 Can simplified advice work in a default framework?

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.

Barry O'Dwyer, managing director at provider Standard Life, believes that the financial services industry 'ought to take [simplified advice models] very seriously'. Similarly, Tom McPhail, from Hargreaves Lansdown which has been providing non-advised drawdown for eight years, is confident that guidance alone can work: 'Our own experience of dealing with non-advised drawdown – and we know more about it than any other business in the UK – is that you have to engage with the customer, walk them through the relevant information and ensure that they understand what they are doing. If the pension provider fails to take responsibility for these simple steps, then it is not unreasonable for them to be called to account for their failings. One of the biggest risk areas will be trust-based schemes offering drawdown. It can be done, but doing it safely requires care and robust processes'.

Chris Daems, director of Principal Financial Solutions, believes that the guidance guarantee can work, but customers need a clear route to more specialist advice. He uses the analogy of the NHS: 'so, where the NHS has a flow like this:

> *NHS Direct (or NHS 111) > Paramedic > Doctor > Specialist (with referrals going to the next stage if the 'patient' needs more help than the current level can provide)*

...the guidance guarantee version might look like this:

> *Web site > Phone > Unqualified face-to-face support > Qualified face-to-face support > Specialist qualified face-to-face support (this also needs to be within a clear framework so when certain information is disclosed or questions asked, it can be passed on to the next level)'.*[629]

Those working for advisers or wealth managers tend to disagree that simplified advice can work in a default framework. The following views are typical.

Kay Ingram, divisional director of individual savings and investments at LEBC, said: 'There is a whole lot to take into account [when planning for retirement]. [It includes] everything from drawdown to deferring pensions and looking at clients' other sources of income. The point is, to [deliver guidance] that people can follow and take action on, it is going to take

[629] Chris Daems (2014) Making the guidance guarantee the go-to retirement service, Retirement Planner, 17 September.

more than a decision tree. The only way really to get an idea is to consult an IFA. It is something that has got to last the test of time and that's what's difficult'.[630]

Austin Broad, technical director at AFH Wealth Management, goes further:[631]

> *Retirement options remain one of the most complex areas of financial planning, driven in part by the fact that, when an individual enters the decumulation phase of their life, it is rarely a simple matter of considering their pension plans in isolation. Most retirement planning requires the retirees' whole financial situation to be considered in formulating the best outcome for them.*
>
> *Clearly this is most acute where the retiree has sufficient assets to consider drawing their future income directly from their retirement funds, avoiding the purchase of an annuity. Known as drawdown, the options and variations available are significant and careful consideration and professional advice is essential.*
>
> *This is completely at odds with the guidance guarantee and more importantly, non-regulated individuals delivering guidance in a strategic area that requires professional understanding of the retiree's tax position, their total assets, their income and their expenditure.*
>
> *The new rules in many ways further compound matters as there are likely to be more complex solutions and greater alternate options for the retiree to consider.*
>
> *This is not about whether to use a particular insurance product or independent option, this is about the strategy adopted, which according to Treasury, does not need a regulated individual to deliver.*
>
> *The delivery of strategic drawdown solutions in the new world will require advisers to consider the holistic financial position of the retiree, together with their objectives and needs. It will require an understanding of life expectancy and tax in order to promote the concept of retirees taking seriously the need for their plan to be sustainable for life and yet meet their other income objectives in the most tax efficient way.*
>
> *Trying to guide somebody through this maze, with what could amount to limited information, is an accident waiting to happen and therefore the emphasis of any guidance, where drawdown is a likely outcome, is to refer to a professional adviser.*
>
> *I am sure that insurance companies will be very interested in the potential for retirees to take on drawdown themselves. Again, for many retirees, following this course of action is likely to present challenges which would*

[630] Quoted in Carmen Reichman (2014) Guidance guarantee plans not good enough, LEBC warns, Professional Adviser, 30 July.

[631] Austin Broad (2014) 'An accident waiting to happen': Why drawdown retirees need more than guidance, Professional Adviser, 2 October.

*benefit from professional advice input. In some of the cases where a retiree goes direct, the problems that are created could take many years to surface and could potentially prove very costly.*

*In conclusion, retirement options, in all but the smallest of pension funds, will benefit from professional advice.*

*The provision of guidance on drawdown, outside of delivering an education is dangerous and should be referred to a regulated source.*

*The decisions made at retirement are by definition long term decisions that need to take account of the whole, not just a part, of the story.*

*Therefore, a fee-based, preferably independent advice approach should be recommended. This would allow the adviser to manage any conflicts they may have, within the agreed fee structure they adopt for the work to be done.*

Jamie Smith-Thompson, managing director at Portal Financial, is concerned about people cutting out advice to reduce costs: 'Who is going to direct the investments and why are they selecting those investments? To be able to do that as an IFA, you need a few years' worth of exam taking and knowledge before you can recommend that to the client. Do you think these DIY people have got that extent of investment knowledge? That is a real concern'.

Rachel Vahey argues: 'There is a worry that those going into unadvised drawdown will not understand the risks involved or how to manage them. Guidance will have a role in explaining this, but professional advice will obviously be the best route to those considering drawdown'.[632] She was concerned about people ending up in their existing provider's poor value drawdown fund: 'So we might have the unappealing situation where instead of failing to shop around for an annuity (as is the case now), people fail to shop around for a drawdown fund and just go for the one with their current provider'.[633]

David Thompson, managing director of business development and proposition at AXA Wealth, said: 'Few would argue that the pensions reforms….are not to be welcomed. Having greater choice and greater flexibility over pension arrangements is surely a good thing. However, we believe that, with greater choice and flexibility, there is also a greater risk that, without professional financial advice, a lot of people will not achieve their financial expectations in retirement…. Less scrupulous providers may be lured by a quick buck and

[632] Reported in Jenna Towler (2014) 'Will the masses be hooked on non-advised drawdown?', Retirement Planner, 22 October.

[633] This is a real possibility according a recent Retirement Planner Inquiry. The main explanations were related to behavioural barriers preventing customers shopping around and staying with their existing provider. According to respondents to the Inquiry, 37% put inertia as the main reason, followed by lack of advice (32%). Other explanations were lack of knowledge, lack of understanding and taking the 'easy option'. Three-quarters of respondents believed that OMO should be made compulsory ahead of annuity purchase. See Jenna Towler (2015) Annuity sales - When will retirees get a better deal?, Professional Adviser, 29 January.

exploit the opportunities to get assets under management… We need to find a way forward that allows people to access professional financial advice which is detailed enough to give confidence in the expected outcome, yet at the same time affordable for individuals – or their employers – with smaller pension pots'.[634]

Despite Tom McPhail's views that guidance alone can work, Hargreaves Lansdown launched a low-cost retirement planning service in June 2015 aimed at filling the advice gap between Pension Wise and regulated financial advice. The HL Retirement Planning Service, which charges a flat fee of £395 plus VAT, 'is an advisory service but stops short of providing specific, personal recommendations'. Mr McPhail said: 'The Pension Wise service provides investors with an invaluable introduction to the key issues they need to think about. The HL Retirement Planning Service takes investors a stage further than Pension Wise, walking them through the issues they need to consider when setting up their retirement income'. The service would help people understand:

- their retirement income options and the tax position of each
- how much secure income they might need
- the risks of drawdown and provides guidance on sustainable income
- the need for contingencies, protecting dependants and factoring in potential care costs
- provides a sense check to their current thinking
- where to go and how to convert their pension into income.

If clients who use the service want to progress to full advice the £395 fee will be knocked off future bills. Mr McPhail noted that HL's service costs 'only around a quarter of a typical full advisory service'.[635]

### *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-

[634] David Thompson (2014) Mind the trap: The unintended consequences of pensions flexibility, Professional Adviser, 27 October. The potential conflict between providers and advisers was also noted in Chapter 2.

[635] Reported in Jenna Towler (2015) Hargreaves Lansdown aims to 'fill advice gap' with low-cost pension planning service, Professional Adviser, 23 June.

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. This can be illustrated by the statement made by Christopher Woolard in his forward to the FCA's discussion paper *Smarter Consumer Communications*, published in June 2015:[636]

> *A well-functioning market needs informed and engaged consumers. It requires consumers to have access to high quality, appropriate information to help them understand the product or service they have or plan to buy. This is especially true in the financial services sector, where it is important that the information helps empower consumers to make informed decisions about their finances.*

This statement is much more consistent with the econ model than the human model of behaviour and econs are typically not classified as vulnerable consumers.

### 3.12.1 Governance of pension schemes in the new pension environment

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.[637]

Governance in trust-based schemes – which are regulated by TPR – require the setting of minimum quality standards from April 2015 which ensure:

- default investment strategies are designed in members' interests and regularly reviewed
- core scheme financial transactions are processed promptly and accurately
- scheme rules do not restrict the trustees' appointment of advisors and administrators
- trustees assess the levels of charges borne by members and the investment costs, with a charge cap of 0.75% on default funds
- trustees have, or have access to, all of the knowledge and competencies necessary to properly run their scheme
- the scheme has a chair of trustees with responsibility for preparing an annual governance statement setting out how the scheme has complied with these governance requirements.

Deloitte has produced a seven-point checklist for trustees:

---

[636] Financial Conduct Authority (2015) *Smarter Consumer Communications*, Discussion Paper DP15/5, June.
[637] Introduced by the Pensions Act 2014.

1. Consult with employers on issues such as the cost to set up and administer new pension options, to determine the amount of flexibility to be granted to scheme members, and what defined benefit de-risking strategies the employer may wish to implement.
2. Communications to members should cover the latest changes and the degree of flexibility their pension scheme will offer. Frequent communications will be required throughout the implementation phase.
3. Scheme administration should be reviewed, particularly around new minimum requirements to signpost members to the guidance guarantee during their retirement process. Similarly, another requirement seeks to ensure members are properly instructed to find independent financial advice at the appropriate time. New pension flexibilities may have additional administrative complexities and costs.
4. Seek legal advice on issues arising from the 'freedom and choice' changes. Conduct a review of the trust deed and rules which may unearth amendment requirements, and consider the implications of the statutory overrides.
5. Get actuarial advice. Changes will be applicable for DB schemes specifically, and centre on cash equivalent transfer values (CETV) calculations. The basis of these should be reviewed and its consistency with cash commutation factors within the scheme considered. Seek advice on whether CETVs should be reduced, by what level, and whether the employer is willing to support payment of full CETVs. Other considerations include the Code of Practice on DB-to-DC transfers and conversions, as well as the impact on scheme funding.
6. Benefit options
    a. DC schemes: A final decision should be made as to the flexibilities offered within the scheme, including a review of annual benefit illustrations to reflect the new freedoms. The process of notifying and recording should also be considered when the money purchase annual allowance is triggered.
    b. DB schemes: As a minimum regulatory requirement, receipt of independent financial advice must be confirmed and recorded before CETV completion. Additional, and optional, considerations include whether CETVs should be provided as part of the retirement process, or whether individuals may take a non-statutory CETV at normal retirement as part of their standard scheme options.
7. Investment strategy
    a. DC schemes: A review should be taken of the default investment strategy, as well as the lifestyle strategy and switching period, to assess their appropriateness. The range of investment funds available to members should also be a consideration both pre and post 'retirement' age.
    b. DB schemes: The investment strategy here should take into consideration the membership profile of the scheme which could change rapidly, and DB CETV requirements in response to possible liquidity and disinvestment issues.

> Ongoing trends should be monitored in this regard for future investment strategy reviews. [638]

Some believe that the new pension regime combined with the terminal decline of DB schemes is likely to reinforce the move away from individual trusts as the vehicle for operating pension schemes. Instead, employers are likely to switch to contract-based DC schemes or enter into master trusts. According to Alan Morahan, head of DC consulting at Punter Southall, 'we are going to see a move away from individual trusts. Many trustees and sponsoring employers are going to struggle to open up the full range of freedoms that are available. So with that flexibility readily available elsewhere, it will mean that those trusts will get wound up and there will be further reduction in the number of trustees that are operating in the market'. Penny Cogher, head of pensions at Charles Russell Speechlys, believes: 'The move to contract-based frees [companies] and their employee trustees from the heavy burden of running a scheme. Classic trusteeship will fade away as business owners follow the example set by large companies in establishing ... a pension committee. These will make sure that their pension provider is delivering a scheme that is fit for purpose'.[639]

From April 2015, governance in contract-based schemes – which are regulated by the FCA – will be based around independent governance committees. IGCs must have at least 5 members, the majority of whom (including the chair) will need to be independent of the firm. Their role is as follows:

- act in the interests of active and deferred members
- assess the value for money of the scheme (comparing the cost with the benefits and services it provides)
- where the IGC finds problems with value for money, to raise concerns (as it sees fit) with the firm's board
- raise concerns to the FCA, alert relevant scheme members and employers, and make its concerns public, and
- produce an annual report of its findings.

Schemes in small companies can appoint an independent third party (known as 'a governance advisory arrangement' (GAA)) to take on their IGC responsibilities.

Questions have been raised about the real powers of IGCs. For example, Jacqui Reid, pensions lawyer at Linklaters, said: 'The jury's out on the extent to which IGCs will bridge the gap between contract-based schemes and trust-based schemes. IGCs can make recommendations to contract-based providers, but they have little power in practice. They

[638] Reported in Retirement flexibilities - a seven-point trustee checklist, Professional Pensions Online, 1 April 2015 .
[639] Quoted in Marek Handzel (2015) Taking flight, Pensions Age, May.

cannot make changes to improve value for money where they find that value for money does not exist [e.g., if the member is in an old-style high charge fund]. Even where it is clear that a fund is underperforming, neither IGCs nor providers can vary existing members' contractual arrangements by moving their members from that fund without the members' express consent'. Richard Wilson, policy lead for DC at the NAPF, said IGCs didn't 'have any actual powers' and were 'essentially advisers'.[640] An insider told us: 'The Government considers IGCs and trustee boards to be essentially equivalent. This is not remotely true. IGCs were set up as a way defending the failure to impose a fiduciary duty (i.e., trustees) on insurance companies. IGCs are neither independent nor governing. Insurance companies appoint the members of the IGC, half of whom can be employees and the other half can be representatives of companies which supply the insurance company. The IGC can only make recommendations. The conflicts of interest are extreme'. However, Steve Webb, the then Pensions Minister, said that providers that ignore their IGC would face huge reputational damage.[641]

There is third governance model – the master trust – which has been around since the 1950s, but has been given a new lease of life with the introduction of auto-enrolment. A master trust is a multi-employer occupational pension scheme where each employer has its own, effectively ring-fenced, division within the master arrangement.[642] They can benefit from economies of scale and hence have lower charges. NEST, The People's Pension and NOW: Pensions are set up as master trusts. These schemes have also joined the master trust assurance framework (MAF).[643]

Specific benefits of the master trust model include:

- the ability for members to benefit from the ongoing management and oversight of investments
- the ability to drive down operating costs through bulk purchasing
- the need to appoint just one group of professional advisers for the whole scheme rather than a group for each division
- one board of trustees for the whole scheme, rather than a board for each section, thereby coming under TPR rather than the more onerous governance rules of the FCA

[640] Reported in Stephanie Baxter (2015) IGCs will have 'little power' to improve value for money, Professional Pensions, 9 February.
[641] Reported in Michael Klimes (2015) Webb rejects 'toothless' IGCs claim, Professional Pensions, 22 January.
[642] TPR's definition of a master trust is 'an occupational trust-based pension scheme established by declaration of trust which is or has been promoted to provide benefits to employers which are not connected and where each employer group is not included in a separate section with its own trustees. For this purpose, employers are connected if they are part of the same group of companies (including partially owned subsidiaries and joint ventures)'.
[643] Introduced in April 2015, MAF was developed by the Institute of Chartered Accountants of England and Wales in association with TPR; http://www.thepensionsregulator.gov.uk/trustees/master-trust-assurance.aspx

- consolidated accounting and governance requirement.

A potential disadvantage is that the trustees are typically appointed by the provider of the master trust, which can lead to employer disengagement with the pension arrangement. On the other hand, some, especially small employers, might welcome this.[644]

Both trustees and IGCs will have to define and assess 'value for money' in their DC schemes. In the case of trustees of an occupational DC scheme, this means assessing whether scheme charges and transaction costs represent 'good value'. In the case of IGCs, this means assessing the 'ongoing value for money' of a provider's contract-based workplace DC pension schemes.

*Table 3.6: Factors to be taken into account by trustees and IGCs in the new pensions environment*

| Factor | Trustees | IGCs |
|---|---|---|
| Objective | Calculate the charges and (in so far as they can) transaction costs borne by members<br><br>Consider investment return<br><br>Compare to others in the market, where possible | Consider the level of charges borne by members and the direct and indirect costs (including transaction costs) incurred in managing and investing<br><br>Consider the design of default investment strategies and the net performance of all investment strategies<br><br>Compare to others in the market, where possible |
| Subjective | Weigh up benefits and services received by members against what members value in:<br>• Governance<br>• Communications<br>• Administration<br><br>(This includes a statutory requirement to consider whether core financial transactions are processed promptly and accurately) | Weigh up benefits and services received by members against what members value in:<br>• Governance<br>• Communications<br>• Administration<br><br>(This includes a FCA requirement to consider whether core financial transactions are processed promptly and accurately) |

[644] This is drawn from Graham English (2011) Master Trusts - Making a comeback, Pensions World, November.

There is no statutory definition of value for money, so according to Helen Ball, head of DC, Sackers, both trustees and IGCs will need to develop their own assessment process which will involve comparing costs against the benefits provided.[645] A well-run scheme in terms of, say, good administration and clear communication might cost more, but could result in better member outcomes and hence be of 'good value'. Table 3.6 shows the factors that need to be taken into account.In assessing value for money, trustees/IGCs will need to establish what factors members value most and then decide how to weight the different factors.[646]

Some information will nevertheless be hard to gather. An important example of this is the disclosure of the full costs of fund management, including transactions costs.[647] This is a needed for assessing value for money and the AMC, total expense ratio (TER) or even the ongoing charges figure (OCF) are inadequate and incomplete measures of fund management costs. From April 2015, trustees and IGCs will have to report transaction costs for the first time.[648]

The DWP-FCA Call for Evidence on this issue in March 2015 stated:[649]

> *Work to increase transparency of transaction costs in the workplace pensions market should be viewed in the wider context of efforts to ensure other consumers are fully informed about all costs and charges associated with other retail investments. Efforts at European Union level are already moving towards including transaction costs in any pre-contractual cost figure disclosed to the end consumer for retail investment products. This is being developed through the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation and the recast Markets in Financial Instruments Directive (MiFID II). Neither PRIIPs nor MiFID apply to workplace pensions, whether occupational pensions or workplace personal pensions, but it is important to work towards achieving consistency across the information consumers will receive in relation to these other retail investments. Negotiations also continue on European Commission governance and transparency proposals within a recast directive on Institutions for Occupational Retirement Provision (IORP II).*

---

[645] Helen Ball (2015) Assessing 'value for money' in DC arrangements, Pensions Insight, 1 April.

[646] The Pensions Regulator (2015) *Regulatory Guidance for Defined Contribution Schemes*, April (http://www.thepensionsregulator.gov.uk/docs/guidance-dc-schemes.pdf)

[647] Transactions costs are just the visible costs. There are also the hidden costs of investment management which reduce the net returns to savers and these can be larger than the visible costs. See David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Pensions Institute Discussion Paper PI-1407, May 2014. (http://www.pensions-institute.org/workingpapers/wp1407.pdf). See also the response by the Investment Association (2015) *Meaningful Disclosure of Costs and Charges*, February.

[648] Pensions Act 2014.

[649] DWP-FCA (2015) *Transaction Costs Disclosure: Improving Transparency in Workplace Pensions – Call for Evidence*, March; https://www.gov.uk/Government/consultations/improving-transparency-in-workplace-pensions-transaction-costs-disclosure

Disclosure of fund management costs will be particularly important in the decumulation phase, since retirees may find it difficult to return to work if their pension pot is depleted too quickly by excessive withdrawals, poor investment performance or high fund management charges, particularly for offering guarantees. However, 'any cost information disclosed to members should be understandable and relevant, and presented in a format that contains sufficient, yet succinct, information to inform the member'.[650]

### 3.12.2 Vulnerable consumers

Notwithstanding Mr Woolard's statement at the beginning of this Section, the FCA is certainly aware of potential consumer vulnerability and has introduced a number of regulatory initiatives in relation to concerns raised by the new pension flexibilities.

In February 2015, the FCA published an Occasional Paper which identified up to half the UK adult population as being 'vulnerable' consumers.[651] 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 paper gave the following examples:

- Policy
    - Many firms lack an overarching strategy or policy on consumer vulnerability
    - Policies designed to prevent financial abuse and fraud can inhibit staff empowerment to use discretion, particularly regarding legitimate access by third parties (e.g., those with power of attorney)
- Systems
    - Failure of internal systems, where firms fail to communicate and connect information internally. For example, this can lead to customers having to tell firms multiple times about bereavement, resulting in numerous duplicate letters from different areas of the business being sent
    - Interfaces or channels of communication that are not inclusive
    - Increasing automation and use of call centres may create challenges in spotting potential vulnerability and ensuring customers are referred on to specialist teams where necessary

[650] Page 48 of DWP-FCA (2015) *Transaction Costs Disclosure: Improving Transparency in Workplace Pensions – Call for Evidence*, March.

[651] Martin Coppack, Yasmin Raza, Simon Sarkar, Kate Scribbins (2015) *Consumer Vulnerability*, Financial Conduct Authority Occasional Paper No.8, February; http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-8.pdf

- Products
    - Inflexible products and services that are designed for a standardised perfect customer and do not factor real-life events into their design. Some customers who face a change in circumstances are therefore not able to receive a flexible, tailored response
    - Product and information complexity and confusing communications
    - Lack of suitable affordable products for people in some non-standard situations
    - Lack of solutions for temporary delegation (enabling a family member or carer to manage your affairs for a short time) which retain privacy and safety
- Implementation
    - Policy/practice gap at firms, where frontline staff are not aware of or do not implement head office policies. Frontline staff may not refer people on to specialist teams
    - Consumer time is not valued highly and many people give up if the process is too time consuming, especially if they are in a stressful situation with other demands on their time
    - Inconsistent approach around flexible temporary forbearance
    - Arrangements around temporary delegation (enabling a family member or carer to manage your affairs for a short time) and accompaniment (sitting in or helping with a phone call or interview) not sufficiently developed and flexible to enable family and carers to help
    - Inappropriate selling and sales practices which exploit behavioural biases
    - Issues around disclosure of a vulnerability and data protection – inaccurate or overzealous application creates unnecessary problems

The paper then goes on to describe what 'good' looks like to consumers, based on research that the FCA conducted:

- Having financial products that are clear and easy to understand
- A choice of ways of communicating to be available whenever you need to make contact and for these to be designed in an inclusive way so that they are clear, easy to understand and meet your needs. This could relate to the method of communication (e.g., audio/braille/face-to-face) or the service delivery (e.g., agreement to talk at a particular time of day depending on carers and medication)
- Feeling that firms will treat you as an individual and you won't face the 'computer says no' response just because your personal circumstances do not fit the standard mould
- Knowing that, should you experience a sudden change in circumstances, you will be offered a flexible and tailored response from your financial services provider

- Being able to talk to someone who will take the time to listen, who is flexible enough to let the conversation take its natural course, and who is sufficiently trained to spot signs of vulnerability and refer on to specialists where necessary
- Being referred on to someone who has the authority and discretion to take a tailored approach to your situation and offer flexible solutions, including use of specialist sources of help and advice if necessary
- Feeling confident that your firm encourages disclosure, that they will work with you in your best interests
- Knowing that if you do disclose information about your needs, that information will be recorded properly, so that you do not have to repeat it every time you make contact with all departments of a particular firm
- Knowing firms will proactively contact you if they suspect you may be having financial difficulties
- Knowing appropriate action will be taken if a firm spots suspicious activity that may signal abuse or fraud
- If you are trying to speak to a firm in a caring capacity, finding that the firm listens and makes a note of your concerns even though it may not be able to divulge any information to you
- If you are recently bereaved, have a power of attorney or a third party mandate, receiving consistent advice and treatment.

The paper concludes by describing what can firms do to deliver good customer outcomes:

- To ensure a consistent approach that is embedded across all operations, it is important to have a high-level policy on consumer vulnerability in place
- It is important that all relevant staff are aware of the policy
- Firms could begin by auditing current practice
- Ongoing evaluation of the effectiveness of a vulnerability strategy plays a significant role
- Research demonstrates that it is important for staff on the front line to have sufficient training to facilitate a proper conversation and that they know where internal expertise lies
- Flexibility in the application of terms and conditions of products and services plays a significant role in ensuring the needs of consumers in vulnerable circumstances are met
- An efficient process for referring consumers on to specialist teams who have authority to make flexible decisions is important
- Good policies and practice in handling disclosure or communication needs of consumers and recording of that information effectively play a key role for consumers and are helpful to staff. Actively encouraging disclosure, by staff able to have proper conversations, has been shown to be helpful here

- Clear, simple information and explanation throughout the product life cycle is important to all consumers
- Policies around data protection in particular, but also safeguarding and affordability, need to be implemented based on a correct understanding. If staff are well trained, they are less likely to apply such policies in an overzealous manner which can create problems for customers. For example, proper affordability is vital to the wider protection of consumers, but firms should have systems in place to allow for appropriate discretion.

#### *3.12.2.1 Vulnerable DC consumers*

In November 2014, the FCA announced in a Policy Statement that it would protect vulnerable consumers and review requirements where money is taken directly from pensions.[652] The regulator noted that (p. 23): 'Drawdown itself may be used quite differently in the new environment. As we assess the impact on the requirements that relate to drawdown, we will consider how to ensure consistent protection for consumers and review requirements on firms where money is taken directly from the pension. One particular area we will explore is non-advised sales of income drawdown and uncrystallised pension fund lump sums. A number of respondents raised concerns here as currently most drawdown products are sold with regulated advice'. The FCA also stated it would modify its rules on projections in drawdown products which currently assume a regular income is being taken over time. If retirees access their pension pots more flexibly, the current rules may produce 'confusing or irrelevant information'.

On 26 January 2015, the FCA announced a new layer of consumer protection called 'additional protection' or a 'second line of defence'. It did this in a 'Dear CEO' letter.[653] 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. In particular, providers must do the following:

- Ask retirees a set of questions about 'key aspects of their circumstances that relate to the choice they are making' such as their 'health and lifestyle choices or marital status' in order to protect them from making the wrong choices[654]
- Issue 'relevant risk warnings' such as the tax consequences of a decision to take cash

---

[652] Financial Conduct Authority (2014) *Retirement Reforms and the Guidance Guarantee*, Policy Statement PS14/17, November, http://www.fca.org.uk/static/documents/policy-statements/ps14-17.pdf

[653] http://www.fca.org.uk/static/documents/dear-ceo-letters/dear-ceo-letter-retirement-reforms-guidance-guarantee.pdf

[654] The people most likely to benefit from transferring out of a DB scheme will be single people, who do not need the partner's benefit in a DB scheme, and those in poor health who have impaired life expectancy.

- Make a recommendation, in customer communications about retirement options, that consumers consult Pension Wise or take regulated advice.

The 'Dear CEO' letter was followed up by a FCA Policy Statement in February 2015 which formally set out the new rules to come into force on 6 April 2015.[655] They will apply to providers operating personal pensions, stakeholder pensions, selling pension decumulation products or facilitating the access of pension savings on an execution-only basis. The FCA also announced that it plans to consult in summer 2015 on whether to retain, modify or add to these rules, as part of a wider consultation on the rules around consumers' interaction with providers as they approach retirement. It also stated that TPR will be publishing complementary guidance for trustees of trust-based schemes.

The introduction of additional protection or second line of defence followed criticism of the FCA at a hearing of the Work and Pensions Select Committee on 17 December 2014 at which Christopher Woolard stated: 'What we can never do, in any area we regulate, is stop fools behaving like fools'. The committee felt that this attitude was a dereliction of the FCA's responsibilities. Mike Thornton MP, a member of the committee said: 'You are the Financial Conduct Authority. How providers act towards their customers is at the centre of your responsibilities'.[656] The effect of the criticism was to raise the level of concern within the FCA about the possibility of not only mis-selling but also theft via scamming.

Some welcomed the changes on the ground that they challenged the inertia of the existing system. Tom McPhail said: 'This second line of defence….is exactly what we have been calling for. Without this, it would have been far too easy for pension providers to carry on rolling their customers over into poor value or inappropriate retirement income products. However it will also raise the bar, making it more challenging for pension companies to deal with their customers; some may decide it just isn't worth the effort'.[657]

Some were concerned that consumers, overwhelmed by the array of new pension options, could easily become confused or misinterpet the new questions about their personal circumstances as advice. For example, Claire Trott, head of technical support at Talbot and Muir, said: 'I am concerned that some retirees who have opted to avoid the use of Pension Wise will also opt not to answer the prescribed questions [put by the provider] fully or honestly and therefore won't receive the most appropriate risk warnings'.[658] Similarly, Paul

---

[655] Financial Conduct Authority (2015) *Retirement Reforms and the Guidance Guarantee: Retirement Risk Warnings*, Policy Statement PS15/4, February; http://www.fca.org.uk/your-fca/documents/policy-statements/ps15-04

[656] House of Commons Work and Pensions Committee (2014) *Oral Evidence: Progress with Automatic Enrolment and Pension Reforms*, HC 668, Wednesday 17 December.

[657] Reported in Natasha Browne (2015) FCA introduces emergency rules to prevent mis-selling from April, Professional Pensions, 26 January.

[658] Quoted in Jenna Towler (2015) Providers back FCA's 'second line of defence' for retirees, Professional Adviser, 26 January.

Evans, pensions technical manager at Suffolk Life, said: 'There will be a lot of providers who are concerned they will be seen as giving advice in asking the "relevant" questions. It is essential clients understand the questions they are being asked. There's clarification needed on what the regulator wants and what providers can do in order to make it work'.[659]

Ms Trott believes that if the second line of defence is insufficiently robust, there could be future mis-selling scandals:

> *The second line of defence is actually an important stage when trying to combat pensions liberation, the time it takes to complete the forms and sign the disclaimers should hopefully give just enough time for people to stop and realise what they are being asked to do, even if they don't read the carefully crafted risk warning letter presented to them. The fact they have to complete a questionnaire in order to access the benefits might be enough for them to reconsider their options.*
>
> *I don't believe conducting the second line of defence over the phone is sufficient enough to ensure that clients who haven't taken advice are suitably warned about the implications of what they are doing, having to sign something to say you want to proceed is much more significant to people than listening to someone and agreeing…*
>
> *Anything we as providers can do to protect clients without infringing their right to access their benefits is great, but it still goes back to full personal advice from an FCA regulated financial adviser is clearly best.*
>
> *The fact that the FCA require providers to give risk warnings to clients who have used the Pensions Wise service is a clear indication that they also consider this guidance to be inadequate.*
>
> *I would like to see all clients taking advice, but it is wholly unacceptable to limit their retirement options just because they've chosen not to. For years, annuities have received a poor press. Many people view annuity purchase as inflexible and representing poor value. If clients' options are curtailed in this way, it could be a real disincentive for the next generation of pension savers. I don't believe that an annuity is a better non-advised option than drawdown and taking the whole fund as cash is a significantly more risky course of action for a non-advised client.*
>
> *I can see a new mis-selling scandal here by creating new default options for clients and this could all be prevented with robust second line of defence practices.*[660]

---

[659] Quoted in Carmen Reichman (2015) Pension provider fears 'advice' risk in FCA's retiree rules, Professional Adviser, 28 January.

[660] Quoted in Claire Trott (2015) Providers pushing pensions freedom advice demands 'too far', Professional Adviser, 21 September.

Even where they do take advice, many members might not like the advice they receive and disregard it. In this case, they are classified as 'insistent clients', although this is not a recognised regulatory term and, from a regulatory point of view, they fall into the non-advised category. Advisers took different views on 'insistent clients'. Some believed that they have a 'moral obligation' and a 'duty of care' towards their clients and would not implement anything they regarded as unsuitable, irrespective of whether the client insists, even if it means they would lose the client's business. Others said they have no moral obligation as long as the client is sufficiently informed and would not want to 'browbeat clients', although they remained concerned about risks to their business.[661]

In September 2015, the ABI's Huw Evans told a Work and Pensions Select Committee hearing: '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 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'.[662]

In January 2016, the FCA announced that 42% of customers taking drawdown were doing so on a non-advised basis.[663]

#### *3.12.2.2 Vulnerable DB-to-DC consumers and others with safeguarded benefits*

In February 2015, TPR issued guidance for trustees of DB schemes on dealing with member requests for DB-to-DC transfers.[664] The guidance aims to:

- help trustees ensure they have appropriate processes in place to manage transfer requests
- prompt trustees to consider the impact of transfer values as part of an integrated approach to the risk management of their scheme
- require trustees to provide clear information for members so that they can get independent advice on the best option for them.

The guidance recognises that 'it is likely to be in the best financial interests of the majority of members to remain in their DB scheme'.[665] If a member's CETV is over £30,000, the

[661] Reported in Carmen Reichman (2015) I don't think that's a good idea: How to deal with insistent clients, Professional Adviser, 19 March.
[662] Reported in Jenna Towler (2015) Comparing pensions to bank accounts 'irresponsible', ABI chief warns, Professional Adviser, 8 September.
[663] Financial Conduct Authority (2016) *Retirement Income Market Data: July – September 2015*, January.
[664] The Pensions Regulator (2015) *DB to DC Transfers and Conversions*, Consultation Document, February; http://www.thepensionsregulator.gov.uk/docs/db-dc-transfers-conversions-consultation.pdf

member must take independent financial advice from a D60 qualified specialist pension adviser before transferring.[666] The member must pay for this advice (unless the transfer is initiated by the employer). The adviser will send a questionnaire to the scheme to establish the benefits in the scheme and then perform a full benefit comparison with the DC pension arrangement the member wishes to switch to. The member is required to provide written evidence to the trustees that the advice has been given. However, trustees are not 'responsible for checking what advice was given, what recommendation was made or to confirm whether the member is following that recommendation'. Further, it is not 'the trustee's role to second-guess the member's individual circumstances and choice to transfer [DB] benefits. Nor is it their role to prevent a member from making decisions which the trustees might consider to be inappropriate to the member's circumstances'. The trustees are required to ensure that the receiving scheme is a legitimate arrangement and not a pension liberation scam.

In March, 2015, the FCA announced new rules on pension transfer advice. In particular, it would change its Regulated Activities Order, amend the definition of 'pension transfer' to reflect the new pension environment, and introduce a requirement for firms to appoint a pension transfer specialist (PTS):[667]

- New Regulated Activities Order
    - Advice on transfers from a DB occupational scheme to a DC occupational scheme will require the firm to be FCA-authorised for pension transfer permission
    - Advice on conversion of safeguarded benefits within a DC occupational scheme to access flexible benefits will require the firm to be FCA-authorised for pension transfer permission
    - Advice on transfer of safeguarded benefits within a DC occupational scheme to access flexible benefits will require the firm to be FCA-authorised for pension transfer permission
    - Pension trustees/managers of occupational schemes must check a scheme member has received advice before a transfer of safeguarded benefits to flexible benefits is carried out. Pension trustees/managers will not be

---

[665] The FCA's own analysis predicted that up to 40 per cent of people transferring out of a DB scheme would be 'irreversibly' worse off with some being 'left destitute' in old age. Reported in Dan Hyde (2015) Savers who cash in final salary pensions are 'irrational', says watchdog, Daily Telegraph, 4 March.

[666] Pension Schemes Act 2015. The advice will be regulated by the FCA. *Financial Conduct Authority (2015) Proposed Changes to Our Pension Transfer Rules,* Consultation Paper CP15/7, March; http://www.fca.org.uk/static/documents/consultation-papers/cp15-07.pdf

[667] Reported in Aileen Lynch (2015) Safety first - How to operate in the new pension transfer world, Professional Adviser, 1 May.

required to check advice has been received where the fund is less than £30,000, or where an annuity is being purchased.

- Definition of pension transfers
    - A transfer of deferred benefits (regardless of when these are to be crystallised) from:
        - an occupational pension scheme
        - an individual arrangement providing fixed or guaranteed benefits that replace similar benefits under a DB scheme
        - an arrangement that contains safeguarded benefits (for example, guaranteed annuity rates and guaranteed minimum pensions)
    - To:
        - an occupational pension scheme
        - an individual pension plan (personal pension/stakeholder)
    - Or:
        - to transfer safeguarded benefits to obtain a right to flexible benefits
    - These proposals mean firms not authorised for pension transfers must consider pension advice with extra precaution to ensure they do not carry out activities beyond their scope of permissions.
- Appointment of a pension transfer specialist
    - Firms that wish to continue to advise clients on some/all of the above areas will be required to apply for a variation of permission. This process will necessitate the appointment of a pension transfer specialist (a person holding an appropriate qualification and who can demonstrate knowledge and experience in this area). Firms that currently hold pension transfer authority need take no action as their permissions will automatically be updated to reflect the proposed definition of this activity.

In June 2015, the FCA issued an amended Policy Statement (PS15/12) on pension transfer rules. It creates a new regulated activity of 'advising on conversion or transfer of pension benefits'. It also clarifies the meaning of safeguarded benefits, a term introduced by the Pensions Schemes Act 2015 and defined in the negative as all benefits that are not a money purchase benefits or cash balance arrangements.

It was not clear at the time whether benefits offering a guaranteed annuity rate (GAR) would be included in the definition. In principle, they are money purchase benefits, but the guarantee could imply that they are safeguarded benefits. The FCA has now decided to exclude GARs from the new regulated actively to avoid possible confusion. It argues that the transfer of a GAR to flexible benefits is less complex than a transfer of a final salary scheme and therefore a PTS is not required, although advice will still be required if the benefit being given up is valued at more than £30,000.

In May 2015, the Daily Mail reported the case of a 65-year old customer with a valuable GAR on his £67,000 DC pension pot, but who wanted to cash it and spend it on a holiday and home renovations. His provider insisted he had to take professional advice. But due to the GAR, he could not find an adviser willing to sign the form authorising the release. The customer says: 'I thought this would be easy. Some of the companies I've spoken to have said it's just not worth the risk of being hit with a future compensation claim.' The same thing has happened to a 60-year old customer who had a pension pot currently worth £21,501, but due to the GAR it will be worth more than £30,000 when he reaches 65. His provider insisted he get advice before cashing in the pension, but eight adviser firms have turned him down. The provider says: 'Mr [customer's name]'s policy has an attractive guaranteed annuity rate, which is available at age 65. This could be worth over double what he could find in the open market with immediate annuity rates. We don't feel we have been overzealous. These rules protect the customer and ensure they do not lose very valuable guarantees without being fully aware of what they might be giving up.' However, the FCA says the provider was wrong to interpret the rules like this. It says firms should look at the size of someone's pension pot today – not what it may pay out in future.[668]

In November 2015, the DWP announced it was looking to establish a simpler method of valuing pensions with GARs to help consumers gauge whether they need to take financial advice. It accepted that both providers and consumers were struggling to determine when the £30,000 threshold is breached because of the 'considerable variety' of 'safeguarded' pensions and the challenges presented by the potential value of a GAR when the 'promise' element is taken into account.[669] In January 2016, the FCA announced that 68% of GARs were not being utilised by pension freedom clients, although this was concentrated amongst those with small pots who had GARs: 79% of those with pots below £30,000 and 90% of those with pots below £10,000 did not take up their GARS. However, 59% of those with pots over £30,000 did take up their GARs.[670]

The FCA requires, as a further protection for consumers, that all other transfers in excess of £30,000 from safeguarded benefits to flexible benefits be checked by a PTS where advice is given, whether the benefits are deferred or for immediate vesting (crystallisation). A transfer value analysis will still be required for these cases where the transfer and immediate vesting is not at the final salary scheme's normal retirement date. A transfer from an occupational scheme with safeguarded benefits to another occupational scheme with flexible benefits will now need PTS involvement, whereas previously this was not required. Even a move from one part of a scheme that has safeguarded benefits to a part

[668] Reported in Ruth Lythe (2015) Thousands of savers are locked out of the pensions freedom revolution - because they're better off than they think they are, Daily Mail, 6 May.

[669] Reported in Scott Sinclair (2015) DWP may simplify GAR valuations for £30k advice threshold, Retirement Planner, 23 November.

[670] Financial Conduct Authority (2016) *Retirement Income Market Data: July – September 2015*, January.

that has flexible benefits will require a PTS to be involved in the advice. One the other hand, a transfer from an occupational scheme with no safeguarded benefits to a personal scheme with flexible benefits will now not need a PTS, whereas previously it would have. The Pensions Scheme Act does not require advice for members whose benefits are worth less than £30,000. However, if advice is given, the same rules above apply: there is no exemption from the FCA rules based in fund size.[671]

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, as the FCA has itself acknowledged. Even in a well-funded DB scheme, members who transfer might get only 80-90% of the value of their benefits,[672] but for a scheme in deficit it could be as low as 60%.[673] 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.

DB scheme members appear to be frustrated by the requirement to take regulated advice before transferring out if calls to Fidelity Worldwide Investment's pensions hotline are anything to go by. Around 10% of calls are from DB clients who just want to take their cash.[674]

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.[675] Henry Denne, head of private clients at Punter Southall, argues: 'Much of the advice process will start on the presumption that remaining in DB is in the best interests of the individual. ..[P]roviding this advice could cost a few thousand pounds and this will need to be paid to the adviser regardless of the outcome of the discussion. They may advise against the transfer. I think the individual will find it difficult to access advice at reasonable cost. Advisers may be reluctant to advise on this area once they understand the full impact of the decision. When advisers read through the guidance on enhanced transfer value exercises, they will realise how much care needs to go into advising in this area'.[676]

---

[671] Reported in Claire Trott (2015) Pension transfer rules - Everything advisers need to know, Professional Adviser, 15 June.

[672] Natasha Browne (2015) Regulator to update guidance on DB transfers, Professional Pensions, 19 January.

[673] Katie Morley (2014) Is it worth ditching a final-salary pension for cash?, Daily Telegraph, 15 November.

[674] Reported in Professional Adviser (2015) Advice rule irritates DB savers as pension freedom trends emerge, 19 May.

[675] This is in addition to the problem that people with small pots finding a willing adviser.

[676] Helen Morrissey (2014) DB members will struggle to access advice for DC transfers, Professional Pensions, 22 July.

The FCA's review of enhanced transfer values[677] published in July 2014 found that 59% of members who took an ETV from a DB scheme did so as an insistent client. The FCA wants advisers to ensure they have recorded the client's reasons for wanting to transfer out of the scheme and have discussed the risks involved as well as alternative options.

The June 2015 Policy Statement cited above also clarified the FCA's position on how advisers can avoid liability when dealing with insistent clients. They need to satisfy the following three regulatory requirements:

1. You must provide advice that is suitable for the individual client, and this advice must be clear to the client. This is the normal advice process
2. It should be clear to the client that their actions are against your advice
3. You should be clear with the client what the risks of the alternative course of action are.

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 PTS in the case of transfers over £30,000, comparing the DB scheme with the DC scheme and starting by assuming the transfer is not suitable.

This was the first time the FCA had issued rules on how advisers should deal with insistent clients – even though it still did not technically recognise the term. Nevertheless, it said: 'There is no rule to prevent advisers from transacting business against their advice if the client insists. In practice, there may be occasions where the client wishes to take a different course of action from the one you recommend and wants you to facilitate the transaction against your advice'. In such circumstances, advisers should ensure they have followed the 'normal advice rules', including doing a thorough fact find and suitability report and advising in the client's best interest.[678]

In November 2015, Aileen Lynch, head of technical services at Compliance First, expanded on the FCA's three steps: [679]

- Step 1

  Conduct the business as an advised sale, following all the processes and procedures carried out for all clients. For confirmation, this will include the following:
    - providing the client agreement (disclosure of costs and services)

[677] Financial Conduct Authority (2014) *Enhanced Transfer Value Pension Transfers*, Thematic Review TR14/12, July.

[678] Financial Conduct Authority (2015) *Proposed Changes to Our Pension Transfer Rules*, Policy Statement PS15/12, June; http://www.fca.org.uk/static/fca/documents/policy-statements/ps15-12.pdf

[679] Quoted in Aileen Lynch (2015) Handle with care: Dealing with insistent clients safely, Retirement Planner, 18 November.

- completing a fact-find
- assessing attitude to investment risk
- preparing research
- delivering a recommendation based on the client(s) needs, circumstances and objectives
- produce a suitability report to confirm this position.

- Step 2

  On receipt of the recommendation, should the client(s) decline/reject the advice, a request should be made for the client(s) to prepare, in their own words, the reason for the rejection, awareness of the risks associated in this course of action and then confirmation of the action they wish to take.

  The risks associated with the action they wish to take could include:
  - penalties on encashment/transfer/switch
  - reduction of future benefits
  - loss of existing/future benefits (death benefits, guarantees, bonuses, etc)
  - depletion of retirement funds/income

  It is also recommended, for the future protection of the firm, that the spouse or dependants/beneficiaries countersign this declaration as they can be considered an interested party in the transaction.[680]

- Step 3

  You should prepare a final letter to clarify that you are acting on the client's insistence and confirming the product, provider, fund choices, etc., or drawdown of funds if in a pension scheme.

  This should also confirm the risks associated with the instruction and, if it relates to the drawdown of a pension fund, it should make specific reference to:
  - taxation
  - sustainability of income
  - impact on state benefits (welfare and social care support)
  - state benefit means-testing – deprivation of capital.

  You should then include a disclaimer to highlight the client's potential loss of regulatory protection, with wording similar to: 'You have chosen not to accept our original recommendation and you should be aware that, by proceeding on your

[680] The FOS has previously commented that a 'breathing space' of a week would be expected in such cases.

specific instructions, you may not benefit from the protection of the rules of the Financial Conduct Authority on assessing suitability or from the Financial Ombudsman Service'.

The FCA's technical specialist, Rory Percival, has provided examples of bad practice discovered by the FCA during its 2014 investigation of ETV pension transfer advice. To illustrate, he said the regulator had come across cases of advisers apparently conducting business on an 'insistent client' basis in order to bypass its suitability requirements. He said that dealing with insistent clients is a 'high risk' practice that requires firms to implement additional controls: 'We found, of the cases that advised on ETV transfers, 59% were on an insistent client basis and, within those, there were a lot of problems, [one of which was advisers] not really providing their own advice'. Some advisers were apparently conducting business based on their clients' wishes rather than determining whether those wishes were suitable for them. Another example was 'papering', where 'it's manifestly not an insistent client case, but that's what the paperwork demonstrated it to be,… [with such cases] presumably undertaken to avoid some of our rules, particularly those around suitability'. There were also specific issues around suitability, such as when an adviser agreed to a transfer on an insistent client basis but then gave advice on which product to switch into: 'Just because one element of the insistent client process is insistent doesn't mean that the bit where you are giving advice, and the client is taking that advice, [doesn't need] to be suitable'. Some organisations, such as the Personal Finance Society, have advised members not to transact against their advice under any circumstances, but Mr Percival concluded: 'That's not our position. You can transact against the advice if you take the (above) three steps. But we understand the rationale for that point of view and it's up to firms to decide what services they provide'.[681]

Despite this reassurance, some advisers still feel exposed. For example, Katherine Dandy, partner in Sackers, has warned that confusion over the pension reforms combined with poor understanding of the potential risks would result in a high level of mis-selling, which, in turn, would trigger mis-selling claims worth billions of pounds. Most at risk will be long-serving members of final-salary schemes who might be tempted to transfer to a DC scheme. She warned of a repeat of the mis-selling scandal in the 1980s and 1990s when members of final salary schemes 'were often mistaken by the belief that they can do better themselves by investing the money elsewhere. This proved not to be the case, and resulted in huge claims'.[682]

---

[681] Reported in Carmen Reichman (2015) Insistent clients - FCA's Percival flags historic poor advice examples, Professional Adviser, 17 June.

[682] Reported in Stephanie Baxter (2015) Budget freedoms could trigger mis-selling claims 'worth billions', Professional Pensions, 15 January. For a summary of the 1990s mis-selling scandal, see David Blake (2003, p.311) *Pension Scehemes and Pension Funds in the United Kingdom*, Oxford University Press, Oxford.

Aileen Lynch, writing in the same article cited above, was also concerned that the issues surrounding insistent clients will only continue to grow over the coming months: '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 difference in perspective is understandable but is almost certain to lead to continued misunderstandings between clients and advisers. Recent decisions from FOS indicate that erring on the side of caution is always the right path for advisers and I would urge you to continue to refuse to undertake business that you believe would be detrimental to the financial wellbeing of the client'.[683]

Richard Nuttall, a compliance officer at support services provider SimplyBiz, believes that clients insisting on going against their adviser's commendations should be asked to put their instructions in writing to show they are aware of the risks. Merely asking a client to sign a typed statement offers inadequate protection as it may not prove the customer understands their actions: 'Something as [important] as this really needs to be in their own handwriting, otherwise it's just another letter they sign [and don't properly understand]'. He warned that 'there could be a raft of complaints as clients who have transacted against their adviser's wishes later run out of money' and added 'the [FCA] don't know how to build the rules around insistent clients. What we have had has been very light touch'.[684,685]

Sheriar Bradbury believes some companies might start to offer a signing off service on business that other advisers turn down in the expectation of making a 'quick income'. If things go wrong, the cost will will fall on the FSCS which is paid for by advisers. Mr Bradbury continued: 'Any adviser who agrees to sign off such a transfer either against their advice or without giving proper advice is "really stupid", even if they ask the client to sign caveats explaining they did not advise the transfer. A lot of IFAs got into trouble over various things in the past because they took risks they shouldn't have taken and they convince themselves it's OK and they want the money. People like me will end up paying for it through the FSCS'. He refuses to allow his advisers to do DB-to-DC transfers on an insistent client basis and argues the FCA should publish further guidance and 'tell people "we don't like this and watch out"'.[686]

---

[683] Quoted in Aileen Lynch (2015) Handle with care: Dealing with insistent clients safely, Retirement Planner, 18 November.

[684] Reported in Carmen Reichman (2015) Ask insistent clients to put it in writing, advisers urged, Professional Adviser, 6 August.

[685] In March 2015, SimplyBiz launched a pension transfer bureau for advisers in partnership with adviser Selectapension (reported in Carmen Reichman (2015) Intelligent Pensions launches DB transfer advice service, Retirement Planner, 23 April).

[686] Reported in Carmen Reichman (2015) Insistent clients easy prey without FCA guidance, warns adviser, Professional Adviser, 5 May.

In April 2015, Intelligent Pensions (IP) launched a DB transfer advice service for financial advisers who want to assist clients planning to transfer their DB pension to a DC scheme. The service allows advisers who do not have the necessary pension transfer specialist qualification to outsource the transfers. Clients can choose a drawdown plan of their choice or stay within IP's own self-invested personal pension wrapper. Advisers can then choose either to remain with the client in their new scheme or transfer responsibility for ongoing advice to IP. The company charges the client an initial advice fee and then a set-up charge to carry out the transfer if the client decides to go ahead. IP launched a flexi-access drawdown plan in March 2015 with ongoing advice at an annual charge of 0.75%.

A survey sponsored by the APFA found that more than 50% of advisers are refusing to implement pension transfers out of DB schemes due to concerns that the regulator could later hold them to account; only 25% are prepared to undertake the transfers. Chris Hannant said: 'This highlights the uncertainty for advisers and the need for the FCA and FOS to clarify the position on advisers' liability when they undertake a pension transfer'.[687]

The Personal Finance Society has also called on the FCA to introduce additional safeguards for advisers dealing with insistent DB transfer clients. It wants clear rules stating that such clients cannot later claim redress from the FSCS. Additional independent warnings should be given by the scheme trustee to those insisting on transferring against the recommendation of their adviser. The PFS has identified a 'problem already emerging' of clients who are 'not really looking for advice', but just want the adviser to facilitate the transfer to satisfy the new rules. It is concerned that many who transfer out of their DB pensions could later regret the decision and 'look for someone to blame'. Keith Richards, chief executive of the PFS, said: 'If the Government expects advisers to facilitate transfers, irrespective of their advice to the contrary, there must be a change of process to further protect the client and guarantee that advisers will not be held liable if a poor outcome subsequently materialises'.[688]

The FCA has found that 70% of providers (and 77% of the 15 largest providers) are willing to accept pension transfer requests from insistent clients, except where the ceding scheme has safeguarded benefits or where the transfer is not facilitated by a financial adviser. However, if a customer is able to find an adviser willing to act on their behalf, it is likely the provider

[687] Reported in Carmen Reichman (2015) Half of advisers shun pension transfers amid FCA backlash fears, Professional Adviser, 7 May. Similar results were found in a survey by Zurich published in October 2015, reported in Carmen Reichman (2015) Half of advisers avoiding pension freedoms advice over liability fears-research, Professional Adviser, 9 October 2015.

[688] Reported in Carmen Reichman (2015) PFS pushes FCA for extra DB pension transfer safeguards, Retirement Planner, 14 April.

will accept the transfer. It therefore seems that advisers are more concerned about insistent clients than providers.[689]

There are a range of reasons why DB scheme members might want to transfer. At one extreme, some people could feel pressured by other family members to use their pension pot to support them rather than provide for their own retirements. A study by the Centre for the Modern Family (which is sponsored by Scottish Widows) published in January 2015 indicated that, of the 2,082 people surveyed, 23% expected to use their pension pot to fund care costs for elderly relatives, while 22% reported that they would use it to fund a deposit for children buying a home. Carolyn Fairbairn, chair of the centre, said: 'Although, for many, the reforms announced in the 2014 Budget will represent greater autonomy over how to use their savings in later life, it is important to consider the knock-on effects on families. Many may feel pressure to access their pensions to support struggling family members and, while it is reassuring that family members are seeing the importance of pulling together in this way, it is vital people are aware of all the short- and long-term implications for retirement pots'.[690]

At the other extreme, according to James Baxter, managing partner of Tideway Investment Partners LLP: 'Members value control of the capital and flexible access to funds above guaranteed lifetime income. They will also be thinking: "I can't believe how big my transfer offer is and I can't afford not to take it"'. Mr Baxter believes that 'capitalising on a DB benefit and getting flexible access to those funds from age 55 can be transformational for many members….The ability to split cash withdrawals from taxable income withdrawals, limit taxable withdrawals to lower income tax bands, save in a tax-exempt fund and pass on funds to children and create higher levels of temporary income when required are all options that don't exist for DB pensioners. These come on top of an offer which is likely to be well beyond what most members believe their pensions are worth. Members are weighing these benefits versus a loss of income security in their eighties, often recognising that life beyond 80 is likely to be quite different, with significantly different financial demands, than life in their fifties, sixties and seventies'.[691]

Some financial advisers believe that the new pension flexibilities could change attitudes to transfers out of final salary schemes. For example, Kim Bendall, director at The Paraplanners, says: 'History tells us advisers would be crazy to recommend a transfer out of a final-salary pension but that's all in the past... I've had the opportunity recently to review

---

[689] FCA *Pension Freedoms Data Collection Exercise: Analysis and Findings*. The average pension transfer time was 16 days (reported in Scott Sinclair (2015) Providers confused on pension transfer advice rules, rofessional Adviser, 16 September 2015).

[690] Forever Young: The New Landscape of Later-Life Planning; http://reference.scottishwidows.co.uk/docs/cmf_report_jan_2015.pdf. See also Dan Hyde (2015) Older savers pressured to give pension cash to children, Daily Telegraph, 14 January.

[691] Quoted in James Baxter (2015) DB to DC transfers: the member's perspective, Engaged Investor, 15 June.

some final-salary pensions in order to determine whether a transfer out may be suitable….In nearly all cases, the critical yield still suggests that the client would be "worse off" if they transfer out; however we believe this is becoming a flawed and unrealistic way of determining the suitability or a potential transfer….Ultimately, the critical yield has to be balanced with the client's non-financial objectives – such as providing options for their spouse when they die, or the ability to pass on some of the pension fund to their children'.[692] Similarly, James Baxter believes DB scheme members 'must overcome perceived wisdom and historic prejudice that it's simply never a good idea to transfer out of a DB benefit. We have absolutely no doubts that if schemes were to start communicating transfer offers to members, with balanced guidance on the pros and cons of the transfer option and some help as to how to get through the advice maze, then the level of transfers would be significantly higher'.[693]

Despite the potential risks, employers and their consultants might well actively encourage DB members to move. The Association of Consulting Actuaries (ACA) was very supportive of the pension freedoms when they were first announced: 'Banning private sector DB-to-DC transfers... would have put UK plc at a huge commercial disadvantage with Europe as it would effectively have locked companies into funding for buy-out'.[694] Employers certainly benefit when members leave the DB scheme. This is because the CETV that the member takes when they leave a scheme reflects the best estimate cost of providing the benefits in the new scheme and does not include the prudence margin that funding on an ongoing basis requires. This margin covers future longevity and inflation risk for example. Further, if the scheme is in deficit, this is reflected in a reduced transfer value. The ACA anticipated that many companies will initiate transfer value exercises after April 2015.

Steve Johnson reports that: 'Transfer value exercises can be popular with companies that want to de-risk by reducing the size of legacy DB pension schemes. They have often been criticised for encouraging people to give up valuable "gold-plated" benefits in return for moving to a riskier personal pension. In 2012, the Financial Services Authority, the financial regulator at the time, said it had found instances where advisers had recommended a transfer but where the FSA could find "little or no justification to do so", potentially leaving people short-changed in retirement'.[695]

Despite this, a number of practitioners support members transferring out of DB:

- Simon Taylor, a partner at Barnett Waddingham, said: 'The new pension freedoms may lead to an increase in members looking to transfer out of defined benefit schemes into defined contribution, which may ultimately help schemes de-risk'.

[692] Kim Bendall (2015) Why the world of pension transfers has changed forever, Professional Adviser, 2 April.
[693] Quoted in James Baxter (2015) DB to DC transfers: the member's perspective, Engaged Investor, 15 June.
[694] Association of Consulting Actuaries Press Release, 21 July 2014.
[695] Steve Johnson (2014) Employees to be lured out of DB pensions, FTfm, 27 July.

- Martyn Phillips, head of buyouts at JLT Employee Benefits, believes that paying a generous transfer value may be cheaper than buying a member out with an insurance company: 'That's a gain from a sponsor objective and from a trustee objective, and it's obviously a more generous offer than the trustees would normally be offering those members'.[696]
- Ian Gutteridge of Premier Pensions Management believes that ETV exercises to encourage DB members to switch to a DC scheme might be an attractive way for employers to reduce their DB liabilities in the new pensions environment. Another option is for the employer to offer a pension increase exchange (PIE): the member receives an increase in the pension but then foregoes annual pension increases on non-statutory pension benefits. The employer could pay for the member to have advice so that 'only appropriate individuals accept a PIE or transfer value'. Mr Gutteridge adds: 'It's a dangerous strategy from the trustees' point of view if they say 'no; we don't want to get involved in this'. Providers have been criticised [in the past] by regulators for failing to give policyholders the full range of options available. Trustees are [also] open to be criticised'.[697]
- Tom Ground, head of bulk annuities and longevity insurance at Legal & General, argues that member option exercises have an important role to play in DB pension scheme de-risking exercises. He says that: 'Transfer value exercises, pension increase exchanges and other member option exercises can provide valued flexibility to scheme members, while potentially increasing the affordability of an insurance de-risking solution, such as a buyout or buy-in. For example, with certain member option exercises, insurers may take the view that there is the potential for "selection risk" and will charge a higher premium to cover this risk. This may have an impact, where a transfer value exercise has been carried out already and the insurer then subsequently assesses the average life expectancy of the remaining members as part of a buyout, buy-in or longevity insurance quote. If the insurer believes that only those members in poor health had taken up the offer, then the average life expectancy of the remaining members will be higher. So the insurance premium would then be higher to reflect the increased longevity of the members. This could, in some circumstances, put the scheme in a position where it may have been better for all parties, if the exercise had been conducted on a wider basis initially. By engaging with an insurance provider at an early stage, ahead of the point of carrying out member option exercises, a scheme can ensure that the initiatives contribute towards achieving the scheme's long term de-risking objectives'.[698]

[696] Reported in Sara Benwell (2015) Rewriting the rules of de-risking, Engaged Investor, 6 February.
[697] Reported in Luisa Porritt (2015) Are transfer exercises back in fashion?, Engaged Investor, 5 May.
[698] Tom Ground (2015) A holistic approach to insurance de-risking, Engaged Investor, 28 April.

A survey of 322 DB schemes conducted by KPMG in May 2015 found that 75% of DB schemes intended to offer transfer quotes to members as part of their standard retirement process, while a third of schemes planned to offer partial transfers. Around 25% of schemes reported that they would offer free or subsidised advice to members, while 30% planned to provide online modelling tools. Only 14% of schemes polled said they had no plans to change retirement processes in the new pension regime. Two thirds of those polled accepted that responsibility for dealing with the impact of the new legislation rested with employers (31%) or trustees (34%), rather than with individuals, providers or the Government.

Stewart Hastie, pensions partner at KPMG, said: 'It is encouraging to see that most employers and trustees are waking-up to the fact that they need to respond to the recent changes to pensions flexibility. The decisions facing pension scheme members at retirement are irreversible. This shows that employers and trustees have recognised that doing nothing is not a risk-free strategy…Both employers and trustees must stay on top of the recent changes and ensure they are engaging with their members. We see a need for education, not just the provision of information. By educating members, employers and trustees can help them plan for their retirement based on their individual needs. Members can also benefit from the full range of flexibility options open to them, in turn, increasing staff morale and the firm's reputation'.[699]

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.[700] Others put the numbers at 2m or 50% of those over 55. Research by industry analysts for Channel 4's Dispatches programme estimated that withdrawals could be as high as £6bn, which is three times more than HM Treasury estimates. Alan Higham, then retirement director of Fidelity Worldwide Investment, told the programme: 'About 20 per cent of the calls we've had are from people who have made very quick plans to spend money on house improvements, buy a new car, go on holiday . . . and are looking to access their pension funds quickly for that purpose'.[701]

A Close Brothers Asset Management survey in April 2015 asked 400 employers about the response by scheme members to the new pension regime. Around 44% of respondents with a DB scheme reported they had been contacted by members considering transferring out, while 11% said they had been approached by a 'significant number' of members. For those with DC schemes, 57% of employers were planning to offer employees help to allow them to make more informed decisions. Around 23% said they thought employees would turn to

[699] Reported in Jack Jones (2015) Most schemes plan to give transfer quotes to retiring DB members, Professional Pensions, 6 May.

[700] Katie Morley (2014) Is it worth ditching a final-salary pension for cash?, Daily Telegraph, 15 November; Nicola Brittain (2015) DB transfer advice – Is it worth the reputational risk?, Professional Adviser, 27 February.

[701] Reported in Jane Croft (2015) Pension withdrawals set to rise by £6bn, Financial Times, 12 January.

the Government's Pension Wise service, 27% expected their staff to ask them for help, while 28% thought employees would seek specialised advice from a financial adviser.[702]

In August 2015, Selectapension released the results of a survey which showed that pension transfer requests from DB schemes doubled in the three months following Flexiday compared with the three months from April 2014. The top providers chosen to receive the transfers were: Royal London, Scottish Widows, Prudential, and LV=. Andy McCabe, managing director at Selectapension, said: 'Pension freedoms have started to make a considerable impact on consumers and have acted as a catalyst for many to reassess whether remaining in a DB scheme is the best option. However, it is important to recognise that transferring from a DB scheme is not suitable for everyone and a decision as complex as this should not be made hastily but with comprehensive financial advice'.[703]

TPR is concerned that a large volume of transfers could destabilise the DB scheme by crystallising liabilities. It has therefore provided guidance to DB pension scheme trustees on reducing a member's transfer value and how to apply for more time to carry out a transfer.[704]

#### *3.12.2.3 Vulnerable consumers in the annuity market*

We distinguish between the primary and secondary annuity market. The primary market is the market where annuities are first sold. The secondary market is where someone who has bought an annuity can subsequently sell it for cash; this market does not currently exist in the UK, but the Government is planning to set one up in April 2017.[705]

<u>The primary annuity market</u>

In August 2014, the Daily Telegraph reported that the FCA had begun an investigation into the sale of annuities sold since 2008 to check if they were unsuitable for customers. The paper said that more than 600,000 pensioners could have been sold annuities that did not take account of their health status. People with diabetes or high blood pressure could have had their pensions increased by around 20% if they had been sold an enhanced annuity instead of a standard one. It is estimated that as many as 60% of retirees have a medical

---

[702] Reported in Owain Thomas (2015) One in ten employers seeing 'significant number' of DB transfer enquiries, Professional Pensions, 21 April.

[703] Reported in Carmen Reichman (2015) Defined benefit pension transfer requests 'double', Professional Adviser, 25 August.

[704] Reported Laura MacPhee (2015) Regulator warns trustees to prepare for an increase in DB to DC transfers, Engaged Investor, 2 June.

[705] HM Treasury and DWP (2015) *Creating a Secondary Annuity Market*, Cm 9046 March;https://www.gov.uk/Government/uploads/system/uploads/attachment_data/file/413764/Creating_a_secondary_annuity_market__web_file_.pdf

condition or make lifestyle choices (e.g., smoke) which reduce their life expectancy and qualify them for an enhanced annuity. They may now be due compensation if they were sold a standard annuity. The difference between the worst standard annuity rate and best enhanced rate could be as great as 30%. Telephone conversations will be examined, as will paperwork sent to customers before they retired. Compensation orders could be issued where failures are identified.

Observers believe the level of compensation could be significant. For example, John Perks, managing director of retirement solutions at LV=, said 'Any element of compensation will be costly because it means rectifying an annuity income for the long term plus the cost of doing that, so there is potentially quite a scary compensation element here'.[706]

The secondary annuity market

The Government's consultation on its plans to create a secondary annuity market in 2017 closed in June 2015.

Many respondents generally welcomed the Government's proposals, but there were also many critics. For example, Mark Polson, founder and principal of the lang cat, said:[707]

> *I'm on record as loving the other freedoms that have been opened up, and encouraging the industry to trust savers with their own money. So why buck and kick against these freedoms being extended to current annuitants?*
>
> *There are two reasons.*
>
> *Firstly, on a micro level, it's going to be terrible value for those who participate. If we accept the mighty Ned Cazalet's recent figures that up to 20% of the purchase price of an annuity is snaffled in charges, then annuitants have already borne significant pain.*
>
> *Do we really believe those that purchase second-hand annuities will be doing so pro bono? Of course not. We don't know how the figures might look, but the purchase has to be profitable for those putting up the capital, and that's just another way of saying that the annuitant will receive what we like to call a 'secondary screwing'.*
>
> *For sure, we won't be multiplying monthly payments left to the actuarial cohort's expected age of death and paying that to the individual. And you can expect medical underwriting and postcoding to work in reverse.*

[706] Quoted in Ollie Smith (2015) Why the FCA annuity mis-selling probe is good politics, Citywire, 8 September 2015.

[707] Mark Polson (2015) The freedom to sell your annuity (read: The freedom to get screwed), Professional Adviser, 6 January.

*As Cazalet's 129-page blockbuster proves, annuities are anything but simple, and unwinding them will be even worse – think Ginger Rogers' famous quote that she did everything Fred Astaire did, except backwards and in heels.*

*Can we expect the industry to behave itself and not give annuitants looking to flee a worse-than-usual screwing? No, we can't. And it is for this reason – the supply side, not the demand side – that at an individual level this proposal shouldn't go ahead.*

*Freedom to get re-screwed by an industry hell-bent on loading the decks against you is no freedom at all.*

*At a macro level it gets even worse. Purchasers of second-hand annuities will only make it work by pooling – that is, by buying lots and lots of them to spread mortality risk. Once we're in that world, we'll start profiling those pools.*

*We might have 'A' pools, with healthy folk in good postcodes, 'D' pools for people who didn't listen to their wives about the bottle of whisky and all that.*

*Once that's happening, it's only a matter of time before we have second-hand annuity funds in the life settlement/second-hand endowment fund style, and we know how well those went. And am I the only one who can see packages of annuities being bundled up, collateralised and sold on on what I suppose would be a tertiary market?*

*….this omni-screwing proposal should be put down humanely before it has a chance to breed.*

Similarly, Richard Parkin, head of retirement at Fidelity International, said: 'With these benefits come significant risks for consumers who are giving up guarantees in return for cash. In essence, this market combines the complexity of defined benefit transfers with the risks of pension freedom. We would therefore expect to see similar levels of consumer protection and requirements for advice that we have for these transactions. We cannot afford to skimp on protecting customers in pursuit of making transactions easy'.[708]

Even amongst those who welcomed the Government's proposals, there was widespread support 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.

For example, Aegon warned that people cashing in their contracts could be left below the means-tested benefits threshold without entitlement to claim a government top-up. It also pointed out that fraudsters would look to exploit any weaknesses in the market place and that beneficiaries could be hit if their partners decided to sell the policy. Similarly, the NAPF

[708] Quoted in Sara Benwell (2015) The dangers of second-hand annuities, Pensions Insight, 15 December.

proposed that there should be mandatory advice if the annuity was valued at £10,000 or more. It also pointed out that customers could face a significant tax bill estimated to raise for the Treasury an estimated £1bn in the first two years. Under the current tax regime, someone wanting to sell their annuity would face a 55% tax charge; however, the Government has said it would remove this charge, so people will be taxed only at their marginal rate.

By contrast, LV= Retirement Solutions supported the idea of mandatory advice but only for those who 'need' it. John Perks, managing director, said: 'Given the potential detrimental risks involved for consumers, we fully advocate that consumers are obliged to take advice before making a decision as to whether they proceed. However, we think the requirement needs to be assessed to avoid the cost of advice damaging the value of smaller annuities'. Similarly, JLT Employee Benefits accepted that consumers must be protected from scams, but did not believe that the advice should be mandatory. TISA wanted consumers to have access to 'tailored guidance' rather than advice which could be viewed by consumers as an 'unnecessary barrier and expense'. The guidance would be carried out under the existing guidance guarantee, Pension Wise, together with an extension of the second-line-of-defence rules – the requirement on providers to highlight warnings about their clients' choices – to apply to all secondary annuity transactions.

APFA has asked for more clarity around adviser liability when advising on annuity sales: 'We would strongly recommend the provision of further guidance to financial advisers and other intermediaries around what constitutes a suitable reason for assigning annuity income rights. The continuing regulatory uncertainty on adviser liability both generally and around the new pension freedoms has meant many advisers are unwilling to engage in the DB-to-DC pension transfers. We hope this will be looked at by the Government and the regulator elsewhere'. Further, it said that existing annuities should only be allowed to be sold to regulated firms, not retail investors, since 'secondary market income streams can be complex and consumers must be protected as far as possible from making financial decisions which are to their detriment'.

There was also concern about reliably quantifying the extent of longevity risk. Hymans Robertson recommended the creation of standardised health underwriting, an auction-style market place, and a robust audit trail to document the seller's reasons for cashing in their contract.

There was also a difference of view about whether the original provider should be allowed to buy back a client's annuity (i.e., provider buy-back). The Government had initially said it did not like the idea. However, TISA'stechnical director, Jeffrey Mushens, said existing annuity providers should be allowed to buy back annuities 'in order to encourage competition and consumer choice'. Mr Perks agreed: 'We believe that individuals should have the right to sell their annuity to their existing annuity provider should the provider be willing to do so, and where the provider can demonstrate that a fair offer has been made.

We do not believe that it is in the spirit of the reforms to restrict individuals' 'freedom and choice' as to how they take their retirement income. We support the proposed approach to allow a wide range of corporate entities to purchase the annuity as this will lead to greater competition and ultimately better value pricing'.[709]

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'. Five million people with an annuity would be able to sell it for a cash lump sum and be taxed at their marginal rate. The annuity can be sold back to the original provider or to another institutional investor. Those taking advantage will be able to spend the money received as they see fit. The Treasury has also said it wants to make 'appropriate financial advice' mandatory for those considering selling their annuity and said that it will make an amendment to the Bank of England and Financial Services Bill to achieve this. It also seems that anyone will be able to sell their annuity. It had previously been thought that those on means-tested benefits would be excluded. Now, the Government intends to rely on existing deliberate deprivation rules which state that anyone on or likely to become eligible for means-tested benefits who gives up income or capital with the deliberate intention of gaining additional support or benefits can be treated as still possessing it.[710] It is also not currently clear whether the proceeds from selling an annuity would remain within a pension tax wrapper.

Harriett Baldwin said the reforms would include:

- Setting out that pension annuities belonging to an individual and held in their own name will be eligible for the new freedoms
- Requiring that all UK-based annuity purchasers and intermediaries are regulated by the FCA
- Allowing annuity providers the choice to buy back an annuity, subject to robust safeguards
- Introducing a comprehensive consumer protection package to ensure people make informed decisions about their savings, including:
    - extending the free and impartial Pension Wise service to cover the secondary annuity market
    - requiring individuals to seek independent financial advice for annuities worth above a certain threshold

[709] Reported in Natasha Browne (2015) Mandatory advice crucial for secondary annuity market, Professional Pensions, 18 June; and Carmen Reichman (2015) Industry split on mandatory advice for annuity trade-ins, Professional Adviser, 19 June.

[710] See Chapter 1.

- Asking the FCA to put in place a consumer protection framework which could include consulting on a range of extra consumer protections, such as risk warnings and ways for consumers to understand the fair value of their annuities
- The Government has also responded to consultation feedback and will work with the industry and the FCA to create a simple online tool to help consumers work out an estimated value of their annuity.

Ms Baldwin continued: 'For most people, sticking with an annuity is the right thing to do. But there will be some who would welcome being able to draw on that money as they choose – the same freedom we gave people approaching retirement in April [2015]. That's why I'm delighted that we're extending our landmark pension freedoms to over five million people with annuities from April 2017. People who've worked hard and saved hard all their lives should be trusted to make the right decision for them and with the help of the regulator, we will ensure these people have the right information to do that'.

Ros Altmann, the Pensions Minister, added: 'The new pension freedom reforms are crucial in allowing people to make the most of their hard-earned savings. Keeping an annuity will still be the right decision for the majority of people. But some were forced to buy annuities in the past that may not have been suitable for them – and I am delighted that this reform will allow more people greater choice and the opportunity of a more flexible income stream. …Individuals may want to sell an annuity for instance to provide a lump sum for relatives or dependants; in response to a change in circumstances; or to purchase a more flexible pension income product instead'.[711]

Tom McPhail said the Treasury's latest amendment was consistent with current rules around pension transfers, which require regulated advice for pots over £30,000. He believes that having a similar safeguard in place should help prevent investors from selling their guaranteed incomes for rock-bottom prices, but the size of the threshold is important: 'There is already some concern that the current £30,000 threshold is causing problems, with some investors unable to obtain the advisory services they need. Any increase to the threshold would have to be accompanied by other suitable protections to ensure investors could make an informed choice'.[712]

[711] Reported in Jenna Towler (2015) Government to launch secondary annuity market in April 2017, Professional Pensions, 15 December.

[712] Quoted in Carmen Reichman (2015) Treasury backs mandatory advice for annuity re-sales, Professional Pensions, 10 December.

Others warned that the change 'opens the door to millions making a financial mistake by flogging a guaranteed income in return for an immediate lump sum that will be much less than they would end up with by sticking with their annuity':[713]

- Steve Webb, former Pensions Minister and now director of policy at Royal London, said: 'There is a real risk of poor outcomes if people on low incomes sell their annuity only to discover that the DWP treats them as if they were still drawing that income'.
- Alan Higham of Pensionschamp.com said the Government was prioritising 'political ideology over people's real needs in retirement. [The change would] 'benefit few consumers while exposing many to significant risks'. He has estimated that someone aged 75 who bought an annuity 10 years ago with £100,000 would be receiving on average £7,000 a year from it. If they were to sell it and were in good health, they would get around £56,000. They would be worse off if they lived for another nine years, yet official estimates indicate that an average healthy 75-year old will live for another 12 years. Mr Higham added: 'Some healthy 75-year olds could easily live to 100, given increased life expectancy, and giving up 25 years' worth of money for eight years looks a very bad deal by anyone's measure'.
- Sarah Pennells of SavvyWoman.co.uk warned that the freedom to cash-in an annuity will be welcomed by 'rogues and fraudsters [who] have already taken millions from people' since the wider pensions freedoms came into force in April.

The Government announced that advisers in the secondary annuity market could be required to undergo further training and take examinations: 'Intermediaries are likely to have new opportunities in this market, including facilitating the purchase of annuities and providing a range of services for the consumer. These new opportunities are likely to improve the profitability of firms. However, there may be a requirement for advisers to take part in additional training or earn new qualifications to work with customers looking to sell their annuity'.[714]

### 3.12.3 The FCA's proposed new rules and guidance following the 'freedom and choice' reforms

In October 2015, the FCA issued a consultation paper on the 'freedom and choice' reforms.[715] This was a follow on from its Retirement Income Market Study, conducted prior

[713] Reported in Simon Read (2015) The Government will let you cash-in your annuity: but it could cost you, Independent, 16 December.

[714] Reported in Jenna Towler (2015) Advisers face second-hand annuity training and exams, Retirement Planner, 15 December.

[715] Financial Conduct Authority (2015) *Pension Reforms – Proposed Changes to Our Rules and Guidance*, Consultation Paper CP15/30, October; http://www.fca.org.uk/static/documents/consultation-papers/cp15-30.pdf.

to the introduction of the pension reforms, which focused on the risks facing consumers and how they could make poor choices at retirement.

The FCA has reviewed its rules and guidance and made proposals for future rule changes to protect the interests of retirees. The proposals include additional rules and guidance for firms on how they should communicate with customers, a review of the retirement risk warnings, which were introduced in February without consultation, and new rules for pension freedoms communications. The key proposals are:

- Rules and guidance to ensure that consumers receive timely, relevant and adequate information to both encourage consumers to explore the full range of options for accessing their pension savings and enable informed decision-making
- New rules on the methodology for providing illustrations to members wishing to access their pensions flexibly, including guidance to set out the type of ongoing information that consumers are provided, once they start accessing their pension savings and remain invested
- To retain the rules on retirement risk warnings, but to remove the requirement for a firm to go through the question and answer process of the rules when a consumer has a pension pot of £10,000 or less and where there are no safeguarded benefits
- To add guidance to make explicit the application of existing rules in the context of pension reforms, particularly in relation to debt collection and debt advice
- Restrictions on the promotion and distribution of high risk investments and amendments to the FCA's definition of certified high net worth investor and restricted investor.

Christopher Woolard said: ‘Pensions are of fundamental importance and it is vital that the market works well for consumers. Our proposals today are designed to ensure that consumers have access to products and services that are well governed and deliver value for money following the Government's pension reforms. We will continue to monitor the market as it evolves following the introduction of the Government's pension reforms to ensure that firms are helping consumers get the best outcome in retirement’.

To ensure consumers are able to make informed decisions about an appropriate retirement solution, the FCA proposes to change the information in the pre-retirement wake-up pack. In addition to information about Pension Wise and regulated financial advice, the FCA proposes to:

- Reduce and simplify the information provided
- Ensure information is presented on all retirement options
- Make it easier to obtain annuity comparisons, which would mean the need to provide more focus on enhanced annuities
- Make it easier to shop around after carrying out these comparisons

- Ensure all information is balanced, so it does not promote one solution over another. This would mean where an illustration is provided, for, say, an annuity, illustrations would also have to be provided for all other available options
- To reduce consumer inertia, restrict the annuity application form being enclosed within the pack. This has the effect of ensuring consumers make a positive election from the options available
- As flexibility allows consumers to access the fund at different stages throughout their retirement, information should be provided at each time, i.e., pre and post retirement.

In cases where the advice is to use income withdrawal, a suitability report needs to be prepared. The current rules apply to flexible access drawdown, but not to uncrystallised fund pension lump sums, and the rules will be updated to make specific reference to the latter.

Non-advised annuity sales could be subject to a commission cap or an outright ban. This is because consumers were at risk of not getting value for money from non-advised annuity sales, and that, in some circumstances, commission payments were so high they exceeded the cost of regulated financial advice. Currently, most annuities are bought without advice – either direct from the annuity provider (typically the accumulation-stage pension provider) or via a third-party distributor. Many third-party distributors were paid a commission by the pension provider for arranging the sale. Commission rates were 1% - 1.5% for a standard annuity and 2.5% - 3% for enhanced annuities. This contrasts with taking regulated advice, which involves consumers themselves agreeing to the service they want to receive and the fee to be paid to the adviser.

However, the FCA is aware of the potential consequences of an outright ban: ‘Other options, such as drawdown, would still carry commission. Therefore limiting any ban to annuities could distort competition between these potentially substitutable products. Firms might, as a consequence, be incentivised to promote drawdown over annuities with potential harmful impacts on consumers in the long term. This would mean that, to avoid distorting competition, we would need to consider banning commission on a wider range of investment solutions’.

The FCA also wants to exclude pension wealth from the definition of a high net worth investor (HNWI) in order to prevent retirees losing their pension pot in high-risk investments. It proposes an amendment to its ‘certified high net worth investor' and ‘restricted investor' (RI) certification criteria, so that lump sum pension withdrawals are excluded from the HNWI income criteria. It also wants money released from pensions as cash to be excluded from the definition of net investable assets for the purposes of HNWI and RI certification, in addition to the current exclusion of money held in pensions. It said: ‘We are concerned some consumers' perception of their overall financial wealth following withdrawal of up to 100% cash from their pension savings may lead consumers to certify

themselves as HNWI. [It could also lead them to] invest more money than is appropriate under the RI category, and for firms to distribute potentially inappropriate investments to these consumers'.

The criteria for certifying HNWIs are based on either net income (£100,000) or net investable assets (£250,000). As a result of the pension reforms, more retirees could find themselves falling within these criteria which, in turn, could leave them exposed to pension scammers or being targeted for high-risk investments. Anyone certified as a HNWI does not receive the regulatory protection of the suitability rules and it also means there are no restrictions on the type of promotions they receive. To reduce the potential risks, the FCA wants to exclude cash from a pension from the definition of net investable assets, in the same way that money held in a pension fund is already excluded.[716]

In September 2015, Mark Neale, the chief executive of the FSCS, called for the Government to extend the level of financial protection to cover the total value of peoples' retirement savings. Currently, the FSCS protects up to £50,000 of people's retirement and investment savings. But this is only for those who invest in regulated products or received regulated financial advice and where the firm has defaulted. The FSCS already covers 100% of the policy value of an annuity. Mr Neale wants the protection increased to 100% of the value of pension pots. He highlighted examples of failures in the self-invested personal pension market, relating to high pressure sales tactics to invest in unsuitable alternative assets, which created a case for improved protection. The FSCS assesses whether a firm is liable for its clients' losses by applying a 'civil liability test', i.e., whether, looking at the evidence, the case would have been won in a civil court.

Mr Neale said: 'In recent years, the bulk of investor compensation we have paid out because of negligent advice has concerned investments in risky and exotic assets, such as overseas property schemes. The recent spate of claims to FSCS arising from investments in SIPPs have fallen into exactly this category. These are exactly the sort of investors who should have FSCS protection. Such investors have seen all or the bulk of modest retirement savings put at risk because they did the right thing and sought professional advice about how best to invest those funds. They received very bad advice which the great majority of responsible financial advisers would not have contemplated. This raises the question of whether - following the Government's reforms – we should take a fresh look at the scope of FSCS protection for retirement savings'.[717]

---

[716] Reported in Reported in Jenna Towler (2015) FCA overhauls at-retirement rules after major pension reforms, Professional Adviser, 1 October; Jenna Towler (2015) Commission on non-advised annuity sales could be banned,Professional Adviser, 1 October; Laura Miller (2015) FCA wants pension rich excluded from sophisticated investor loophole, Professional Adviser, 1 October; Aileen Lynch (2015) Consumer danger: Assessing the FCA's new pensions freedom rulebook, Professional Adviser, 16 October.

[717] Reported in Carmen Reichman (2015) FSCS chief renews calls for full protection of retirement savings, Professional Adviser, 28 September.

### *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 few 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.

#### 3.13.1 Access

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 with the FCA, the media – led by the Daily Mail and the Daily Telegraph – saw them as unnecessary and costly barriers to people accessing their money and this view was immediately taken up by Government ministers.

Typical of media reaction is this article in the Daily Mail:[718]

> *George Osborne's pensions revolution was in crisis last night with thousands of savers unable to spend their nest eggs as they want.*
>
> *Just 65 days into the new regime, financial giants are under siege from furious customers.*
>
> *The Chancellor had promised savers easy access to their cash. But today a Money Mail investigation can reveal a string of disastrous failings:*
>
> - *Firms refusing withdrawals for fear of being sued for negligence in years to come;*
> - *Savers being forced to pay up to £1,000 for financial advice if they want their money;*
> - *Customers turned away because they have only small pensions;*
> - *Delays of up to 90 days in paying out cash;*
> - *Sky-high charges for withdrawals or for switching to rival firms;*
> - *Insurers knocking thousands off the value of pensions [that] customers want to access.*
>
> *....Since April 5 this year anyone over 55 should in practice be allowed to take all their savings out in cash, or dip in and out of it as they want – just like a bank account.*
>
> *But in reality savers are finding that they cannot get their hands on their money.*

[718] James Coney (2015) What a pensions shambles! Revolution in crisis as savers are barred from taking out cash and charged £1,000 just for advice... and scandal could be worse than PPI, Daily Mail, 9 June.

*Some firms such as NEST, Friends Life and Phoenix will not allow savers to use their pension like a bank account.*

*Others charge hefty fees of up to £240 for each withdrawal, or place restrictions on how much someone can take out.*

*Money Mail has been bombarded with letters from pensioners who have been told they cannot have their savings unless they first see a financial adviser. This typically costs about £1,000. And even if they do consult an adviser they may still may not be able to get at their cash if the adviser does not think taking the pension is a good idea and refuses to help.*

*Some savers had found that the specific type of pension they have does not qualify. And many have faced lengthy delays because insurers have been forced to dig out pension contracts that are three decades old.*

*Customers of firms such as Clerical Medical, Phoenix Life and Aegon have experienced huge delays in getting hold of their cash.*

*…Dr Yvonne Braun, of the Association of British Insurers, said: 'Providers have and are continuing to work round the clock to ensure these reforms are implemented as smoothly as possible.*

*'In the first month alone, the industry handled over one million telephone enquiries – up 80 per cent on normal. 'While the vast majority of customers have been able to access their funds in full, some may be required to take advice as a result of the Government's rules because they have valuable guarantees.'*

In June 2015, the Daily Telegraph, launched a 'Make Pension Freedoms Work' campaign with five demands:[719]

1. All pension providers must offer savers 'bank account' type access to their money. Where providers won't do this, they must allow their customers to switch to rival providers for free
2. Charges for making use of the new pension freedoms – per cash withdrawal, for example – should be reasonable and capped
3. The Government's default work pension provider, NEST, should offer its own range of bank account features that will be suitable, and affordable, even for modest savers
4. Exit penalties for all pension savers, even where these penalties have been written into old-style pension plans should be scrapped for every saver beyond the age of 55
5. Savers wanting to move their pension cash from one provider to another should be offered a safe, standardised process where all the associated risks and costs are clear.

[719] http://www.telegraph.co.uk/finance/personalfinance/pensions/11653726/Pension-freedoms-This-is-how-to-make-them-work.html

Even the Consumers' Association stepped into the debate. Richard Lloyd, executive director of Which?, said: 'The recent pension reforms are a golden opportunity to make the pensions market work in the best interest of consumers. So it is disappointing to see one of the biggest providers not stepping up and implementing the changes'.[720]

In the same issue of the Daily Mail cited above, Ros Altmann, as Pensions Minister, and Harriett Baldwin, as Economic Secretary to the Treasury, wrote (under the heading 'Insurers shouldn't have any excuses'):

> *Earlier this year, George Osborne introduced the most significant reforms to the pensions system in a century.*
>
> *Gone is the effective requirement to buy an annuity. If you're over the age of 55, you now have the freedom to access your defined contribution pension pot in the way you want — in flexible payments, by taking some out and leaving the rest for later, as a regular income, or as cash.*
>
> *As the Prime Minister said this week, we want to give people more control over the money they saved hard for over their working lives.*
>
> *It's great that many pension providers and schemes have risen to the challenge and are offering their customers flexibility.*
>
> *However, it is disappointing that some firms are lagging behind, and some providers have chosen to focus their efforts on far too narrow a range of options.*
>
> *No matter which pension provider you saved with, you should be able to use your pension how you want to.*
>
> *The industry should be embracing this exciting opportunity and developing innovative and competitive products that work for you — and we will work closely with them to help them achieve this.*
>
> *We have to recognise that some companies have met practical difficulties along the way, including creaking IT systems that can't 'speak' to each other.*
>
> *That is why we've allowed insurance companies flexibility over how and when they introduce these reforms. But we are determined that customers should in no way be disadvantaged by that.*
>
> *So, we have made sure that if you can't access your pension flexibly, or feel you are being charged too much, you can transfer your savings to another provider.*
>
> *We are monitoring these issues closely and will continue to ensure that there is a system in place that works for you. We have also legislated to*

[720] Quoted in Dan Hyde (2015) Pension companies 'failing to move with times', says minister, Daily Telegraph, 4 June.

*allow pension schemes to override their previous narrow scheme rules, so they can offer the flexibilities if they want to.*

*This means that there is no excuse for firms to claim that their rules mean you can't access your money.*

*There are some circumstances where you will be asked to seek independent financial advice from a regulated professional adviser — that's simply because your pension has special, valuable features which you need to understand before you make a decision.*

*Ask your pension provider to explain why they're asking you to take financial advice.*

*The Government will be watching this issue closely and working with the industry and regulators to address any problems.*

*If you're considering accessing your pension, make sure you take the time to find out what the options are, get help and support, and make the decision that is right for you and your family.*

*After all, this could well be a once-in-a-lifetime decision that will affect what you have to live on for the rest of your life.*

*To help you make that decision, the Government has set up Pension Wise, which offers free, impartial guidance on your options and will help you to understand the tax that you might pay, what charges to look out for and other important information.*

*These have been major changes, underpinned by a very simple philosophy: it's your money, you have earned it, you have saved it and we want you — not the Government or pensions companies — to choose what you do with it.*

*Our focus now will be to make sure that the new system works in practice — and that the industry helps you get the most out of these historic reforms.*

Despite this, there were mixed messages from the Government about when it would intervene to oblige providers to offer full pension flexibility. Writing in the Daily Telegraph, Iain Duncan Smith, the Work and Pensions Secretary, said the Government was ready to 'name and shame' providers who were not giving their customers pensions freedom. He also said the Government was talking to regulators to ensure that people have the flexibility they deserve and will 'not hesitate to take action'. In contrast, Ros Altmann said the Government would not intervene immediately to 'give the reforms a chance' first to 'see how they work'. A DWP spokesman said: 'It is early days and no-one is proposing an immediate intervention, but both ministers are clear that the situation needs to be carefully monitored. We are prepared to "name and shame" those companies who are putting barriers in the way of people getting access to their money if such action becomes necessary to encourage the industry to make changes. If, as the market develops, it becomes apparent

that Government action is necessary to ensure consumers get a good deal, then action will be taken'.[721]

The ABI immediately hit back at proposals that providers – most of which are insurance companies – would be 'named and shamed' for not offering the full range of pension freedoms. Huw Evans, director general, said: 'We warned in February that not enough had been done to ensure a completely smooth implementation of these major reforms. The priority now is for the Government, regulators and providers to work through these teething problems together. The reforms are proving successful so far for the majority of customers and we have to build on that rather than get into a blame game'. In the meantime, Friends Life – one of the life offices criticised – has refused partial withdrawals to its customers, although it says it plans to offer this in 'due course', while NEST and Phoenix – two of the other providers criticised – have confirmed they will not be providing the full freedoms in-house.[722]

The ABI also went on to propose a series of measures to help resolve the 'implementation challenges' that 'freedom and choice' raised for insurance companies. In particular, it suggested that mandatory advice on pension freedom cases with guaranteed annuity rates worth more than £30,000 should be scrapped and replaced with a 'customer control' mechanism, giving people access to their pension pot without having to pay for advice. It said the mechanism should be delivered through a specific guidance session by Pension Wise, and enshrined in a protocol agreed with the FCA and the FOS.

The ABI also published an action plan to facilitate pensions freedom implementation:

- Establish a joint taskforce between the Government, the regulators, providers and advisers to deal decisively with the remaining issues
- The FCA to conduct a broader review of the balance of responsibility between customers and providers in light of pension flexibility
- The FCA to set out clearly those products and circumstances where advice should be taken
- The Treasury to work with the FCA and DWP to clarify the definition and valuation of safeguarded benefits, by a change in the law
- Providers to work with the FCA and DWP to clarify the definition and valuation of safeguarded benefits, by a change in the law
- The Government to publish Pension Wise data and restart marketing to ensure maximum take up of this valuable service

[721] Reported in Carmen Reichman (2015) Mixed messages from govt on pensions freedom intervention, Professional Adviser, 15 June.

[722] Reported in Natasha Browne (2015) ABI warns against 'blame game' on access to pension freedoms, Professional Pensions, 15 June.

- The ABI and its members to start work on developing a standardised language on products and charges to help customers consider their options
- The ABI and its members to ensure clear, consistent communications to customers on the products and services available.

The ABI said: 'While the vast majority of customers so far have successfully exercised their choices without complaint, it is clear that implementing the law and regulatory requirements as they currently stand is not enough to ensure the benefits of the reforms can be universally felt. This action plan proposes a solution to the problem of customers unable or unwilling to access advice in the circumstances set out in the law….We also request the urgent establishment of a joint taskforce between the Government, regulators, providers and advisors to work through the outstanding issues and deal decisively with them. The ABI and its members remain completely committed to making the pension reforms a success so customers can make the most of the pension freedoms. But it is clear this cannot happen fully without a decisive and joined up approach to the implementation challenges that have arisen. If the proposals in this action plan are taken forward, we are confident customers will be able to enjoy the freedoms in a suitably regulated environment'.[723]

### 3.13.2 Early exit charges

Another issue that soon became apparent was that not only were people facing difficulties transferring their pension pots, those that were able to do so were being charged significant exit charges. A report in the Financial Times showed that exit charges could typically lie between 5% and 15% of the value of the pension pot, although in a few cases the charge could be as high as 20% or even 50%. The Chancellor, George Osborne, said that deductions of this size were 'unjustifiable'.[724] In June 2015, the ABI said nearly 90% of customers eligible for the pension freedoms will not face early exit charges.[725] However, the FCA reported that while 84% of customers will not face an early exit charge, 670,000 consumers aged 55 or over faced an early exit charge (16% of the total). Of these, 358,000 faced charges between 0-2%, 165,000 faced charges between 2-5%, 81,000 faced charges between 5-10%, and 66,000 faced charges above 10%.[726]

[723] Reported in Professional Adviser (2015 ) ABI urges govt to scrap mandatory pensions freedom GAR advice, 19 June.

[724] Quoted in Dan Hyde (2015) Pension 'exit' penalties cut so over-55s can withdraw cash, Daily Telegraph, 17 June.

[725] Reported in Professional Adviser (2015) Govt to scrutinise early exit charges under pensions freedom, Professional Adviser, 17 June.

[726] Reported in Jack Jones (2015) One in 30 retirees facing exit charges above 5%, Professional Pensions, 16 September.

Insurers impose exit charges on policies that are cashed in before their maturity date, which typically coincides with the retirement date of the policy holder, e.g., age 65. This mostly affects policies sold in the 1980s and 1990s.[727] Such policies were sold by sales staff who received up-front commission from the insurer. The insurer recoups the commission over the remaining life of the policy in its annual charge and imposes an exit charge if the policy is cashed in early.

Claire Trott, from Talbot and Muir, believes the exit charges are really market value adjustments (MVAs): 'To me the majority of "high exit fees" are actually MVAs. People see it as an exit fee, because they are penalised for taking [their money] early, [but] you are breaking your contract and [the company] is recouping the cost [of selling the policy]'. She also pointed out that those breaking their contracts early could also miss out on terminal bonuses that would significantly enhance their pension pot: 'The pension pot could be reduced by a hefty amount if you take your pension 10 years before the contract ends, for example, at 55 rather than 65…You need to look at the contract and take account of anything in it that could reduce your fund value'.

Neil Lovatt, from Scottish Friendly, said policyholders should also be aware of 'enhanced allocation rates' which would be lost if policyholders withdraw early. The purpose of the enhancements was to provide an incentive to remain with the insurer. However, the enhanced rates were linked to the ongoing payment of commissions, so if the policy was cashed in early, the enhancement would be wiped out: 'Some people have extra charges built in to their contracts. People who have a contract 15 years ago…would have got an allocation value of more than 100% and that extra has been in there from day one and because you are [breaking the contract early], the [extra] is taken back….Contracts were built until retirement age and if you leave early there will be a clawback'.[728]

### 3.13.3 Official responses

The official responses to the criticisms raised over the issues of access and exit charges were swift in coming – from the FCA, TPR, HM Treasury and the Work and Pensions Select Committee.

#### *3.13.3.1 Financial Conduct Authority*

On 1 July 2015, the FCA announced that it had written to all pension providers requesting data on how customers were accessing their pension pots following Flexiday. The request

[727] Policies sold since 2000 tend not to include exit charges, since they unfairly restrict people to stay with a particular insurer, irrespective of the insurer's investment performance.

[728] Reported in Michelle McGagh (2015) Pensions: the savers left in the lurch by exit fee clampdown, Citywire, 30 July.

for data includes a questionnaire seeking information on exit charges; transfer procedures; treatment of insistent clients; financial advice requirements; and the options they offer consumers seeking access to their pots. The announcement followed a request from Harriett Baldwin to Martin Wheatley, then FCA chief executive, to take action on the implementation of 'freedom and choice'.[729]

The move was widely welcomed in the press. Typical are these views from the Daily Mail:

> *The pensions industry has been given one month to clean up its act over the treatment of older savers.*
>
> *Following a Daily Mail campaign, regulators have written to the chief executive of every pension provider to demand they hand over details of the fees they are charging customers to withdraw their savings.*
>
> *They have also been told to come clean about any other barriers customers face when they try to get hold of their money under the new pension freedoms.*
>
> *The Financial Conduct Authority has given companies until August 7 to declare the exit fees charged if people over 55 try to move to a more flexible scheme or a rival firm.*
>
> *They will also have to present evidence of what options they have been offering customers.*
>
> *If they fail to disclose the information, regulators could impose sanctions, which might include fines in the most serious cases.*
>
> *The demand by regulators follows concerns that millions of savers are being blocked from using the pension reforms.*
>
> *Since April, the over-55s have been able to cash in their pension for the first time rather than being forced to buy an annuity, a fixed monthly income for life.*
>
> *But the Mail discovered that excessive fees and other restrictions meant many were unable to use the full freedoms.*
>
> *While most were able to withdraw all their money in one go, many could not use their pension 'like a bank account' by taking it in chunks and keeping the rest invested.*
>
> *Some insurers refused to offer this flexibility, and then charged huge fees to move to a rival firm that did.*

[729] Reported in Professional Pensions Online (2015) FCA writes to all pension providers over 'freedoms' access, 1 July.

*Last month the Mail launched its Play Fair On Pensions campaign, which called for providers and regulators to lift rules preventing people accessing their hard-earned savings.*[730]

### *3.13.3.2 The Pensions Regulator*

On 2 July 2015, TPR announced it had launched an investigation into exit charges and the DC scheme transfer process to complement the FCA's investigation announced the previous day. It said it will survey a sample of schemes and the results will be used in a discussion of the broader 'operational readiness, governance and member communications' of schemes looking to provide flexible decumulation options. It also said that a similar investigation was taking place to understand the impact of pension freedoms on DB schemes, any subsequent risks and the application of its regulatory guidance. TPR said: 'We remain committed to making pension flexibilities work in the interests of retirement savers and expect to conduct further research on decumulation, to include costs and charges, in the autumn. We will consider with Government and the FCA what further action may be required to promote good outcomes for members'. It said it was considering creating more prescriptive guidance for trustees communicating the pension freedoms to members of large schemes.[731]

### *3.13.3.3 HM Treasury*

On 30 July 2015, the Treasury released a consultation document called *Pension Transfers and Early Exit Charges*.

The consultation will: [732]

- consider the issues around early exit charges, to ensure that people are not facing unjustifiable charges when moving scheme or accessing their pension savings flexibly within their scheme as part of the new freedoms
- seek views on how the process for transferring pensions from one scheme to another could be made quicker and smoother, and
- explore issues and concerns in relation to the provision and need for financial advice when making certain transfers.

---

[730] Louise Eccles and Ruth Lythe (2015) Crackdown on punitive fees to free pension cash: Victory for Mail campaign as industry is given one month to clean up its act , Daily Mail, 3 July.

[731] Reported in Natasha Browne (2015) TPR to probe schemes on DC transfer procedures, Professional Pensions, 2 July.

[732] HM Treasury (2015) *Pension Transfers and Early Exit Charges*: *Consultation*, July; https://www.gov.uk/Government/uploads/system/uploads/attachment_data/file/449861/PU1847_Pensions_transfers_v4.pdf

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:

1. 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
2. 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
3. A voluntary fee – this would allow the pension industry to set exit fees and even waive fees in cases where they see fit.

The Treasury's concern is that '[w]here an individual wishes to access their pension under the new freedoms, they should be able to do so quickly and smoothly and the Government is concerned that exit charges may represent an unreasonable barrier to their doing so. For example, an exit charge might prevent an individual from accessing freedoms where the level of the charge represents a significant proportion of the funds being accessed, or where it is so high that even those with larger pots regard the level of the charge as prohibitive. In these circumstances, the level of the charge might be considered disproportionate and, therefore, unfair and excessive'.

The consultation paper said: 'Although many of these individuals will face charges that represent fair and reasonable charges to cover costs, the Government believes there is a high degree of overlap between transfer fees and exit charges and, in the case of the latter, would like to understand, in particular, whether and why some charges may be significantly higher than others', adding that as many as one in ten savers in workplace schemes could be affected by charges when transferring their pension.

The Treasury said there were 'particular issues' concerning certain pension products sold in the 1980s and 1990s: 'In some cases, policyholders are reported to have been paying high annual management charges, with high exit penalties for switching to another provider. Although the majority of these schemes are now closed to new members, a significant number of these plans continue to operate for existing customers'. However, the consultation excludes pensions that have a 'market value adjustment' or 'terminal bonus' written into the contract.

Claire Trott of Talbot and Muir said: 'A consultation on high early exit penalties should be welcomed. There will be many people trapped in poor performing historic pensions that won't be in a position to access their income in a flexible way without incurring excessive fees to do so. [However], the consultation should not miss the point that many of the historic charging structures were low in the early years because of these built-in exit

penalties and some companies will be out of pocket if they are forced to reduce the penalties. This doesn't mean that it shouldn't be looked into though. The constant changing of pensions legislation can be very costly for pension providers with large historic books and bringing in the changes expected by the Government in the short timescales given has been a challenge for many. The consultation needs to take into account the cost of providing the retirement options and how these differ between different retirement products. Running drawdown in a self-invested personal pension with a wide range of assets, such as commercial property and various other assets, will be significantly more time consuming than drawdown run in a basic personal pension with a range of mutual funds also run by the same provider. The consultation should look at value rather than outright cost'. Nevertheless, she felt that the exclusion of MVAs meant that there was 'little need for the Government to legislate'.[733]

Stephen Scholefield, pensions partner at Pinsent Masons, said, while tackling exit fees makes the Chancellor an 'unlikely consumer champion', it will not be enough to ensure the freedoms are successful: 'To have real success, he'll need to create a safe-harbour environment in which providers can process transfers efficiently, whilst savers don't live to regret their decisions. Otherwise, ambulance chasers will be joining car retailers in looking to profit from those who cash out their pension savings'.[734]

Some argued that there was a case for some form of exit charge. For example, Jamie Smith-Thompson of Portal Financial agreed that exit fees up to 20% were punitive and excessive and therefore a cap would help to protect consumers. However, he was concerned that this could turn into a 'witch-hunt on fees in their entirety' and argued that exit fees could actually help protect savers: 'It is not a requirement for all consumers to seek financial advice before emptying their fund or transferring away, which means many people will be able to make that decision by themselves without necessarily knowing about certain implications, such as tax or how it may affect their benefits. A sensible charge can encourage people to think twice and be really sure they are doing the right thing, and hopefully even prompt them to seek advice so they don't have any surprises'.[735]

The Daily Telegraph reported that key pension providers had already held meetings with the FCA to lobby against a draconian cap being imposed on charges. The providers also wanted a coordinated approach so all firms reduce their fees at the same time to ensure that no

[733] Reported in Jenna Towler (2015) Govt vows to cap 'excessive' pension exit fees, Retirement Planner, 30 July.
[734] Reported in Stephanie Baxter (2015) Cap on pension exit charges 'could turn into witch-hunt', Professional Pensions, 18 June.
[735] Reported in Stephanie Baxter (2015) Cap on pension exit charges 'could turn into witch-hunt', Professional Pensions, 18 June.

provider faced a sudden exodus of customers to rival companies, although it was recognised that this might breach competition law, since it could be classed as price fixing.[736]

In January 2016, the Treasury announced that it will legislate to cap excessive early exit charges.[737] The following month, it said that the cap would come into effect in March 2017. implementation target. The FCA will be responsible for setting the level of the cap and will consult fully on this in due course.[738]

#### *3.13.3.4 The Work and Pensions Select Committee*

On 17 July 2015, the Work and Pensions Select Committee announced it would launch an inquiry into the new advice and guidance regime. The committee wanted to hear evidence on the take-up, suitability, affordability and independence of the advice, guidance and information available to those approaching retirement. It also wanted to hear recommendations for improvement. Committee chairman, Frank Field MP, said: 'Many constituents were ripped off in the process of putting their earnings into pension savings. We have a duty to ensure they are not ripped off again if they wish to take their money out and spend some lump sums'.

Richard Graham MP, a member of the committee as well as chairman of the All-Party Parliamentary Group (APPG) on pensions, said: 'Taking away the requirement to buy an annuity and introducing much greater flexibility in how and when individuals can access their pension savings should be a positive change for many. However getting the right guidance is key, and this inquiry will look at the guidance and advice being given, and how effective the system is in helping people make informed choices'.[739]

In September 2015, the ABI's Huw Evans told a Work and Pensions Select Committee inquiry hearing that likening pensions to bank accounts is the 'most irresponsible' thing anyone can say in relation to pensions freedom: 'If I could rub a lamp "Aladdin-style" and have a few wishes, certainly one of them would be to stop people referring to pensions as a "bank account". It is the most irresponsible thing anyone can say. You cannot attract a tax liability when you withdraw money from a bank account or set up a direct debit. You can if you

[736] Reported in Dan Hyde (2015) Hope of amnesty on pension exit penalties, Daily Telegraph, 30 July.

[737] Reported in Jenna Towler (2016) Treasury to cap 'prohibitive' pension exit penalties, Professional Adviser, 19 January.

[738] Reported in Jenna Towler (2016) Pension exit charge cap set for March 2017, Professional Adviser, 10 February.

[739] Reported in Jenna Towler (2015) MPs launch pensions freedom advice and guidance inquiry, Professional Pensions, 17 July.

access pension liabilities. There is a piece [of work to be done] around customer expectations and we have to use the right language'.[740]

The Work and Pensions Select Committee reported the results of its inquiry in October 2015.[741] 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'.

### *3.14 Pension fraud and investment scams*

*Red flags for spotting pension fraud*

- Any unsolicited approach: phone, email, text messages or in person
- Free pension reviews, particularly from unregulated companies marketing early access to cash or guaranteed investments
- Pushy advisers that encourage members to speed up signing paperwork, as well as the use of couriers to collect/sign paperwork
- Any mention of loopholes, overseas or strange/creative/unique investments – unregulated investments, such as hotel rooms, car parking spaces, forestry, renewable energy, storage pods
- Any mention of loans or bonuses provided by Government
- An offer to help you access your pension savings before age 55
- A recommendation to take a large amount of money, or your whole pension pot, in a lump sum and invest it.
- Warnings that the deal is limited and you must act now
- An encouragement not to get professional financial advice or talk to Pension Wise
- Contact by somebody who is not on the FCA register

Source: Retirement Advantage, reported in Jenna Towler (2015) Pension scam alert, Professional Adviser, 1 July.

[740] Reported in Jenna Towler (2015) Comparing pensions to bank accounts 'irresponsible', ABI chief warns, Professional Adviser, 8 September.

[741] House of Commons Work and Pensions Committee (2015) *Pension Freedom: Guidance and Advice*, HC 371, 19 October; http://www.publications.parliament.uk/pa/cm201516/cmselect/cmworpen/371/371.pdf

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.[742] Tom McPhail believes 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'.[743] Even the Pensions Minister at the time, Steve Webb, received a text message from a con artist on his mobile phone: 'if you have a frozen pension prior to 55 you are entitled to a free review. Please call back'.[744]

In October 2015, a survey commissioned by Portus Consulting, found that one in seven savers over the age of 55 has been targeted by a pensions scam since Flexiday. It also showed that 69% of those targeted said they were offered a free pension review. Over 27% said the suspected scam involved an exotic investment scheme, promising attractive levels of return. The most common method used by potential scammers to contact over-55s is by email (cited by 36% of the people interviewed), followed by the telephone (33%).[745]

Con artists can be pushy and charming. Each year, they steal £1.2bn from investors, including pension liberation, an average loss of £20,000. They are drawn to the most vulnerable: those in debt and desperate for cash, or who are confused about the rules surrounding their pension. Margaret Snowdon, head of the Pension Liberation Industry Group (PLIG), says fraudsters are very difficult to identify: 'They do tend to mimic legitimate schemes and providers. They are fairly clever or they would be easily found out. It is probably the patterns of behaviour that help identify them – cold calling for example, or pushy and threatening to sue on delays'. They have a background in either financial services, including ex-IFAs, accountants, solicitors, or in wealth or debt management. They invest in expensive marketing material and websites. [746]

---

[742] The fees that the scammers charge can be as high as 30% and in addition there could be a tax charge of up to 55%, see Sarah O'Grady (2014) Warning as fraudsters target elderly in scam to get pension savings, Daily Express, 11 December; see also Jenny Towler (2015) Pensions freedom 'absolutely made' for cunning fraudsters – Phoenix Group. Professional Adviser, 29 January.

[743] Quoted in Andrew Oxlade (2015) Pensions freedom: how we can help you make the most of it, Daily Telegraph, 16 February.

[744] Reported in Daily Mail, 12 February 2015

[745] Reported in Rebecca Shahoud (2015) One in seven targeted by pension fraudsters, Professional Pensions, 27 October.

[746] Natasha Browne (2015) A portrait of a con artist, Professional Pensions, 2 February.

Jack Doyle and Sam Dunn provide this warning:[747]

> *How crooks will target you*
>
> *Promised pension freedoms herald a bright new dawn for millions of savers. Unfortunately, they will also act as a clarion call for crooks to target millions of pounds about to be unlocked by the trusting and the unwary.*
>
> *The danger lies in scammers' ability to contact you by phone, text or email – and their persistence to wear you down.*
>
> *Their first approach is usually the most enticing. A text might typically offer a 'free pension review', 'one-off investment opportunity' or promise of 'upfront cash'.*
>
> *But the minute you respond to the cold-caller, they'll begin to crank up the pressure. Their prize is your pension pot – and they need you to agree to sign a funds transfer form to get their hands on it.*
>
> *So the promises will come thick and fast. They might suggest juicy returns of 8 per cent or more, talk authoritatively about locking away cash in overseas investments or dangle cashback payments.*
>
> *To soothe fears, they may also claim to be a Government adviser or say they've been endorsed by officials. And while there will be talk of you, at 55, having plenty of time to lock your money away, there will be no mention of the imminent tax bill you'll need to pay. The fee they'll charge, perhaps as high as 30 per cent, will be glossed over.*
>
> *It might take a dozen or so emails and phone calls – or even ten times that – but once you're hooked, they'll then push you to sign a transfer form as soon as possible.*
>
> *This may be sent to you by email as a form to fill in online or even couriered over to your front door. You'll be convinced it's a simple final matter of filling in the details of your existing pension scheme – usually its name and number.*
>
> *Legally, your original pension provider – usually an insurer – can only agree to transfer the money on the condition it will go straight to another registered pension plan. However, the scammers – acting as the broker – do no such thing. They'll take the money and then release only a chunk of it to you as a loan or cash sum.*
>
> *And once your funds are released from your insurer and into a new account – often overseas and outside UK jurisdiction or the arm of the regulator – then your chances of ever seeing the cash again will vanish.*

[747] Jack Doyle and Sam Dunn (2015) Beware of the pension sharks: Flood of spam texts and cold calls 'could create the next PPI scandal', Daily Mail, 16 March.

*You may find the scammer picks up the phone the first time you call to check up on your investment – but they won't be there the next time.*

*As well as the hefty fee, HMRC will then slap you with a tax charge of up to 55% because you've taken out an 'unauthorised payment' from your pension.*

*Always check the credentials of the company and any advisers, who should be registered with the Financial Conduct Authority at fca.org.uk.*

*If you think a company is trying to get you to liberate your pension, report the company to Action Fraud or call it on 0300 123 2040. It can prosecute companies found breaking the law.*

In April 2015, Citizens Advice warned that sophisticated fraudsters were targeting 'cash rich' retirees. It released a report *Consumer Experience of Pension and Pensioner Scams before April 2015* which analysed 150 case reports from consumers made in the run up to the new pensions regime.[748] It has identified five key types of pension scam:

- Moving savings to a new pension
- Fake investment opportunities
- Offering free 'advice' or services
- Charging for 'dodgy' services
- Getting personal information from people.

The report also identified cold calling as the most common means of initial contact (covering two-thirds of cases), although text messages, post, visiting in person and internet contact were also methods used by scammers. In some cases, multiple approaches were used: for example, phoning and then sending someone to their house, texting then phoning, or calling and then following up with letters.

It said scammers used either a 'carrot and stick' approach or employed high-pressure tactics: 'We've heard from many consumers who have been offered the chance to take advantage of a "tax loophole" or a "special investment rate", while others have been told they've won lotteries despite never entering one. Pressure is often applied by saying that special offers are time limited, or by bombarding people with correspondence to catch them at a weak moment. To appear authentic, some scammers claim to be acting on behalf of a client's pension provider. In other cases they use official sounding names like 'the Pensions Office' or say they are a Citizens Advice "pensions officer"'.

In terms of human cost, the report said one person had lost £200,000 as a direct result of pension scams and added: 'The money lost in a scam can mean the difference between a

748

https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/other-issues-policy-research/consumer-experience-of-pension-and-pensioner-scams-before-april-2015/

comfortable retirement and a life on the breadline…. One consumer spoke for many when they said: "I feel really stupid to have given away my pension money to a crook on the phone"…. As well as direct losses, people can also lose through unexpected tax or benefit consequences'.

In a follow-up report, Citizens Advice said that there is increasing evidence that fraudsters are using investment scams to target people's pension pots. Scams include:

- Unspecified financial products which see fraudsters offering to invest pension money in other products without explaining what those products are
- Free pension 'reviews'. People are texted or cold-called with offers of free pension reviews. Citizens Advice has had reports of fake-IFAs – who could not describe investments – visiting homes
- Investment schemes where victims are persuaded to invest money in property, or in fine wine.

Gillian Guy, chief executive of Citizens Advice, said: 'Pension scams threaten people's financial security. People are being targeted again and again with bogus investment offers or fraudulent pension opportunities. Opportunistic fraudsters are finding new ways to go after people's pension pots including offering free pension reviews and promising to invest in funds that don't necessarily exist. Pension and investment scams are particularly dangerous, as they can destroy people's entire pension pot, leaving them with little or no savings for retirement. We will be monitoring pension scams closely in order to track how they are evolving, and warn consumers what to look out for. If you've had an offer or signed up to a scheme you're unsure about, contact Citizens Advice for support'.[749]

In March 2015, the Information Commissioner's Office (ICO) reported that it was investigating claims made by the Daily Mail that its reporters, posing as a cold-calling company, had bought a database containing information on the pensions, salaries and investments of 15,000 people for 5p a record. The ICO said it was making enquiries to establish whether there have been any breaches of the Data Protection Act or Privacy and Electronic Communications Regulations. It was also in contact with the police. The information was sold without consent, leaving these people vulnerable to fraudsters. The ICO also reported that it had received more than 1,000 complaints about pension-related spam texts, automated calls and cold-calling relating to pensions in the second half of 2014. According to the Pensions Regulator, pension scheme members have so far lost £500m via 'pension liberation' scams, where companies illegally encourage people before the age of 55 to transfer money from their pension fund into investments offering implausibly high

[749] Reported in Jenna Towler (2015) Pension fraud 'increasingly linked' to investment scams, Professional Adviser, 7 August.

returns. These people end up not only losing their investment, they also have to repay the tax relief they receive.[750]

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. The regulator is urging pension trustees and providers to include its leaflet in the next annual statement sent to members, and anyone who requests a transfer in the meantime. The campaign highlights cases where victims have lost thousands of pounds by being scammed into moving their retirement savings into unregulated high-risk or bogus investments. One woman, whose 40-year-old son took his own life after never receiving a promised £17,000 lump sum following the transfer of his £42,000 work pension, said: 'I don't want other mothers to suffer what I've been through, and what my family has been through. No matter how desperate things get, don't be tempted to cash in your pension. Don't do it – the people behind these scams are rogues who exploit people's vulnerabilities'. Another 49-year-old scam victim, who is potentially facing an £18,000 tax bill and risks losing her home after falling victim to a 'pension loan' scam said: 'These scams target vulnerable people. I feel very angry that I have been misled. Ignore the sales patter, ignore the glossy websites, ignore the cold calls and text messages. Go to an independent financial adviser – speak to an expert'.[751,752]

In October 2014, the FCA launched ScamSmart, a campaign to alert people to the dangers of 'scammers offering opportunities that are too good to be true'. The Treasury has made it a criminal offence for anyone to pretend to offer Pension Wise guaranteed guidance. In July 2015, the FCA provided updated figures on ScamSmart. Around 100,000 people had visited the ScamSmart website since October last year. Around 20% had checked an investment through the warning list.[753]

In March 2015, the Pension Liberation Industry Group introduced a code of good practice for combating pension scams:[754] 'The Code of Good Practice is voluntary and sets an industry standard for dealing with requests by members for transfers from a UK registered

---

[750] Claer Barrett and Josephine Cumbo (2015) Watchdog probes sale of financial data, Financial Times, 30 March.

[751] The Pensions Regulator (2014) Pension scams – a lifetime's savings lost in a moment, 24 July; http://www.thepensionsregulator.gov.uk/press/pn1423.aspx. The campaign is being led by the Department for Work and Pensions, The Pensions Regulator, The Pensions Advisory Service, Money Advice Service, Financial Conduct Authority, Serious Fraud Office, HMRC, Action Fraud, National Crime Agency and City of London Police.Visit www.pension-scams.co.uk for more information. If you fall victim of a pensions scam please report it to Action Fraud on 0300 123 2040; www.actionfraud.police.uk.

[752] See also Professional Adviser (2015) Pension scams push savers to take their own lives, 5 May.

[753] Reported in Professional Pensions Online (2015) FCA writes to all pension providers over 'freedoms' access, 1 July.

[754] *Combating Pension Scams: A Code of Good Practice*, March 2015; http://www.combatingpensionscams.org.uk/

pension scheme to another registered pension scheme or Qualifying Recognised Overseas Pension Scheme.

The Code is aimed at trustees, administrators and providers and sets out industry standard due diligence to follow when considering a transfer request. The legislation relating to transfers is not prescriptive as to due diligence that trustees/providers should carry out on transfer applications'.

The Code operates according to the following three principles:

1. Trustees, providers and administrators should raise awareness of pension scams for members and beneficiaries of their scheme.
2. Trustees, providers and administrators should have robust, but proportionate, processes for assessing whether a receiving scheme may be operating as part of a pension scam, and for responding to that risk.
3. Trustees, providers and administrators should generally be aware of the known current strategies of the perpetrators of pension scams in order to inform the due diligence they need to undertake and refer to the warning flags as indicated in the Regulator's Guidance, FCA alerts and Action Fraud.

In May 2015, the FCA issued a warning announcing that fraudsters were using the details of the firms it authorises, such as their 'firm reference number' (FRN), in an attempt to convince customers that they work for a genuine, authorised firm. This followed a similar announcement in April about a scam firm which used the details of investment manager BlackRock to defraud investors. The regulator pointed out that investors who give money to unauthorised firms have no recourse to the FSCS or the FOS if they lose their money.[755] There is even a case of a fraudster, who goes by the name William Howarth, pretending to be calling from the FCA.[756] There are fraudsters pretending to be from National Savings & Investments who are cold calling pensioners and trying to sell them 'pensioner bonds'.[757]

In July 2015, the BBC reported that fraudsters had built a database of around 200,000 people – with an average age of 74 – on so-called 'suckers lists'. Almost 11,000 of them had already lost an average of £1,184 each.[758] Also in July 2015, provider Retirement Advantage reported the results of a YouGov survey that it commissioned which showed that 17% of over 50s and 20% of over 55s had been approached by a company offering to 'help' them access their pension savings early, typically via a legal loopholes or a one-off investment

[755] Reported in Laura Miller (2015) Fraudster alert - FCA warns on four investment firm clones, Professional Adviser, 5 May.

[756] Reported in Laura Miller (2015) FCA warns of cold calling fake regulator fraudster, Professional Adviser, 19 May.

[757] Professional Adviser (2015) NS&I warns on 'pensioner bond' fraud as application deadline looms, 14 May.

[758] Reported in Professional Adviser (2015)Thousands of pensioners found on fraudsters' 'suckers list', Professional Adviser, 24 July.

opportunity. Andrew Tully, pensions technical director at Retirement Advantage, said: 'It is clear that there are already scammers preying on people who might like the idea of using the new pension freedoms to take large amounts of cash from their pension schemes. The scammers may be offering get-rich-quick schemes or even early access before age 55 to trick people out of their hard-earned savings. Retirees need to be on their guard: if an opportunity sounds too good to be true, it almost certainly is. It is vital that the Government and financial industry work together to ensure all practical measures possible are in place to protect people from these scams. We need to make people aware that there are fraudsters hoping to trick them out of their money. Hopefully Pension Wise will help educate people around the risks, but professional financial advice will be crucial to ensure people understand the options available to them and make the right decision for their personal circumstances. The Government also needs to make life difficult for the scammers, and punish those found guilty of preying on innocent victims'. The ABI's campaign Your Retirement, Your Choice also aims to prevent people avoid pension scams by helping them understand their options better.[759]

There is also evidence of an increased number of frauds using prominent financial addresses in the heart of the City of London. The City of London police force said it was struggling to cope with the increased number of cases being reported and it now concerned about the City's own reputation. It said that it has already investigated dozens of individuals, and has identified at least 14 different criminal groups.[760]

Even if the investment opportunities being offered are not scams, they can be unregulated which can be equally risky. An example of this is the case of Capital Alternatives and the schemes it promoted – Capital Carbon Credits (later renamed Reforestation Projects) and African Land – which the FCA claimed were deliberately structured to avoid regulation. Most investment funds are collective investment schemes (CIS), where investors pool their assets and have these managed by an independent fund manager, and most are regulated. The promotion and operation of a CIS is a regulated activity and cannot be lawfully carried out by anyone who is not authorised by the FCA. Capital Alternatives is not authorised by the FCA. In June 2013, the FCA banned the promotion and sale of unregulated collective investment schemes (UCIS) to most retail investors in the UK, the exceptions being certified high net worth individuals, certified sophisticated investors, and self-certified sophisticated investors. Capital Alternatives denied that its schemes were CIS or UCIS and took the FCA to court. In March 2015, the Court of Appeal agreed with the FCA that the Capital Alternatives schemes met the definition of CIS, namely that investors' monies was pooled and the investments were managed centrally. Capital Alternatives appealed to the Supreme Court which in August 2015 confirmed that Capital Alternatives' schemes were in fact UCIS and

[759] Jenna Towler (2015) Pension scam alert - Five tips to share with clients, Professional Adviser, 1 July.

[760] Reported in Investment Week (2015) Investment scams spike as fraudsters use City firms' addresses, 20 August.

hence cannot be sold to unsophisticated UK investors. Tobias Haynes of Regulatory Legal said: 'The decision of the Supreme Court is a welcome one, and one which is a true consumer victory. The decision opens up the doorway to many vulnerable investors who otherwise would have no recourse. This is particularly the case where SIPP providers have allowed retail investors to invest directly into UCIS without having first been satisfied that the consumer was properly certified as a high-net-worth or sophisticated investor'.[761]

The Personal Finance Society has warned about the dangers of consumers becoming confused about the difference between regulated and non-regulated financial advice as a result of the 'inevitable wave of non-regulated scammers' capitalising on 'freedom and choice'. It called for greater oversight of non-regulated advice. Keith Richards, chief executive, said: 'The public generally do not understand the difference between regulated and unregulated activities and, in fairness, should not be expected to. They are, therefore, more exposed to scammers, fraudsters and opportunists who often look like regulated firms or processes….The increasing danger of consumers finding their way into unregulated activity is worrying. It is now time for all activity to come under the same umbrella, to provide consistency of standards and consumer protection'.[762]

In August 2015, Portal Financial published the results of a survey which appear to show that consumer education campaigns around spotting financial scams and finding financial advice were not working. The results of the survey of 1,000 people over the age of 55 in four regions across the UK are shown in Table 3.7. Jamie Smith Thompson said: 'The result raises questions over the effectiveness of the MAS and Pension Wise awareness campaigns, but it also highlights the problem that, at the moment, you can't simply use the message "go to a regulated company and you will be protected" for every financial product. MAS and Pension Wise's job would be easier if that were the case. Until legislation is changed to bring all financial product sales under the regulatory umbrella it is going to be hard for the man in the street to tell a sophisticated scam from a genuine service. The current system of identifying and shutting down scam companies can take a very long time, which in turn means more people can be affected'.[763]

[761] Reported in Laura Miller (2015) Supreme Court backs FCA's tough stance on collectives in landmark case, Investment Week, 5 August.

[762] Jenna Towler (2015) PFS chief warns on 'increasing danger' of unregulated activity, Professional Pensions, 26 May.

[763] Reported in Carmen Reichman (2015) Pension scam awareness campaigns 'failing to reach' retirees, Professional Adviser, 25 August.

| *Table 3.7: Portal Financial survey concerning financial scams and financial advice* | | | | |
|---|---|---|---|---|
| Question | Midlands and Wales | North & Scotland | Northern Ireland | South |
| Have you ever been contacted by a company that you felt could be running a financial scam? | Yes: 50%<br>No: 50% | Yes: 51%<br>No: 49% | Yes: 69%<br>No: 31% | Yes: 55%<br>No: 45% |
| Are you confident that you could tell the difference between a scam and a genuine offer from a regulated company? | Yes: 59%<br>No: 41% | Yes: 58%<br>No: 42% | Yes: 46%<br>No: 54% | Yes: 63%<br>No: 37% |
| Have you noticed an increase in the volume of pension-related sales calls in the last month or so? | Yes: 40%<br>No: 60% | Yes: 43%<br>No: 57% | Yes: 77%<br>No: 23% | Yes: 33%<br>No: 67% |
| If you wanted accurate financial advice on the pension reforms, would you know where to go? | Yes: 73%<br>No: 27% | Yes: 80%<br>No: 20% | Yes: 54%<br>No: 46% | Yes: 77%<br>No: 23% |
| Source: Portal Financial | | | | |

As a consequence of investment scams, compensation payouts from the FSCS 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 at FSCS, said: 'Many savers had been poorly advised to move pension savings from safe workplace schemes to risky investments'.[764]

The Pensions Ombudsman (PO) deals with member objections to transfer requests that have been blocked by providers who suspect members could become a victim of fraud. The PO's rulings have been consistent in stating that scheme administrators cannot block a member's request where there is a statutory right to transfer and that right will only exist where it has been established that the receiving scheme is a properly established and registered arrangement. Geoff Egerton, associate at Linklaters, said: 'You do your due diligence. And you do your work to make sure that you've flagged the warnings from The Pensions Regulator's guidance, which says you should satisfy yourselves that this isn't a

[764] Reported in Holly Black (2015) Alert over rise in failed pensions with thousands feared to have lost money in high risk schemes, Daily Mail, 21 July.

pensions liberation vehicle. But once you've done all that, if the right exists, there has to be a transfer'.[765]

There are also concerns about pensioners cashing in their annuities, and the introduction of the secondary annuity market was pushed back from 2016 to 2017 as a consequence of these concerns. Providers have warned about the 'terrible consequences for elderly policyholders if the changes are pushed through before the right safeguards are in place….[M]any people would be offered a very low value for their annuity and could face rip-off charges to cash it in'. The ABI recognised the plan for a secondary annuity market 'poses a risk'. Dr Yvonne Braun, of the ABI, said: 'Naturally there are considerable challenges in establishing a functioning market, [with] many unresolved complex legal, regulatory and prudential questions. We urge the Government not to rush these proposals through for 2016'. The ABI said more clarity was needed around how a partner would be protected if someone sold a joint life annuity. Also those selling their annuities would include vulnerable older people with 'reduced mental capacity'. In addition, the ABI was concerned about how the Government would 'protect people from scams and fraud'.[766]

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

#### 3.15.1 Customer engagement

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. This could be a serious problem, since as Nigel Aston, head of DC at State Street Global Adviser, says: '"Freedom and choice" legislation hasn't suddenly created a population of self-empowered, interested, financially savvy people….[However], all the research points to the fact that they can make really good decisions…but they can only do it when they've been given some sort of guidance and better products'.

A survey of trustees and pension managers at nine trust- and contract-based DC schemes was carried out by Spence Johnson on behalf of the Defined Contribution Investment Forum (DCIF) in March 2015. This confirmed that their biggest challenge is improving engagement with members to ensure people understood what they wanted. The schemes agreed that engagement was much more difficult than choosing an investment solution which one respondent said was 'quite simple'. The schemes had developed straightforward

[765] Reported in Natasha Browne (2015) Liberation fraud - Where do trustees stand after the latest ombudsman decisions?, Professional Pensions, 29 April.

[766] Reported in Louise Eccles (2015) Fears grow that pensioners cashing their annuities will be 'at the mercy of fraudsters' if reforms are rushed through next April, Daily Mail, 26 June.

communications on the impact of the pension freedoms, but are looking for tools that can help them improve longer term engagement.[767]

We know that in other areas of economic activity, particularly those involving immediate gratification, people can become engaged and put the necessary effort in. An example put to us was holiday planning. The more effort put in, the better the holiday. We need to find a comparable way of engaging people in retirement planning, so that more effort gets better outcomes.

There is also an important question about the best time to begin the engagement process. According to a survey by Mercer, 52% of employers and trustees believed the guidance guarantee should be offered 5-7 years before retirement, 32% when the member chooses, 15% when they take their first pension and only 1% at retirement. The following are typical of the majority view: 'It's too late at retirement. It needs to be considerably earlier to ensure adequate money is going in, and the correct investment strategy is being applied to the potential decumulation option to be used' (John Chilman, First Group) and 'We believe that pension guidance should start a lot earlier than a year or two prior to retirement and needs to be part of an integrated approach to improve financial awareness and understanding in the workforce' (Chartered Institute of Personnel and Development).[768]

For the plan to be effective, there needs to be a set of key decision dates both before and after the plan begins:

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

### 3.15.2 Customer communications

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*.[769] The DP begins by arguing that information, while important, is not

[767] Reported in Stephanie Baxter (2015) DC schemes want more tools for 'biggest challenge' of member engagement, Professional Pensions, 1 May.
[768] Reported in PLANSPONSOR UK, June 2014.
[769] Financial Conduct Authority (2015) *Smarter Consumer Communications*, Discussion Paper DP15/5, June; https://www.fca.org.uk/news/dp15-05-smarter-consumer-communications

enough: there needs to be better communications with customers. In the introduction to the DP, Christopher Woolard said:

> *Like many other regulators, we have relied heavily on information to help ensure greater consumer protection and make competition work. In some cases, we specify the type of information firms should disclose to customers and the format it should take. We will continue to do this where we feel it is necessary to improve outcomes for consumers.*
>
> *We recognise, however, that information itself does not necessarily empower the consumer. Our work on behavioural economics has clearly shown it can overwhelm, confuse, distract or even deter people from making effective choices if presented in a way people struggle to engage with. 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.*
>
> *Communications play a fundamental role in helping consumers to make informed decisions. Effective, engaging information can be a key tool in promoting effective competition to supply products and services that consumers want. Greater transparency in firms' communications with consumers can also lead to greater efficiency for the industry, with less time spent handling complaints.*
>
> *Effective, engaging information is also already integral to our regulatory approach: we require firms to have due regard to the information needs of their customers, and to communicate information in a way that is clear, fair and not misleading. While some firms may feel they already do this, from what we have seen in our research, thematic reviews and market studies, it is evident most firms need to do more to communicate with consumers in a way that truly empowers them to make effective decisions.*
>
> *We expect all firms to embed an organisation-wide culture where the importance of communicating effectively with consumers is recognised and prioritised. The information needs of potential customers need to be fully considered when developing a product or service and throughout the lifecycle of that product or service.*
>
> *We are committed to driving improvements in the effectiveness of the information consumers receive about the financial products and services they have or want to buy. This DP is intended to kick start a debate around how the FCA, industry, consumer groups and other stakeholders can work*

*together to deliver information to consumers in smarter and more effective ways, including adopting innovative techniques as we move away from the paper-based mindset.*

In the DP, the FCA reiterates its expectation that firms:

- understand and recognise the importance of communicating effectively with consumers
- create product and service information for consumers with at least as much behaviourally informed creativity as is applied to business development, marketing and financial promotions
- create communications as an integral part of the product or service design process.

It acknowledges that many firms are doing this and it signals its support and encouragement for firms that are:

- writing for the consumer first and then ensuring communications are compliant, rather than the other way round
- moving away from a box-ticking approach to communication design, or the perception that communications driven by regulation are the responsibility of compliance and legal staff
- building a wider understanding of their customers' information needs and objectively considering not only what consumers actively demand to know, but also:
    - what the consumer needs to know
    - how much they need to know
    - when they need to know it
- prioritising efforts to ensure that information is effective for the intended audience and testing communications among real consumers
- adopting innovative techniques to improve how key information about products is conveyed and delivered to consumers.

The FCA said it was pleased with the good practices and innovative approaches to communicating effectively with consumers that it saw emerging in some firms. This included firms that:

- designed communications to meet the needs of the product or service's target market
- ensured their communications effectively delivered the key information to consumers by, for example, using plain language, a clear and short format, bullet points and clear graphics
- provided information at a time consumers need it and in an engaging format

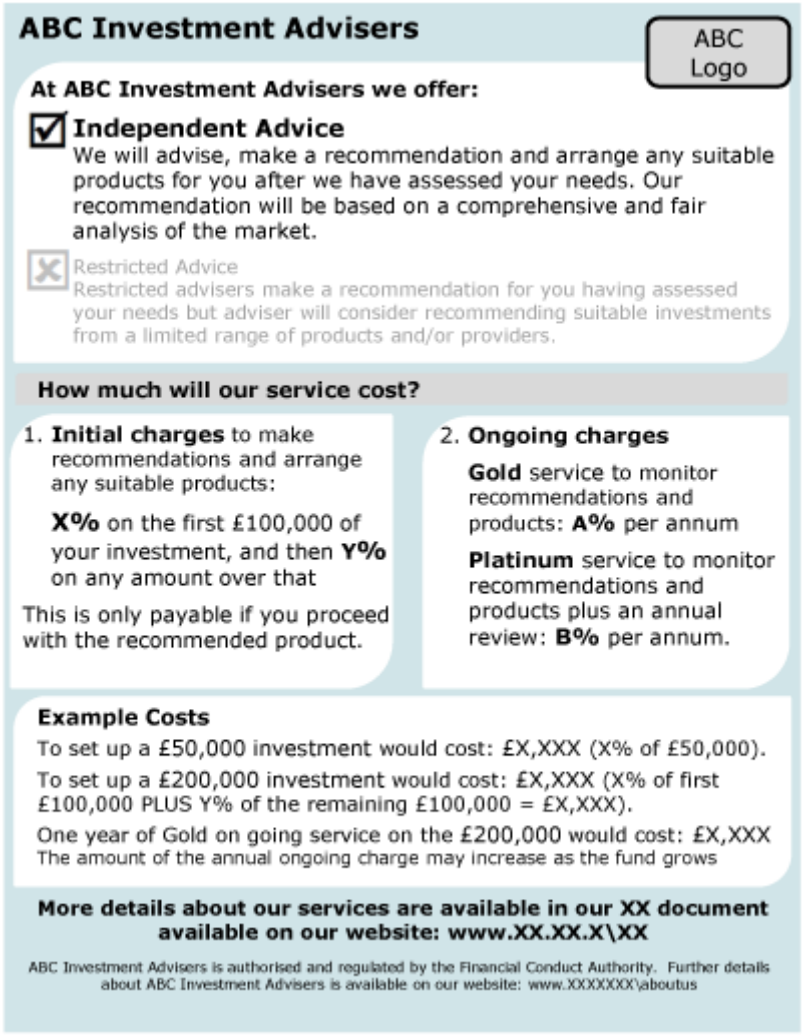
- developed interactive communications, harnessing technology such as mobile devices, tablets, apps, social media, YouTube and online tools to ensure key information was more accessible to consumers.

One problem area that the FCA identified was communication about charges to consumers. It noted that the compounding impact which charges have on investment returns over the long term 'can be a difficult concept for some consumers to understand'. It identified Nutmeg as an example for other firms to follow in terms of 'presenting this [impact] graphically, with a clear explanation'.

*Figure 3.4: FCA-proposed label for the services offered by firms derived from the US Environmental Protection Agency's 'fuel economy' label'*



*Figure 3.5: FCA-proposed label for firms' charges schedule derived from the US Environmental Protection Agency's 'fuel economy' label'*




The FCA said it also liked the idea of disclosure 'labels' to outline firms' charges and the type of advice they offer to consumers. It pointed to the 'fuel economy label' designed by the US Environmental Protection Agency which has been on display on all new cars in the US since 2008 and which it adapted in Figures 3.4 and 3.5.

### 3.15.3 How responsible is the consumer?

The regulatory tension between the econ and human view of the customer was clearly demonstrated by Martin Wheatley, then chief executive of the FCA, speaking at the NAPF investment conference in Edinburgh on 11 March 2015.[770]

He 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. He added:

> *Certainly, under the system as it will be, there will be no ability to prevent all of the people, all of the time from making "sub-optimal" decisions. Some savers, come 55, will invariably head to Las Vegas, buy fast cars or otherwise calculate how to run down their pension pots in days and months, rather than years. Optimists will be inclined to believe that these numbers will be fractional. Pessimists that they may be more significant. But the reality is that this is all simply part of the process that flows from the benefit of freedom. Some responsibility, by definition, has to bump across from industry to customers otherwise you simply return to difficult conversations around why policy makers should, in effect, decide how savers draw their money.*
>
> *Come April 6, what you will have is a structure under which customers will, on seeking access to their pensions, immediately be recommended to seek guidance – via Pension Wise or financial advice. After which, when a decision has been made, the system will effectively have a further check, if necessary triggering a personalised risk warning. Allowing a final opportunity for people to assess the wisdom of their choice. [With all this in place, customers] will be in a position to make what are, clearly, life-influencing decisions on future income, with some confidence that the structure behind their choice is sound.*

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*

[770] Reported in Carmen Reichman (2015) Wheatley: Consumers liable for 'Las Vegas' retirement decisions, Professional Adviser, 11 March; Tessa Norman (2015) Wheatley: 'Pension reforms are Y2K moment for industry', Money Marketing, 11 March.

*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, as pointed out in a briefing note released by Just Retirement in June 2015, the Government has put no monitoring mechanism in place.[771] The briefing note states: 'Our primary concern is the lack of a co-ordinated and comprehensive forward plan for monitoring the impact of the reforms on consumer outcomes, both in the early stages and over the longer term. This is important because of known problems with consumers' engagement with pensions and retirement planning decisions which have led to negative outcomes for consumers…The Government accepts it cannot predict the outcome of the reforms and has made clear that individuals are responsible for their decisions. Nonetheless, it will be important to monitor the available data in order to understand developing norms, and to help prevent consumer detriment likely to result from poor financial capability, disengagement and the impact of financial scams'.

The briefing note identifies the following information sources that will be crucial inputs into any evaluation of the success of the reforms:

- 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.

However, the data collected by the FCA does not currently capture certain information, such as the rate of cash withdrawals from DC pension savings, type of annuity (e.g., joint or single life, enhanced or standard, level or escalating/inflation-linked), or details of the risk profile or funds invested through income drawdown contracts at the time of purchase. The briefing note states that: 'These data points are important in the context of the pension reforms due to known shortcomings in financial engagement and capability, especially in relation to

[771] Just Retirement (2015) Briefing note on the need for adequate monitoring of pension reform outcomes, June.

retirement choices. Consumer analysis, including the FCA's own thematic work on the retirement market, has shown that consumers are often ill informed or make decisions without being aware of better options, with the outcome often irreversible. Common examples include individuals failing to consider their dependant's needs and opting for a single life annuity instead of a joint-life policy, or buying a standard annuity without realising the significantly higher income provided by enhanced annuities. The potential risk of mis-selling and mis-buying has increased with the new options available since April 6 [2015], and new risks, such as the potential for individuals to unknowingly trigger a large tax charge on lump sum withdrawals'.

The briefing note identifies the monitoring gaps that need to be closed in order to fully assess the success of the pension reforms:

> *The concerns outlined above emphasise the need for substantive data on a range of key measures without which regulators and the Government will be unable to monitor outcomes in the new pensions environment. Compared to the depth of information required for non-retirement products such as mortgages, the FCA's present retirement product data collection is minimal and will not be sufficient to monitor consumer outcomes in the new environment.*
>
> *Similarly, the Treasury has yet to set out any plans for the collection and publication of data on the feedback from Pension Wise users. This will be an important measure, providing basic user feedback on the service itself, its quality and whether it is succeeding in helping individuals navigate the new pension freedoms.*
>
> *In addition to collecting this feedback on Pension Wise, data on the wider outcomes for all retirees must be captured to understand the longer-term impact of the reforms. This must also include proper assessment of the impact of at-retirement processes for consumers including product provider behaviour and the adequacy of regulatory protections including the second line of defence or 'retirement risk warnings'.*

The briefing note ends by arguing: 'The need to collect and then aggregate a range of inputs including Pension Wise user data, FCA sales data and intelligence from regulators' thematic and supervisory work, points to the wider need to coordinate these various activities. Addressing these intelligence gaps will allow policymakers to identify and address potential consumer detriment at an early stage, enabling the Treasury, FCA and TPR to refine the regulatory and policy framework, and by so doing ensure the reforms benefit consumers'.

The *Aon DC Survey*, published in November 2015, indicated that achieving better member outcomes was a top priority for DC schemes (suggested by 57% of respondents). This was followed by communications (46%) and increased member engagement (45%). Nevertheless, Sophia Singleton, head of DC Consulting at Aon Hewitt, said that schemes needed to put practical steps in place if they are to meet these objectives: 'Now is the time

to re-set the DC agenda. If schemes are serious about the ambition to achieve better member outcomes, then they need to start setting clear targets and putting plans in place to achieve them. They must also set and measure themselves against clear key performance indicators to ensure their intentions become reality'.[772]

In October 2015, the Work and Pensions Select Committee also reported[773] 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; and subsequent decisions made and reasons for those decisions.

Apparently, the Government is relying on incomplete HMRC data to assess the reforms. Tom McPhail said there is 'considerable disquiet' about Government vigilance over the policy and a lack of early warning systems about unintended consequences: 'HMRC has published some very superficial data, which was underwhelming. Either they are not getting much data or they are not sharing it. Either way, it doesn't look good. The Treasury appears to have been surprisingly blasé about the consequences of reform, which are approached from an ideological standpoint….There are longstanding divisions in the system [such as, the division of pension policy between DWP and the Treasury] which exacerbate the data problem. Why has no one sought to mitigate the divisions and bring all data sources into one helicopter view for what is going in UK retirement savings?'.[774]

Frank Field MP, chair of the Select Committee, said: 'Reluctance to provide information about how a reform or service is working is rarely a good sign. It is very difficult for the Government to support its claims that all is well, or for us to make any assessment of progress, when no data are forthcoming despite repeated requests. The scarcity of information regarding Pension Wise, in particular, is not conducive to effective scrutiny. The committee repeats its call for Government to address these omissions urgently, and particularly to introduce a research programme tracking consumer outcomes…. We have seen all too clearly, too many times, what happens when financial information is not properly provided and regulated'. The committee also said the Pension Wise website was 'not fit for purpose' and that the lack of regulatory clarity over what is 'advice' and

---

[772] Reported in Helen Morrissey (2015) Schemes must be able to measure member outcomes, Professional Pensions, 24 November.

[773] House of Commons Work and Pensions Committee (2015) *Pension Freedom Guidance And Advice: First Report of Session 2015–16*, HC 371, 19 October;
http://www.publications.parliament.uk/pa/cm201516/cmselect/cmworpen/371/371.pdf

[774] Reported in Sam Dale (2015) Freedom and choice in a governance vaccuum, Pensions Insight, 30 October.

'guidance' is putting savers at risk of poor decisions. Nick Thomas-Symonds, shadow Pensions Minister, said the report showed the Government was failing to protect and inform consumers: 'Since pension freedoms have been introduced, money lost through scam activity has increased. Labour is urging the Government to look very closely at this report and act now in order to avert the next great mis-selling scandal'.[775]

However, Martin Tilley, director of technical services at Dentons Pensions Management, has described the claims by the Select Committee that pensions freedom could be the next 'mis-selling scandal' in financial services as a misplaced attack on providers and advisers. He said: 'The industry wasn't consulted about the changes before they were announced, didn't ask for them and has been criticised at every turn for not adopting the changes more quickly and charging too much to implement them: the latter sometimes in campaigns by national journals who are happy to print popular opinion without understanding the facts. By using the phrase 'mis-selling', I'd suggest this is a similarly ill-addressed attack'. Mr Tilley added that customers are now able to do things that might not be in their best interest 'not because the industry is selling it, simply because legislation now allows it'.[776]

### *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 around 4.5m (i.e., 17% of the 26.3m employed population, up from 8% in 1980) who are self-employed[777] and around 6.2m (24%) non-eligible job holders.[778] This means that around 11m people working in the UK will not be auto-enrolled onto any pension scheme. There are, however, a number of problems with interpreting these figures which should be noted. For example, the definitions used by ONS for employment categories are different from those applied by TPR for auto-enrolment, which include 'eligible jobholders', 'non-eligible jobholders' and 'entitled workers'. In addition, permanent employment, contract employment in the workplace and self-employment are not mutually exclusive categories. On average, people change jobs 10 or 11 times during their working lives. This can include periods of permanent employment (where the individual is eligible for auto-

[775] Reported in Josephine Cumbo (2015) MPs warn of pension changes 'endangering savers', Financial Times, 19 October.

[776] Reported in Jenna Towler (2015) MPs' pensions freedom mis-selling warning is 'ill-addressed' attack, Professional Adviser, 19 October.

[777] Source: ONS, https://www.nomisweb.co.uk/reports/lmp/gor/2092957698/report.aspx,

[778] The Pensions Regulator (2015) *Automatic Enrolment: Declaration of Compliance Report*, April; http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf

enrolment), periods of non-eligible employment (where the employment contract renders them ineligible for auto-enrolment), and periods of self-employment.

The Royal Society of Arts (RSA) recently published two reports on the self-employed.[779] Between the 2008 recession and 2014, more than 500,000 people have become self-employed, accounting for more than half of all jobs created during this period.[780] Five key trends are discernible in this boom in self-employment:

- The rise of one-person businesses – 95% of new micro-businesses (which employ between 0 and 9 employees) started since 2000 have no employees; one-person businesses now account for 75% of all businesses in the UK
- The growth of part-time self-employment – the number of self-employed people working less than 30 hours a week has increased by 60% since 2000, compared with a 20% increase in full-time self-employment over the same period
- The increasing importance of self-employment outside of London – for instance, 92% of all new jobs in the North West since 2000 have been in self-employment
- The changing demographic of the self-employed – the biggest growth areas in self-employment have been among women, the under 25s and older people. The number of self-employed people over 65 has increased by 140% since 2000.
- The uniqueness of the boom to the UK – the UK is an outlier amongst developed countries: self-employment has fallen in Germany, Canada and the US since 2008.

In terms of the self-employed's pension arrangements, there is some information contained in these RSA studies, as well as two other reports from the Resolution Foundation[781] and from Scottish Widows.[782]

The RSA studies found that the self-employed are half as likely as employees to contribute to a private pension. They also typically have a pension pot that is half the size at the point of retirement: according to the Wealth and Assets Survey, 55–64 year-olds in self-employment have a median private pension pot of £50,000, compared with £98,700 for those in a typical job. One key reason for this difference is the self-employed people do not benefit from employer contributions: according to Prudential, those who choose to work for

---

[779] Benedict Dellot (2014) *Salvation in a Start-up? The Origins and Nature of the Self-employment Boom*, Royal Society of Arts, May (https://www.thersa.org/discover/publications-and-articles/reports/salvation-in-a-start-up); Benedict Dellot and Howard Reed (2015) *Boosting the Living Standards of the Self-employed*, Royal Society of Arts, March (https://www.thersa.org/discover/publications-and-articles/reports/boosting-the-living-standards-of-the-self-employed)

[780] RSA analysis of the Labour Force Survey, September-November 2014.

[781] Conor D'Arcy (2015) *The Self-employed and Pensions*, Resolution Foundation, May; http://www.resolutionfoundation.org/wp-content/uploads/2015/05/Self-employment-and-pensions.pdf

[782] *The Scottish Widows Retirement Report*, June 2015; http://www.scottishwidows.co.uk/extranet/working/about/reports/pension-report

themselves forego an average of £91,500 in employer contributions over their lifetime. The self-employed also tend to start saving at a relatively late age, with less than 15% of self-employed 25–34 year-olds contributing to a private pension.

The latter two 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) were saving nothing for retirement in 2015, up from 23% the previous year. The Resolution Foundation report found that the self-employed who run businesses with employees (17% of the total) are much better prepared for retirement than those who work for themselves without additional support. The former can either sell their business or keep it and draw an income. In many cases, the self-employed were previously employees and can therefore expect some occupational or personal pension income when they retire.

The RSA studies also found that many self-employed people have made an active decision not to contribute to a personal pension. Instead, they will use ISAs to provide for their retirement. Data from the Wealth and Assets Survey shows that 55% of households with a self-employed worker have savings in an ISA (averaging £17,000, compared with £8,000 for employee-only households). These studies point out that, although ISAs give people more flexibility, large ISA savings may adversely affect their benefit entitlements under Universal Credit.

In September 2015, the PPI published a briefing note on those who were ineligible for auto-enrolment.[783] 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.[784]
- 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 assessed on a 'per job' basis. Two other groups that 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.

[783] Pensions Policy Institute (2015) *Who is Ineligible for Automatic Enrolment?*, Briefing Note Number 75, September.

[784] Someone on the minimum wage and working 40 hours a week would earn £13,520 p.a.

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.

The Resolution Foundation report argues: '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'.

The RSA reports do not, however, 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.[785] 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. 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'.

We will examine the experience in Australia, Switzerland, Chile and the US.

#### 3.18.1 Australia

Australia has been put forward as a success story for a 'freedom and choice' regime might look life. Many of those familiar with the Australian experience take a different view.

Many people in Australia – a country with no requirement to annuitise the pension pot – actually pre-spend their pension fund: they spend more than their disposable income in the lead up to retirement, knowing that they will use their pension fund to pay off their debts.[786] Paul Leandro, partner at Barnett Waddingham, said: 'We went out there looking for the silver bullet and we just did not find it…The Australian model is still relatively immature and it will be some 40 years before we see people retiring after having contributed 9.5% to their pension and there has also been little focus on what happens at decumulation. What is also important is that people don't view this money in terms of a

[785] Pensions Policy Institute (2015) *Transitions to Retirement: How Might the UK Pensions Landscape Evolve to Support More Flexible Retirements?*, April;
http://www.pensionspolicyinstitute.org.uk/publications/reports/transitions-to-retirement---how-might-the-uk-pensions-landscape-evolve-to-support-more-flexible-retirements

[786] Mark Wood (2015) Australians got pension freedom and they are running out of money, Daily Telegraph, 14 April.

retirement income. Around 27% spend the money on a holiday, while only about 4% purchase an annuity'.[787]

The Australian Financial System Inquiry discussed earlier discovered that a lack of risk sharing and over-reliance on drawdown products had left Australians with inadequate incomes in old age. The FSI had estimated that moving to a system that managed longevity risk reduced the level of assets needed for adequate retirement incomes by around 15%. It was for this reason that the FSI recommended that Australian pension schemes introduce a default comprehensive income product for retirement, the CIPR.

Kevin Davis[788] in an article for Reform[789] entitled *Retirement Incomes Policy Reform in Australia*,[790] wrote:

> *A number of shortcomings [in the Australian retirement income system] were highlighted by the recent Financial System Inquiry. The main focus of the FSI in the areas of superannuation and retirement income was on improving efficiency in the accumulation phase and increasing risk-pooling in the retirement phase. These have the potential to increase retirement incomes substantially, and reduce age pension related Government budgetary pressures. The recommendations of the FSI, together with other recent reforms, should enhance sustainability and adequacy.*
>
> *One fundamental problem, identified by the FSI, is a lack of member-driven competitive pressure to induce lower fees and costs and improve efficiency in institutional funds, particularly for default funds….Absent significant improvements, consideration should be given to introducing a formal competitive process (such as a tender or auction) for allocating new employees into default funds. (Those recent reforms sought to introduce a cost effective, simple default fund product, improve transparency and governance and streamline administrative arrangements.)*
>
> *Another major concern is that superannuation assets are not being efficiently converted into retirement incomes due to a lack of longevity risk pooling and overreliance on account-based pensions. Evidence suggests that the major worry among retirees and pre-retirees is exhausting their assets in retirement. An individual with an account-based pension can reduce the risk of outliving their wealth by living more frugally in*

---

[787] Reported in Helen Morrissey (2015) UK should beware of following Australian pension example, Professional Pensions, 27 April.

[788] Professor Kevin Davis, Professor of Finance, University of Melbourne; Research Director, Australian Centre of Financial Studies; and Professor, Monash University; and Member of Australian Financial System Inquiry Panel (the Murray Inquiry).

[789] Reform (2015) *Beyond April 2015: The Long View on UK Pension Reform*, February; http://www.reform.uk/wp-content/uploads/2015/02/Beyond-April-2015_V3-FINAL.pdf

[790] Reform (2015) Beyond April 2015: the long view on UK pension reform, February; http://www.reform.uk/wp-content/uploads/2015/02/Beyond-April-2015_V3-FINAL.pdf

*retirement and drawing down benefits at the minimum allowable rates (which a majority of retirees do).*

*The Inquiry also noted that many retirees find it challenging to navigate the transition to the retirement phase of superannuation. The task of managing multiple financial objectives and risks in retirement is complex and the quality of financial advice can vary significantly.*

*Accordingly, the Inquiry recommended that institutional super funds be required to offer their members a 'pre-selected' comprehensive retirement income product which, where appropriate, includes a regular and stable income stream, longevity risk management and some flexibility. A product involving some mix of an account-based pension and deferred annuity is one such example, and the longevity risk pooling provides an opportunity for higher consumption streams for participating retirees. There is, of course, no free lunch, as beneficiaries receive lower inheritances from residual super balances. This is consistent with another of the Inquiry's recommendations to shift the focus of the system from tax-preferred wealth accumulation and estate planning to provision of retirement income by setting clear objectives for the system.*

*Offering a 'pre-selected' product was preferred to a system where individuals are 'defaulted' or mandated into a specified product. This maintains consumer sovereignty, while positively influencing retiree choice towards taking up products that include some longevity insurance. A default solution also faces practical complications given retiree diversity.*

The concerns about Australia were reinforced by a study published by the Social Market Foundation published in November 2015.[791] The study identifies two types of Australian consumer:

- 'Cautious Australians' who preserve their capital by reducing it by less than 1 per cent a year. They face a very low risk of running out of savings, even if they live longer than average. But this comes at the cost of reduced incomes and lower living standards throughout retirement.
- 'Quick-spending Australians' who consume pension funds quickly with four-in-10 running out by age 75 – long before they reached average life expectancy. Their incomes risk sinking towards poverty levels.

The study argues that lessons should be drawn by the UK Government. In particular, it should create a two-tier 'Early Warning System' to understand what retirees are doing with

[791] Nigel Keohane, Ben Richards and Katie Evans (2015) *Golden Years? What Freedom and Choice will mean for UK Pensioners*, Social Market Foundation, November; http://www.smf.co.uk/wp-content/uploads/2015/11/Social-Market-Foundation-Publication-Golden-Years-What-Freedom-And-Choice-Will-Mean-For-UK-Pensioners.pdf

their pension savings and to identify emerging long-term risks both to consumers and the taxpayer. It recommends:

- A 'Retirement Risk Dashboard' – to help the Government monitor retirement decisions and provide a view on long-term outcomes for consumers and the state. This would be based on a range of statistics such as pension balances, pension cash withdrawal, insurance take-up, levels of investment risks and take-up of guidance and advice.
- 'Personal Pension Alerts' – to help policymakers intervene where appropriate with the sub-groups it has identified as at particularly high risk. Potential interventions could include: 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.

Nicholas Morris is writing a book with the working title *When Markets Don't Work: Lessons from Australia's Superannuation Fiasco* which focuses on investment issues. He summarised the situation as follows:

> *Today, Australia has a complex and expensive [investment fund] industry which manages these very large [superannuation] funds. Most funds are predominately actively managed, with substantial associated costs. On average, administrative and investment management costs exceed 3% of managed funds, or over $50 billion, per annum. As risk-free investments struggle to earn much more than this in today's markets, the result is that returns after expenses are very modest. Compared to funds in Canada, the US and Europe, Australia's funds perform badly….*
>
> *Why did this outcome emerge and what can other countries learn from it? The answer is that principal-agent and conflict of interest problems combined with lack of effective competition and light-handed regulation allowed rent extraction by private sector managers on a massive scale. The prevailing regulatory ethos in Australia followed that adopted in many other countries in believing that disclosure and competitive pressures would prevent excessive rent extraction from occurring. Inattentive trustees, and contractual eclipse of trust law arrangements, led to weak representation of members….*
>
> *[I]nefficiency [in the fund management industry] results from the development of a complex, multi-layered, industry, with extensive delegation of both functions and responsibilities, and from extensive use of active funds management with excessive focus on short-term results. Additionally, although in principle there should have been economies of scale as the funds administered grew, most of this has not been passed on to scheme members. Rent extraction has been facilitated and permitted by a laissez-faire and unfocused regulatory system, including a disclosure*

*regime which permits the majority of costs to remain hidden, and limited effective competition.*

*The evidence from Australia illustrates how a large degree of separation between fund managers and members, created by extensive outsourcing and delegation of responsibility, creates a poor outcome for scheme members. The result is a sorry tale of costly complexity, poor representation of member's interests, limited disclosure and extensive unresolved conflicts of interest.*[792]

### 3.18.2 Switzerland, Chile and the US

Chris Curry in an article for Reform entitled *The UK Retirement Market: Lessons from Abroad*,[793] wrote:

*[C]ountries, such as Switzerland and Chile, have high levels of annuitisation. Despite Swiss savers being permitted unlimited access to their private pension savings (though some schemes restrict access), around 80 per cent of DC assets are put into lifetime annuities. This is attributed to cultural attitudes; Swiss workers are described as being 'financially conservative' and 'preferring guaranteed incomes for life' over taking lump sums.*

*However, Swiss annuities are funded by hosting pension schemes and their rates (which are regulated by the Government) are considered to be very generous, given the current low interest rates in the Swiss market and low mortality rates amongst annuitants.*

*Chileans who wish to access their DC pension savings must opt either for a lifetime (deferred or immediate), index-linked annuity or for phased withdrawals from a pension fund. The number of DC savers purchasing an annuity in Chile has risen from 3 per cent of pensioners in 1985 to just under 70 per cent of DC savers for whom annuities were an option in 2007. This equates to around 70 per cent of DC assets.*

---

[792] Some of the problems the book will highlight have been discussed in Australia, though the full extent of the problems is not widely understood even there. See for example, Alan Kohler, 'Australia's super system is a national disgrace', ABC, 31 Oct 2012 and Mike Steketee, 'Unfair, inefficient and expensive: what went wrong with Australia's superannuation system', Inside Story, 18 February 2013. The 2010 Cooper Review concluded that that disclosure to members had failed to achieve its objectives, that there were inadequate accounting and financial reporting standards, and that fees were too high. A recent Grattan Institute Report also points out the high charges in Australian pension schemes: see Jim Minifie (2014*), Super Sting: How to Stop Australians Paying Too Much for Superannuat*ion, Grattan Institute Report No. 2014-6, April 2014. The recent Financial System Inquiry (2014) has also concluded that 'there is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards'.

[793] Reform (2015) *Beyond April 2015: The Long View on UK Pension Reform*, February; http://www.reform.uk/wp-content/uploads/2015/02/Beyond-April-2015_V3-FINAL.pdf

*The high demand for lifetime annuities in Chile is attributed to the restrictions on accessing savings and on the lack of a sufficient universal state pension to fall back on. In addition, fund providers must guarantee a minimum rate of return, which is backed by the Government.*

*Both Switzerland and Chile offer higher annuity rates than would have been expected given market conditions.*

*Annuities are perceived as a 'good deal' for annuitants in these countries.*

*….The purchase of lifetime annuities is minimal in the USA, estimated to account for less than 2 per cent of pensioner income in 2009. Savers in the USA are permitted to access their DC savings from retirement age without restriction and the lack of interest from consumers in annuitisation is attributed to the lack of bequest options, large fund sizes, 'adverse selection' and consumer concerns about developing health problems in later life.*

Finally, it is interesting to note that the UK is not the only country concerned about pension advice. In the US, President Barack Obama has introduced a fiduciary standard for financial advisers who recommend retirement-account investments which requires them to act solely in their clients' interests. Currently, advisers' recommendations must be 'suitable' for a client, but they do not have to be in the client's best interest, which would be a fiduciary standard. The absence of a fiduciary standard has allowed advisers to recommend products which earn the advisers higher commissions of around 1%. This is particularly the case when 401(k) accounts (the US equivalent of the accumulation phase of personal pension schemes) are rolled over into independent retrement accounts (IRAs) (the US equivalent of a retail drawdown product) when someone retires. In 2013, about $353 billion was rolled from 401(k) accounts into IRAs. However, advisers claim that anyone with less than $50,000 would no longer be able to find an adviser willing to deal with them.[794]

### *3.19 Feedback from our interviews and responses to the consultation paper*

#### 3.19.1 Feedback from our interviews[795]

##### *3.19.1.1 Consultants*

What will members with DC schemes do?

There was considerable uncertainty about what scheme members would actually do, although the most common view is that many will follow 'the path of least resistance' and just accept their existing provider's decumulation product.

[794] Andrew Ackerman and Karen Damato (2015) Obama Backs New Rules for Brokers on Retirement Accounts, Wall Street Journal, 23 February.

[795] The interviews took place in late 2014 and early 2015.

Nobody yet has a clue as to how many people will want to take all their cash immediately or over a very short period (to mitigate a high tax bill in a single year). They will need to consider a range of complex decisions depending on what they've got in DB, DC, state pension, and other sources of capital.

They need advice, but regulated advice will not make financial sense for most people. There was widespread criticism of the FCA's role when it comes to the issue of advice:

- 'The FCA doesn't consider the profit motives of advisers. In effect it has stopped employers and trustees from helping members, because they have to tread on eggshells around the advice/guidance mess. It's a case of "whatever you do, under no circumstances must you give members useful information"'.
- 'The FCA is in denial – if the right people to advise members are not permitted to do so, we will have another scandal of similar proportions to the personal pension mis-selling scandal [in the 1980s and 1990s]'.

#### *3.19.1.2 Providers and investment managers*

What are your views on defaults?

In one sense, there is always a default in decumulation which is 'doing nothing'. So, the default might be to stay in the final stage of accumulation default fund, unless an active decision is made. What subsequently happens depends on the scheme rules:

- In a contract-based scheme, it is not possible to force annuitisation (due to unfair contract terms legislation), although it might be possible, depending on the contract, to require the member to take a surrender value at some age (e.g., 75)
- In a trust-based scheme, trustees have the power to say to a member 'if you don't tell us otherwise, after one year we will buy you an annuity' (i.e., they can force annuitisation as a default). Trustees do want a process for moving people from accumulation to decumulation, but are concerned about having a specific default, since retrospectively, a member could claim they would have been better off with a different solution. So trustees still need to give choices (which conflicts with the idea of a single default).

It was also recognised that many people will take 'the path of least resistance', whereby the individual accepts the decumulation product of the pension provider. This used to be the provider's annuity (rather than the open market option). Now, this will be cash or some form of drawdown product.

Some insurance company participants questioned whether there was even a need for a separate default decumulation fund. It could simply be a continuation of the accumulation fund, but used to deliver a certain percentage of the fund as income each year until, say,

age 75. Others pointed out that this could lead to a similar consumer detriment as previously existed with rollover/internal annuities.

There was support for the idea of default pathways using decision trees, with a small number of branches in the decision tree, dealing with health, dependants, other assets and liabilities, tax, etc. However, others thought that narrowing down to a single universally suitably default will be difficult if not impossible, even though they recognised that defaults may be useful.

It was agreed that an appropriate default should recognise and give appropriate weighting to the need for a secure retirement income as the basis upon which to build other access options, accepting that there is both a demand for a secure income (guaranteed income for life) and a demand for flexibility. However, the first aim should be to secure basic lifelong income to meet the needs of 'heating and eating'. You can then add a platform for drawdown.

Two defaults were proposed (both meet the needs of a good scheme):

- Drawdown plus a deferred annuity
- Layering – first secure essential life-long expenditure ('heating and eating'), then allow for luxuries (e.g., a SPEEDOMETER plan).

However, there are challenges with the first of these proposals. Individuals do not really want to manage investment risk. In the US, for the small number those who choose to take out longevity insurance, around 10-15% of the fund at retirement is used to buy a deferred life annuity. In the UK, a key problem with a deferred annuity is cost and this will be made worse by the introduction of Solvency II in 2016. People might decide to wait until, say, age 85 and buy an immediate annuity, but these might not appear to be good value due to selection factors.

We were told that there is potentially a problem with having a default that arises from MiFID.[796] MiFID says you cannot put people into a commercial contract without their consent. However, we were informed that it is possible to get around this by getting a Letter of Comfort from the EU. This was the mechanism used to get around a similar problem in the case of auto-enrolment in the UK.

What are your views on guidance and advice?

We first asked about the distinction between guidance and advice in relation to a decision tree for a default decumulation strategy. We were told by Huw Evans, CEO of the ABI, that there is an important difference between 'advisory' and 'advice' in English law. A decision tree would be advisory, but is not really advice. However, there is no distinction between

[796] https://www.fca.org.uk/firms/markets/international-markets/mifid-ii/mifid-review

'advisory' and 'advice' in the current regulatory framework. If a decision tree is classified as advice, then it means that it is regulated. This is not at all useful and would need to change for a decision tree to work in the manner intended.

We were also told that schemes using a decision tree would need to make sure customers have used the Government's new guidance service, Pension Wise, even though this just takes stock of people's assets and liabilities and explains the options available.

If these two hurdles can be crossed, then we were told that it might be possible to follow up Pension Wise with a standardised decision tree (possibly with statutory approval) which would 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 with assets below £100,000.

It would be better if the decision tree had a standardised set of questions across all providers. These might be aligned with the questions asked under advanced protection (or the second line of defence) which gives the FCA comfort that a provider is not selling a standard product to someone with a health problem, is not selling a single life product to a married man, is not selling a fixed-income product to someone who makes clear that he wants an inflation-protected income, etc. However, we were told that this would cause a problem if the provider does not offer a product covered by a particular question.

Turning to the question of advice more generally, the nature of 'advice' will vary in terms of how it is regarded under FCA regulations. It could be fully regulated fee-based advice (where the firm makes a clear recommendation and therefore is responsible/liable) or some other form of 'non-advice' (where the firm provides decision trees, explains options etc, but the individual makes the final choice – in which case the individual is responsible and the firm has little or no liability).

All participants were agreed that the FCA's various definitions of advice is a major problem and out of step with what the DC decumulation market needs. This has to change. One participant told us that the FCA's attitude is that only the best will do, which implies that we have a zero-failure regime. But the 'best is enemy of the good' – it results in advice costs of at least £1,500 which no one wants to pay. However, it was believed that the FCA will say its hands are tied by EU law.

The concept of advice has to change to make it more useful to customers. Advice should help people understand the difference between 'want' and 'need' and help people clarify the decisions they need to make. At present, people are presented with a whole range of complex questions and choices and then told 'you're on your own'. Even guidance or a steer towards a single solution or even two solutions constitutes 'advice' under current rules. The implication is that most customers are overwhelmed by choice, but have nowhere to turn without paying £1,500 for advice.

What is the solution to this problem? We were told that the simplest solution involves only three routes:

- Execution-only – the customer makes all the decisions
- 'Filtered choice' – the customer is steered towards tailored options (e.g., low-risk funds); but this is still currently classified as advice
- Personal recommendation (i.e., full regulated advice)

It would then be necessary to find a way to nudge the mass population towards a soft default or a set of default pathways. Three types of nudging were suggested to us:

- Guidance
- What do 'people like me' do?[797]
- Advice (needs to be simplified, targeted)

However, participants told us that the industry is still a long way from this ideal. For example, one provider told us they had built a simplified advice website but acknowledged that it does not really serve customers' needs. The FCA has reviewed existing simplified advice models, but says that they are not clear enough. No life office has yet brought a simplified advice model to the market, which is regarded as very telling.

All agreed that guidance/advice is where there is a need for real innovation – far more than in product design. The use of web-enabled technology is already producing good results. Consumer education is another key factor and the industry needs to rise to the challenge.

It was also agreed that guidance and advice could not be a single event, but had to be a process. There needed to be periodic financial health checks, with at a minimum of one leading up to retirement, and another before age 75.

There was common agreement amongst interviewees that the FCA's advice and guidance regime is little short of catastrophic and does virtually nothing to prevent customers 'self harming'. There was also common agreement that the two regulators, the FCA and TPR, should merge.

#### *3.19.1.3 Trade unions*

What are your views on advice to members?

A participant opened with the comment: 'What you can have is a default to financial advice. The scheme or employer can say we will pay for you to have a session with a regulated financial adviser who will take responsibility for that advice (and the individual therefore has recourse if wrong advice is given). Guidance is great because it takes you through your

[797] See for example, https://www.fidelity.co.uk/investor/getting-started/tools-info/people-like-me.page

options. But if the best thing for you is drawdown or an annuity, that is buying a regulated financial product. But the way the industry is at the moment, it is difficult to get financial advice for pots less than £30,000'.

We pointed out that 75% of people currently have pots less than £30,000 and regulated advice can cost £1,000 or more, which prompted the discussion:

- 'If schemes are paying for this, may be they are able to bring costs down'
- 'If it is the case of an employer having to pay, I cannot see them leaping at that'
- 'To my mind, the only way you would get employers to take on the real responsibility and cost is if the state said "we are going to subsidise advice through tax relief or some other mechanism"'
- 'There is no incentive for an employer to do it'
- 'Low and middle-income savers lack the trust and experience of dealing with financial advisers. This is why attention should be focused on default options not advice'
- 'Some unions (e.g., Unison with Lighthouse, Unite) and have directories of financial advisers'
- 'Advisers have an interest in (maintaining) complexity. With good defaults you can take a lot of the complexity out of it. People do not really want regulated advice. They want to be directed'
- 'Advisers just try to sell you stuff'.

### 3.19.2 Responses to the consultation paper

We summarise the responses to Questions 22-31 in the consultation paper here.

22. *It is now recognised that many people face a number of behavioural barriers which prevent them behaving optimally. When it comes to decumulation, what are the key barriers?*

A wide range of behavioural barriers were mentioned by the different respondents. The barrier to optimal behaviour that was most commonly mentioned was the lack of financial literacy. Other behavioural barriers included poor understanding of longevity risk, lack of engagement, short termism, framing effects, procrastination and over/under confidence.

23. *We need to recognise that retirees: have different expenditure needs during different phases of their retirement; need to pace their spending throughout retirement in order to optimise the use of their lifetime assets and income and their ability to make intended bequests; and need a choice architecture that reflects the market segment to which they belong. (a) What is your understanding of the regulatory consumer market segmentation and is this appropriate in relation to the needs of DC retirees? (b) What nudges and choice*

*architecture do people need to deal with these issues and overcome the behavioural barriers they face?*

There was general agreement on the characterisation of market segmentation into mass market, mass-affluent market and high net worth. A substantial minority of responses were enthusiastic about nudges, but more thought that it was more important to provide better information.

24. *(a) What lessons from auto-enrolment in the accumulation phase can be brought to the decumulation phase?*

Responses to this were very mixed. Respondents agreed that inertia had provided benefits in the accumulation phase of pension saving, but not all thought that this could be used in the decumulation phase: one reason for this was the greater diversity of needs in the decumulation phase, which makes it much harder to provide appropriate defaults. There were also differing views on whether defaults were needed to address the issue of inertia or whether they discouraged engagement with the process and made matters worse. Several responses suggested having a menu with a limited number of default choices.

24. *(b) Given the importance of income security for the elderly and the existence of longevity risk, is there a case for defaulting people into buying longevity insurance via auto-enrolment (i.e., drawdown with longevity insurance becomes the default retirement strategy)? Consider the advantages and disadvantages of such a strategy.*

Responses were equally divided on whether or not there should be defaults into longevity insurance. Opponents said that such a policy was inconsistent with 'freedom and choice' and that it would be hard to select an appropriate range of options for heterogeneous pensioners with different needs. The most enthusiastic supporters said that people could always opt out.

24. *(c) What would be the likely annualised cost of such products for individuals?*

Responses suggested that the cost of default longevity products depends on too many factors to provide a simple answer.

24. *(d) How could the default principle, upon which the success of auto-enrolment is predicated, be best reconciled with the individual freedoms for DC decumulation introduced in the 2014 Budget?*

Responses were very divided on whether or how defaults into longevity products could be reconciled with choice and there was no agreed position. Supporters of defaults thought there was no real problem of reconciliation: defaults were useful in eliminating confusion and helped those who wanted to be told what to do, while everyone was free to opt out. Opponents said individuals needed advice to take full advantage of the individual freedoms.

25. *What are the implications of the Chancellor's announcement in September 2014 effectively ending the 55% tax rate on inherited pension pots?*

A third of respondents thought that ending the 55 per cent tax rate on inherited pension pots would encourage more pension savings. Others thought people might feel obliged to use their pension pot for inheritance, rather than spend it during their own retirement. Most recognised that the issue was irrelevant for people with small pension pots.

26. *What are your views on the guidance guarantee and how effective it will be?*

Many responses thought that it was too soon to tell whether the guidance guarantee would be effective and many had concerns that it would be insufficient, especially for those who wanted to be told what to do.

27. *(a) Will other forms of guidance and advice be needed?*

There was a very strong view that more support would be needed than the guidance guarantee alone. A quarter of responses thought that there needed to be a level of support between guidance and advice.

27. *(b) For DC savers who prefer to make their own decisions, what is the best way to build on the guidance guarantee to help individuals avoid buying retail products that are inappropriate (e.g., in relation to risk) and/or poor value (e.g., in relation to price)?*

Most responses thought that better information needed to be provided to build on the guidance guarantee, possibly via online resources. Only a minority referred to advice or nudges.

28. *(a) What specific risks should regulatory safeguards aim to address in relation to financial decisions made at retirement?*

Respondents identified three main risks of decision-making at retirement that need to be addressed by regulation: the risk that individuals purchased inappropriate products (e.g., a married person buying a single life annuity); the investment risks faced by individuals; and the risk of scams and mis-selling.

28. *(b) At what point does individual choice cease to be a regulatory concern/responsibility?*

Responses disagreed on when individual choice ceases to be a regulatory concern. On balance, responses suggested that it was when (or if) an individual secured an income for life. A significant minority (42 per cent) said that the point of the recent reforms was to provide choice and that this would inevitably mean that at some point consumers should be free to make mistakes and hence not the concern of the regulator.

29. *Some DC customers might draw down all their pots in the early years of retirement, a decision they might subsequently regret. What is the most effective way of assisting DC customers to act in their best long-term interests?*

Respondents were divided on how to assist DC customers to act in their best long-term interests and not make decisions that they subsequently regret. Some responses noted that the point of 'freedom and choice' is to allow choice and that the possibility of bad choices must be accepted as part of that. The responses to this question on how to avoid bad choices were varied and included defaults, better education and incentives to secure an income (at varying points in retirement).

30. *(a) What is the best way of ensuring that any DB-to-DC transferees only undertake such a transfer when it is in their best interests?*

The large majority of respondents thought that transfers from DB to DC should only be allowed after taking advice (with an exception for small pots). Many accepted that the advice could be ignored, although one suggested that transfers should be banned if the advice was negative. One response suggested that if individuals wanted to transfer out they should take advice at their own expense.

30. *(b) What are your estimates of the number of DB-to-DC transferees (deferred and also active) and size of assets involved?*

Very few responses provided estimates of the number of DB-to-DC transferees. Those that did thought that about ten per cent would transfer.

30. *(c) Is the requirement for regulated independent advice for such transferees adequate?*

The few responses to this question believed that the requirement for regulated independent advice for DB-to-DC transferees was adequate.

30. *(d) Can/will the guidance guarantee process cope with DB active/deferred members who seek help in considering their options?*

Respondents thought that the guidance guarantee for DB members was inadequate.

31. *Are there other ways of supporting pension savers to make the right choice at retirement for them and their family?*

Respondents suggested that a combination of approaches (including advice, nudges, incentives and information) would be needed to support pensioners to make the right choice at retirement. Some believed that better education and improved financial literacy were required in the longer term.

### *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'.[798] 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':[799]

> *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.*

[798] Sara Benwell (2015) 'Freedom and choice' could be the undoing of the pensions industry, Pensions Insight, 30 January.

[799] Quoted in Sara Benwell (2015) 'Freedom and choice' could be the undoing of the pensions industry, Pensions Insight, 30 January.

> *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),[800] 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.[801] 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'.[802]

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:

---

[800] This is the new name, from October 2015, of the National Association of Pension Funds (NAPF).

[801] Reported in Stephanie Baxter (2015) NAPF 2015: Incoming chair blames industry and policymakers for complexity in pensions, Professional Pensions, 16 October.

[802] Reported in Michael Klimes (2015) NAPF 2015: Whitbread chief says trust in pensions 'lowest in my lifetime', Professional Pensions, 14 October.

- 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:[803]

> *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.*

[803] Louise Eccles and Ruth Lythe (2015) 100,000 are hit by huge fees to join pension revolution: One in ten over-55s eligible to take advantage of new freedoms are forced to pay to get their hands on savings, Daily Mail, 10 June; Sam Dunn and Ruth Lythe (2015) Delays, sky high fees and firms refusing to hand over savings: Six fatal flaws strangling the pensions revolution, Daily Mail, 9 June.

*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?'[804] 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

[804] Quoted in Professional Adviser, 13 August 2014.

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.[805] 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'.[806]

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"'.[807]

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

[805] Peter Bernstein (1992) *Capital Ideas*, Free Press, New York.

[806] John Porteous (2015) The death of the 'once and done' pension plan, Professional Adviser, 16 April.

[807] Reported in Jenna Towler (2014) 'Will the masses be hooked on non-advised drawdown?', Retirement Planner, 22 October.

work done, typically expressed in terms of hours worked.[808] 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.[809] Similarly, the Society of Later Life Advisers (SOLLA) has created an industry standard for retirement advisers called the SOLLA Retirement Advice Standard (RAS).[810] 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

[808] Of course, the hourly rate provides an incentive to 'over-service' the client in order to build up the fee.

[809] Reported in Carmen Reichman (2015) Intrinsic and OMW to launch national advice business, Professional Adviser, 2 October.

[810] http://retirementstandard.co.uk/for-advisers/

and long-term care.[811] 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.[812]

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'.[813]

#### *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.

---

[811] Reported in Carmen Reichman (2015) SOLLA launches retirement advice standard, Professional Adviser, 9 September.

[812] Reported in Professional Adviser (2015) CII to launch life and pensions qualification for front line staff, 5 November.

[813] Lawrence Gosling (2015) Does the advice industry really need new talent?, Professional Adviser, 28 August .

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'.[814]

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

[814] Reported in Michael Klimes (2015) Industry in danger of disappointing by not giving choice, Professional Pensions, 25 September.

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.[815]

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 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'.[816] 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

[815] Reported in Retirement Planner (2015) Advisers urge FCA to regulate provider/client contact, 14 September.

[816] Reported in Jenna Towler (2015) Walk the line: Where does guidance stop and advice start?, Professional Adviser, 1 October.

restricted to those will assets above £100,000 – although it is also clear that many will be comfortable with only this type of cleint.

#### *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'.[817]

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

[817] Reported in Jenna Towler (2015) Walk the line: Where does guidance stop and advice start?, Professional Adviser, 1 October.

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"'.[818]

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 decisions has to 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'.[819]

#### *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.

---

[818] Derek Bradley (2014) Simplified advice can't work without simplified regulation, Professional Adviser, 30 July.

[819] Reported in Jenna Towler (2015) Comparing pensions to bank accounts 'irresponsible', ABI chief warns, Professional Adviser, 8 September.

**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'[820])

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.:**

[820] Terms used by the Universities Superannuation Scheme.

    - **by level of assets – Is there a level of a ssets 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.[821]

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.[822]

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:**

---

[821] The actuarial profession was required to do this following the Equitable Life debacle and the resulting Morris Review of the Actuarial Profession in 2005. Further, there are only around 5,000 actuaries in the UK, less than 25% of the number of financial advisers;
http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/morris_final.pdf

[822] Following the Morris Review, the actuarial profession adopted five core ethical principles which should underpin the conduct of all members when related to their professional lives (see *The Actuary Magazine*, August 2009):

- Integrity
- Competence and care
- Impartiality
- Compliance
- Openness.

- **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.[823]

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'.

[823] In January 2016, it was reported that the FCA and TPR were working on designing a 'pensions dashboard'. Michael Roe, development manager at Origo, said that the technical architecture was available to support this initiative (reported in Sara Benwell (2016) FCA and TPR working together on pensions dashboard, Pensions Insight, 22 January).

**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).

***Appendix: Information services for customers and advisers***

Services for customers

In September 2015, the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA) launched a Financial Services Register of firms and individual and collective investment schemes. The register will include the names of unauthorised firms as well as firms knowingly running a scam.[824]

The Money Advice Service's (MAS) retirement adviser directory was launched in April 2015. It contains a list of 5,000 financial advisers – both independent and restricted – specialising in retirement planning for those wanting to access regulated paid-for advice following the introduction of the new pensions regime. The directory asks people a number of filtering

[824] Reported in Laura Miller (2015) FCA to include scam firms in relaunch of official register, Professional Adviser, 4 September.

questions, such as why they want advice and what size of pot they have, to ensure they are guided to the most suitable advisers. The MAS is also working on a charges display to its directory so people can compare costs before they seek advice. A total of 6,000 people accessed the directory in its first month of operation, although MAS is not currently able to say how many people went on to receive advice.[825]

In April 2015, the Personal Finance Society launched a consumer financial education website called Yourmoney to help consumers make better informed decisions about their personal finances.[826] It contains a fully-searchable directory of more than 22,000 accredited financial advisers, all of whom are members of the PFS and must abide by the society's code of professional ethics. The directory contains information on the costs of professional advice. It also contains links to financial planning tools from the Money Advice Service, Which? and Moneyfacts. It can be accessed at: www.thepfs.org/yourmoney.[827]

In March 2015, the Association of British Insurers launched Your Retirement, Your Choice, a campaign to help customers understand their choices in retirement in the new pensions environment. Its aim is to prevent people from rushing into decisions, while pointing them to the Government's guidance guarantee. It will also make people aware of pension scams and how to avoid becoming a victim.[828]

In October 2015, the Money Advice Service launched a 10-year strategy to enhance financial capability in the UK.[829] The aim is to improve people's ability to manage money well day to day, prepare for and manage life events, and deal with financial difficulties. It will also educate people about the difference between financial guidance and advice, help them understand when they need advice and how to get it. The work will cover consumers of all ages – from education in schools to at-retirement. Progress will be monitored through a 'financial capability survey' and formal reviews will be published in 2020 and 2025, alongside updates on the strategy's website. Advisers will be able to contribute to the strategy by joining a number of steering groups, which will each have their set of specific targets and success measurements.

---

[825] Reported in Carmen Reichman (2015) Thousands flock to MAS adviser directory in first month, Professional Adviser, 6 May.

[826] The Personal Finance Society is one of a number of associations in the UK to which financial advisers are affiliated. Two others are the Institute of Financial Planning (IFP) and the Chartered Institute of Securities and Investment (CISI). In August 2015, it was announced that the IFP would merge with the CISI in November 2015.

[827] Reported in Laura Miller (2015) PFS launches consumer education website with 22,000 strong adviser database, Professional Adviser, 24 April.

[828] Reported in Carmen Reichman (2015) ABI launches pension freedom awareness campaign, Professional Adviser, 17 March.

[829] Reported in Carmen Reichman (2015) Consumer education strategy looking at guidance and advice launched, Professional Adviser, 28 October.

The strategy will be governed by MAS's Financial Capability Board, whose members at the time of launch were:

- Andy Briscoe, chair, the Money Advice Service (chair of the Board)
- Jasper Berens, head of UK Funds, JP Morgan
- Sherard Cowper-Coles, senior advisor, HSBC and chair of the Financial Inclusion Commission
- Benny Higgins, chief executive, Tesco Bank
- Elaine Kempson, emeritus professor, University of Bristol
- Lily Lapenna, founder & co-chief executive, MyBnk
- Phil Loney, group chief executive, Royal London
- Eleanor Marks, deputy director communities division, Welsh Government
- Louise Macdonald, chief executive, Young Scot
- Gwyneth Nurse, director of financial services, HM Treasury
- Steve Pateman, executive director, head of UK banking, Santander
- Caroline Rookes, chief executive, the Money Advice Service
- Roger Sanders, managing director, Lighthouse Group
- Hector Sants, chair Archbishop of Canterbury's Task Group and StepChange Debt Charity
- Otto Thoresen, chair, National Employment Savings Trust
- Sian Williams, head of national services, Toynbee Hall
- Chris Woolard, director of strategy and competition, Financial Conduct Authority
- Tom Wright, group chief executive, Age UK

## Services for financial advisers

Defaqto has launched a pension ratings service for financial advisers in May 2015 which measures the quality of the service from pension providers. Pension Service Ratings uses advisers' satisfaction scores on 41 aspects of service to set the provider ratings. The data was collected using a survey of 500 financial advisers who advise on personal pension products. Defaqto then allocates providers to the following classes: gold, silver or bronze, or not rated.[830]

F&TRC launched a similar service in July 2015.[831] Pension providers are awarded a gold, silver or bronze rating depending on their proposition in eight sub-categories:

- Product offering and administration
- Investment and fund options
- Record keeping and governance

[830] Reported in Professional Adviser (2015) Defaqto launches pension ratings service, 1 May.
[831] Reported in Retirement Planner (2015) F&TRC launches ratings service for workplace pensions, 14 July.

- Scheme setup
- Joiners and leavers process
- Education
- At-retirement options
- Auto-enrolment process.

## 4. Helping savers to manage longevity risk

> *'I'm just one hundred and one, five months and a day'.*
>
> *'I can't believe that!', said Alice.*
>
> *'Can't you?', the Queen said in a pitying tone. 'Try again: draw a long breath, and shut your eyes'.*
>
> *Alice laughed. 'There's no use trying', she said: 'one can't believe impossible things'.*
>
> Lewis Carroll (1871) *Through the Looking-Glass, and What Alice Found There*

A particularly important issue in retirement income provision is longevity risk. There are two components to longevity risk. The first is the uncertainty over how long any particular pension scheme member is going to live after retirement. This is known as idiosyncratic longevity risk. Both individuals and schemes face idiosyncratic longevity risk. The second is uncertainty over how long members of a particular age cohort are going to live after retirement. This is known as systematic longevity risk. Only schemes face systematic longevity risk. Individuals have a poor understanding of idiosyncratic longevity risk.[832] Pension schemes can reduce idiosyncratic longevity risk by pooling the risk amongst a large number of scheme members, i.e., by taking advantage of the law of large numbers. Systematic longevity risk, however, cannot be reduced in this way: it needs to be hedged using a suitable hedging instrument.

### *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

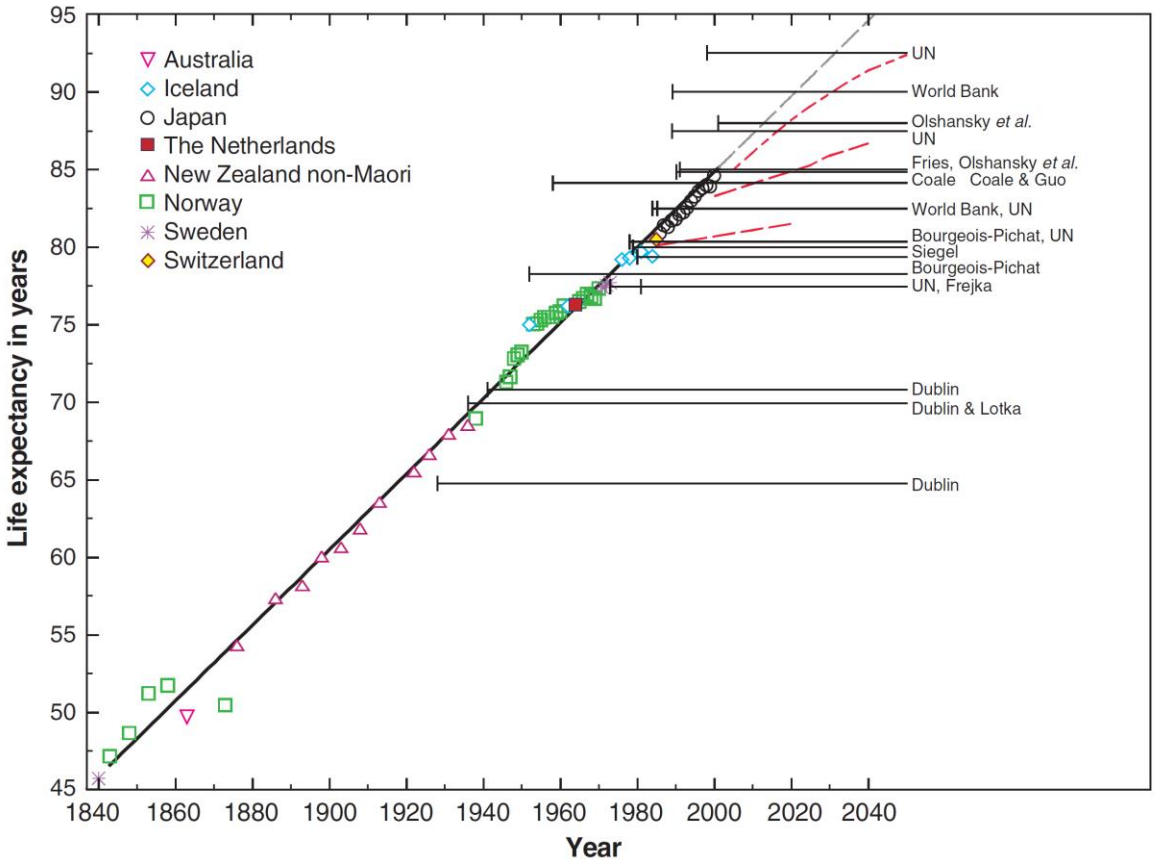
[832] As the American Academy of Actuaries, the UK Institute and Faculty of Actuaries, and the Australian Actuaries Institute say on p.1 of their October 2015 joint report *The Challenge of Longevity Risk: Making Retirement Income Last a Lifetime*: 'Longevity risk is not well understood by many people and this lack of understanding can have significant implications for retirement incomes, particularly as longevity increases'; http://www.actuaries.org.uk/news-and-insights/media-centre/media-releases-and-statements/longevity-risk-ticking-time-bomb.

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 life expectancy and longevity risk*

As we mentioned in Chapter 1, 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.

*Figure 4.1: Historical increases in life expectancy*



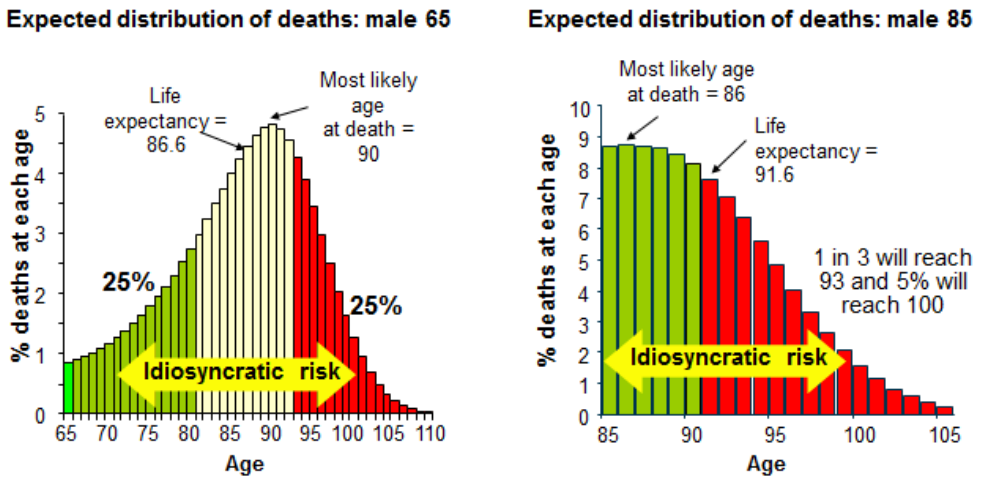

Source: Jim Oeppen and James W. Vaupel (2002), Broken Limits to Life Expectancy, Science, 296(5570): 1029-1031

Figure 4.1 shows that in advanced countries, life expectancy has been increasing at the rate of approximately 2.5 years per decade since 1840.[833] Being told their life expectancy is a

[833] In November 2015, the Office for National Statistics released data which shows that life expectancy continues to improve. For example, a new-born baby boy in England can expect to live to 79.5 years. This is an increase of 5.9 years over two decades. New-born girls in England can expect to live to 83.2 years – an increase of 4.1 years over two decades. Meanwhile, 65-year-old men and women in England can expect to live to 84

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 as the left chart in Figure 4.2 shows. 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 as the right chart in Figure 4.2 shows. This figure also illustrates the nature of idiosyncratic longevity risk, the uncertainty about how long any particular individual will live.

*Figure 4.2: The variability of individual lifetimes*




Source: 100% PNMA00 medium cohort 2007

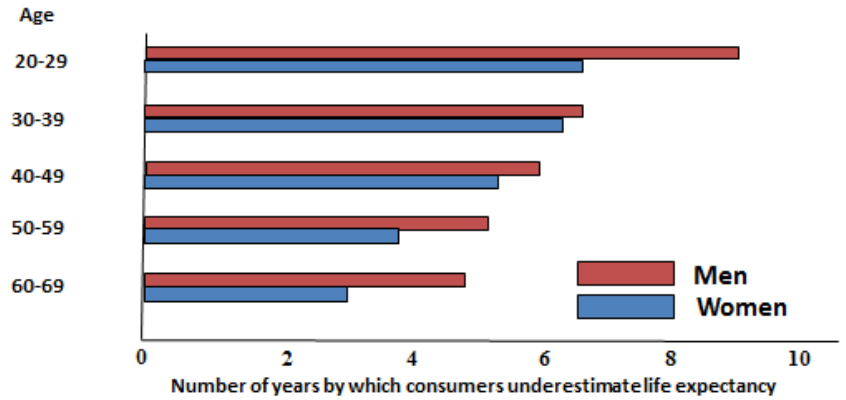
Furthermore, individuals are notoriously bad at estimating their own life expectancy. Figure 4.3 reveals that all age groups – and men more than women – tend to significantly underestimate their own life expectancy. While the extent of the underestimation decreases with age, men in their 60s still underestimate 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 the results in Figure 4.3 is that people tend to over-estimate how many people die between 65 and 70, and under-estimate how many live beyond 80 as Table 4.1 shows.[834] To illustrate, the table shows that members of DC schemes aged over 60 believe that 20% of 65-year olds will die before 70, whereas the correct figure is 10%. They also believe that 80% will die before 80, whereas the true figure is only 60%.

---

and 86, respectively. In December 2015, the ONS predicted that life expectancy at birth would reach 97.6 for men and 100 for women born in England in 2064.

[834] Reported in Ian Porter (2015) The longevity issue - Mapping the new retirement landscape, Retirement Planner, 14 May.

*Figure 4.3: Individual underestimates of life expectancy by age*




Source: Christopher O'Brien, Paul Fenn, and Stephen Diacon (2005), How Long do People Expect to Live? Results and Implications, Centre for Risk and Insurance Studies, Nottingham University Business School, CRIS Research report 2005-1, April; the figure shows self-estimated life expectancy compared with the Government Actuary's Department forecast life expectancy.

*Table 4.1: Percentage of 65-year old members of a DC pension scheme with a £10,000 pension pot who will die before a specified age*

| Die before age | Estimate by members of DC pension schemes aged 60+ (%) | Real data (%) |
|---|---|---|
| 70 | 20 | 10 |
| 80 | 50 | 20 |
| 90 | 80 | 60 |
| 100 | 90 | 90 |

Source: Ignition House

*Table 4.2: Difference between self-estimated and actual life expectancy at age 65*

| Men | | | | Women | | | |
|---|---|---|---|---|---|---|---|
| Aviva survey self-estimate | UK average (ONS) | Insured lives | Healthy insured lives | Aviva survey estimate | UK average (ONS) | Insured lives | Healthy insured lives |
| 15 | 18.3 | 21.3 | 23 | 19 | 20.8 | 23.1 | 23.7 |
| | (3.3) | (6.6) | (8) | | (1.8) | (4.1) | (4.7) |

Note: Difference compared with Aviva survey self-estimated life expectancy reported in brackets. Source: Aviva (2015, p.6) *Making Your Money Last in Retirement*, January.

A study by Aviva published in 2015 updates the results of Figure 4.3.[835] Table 4.2 shows that 65-year old males underestimate their life expectancy by 3.3 years and 65-year old females by 1.8 years, compared with the UK average population. However, assured lives – people taking out life assurance – and healthy assured lives will live longer than the national average. Healthy assured lives underestimate their life expectancy by 8 years for men and 4.7 years for women. The general pattern is clear and persistent: almost everyone underestimates their life expectancy by a number of years, and men underestimate this more than women.

The Aviva report notes (p4): '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'.

*Table 4.3: Reasons people say they will live a shorter life than average*

| Reason | Men (%) | Women (%) | All (%) |
|---|---|---|---|
| A serious health condition/illness | 64 | 63 | 63 |
| A serious health condition/illness in the family (which they currently do not have) | 14 | 10 | 12 |
| Family does not live long | 27 | 28 | 28 |
| Lifestyle – drinking and lack of exercise | 28 | 27 | 28 |
| Smoker | 18 | 22 | 20 |
| Does not have the money to support themselves should they fall ill | 8 | 11 | 10 |

Source: Aviva (2015, p.4) Making Your Money Last in Retirement, January.

[835] Aviva (2015) *Making Your Money Last in Retirement*, January; https://www.aviva.com/media/upload/Making_your_money_last_in_retirement-Aviva__longevity__report.pdf.

The report also gives the reasons why people believe they have a lower life expectancy than the average – see Table 4.3. 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.

*Table 4.4: Concerns people have about old age*

| Concern | % most concerned |
|---|---|
| Living longer than expected and having insufficient money | 5 |
| Ill health | 56 |
| Dementia | 50 |
| Being dependent on other people | 36 |
| Going into a care home | 30 |
| Dying or people close to them dying | 25 |

Source: Aviva (2015, p.6) Making Your Money Last in Retirement, January.

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 – see Table 4.4.[836] The main reason for this is that this possibility is 'too far into the future to worry about'. The table does, however, show that people are concerned about going into a care home, but research by Just Retirement indicates that only 10% of people stated that they were prepared for the cost of care.[837] In addition, the table shows that people are concerned about dementia. But we should remember that 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.[838] The

[836] Americans by contrast take a very different attitude. According to a 2010 Allianz survey of 3,257 people, 61% said 'they were more scared of outliving their assets than they were of dying'. This figure increased to 77% for those between the ages of 44 and 49, and to 82% for those in their late 40s with dependants. A 2014 survey conducted by Wells Fargo of 1,001 middle-class Americans (aged 25-75) said they 'would rather "die early" than not have enough money to live comfortably in retirement' (reported in Jessica Rabe (2015) Which profile fits a money manager's ideal customer?, Convergex.com, 12 October).

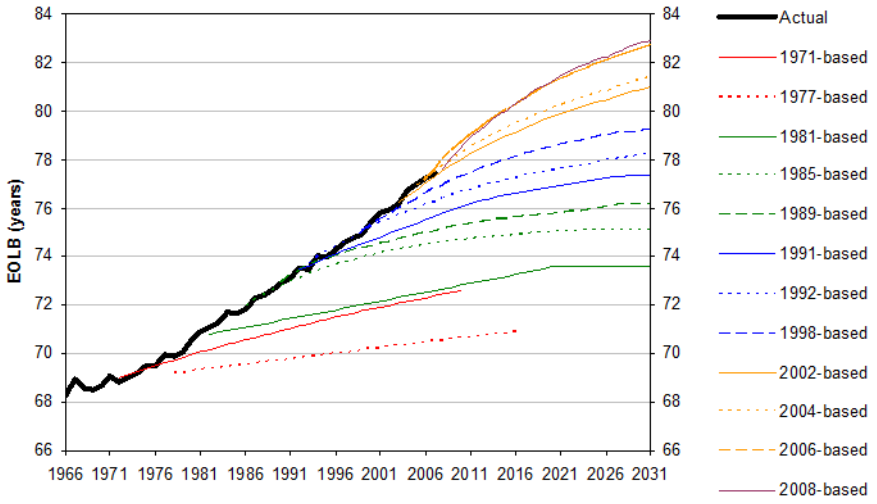
[837] Reported in Ian Porter (2015) The longevity issue - Mapping the new retirement landscape, Retirement Planner, 14 May.

[838] Michael S. Finke, John S. Howe and Sandra J. Huston (2011) *Old Age and the Decline in Financial Literacy*; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948627. The 2% rate of decline in financial literacy does not increase with advanced age, nor is the decline related to cohort effects or differences in gender or educational attainment. On the other hand, confidence in financial decision making abilities does not decline with age. Clearly, undiminished confidence when combined with reduced capabilities can lead to very poor investment decisions by older people.

Aviva report concludes (p6): '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. Figure 4.4 indicates that the ONS has systematically and significantly underestimated the increase in life expectancy since 1971. The figure shows one aspect of systematic longevity risk, namely the risk of underestimating the trend improvement in life expectancy. The actual increase in life expectancy is shown by the solid black line – this follows the same straight line increase depicted in Figure 4.1. All the ONS projections assume that there will be a levelling off of life expectancy, but there is little evidence that this is happening.[839] However, it is fair to say that the ONS's more recent projections have been 'more accurate' than its earlier ones, since they involve a lower degree of levelling off.

*Figure 4.4: Actual and projected period life expectancy at birth, males, UK, 1966-2031*

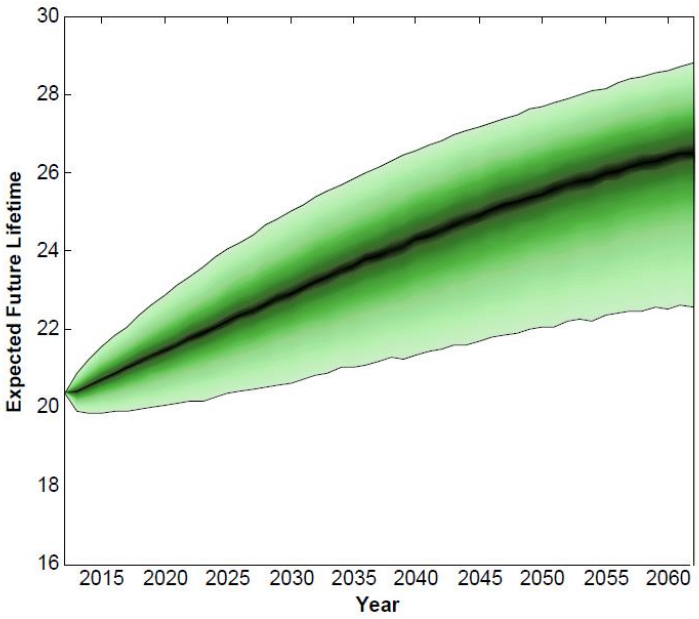



Source: Office for National Statistics

[839] In September 2015, the Institute and Faculty of Actuaries' Continuous Mortality Investigation (CMI) did report a slowdown in increases in life expectancy over the last four years. It found that expected lifespans increased by four months between 2011 and 2015, while life expectancy at 75 showed no improvement at all. Between 2000 and 2011, life expectancy increased by three months a year in line with long-run historical trends. Tim Gordon, CMI chairman, said: 'Insurers and pension funds will need to consider whether this recent experience indicates a fundamental change in mortality improvement trends, or whether it is a short term variation due to influences such as influenza and cold winters - the financial implications are material'. 2015 was an 'exceptionally heavy year for mortality' with 25,000 more deaths than the 300,000 expected in England and Wales over the first seven months, in part because winter flu vaccine had been less effective than usual (reported in Jack Jones (2015) Life expectancy increases slow dramatically, Professional Pensions, 28 September).

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 longevity fanchart[840] in Figure 4.5 shows that 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 (assuming he survives to 65)?

*Figure 4.5: Longevity fanchart for 65-year old males*




Source: Kevin Dowd, David Blake, and Andrew Cairns (2010), Facing up to Uncertain Life Expectancy: The Longevity Fan Charts, *Demography*, 47(1): 67-78

[840] This presents projections of male life expectancy at age 65 out to 2060. The dark central line shows the best estimate of the increase in life expectancy to 2016, while the outer lighter shaded area shows the 90% prediction interval: we can be 90% confident that the true life expectancy will lie in this band. The model used to make these projections is the Cairns-Blake-Dowd (CBD) stochastic mortality model (see Andrew Cairns, David Blake, and Kevin Dowd (2006), A Two-Factor Model for Stochastic Mortality with Parameter Uncertainty: Theory and Calibration, *Journal of Risk and Insurance*, 73, 687-718).

### *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.

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. This is really no more than what large defined benefit schemes do already, but instead of the pension being pre-determined, it will fluctuate in line with the investment performance of the underlying assets and changing mortality assumptions. The pension only becomes pre-determined once the longevity insurance comes into effect. The pension then becomes fixed in nominal terms if a level annuity is purchased or increases in line with inflation if an index-linked annuity is purchased.

### 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. This is evident in the historically low annuity rates available for those in their late-50s and 60s who are in good health.[841] Low returns also go some way towards explaining why only about 5% of annuitants buy inflation-linking, since it reduces the initial income by around 40%.[842] This means that buying annuities at the point of retirement embeds both low yields and massive inflation risk for the remainder of retirement.

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.[843] As we saw in Chapter 2 (Section 2.5), 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.[844] This is because, as the upward-sloping curved line in Figure 4.6 shows, the mortality premium – which is closely related to the corresponding age-specific mortality rate – built into annuity rates increases with age.[845] This means that it is optimal to annuitise around the time that the mortality premium exceeds the equity premium – the horizontal line in the figure.[846] This explains why it might well be sensible for healthy retirees with sufficient resources to

---

[841] The low annuity rates are due to both the relentless increase in life expectancy and the historically low long term interest rates that resulted from the programme of quantitative easing introduced by the Bank of England in March 2009 to save the UK banking system from the effects of the Global Financial Crisis which started in 2007-08.

[842] Money Advice Service quotations, 5 January 2015.

[843] As previously mentioned, we do not address the needs of late retirement, when long-term care may be required. This is because, at present, DC pots are too small to accommodate long-term care (LTC) planning. In due course, this will become an important problem to solve in association with the pension problem.

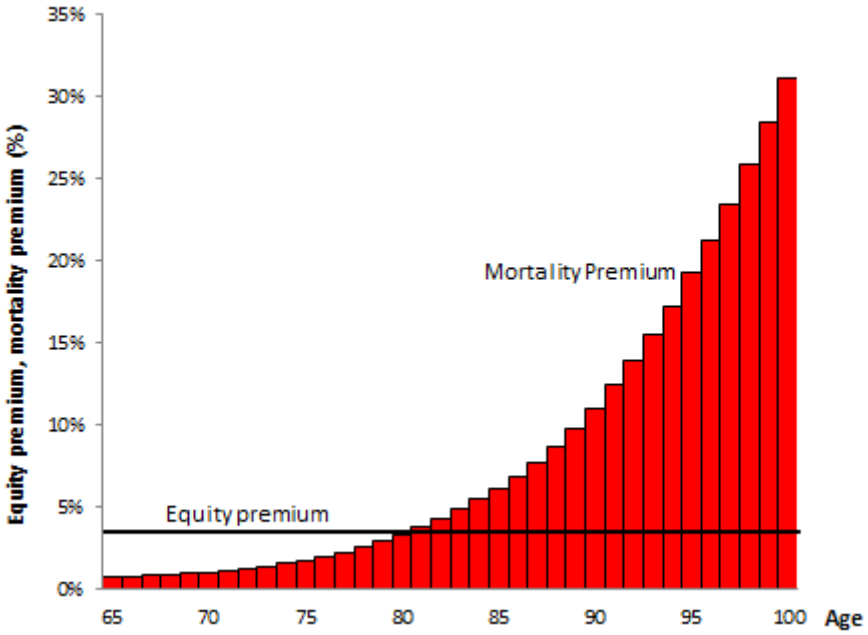
[844] By optimal, we mean that, if people were behaving rationally, they would be better off making this switch than leaving it to chance whether they run out of money before they die (assuming no bequest motive). See Menahem Yaari (1965). Uncertain Lifetime, Life Insurance and the Theory of the Consumer, *Review of Economic Studies*, 32, 137‑50.

[845] Figure 4.6 repeats Figure 2.3 (The Milevsky switching rule) from Chapter 2.

[846] We can think of the return on an annuity as being equal to the return on a risk-free asset such as a government bond plus a mortality premium to those who survive. The mortality premium is related to the mortality rate during the year: those who die during the year no longer receive their annuity and this is then shared out amongst survivors. We can think of the return on growth assets such as equities as equalling the risk-free rate plus the equity premium, the additional return that investors require to hold risky assets rather than risk-free government bonds. The mortality premium = $q_x / (1 - q_x)$, where $q_x$ is the mortality rate at age x.

wait until they are in their late 70s or early 80s before annuitising.[847] People in poor health should, of course, purchase an enhanced annuity.

*Figure 4.6: The optimal age to draw longevity-insured income*




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 as Table 4.4 appears to indicate. 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[848] 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. People also need to be

[847] This is strictly true for someone who is risk-neutral and makes investment decisions on the basis of expected returns only: the expected return on annuities will exceed the expected return on equities after this point. For someone who is risk averse, the optimal age will be earlier than this. For someone who is extremely risk averse and does not like any income volatility in retirement, the optimal age to purchase longevity insurance will be at the point of retirement. See David Blake, Andrew Cairns, and Kevin Dowd (2003) PensionMetrics 2: Stochastic Pension Plan Design during the Distribution Phase, *Insurance: Mathematics & Economics*, 33, 29-47.

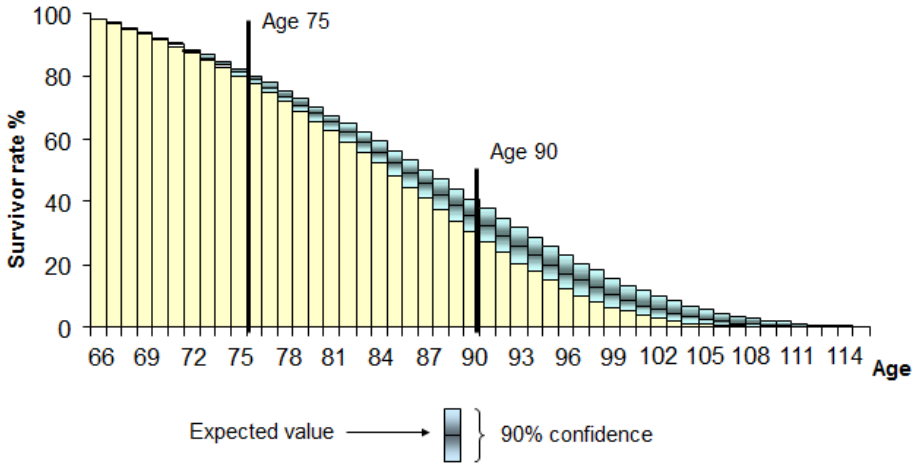
[848] We also need to be innovative in branding, given the current unpopularity of products called 'annuities' and rebrand them as 'guaranteed income for life' products.

continually warned about the very real possibility that they will finding themselves in the upper part of the longevity fanchart in Figure 4.5.

### *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.[849]

*Figure 4.7: Survivor fan chart - Males aged 65*




Source: Derived from the Cairns-Blake-Dowd stochastic mortality model, estimated on English and Welsh male mortality data for 65-year olds over the period 1991-2006

In order to see how a longevity bond can hedge systematic longevity risk, we need to both quantify longevity risk and identify where it is concentrated. Figure 4.7 presents a survivor fan chart.[850] This shows the uncertainty surrounding projections of the number of survivors to each age from the cohort of males from the national population of England and Wales who retire aged 65. The grey bars indicate the 90% confidence interval on the projected survivor rate for each age out to 115. The line in the middle of each bar indicates the expected proportion of the cohort to survive to each age. The figure shows that there is

[849] It can also be hedged with a longevity swap in the same way that inflation can be hedged with an inflation swap. In fact, a longevity bond is the combination of an annuity bond and a longevity swap.

[850] See David Blake, Andrew Cairns and Kevin Dowd (2008), Longevity Risk and the Grim Reaper's Toxic Tail: The Survivor Fan Charts, *Insurance: Mathematics & Economics*, 42: 1062-66.

little uncertainty out to age 75: we can be fairly confident that approximately 19% will have died by 75. The uncertainty peaks at age 93: the prediction interval band is widest at this age. The best estimate is that 36% will survive to age 90, but it could be anywhere between 30% and 41%. This is a very large range. The figure also shows the extent of the so-called 'tail risk' after age 90: there is some probability – even if small – that some members of this cohort will live beyond 110.

A survivor fan chart is very useful to a pension scheme or annuity provider since it shows the likely range in the numbers of pensioners or annuitants from a given birth cohort surviving to each age. If more survive to each age than was expected, the pension scheme or annuity provider has to make higher total pension or annuity payments than was anticipated. The opposite holds if fewer survive to each age than was anticipated.

We will now show how a longevity bond with the following characteristics can help to hedge systematic longevity risk:

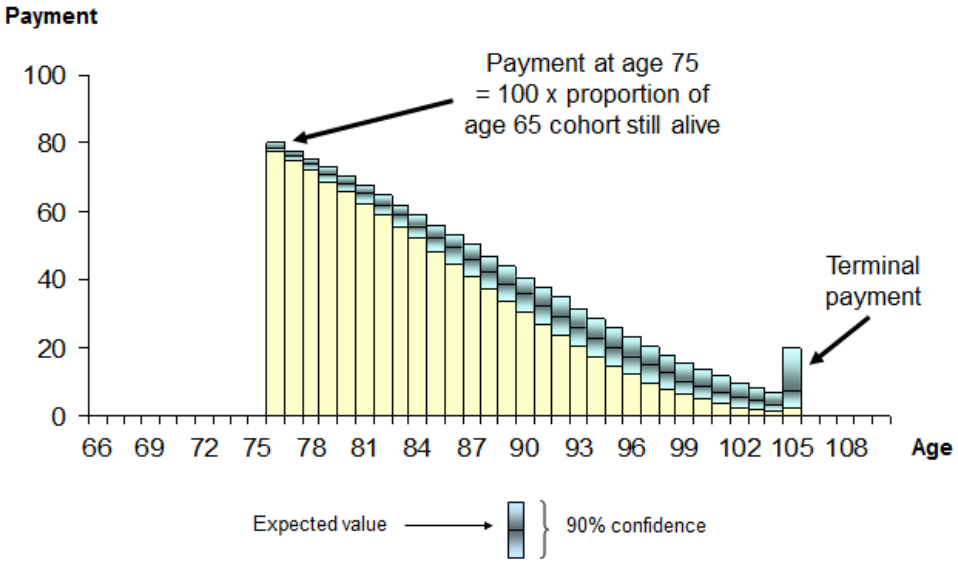
- The bond pays coupons that decline over time in line with the actual mortality experience of a cohort of the population, say 65-year-old males from the national population: so the coupons payable at age 75, for example, will depend on the proportion of 65-year-old males who survive to age 75
- Coupon 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)[851]
- 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).

Figure 4.8 shows the possible range of coupon payments on a deferred longevity bond based on the national population of English and Welsh males who are aged 65. Such a bond would provide a hedge for the systematic longevity risk faced by pension schemes and annuity providers. If population survivorship is higher at each age than was expected, the bond pays out higher coupons. This is what pension schemes and annuity providers need in order to help match the higher than expected pensions and annuity payments they have to

[851] There is no point in paying for insurance when the risk is low.

make. If, on the other hand, survivorship is lower at each age than was expected, the bond pays out lower coupons. But the pension schemes and annuity providers are not likely to mind this, since their pensions and annuity payments are also likely to be lower.

*Figure 4.8: Deferred longevity bond for male aged 65 with 10-year deferment*




Note: Longevity bond is payable from age 75 with terminal payment at age 105 to cover post-105 longevity risk

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.[852] 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. Different birth cohorts have different survivor

[852] This is the risk that the 'underlying' – in this case, the survivor rates of the particular population being hedged – does not move in line with the hedging instrument – which, in this case, depends on the survivor rates of the national population.

rates to each age. While survivor rates to each age tend to increase over time, in line with the trend improvement in longevity, they do not do so uniformly: some birth cohorts experience faster improvements than others.[853] Females, on average, live longer than males. Professionals tend to live longer than white-collar workers who, in turn, tend to live longer than blue-collar and manual workers. But it is not simply the differences in life expectancies between these various groups that are important, it is unexpected changes in the trends in their survivorship experience that causes basis risk.

Yet another reason for basis risk involves the difference between 'lives' and 'amounts'. A population longevity index[854] will weight each life equally, but members of the higher socio-economic groups will tend to have higher pensions and annuities than members of the lower socio-economic groups. They are also more likely to have multiple pensions and annuities. The directors of, say, a small engineering company are likely to represent a large share of the company's pension scheme liabilities and are more likely to live longer than the average member. All these factors will increase basis risk and its complexity.

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. In theory, there could be a longevity bond for both males and females, for each age and for each socio-economic group. Such granularity of the longevity bond market would allow a high degree of hedge effectiveness to be achieved. But it would also result in negligible liquidity or pricing transparency: the more bonds there are, the less trading there will be in each bond and the less frequently the bonds will be priced by the market. As is the case in other markets – especially derivatives markets – a small number of suitably designed bonds should provide an appropriate balance between hedge effectiveness, liquidity and pricing transparency. [855]

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. As we discussed in Chapter 2, DC schemes traditionally used a lifestyle investment strategy involving target-date funds. This involves a high weighting in equities and other growth assets in the 'growth stage' of the accumulation process in order to benefit from the equity premium. There is then a systematic switch to less volatile assets, typically long-dated fixed-income bonds,

---

[853] Richard C. Willetts (2004), The Cohort Effect: Insights and Explanations, *British Actuarial Journal*, 10, 833–77.

[854] This is an index based on the mortality experience of the national population.

[855] This is demonstrated in: David Blake, Andrew J. G. Cairns and Kevin Dowd (2006), Living with Mortality: Longevity Bonds and other Mortality-Linked Securities, *British Actuarial Journal*, 12, 153-228; Guy D. Coughlan, Marwa Khalaf-Allah, Yijing Ye, Sumit Kumar, Andrew J. G. Cairns, David Blake, and Kevin Dowd (2011), Longevity Hedging 101: A Framework for Longevity Basis Risk Analysis and Hedge Effectiveness, *North American Actuarial Journal,* 15(2), 150-176.

during the 'consolidation stage'[856] of the accumulation process – the so-called glide path – in order to reduce the volatility of the lifetime retirement income secured at retirement. It used to be the case that most people drew their longevity-insured income at the same time as they retired. The 2014 Budget is likely to lead to some DC scheme members deferring drawing a longevity-insured income from their DC scheme until later in their retirement, while keeping the fund invested in growth assets and using income drawdown in the interim. Nevertheless, it would still be useful to hedge systematic longevity risk during this period by holding some of the fund in longevity bonds.[857]

### *4.5 Why should the Government issue longevity bonds ?*[858]

In principle, longevity bonds could be issued by private-sector organisations. It has been argued that pharmaceutical companies would be natural issuers, since their revenues are positively linked to survivorship: the longer people live, the more they will spend on medicines.[859] While this is true, the scale of the demand for longevity bonds far exceeds conceivable private-sector supply from companies such as pharmaceuticals. Further, there would be significant credit risk associated with the private-sector issuance of an instrument intended to hedge a systematic risk many years into the future. In practice, we would argue that the only realistic issuer of longevity bonds in scale is the Government.[860]

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.

---

[856] This is the name given by NEST to this stage.

[857] If longevity improves at a higher rate than that expected along the glide path, this too will reduce the amount of the annuity that can be paid from a given lump sum. It might also be a better way of providing income security from a DC pension scheme at retirement than the alternative of purchasing deferred annuities, since the annuity provider has to hold significant capital against the deferred annuities it sold (under Solvency II), the cost of which would have to be passed onto the member. Longevity bonds also give more flexibility over when to take a longevity-insured income than deferred annuities.

[858] This section draws David Blake, Tom Boardman and Andrew Cairns (2014), Sharing Longevity Risk: Why Governments Should Issue Longevity Bonds, *North American Actuarial Journal*, 18(1), 258-277.

[859] Kevin Dowd (2003), Survivor Bonds: A Comment on Blake and Burrows, *Journal of Risk and Insurance*, 70, 339-348.

[860] The first suggestion for governments to do this was made in David Blake and William Burrows (2001), Survivor Bonds: Helping to Hedge Mortality Risk, *Journal of Risk and Insurance*, 68: 339-348.

### 4.5.1 An efficient annuity market for pensioners

The Government has an interest in ensuring there is an efficient annuity market, given its desire to encourage retirement savings in DC pension schemes that need annuities to turn pension savings into guaranteed lifetime retirement income. If the private sector is unable to hedge systematic longevity risk, it increases the likelihood that insurance companies stop selling annuities, especially deferred annuities, or increase annuity prices which would reduce pensioner income in retirement.

A consequence of the above is that Governments might find themselves having to pay additional means-tested benefits to supplement pensioners' incomes, as well as receiving lower income tax and expenditure taxes (such as value added tax) from pensioners due to their lower incomes.[861] This will, ceteris paribus, lead to higher taxes on the working population. This outcome will therefore not be popular with workers or pensioners. Further, workers are likely to reduce savings into DC pension schemes. Those that do continue to save in DC schemes will face even greater uncertainty about their prospective pension income, since an efficient private-sector annuity market might no longer be in existence when they retire.

### 4.5.2 An efficient capital market for longevity risk transfers

The capital markets have a key role to help ensure there is an efficient annuity market and to help to reduce concentration risk. It can therefore also be argued that the Government has an interest in ensuring there is an efficient capital market for longevity risk transfers. There are two areas where Government support is required.

First, the Government can help with the construction of national longevity indices. It is for reasons of accuracy that longevity indices would most likely have to be based on national mortality data. A key component of the success of the new capital market will be the timely publication of accurate and independently calculated longevity indices. The longevity indices would cover mortality rates, survivor rates and life expectancies for both males and females.

Only the Government has access to the information necessary to produce these indices on account of the legal requirement to report deaths and related information such as dates of death and birth and gender to an official agency, which in the UK is the General Register Office of Births, Marriages and Deaths.[862] Further, only the Government has access to the

[861] Many of the people who traditionally bought annuities in the UK were also on means-tested benefits. Any reduction in annuity payments arising from more onerous capital requirements resulting from insurers being unable to hedge longevity risk will *immediately* increase means-tested benefits.

[862] The government will always have more detailed information than the private sector as a result of data protection legislation. This legislation prevents the release of information that would allow an individual – even one who has died – to be identified. Mortality data will only be published in a sufficiently aggregated form – in terms of date and location of death – that makes it impossible for specific individuals to be identified.

information needed to estimate the size of the exposed population. In the UK, this is currently derived from decadal censuses with annual updates between censuses based on reported deaths and estimated migration flows. However, the resulting estimates are not accurate enough at high ages. It is important to be able to track a cohort over time, particularly at high ages: the Government is in a unique position to do this, since it makes social security pension payments to almost every old person and needs to keep good records to do this. While longevity indices based on social class would be useful, the social class of a deceased person is not recorded at the time of death and while attempts have been made to construct social class indices, based on factors such as post code, these lack the accuracy of national indices. A similar argument would hold for longevity indices based on amounts rather than lives.

Second, the Government can make an important contribution by issuing longevity bonds to facilitate price discovery, thereby encouraging capital market development. Longevity risk is not currently actively traded in the capital markets, so we do not have a good estimate of its market price or premium.[863] But if the Government issued a small number of longevity bonds, this would help to establish and maintain the market-clearing 'price points' for longevity risk at key ages and future dates, and hence establish a market price for longevity risk. In other words, the bonds would help to establish the riskless term structure for survival rates for ages above 65 for future years. There is a clear analogy with the fixed-income and index-linked bond markets. In these markets, the issuance of government bonds helped to establish the riskless term structures for interest rates and inflation rate expectations, respectively, for terms out to 50 years or more. The private sector was then able to issue corporate fixed-income and index-linked bonds with different credit risks (AAA, AA, etc.) and establish credit term structures above the riskless benchmark curves.

The establishment of a market price for longevity risk would be particularly useful for EU insurance companies operating under Solvency II. The maximum longevity risk premium that an annuity provider would be willing to pay to buy a longevity bond would be related to the level of capital that the regulators agree can be released as a result of holding the longevity bond to back annuity liabilities.[864]

The establishment of price points will also help to facilitate the capital market development of longevity swaps and other longevity derivatives similar to the interest-rate and inflation swaps that developed in the fixed-income and index-linked bond markets. Market

[863] The longevity risk premium is paid by the longevity bond's buyer to the bond's issuer to remove systematic longevity risk. It therefore results in a lower coupon that the bond's issuer has to pay the bond's buyer for purchasing the bond, thereby lowering the effective yield on the bond.

[864] It will also be related to the extent of the basis risk that remains unhedged and potentially the size of any illiquidity premium contained in the price of longevity bonds. If longevity bonds are not actively traded, investors will demand an illiquidity premium to hold them and the regulator might be reluctant to accept that the bonds' prices can be used for mark-to-market pricing for capital release purposes.

participants were able to use market interest-rate and inflation expectations rather than projections from models. The same would happen in the longevity swaps market. The longevity swaps market began to develop in the UK in 2007-09 with eight publicly announced swaps involving six annuity providers and two pension funds. A number of global investment banks and reinsurers intermediated the deals – J.P. Morgan, Deutsche Bank, RBS, Credit Suisse, Goldman Sachs, Société Générale, and SwissRe – and the longevity risk was passed through to investors – such as insurance-linked securities (ILS) investors, hedge funds, sovereign wealth funds, family offices and endowments – attracted by a new asset class that is uncorrelated with traditional asset classes, such as equities, bonds and real estate. More than £60bn of longevity swaps have been executed in the UK since 2007.

### 4.5.3 Intergenerational risk sharing

The Government is the only agency in society that can engage in intergenerational risk sharing on a large scale and enforce intergenerational contracts.[865] This is important, given that longevity risk is a risk that crosses a number of generations.

This is how intergenerational risk sharing operates. The Government would receive a longevity risk premium by issuing longevity bonds. In effect, the current retired population pays future generations an insurance premium to hedge its systematic longevity risk. If, in equilibrium, the risk premium is sufficient to ensure that the generation bearing the risk is adequately compensated, then each generation is treated fairly. The current generation of pensioners derives benefit from annuity companies being able to use government-issued longevity bonds to provide better value annuities. The premium that this generation pays for taking away the longevity risk is effectively the premium required to compensate the younger generations to whom the Government is passing on the risk in the form of possible higher taxes to enable the Government to continue paying state pensions to members of the current generation who live longer than expected.

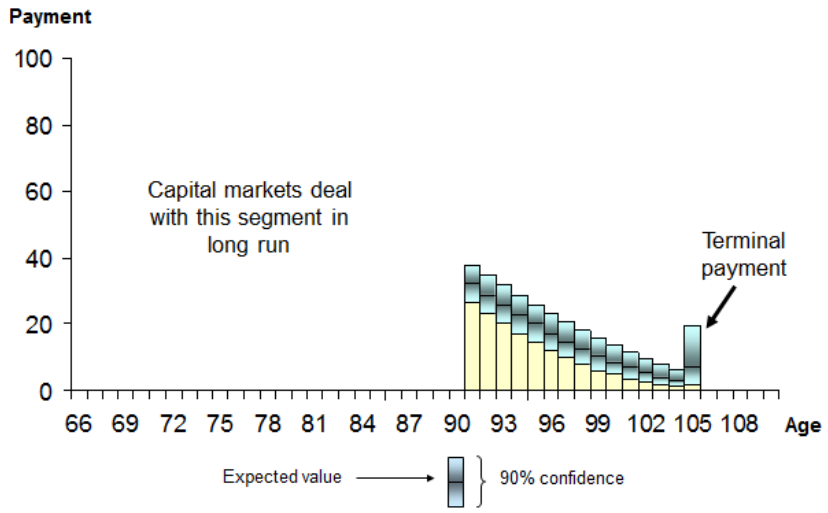
A key role for Government in this context is to provide a hedge for systematic longevity risk by offering tail risk protection against trend risk. Once the market for longevity bonds has matured, in the sense of producing stable and reliable price points in the age range 65-90, the capital markets can take over responsibility for providing the necessary hedging capacity in this age range using longevity securities and derivatives. All that might then be needed would be for the Government to provide a continuous supply of deferred tail longevity bonds with payments starting from age 90 in order to allow pension schemes and insurers to hedge their tail risk.[866] Figure 4.9 illustrates the cash flows on such a bond. These bonds will be necessary on a permanent basis, since the capital that annuity providers would be

[865] In the private sector, long-term contracts can involve significant credit risk as mentioned above and collateralisation can introduce significant frictional costs.

[866] Pension schemes and annuity providers might still be willing to invest in government-issued longevity bonds covering the age range 65-90 if they are competitively priced compared with capital market hedges.

required by the regulator to post in order to cover this risk would be very high in the absence of a close matching asset. The bonds are also necessary because the investors who have recently become interested in taking the other side of the longevity swaps market have no appetite for hedging long-duration tail longevity risk. They would also be needed to help kick start a deferred annuity market.

*Figure 4.9: Deferred tail longevity bond for male aged 65*




Note: Longevity bond is payable from age 90 with terminal payment at age 105 to cover post-105 longevity 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[867] 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.[868]

[867] The mortality rate term structure is the two-dimemnsional plot of mortality rates against age and time, and is analogous to the interest rate term structure which is a one-dimemnsional plot of interest rates against time.

[868] The Pensions Regulator is responsible for the regulation of occupational trust-based DB and DC schemes and attempts to limit the number of DB schemes needing support from 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, not only in the UK, where the situation is most immediate, but also internationally.

The Pensions Commission suggested the Government should consider the use of longevity bonds to absorb tail risk for those over 90 or 95, provided it exits from other forms of longevity risk pre-retirement which it has done by linking state pension age to increases in life expectancy and by raising the future state pension age from 65 to 68 by 2046. 'One possible limited role for Government may, however, be worth consideration: the absorption of the 'extreme tail' of longevity risk post-retirement, i.e., uncertainty about the mortality experience of the minority of people who live to very old ages, say, beyond 90 or beyond 95'.[869]

The Confederation of British Industry, which represents employers, has argued: 'Government should drive development of a market in longevity bonds, a similar instrument to annuities, by which the payments on the bonds depend on the proportion of a reference population that is still surviving at the date of payment of each coupon. This should be done through limited seed capital and supporting policy work on the topic. Government could also consider how best to match government bond issues to pension scheme needs, including the provision of more long-dated bonds and whether Government should issue mortality bonds itself'.[870]

---

[869] Pension Commission (2005, p. 229) *A New Pension Settlement for the Twenty-First Century*, TSO, Norwich. An alternative proposal from the Pension Commission was for the state to take over responsibility for providing annuities to people once they had reached 90. The state would then be hedging both the idiosyncratic and the systematic longevity risk of post-90 year olds.

[870] Redressing the Balance - Boosting the Economy and Protecting Pensions, CBI Brief, May 2009.

According to the OECD: 'Governments could improve the market for annuities by issuing longevity indexed bonds and by producing a longevity index'.[871]

The World Economic Forum has argued: 'Given the ongoing shift towards defined contribution pension arrangements, there will be a growing need for annuities to enhance the security of retirement income. Longevity-indexed bonds and markets for hedging longevity risk would therefore play a critical role in ensuring an adequate provision of annuities'.[872]

The IMF states: 'Although the private sector will further develop market-based transfer mechanisms for longevity risk if it recognises the benefits of doing so, the Government has a potential role in supporting this market. Measures could include provision of better longevity data, better regulation and supervision, and education to promote awareness of longevity risk. Those Governments that are able to limit their own longevity risk could consider issuing a limited quantity of longevity bonds to jumpstart the market'. [873]

Finally, Bernhard Brunner, Director of risklab at Allianz, argues: 'An injection of liquidity is therefore imperative. This is where Governments can come in. By issuing standardised longevity bonds index-based on the country's own population, Governments can make prices publicly available. These would then be used as reference points for other transactions and assist the growth of the longevity derivatives market, solving the problem of transparency that is also holding the market back in current over-the-counter deals….Government-issued longevity bonds could also help remove two other obstacles: standardisation and education'. [874]

### *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[875] – 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

[871] Pablo Antolin and Hans Blommestein (2007), *Governments and the Market for Longevity-Indexed Bonds*, OECD Working Papers on Insurance and Private Pensions, No. 4, OECD Publishing, Paris.

[872] World Economic Forum (2009) *Financing Demographic Shifts Project,* June, Geneva.

[873] International Monetary Fund (2012), *The Financial Impact of Longevity Risk,* Chapter 4 of *Global Financial Stability Report*, April, Washington DC.

[874] Sharing the Load, *Project M #14*, Allianz, April 2013.

[875] David Blake, Tom Boardman and Andrew Cairns (2014, p. 260) Sharing Longevity Risk: Why Governments Should Issue Longevity Bonds, *North American Actuarial Journal*, 18(1), 258-277.

hedged. First, the Government receives a longevity risk premium from issuing the bonds. Second, in the event that the risk premium proves to be insufficient, the Government can reduce its state pension spend and increase its pre-retirement tax take by systematically raising the state pension age in line with increases in life expectancy, as recommended by the Pensions Commission. The next generation might have to work longer, but will, in any case, have ended up being a fitter generation than the previous one and so be able to earn more income which, in turn, will produce more tax. Third, since the issuance of longevity bonds should result in a more efficient annuity market and hence higher incomes in retirement, this should also result in an increase in the tax take and help to reduce the amount of means-tested benefits. In addition, it should be noted that the higher tax take and lower means-tested benefits arising from a more efficient annuity market applies to the lifetimes of all pensioners buying an annuity, whereas the tail risk protection provided by deferred tail longevity bonds applies only to those surviving over 90, some 25 years in the future.

Overall, once a Government is only issuing deferred tail longevity bonds, the risk will be very manageable and consistent with the Government's role of facilitating intergenerational risk sharing. There could be a significant cost-benefit to the Government from the issuance of longevity bonds and therefore a strong case for a Government to issue longevity bonds.

The second argument is that there is no role at all for a Government in issuing longevity bonds as argued by Dowd (2003) and Brown and Orszag (2006).[876]

Dowd (2003) criticised the original argument used by Blake and Burrows (2001)[877] to justify government issuance of longevity bonds (or what Blake and Burrows called survivor bonds), namely the appeal to the Arrow-Lind Theorem on social risk bearing. This theorem states that by dispersing an aggregate risk across the population (of taxpayers) as a whole, the associated risk premium on a longevity bond issued by the Government would be lower than that charged by a private-sector issuer. Dowd countered that many of the assumptions underlying the theorem – such as taxes are costless to collect, each household bears an equal share of the tax burden, and an absence of distributional effects – do not hold in practice. Instead, he argued that capital markets are better suited than any Government to bear and share risks, since they allow risks to be diversified internationally. In short, Dowd argued that Government intervention was unnecessary, since private-sector parties were perfectly capable of creating and trading longevity-linked instruments and derivatives themselves. There was no market failure for the Government to correct, rather the time is not yet ripe: 'The fact that a particular innovation has not yet occurred does not in itself

[876] Kevin Dowd (2003), Survivor Bonds: A Comment on Blake and Burrows, *Journal of Risk and Insurance*, 70, 339-348; Jeffrey Brown and Peter Orszag (2006) The Political Economy of Government-Issued Longevity Bonds, *Journal of Risk and Insurance*, 73, 611-631.

[877] David Blake and William Burrows (2001) Survivor Bonds: Helping to Hedge Mortality Risk, *Journal of Risk and Insurance*, 68, 339-348.

constitute an argument for Government intervention to bring it about. Any good new idea, including that of survivor derivatives, should eventually take off – but we have to give it time.... When the time is ripe, it is therefore entirely possible, and even likely, that markets for survivor derivatives – survivor bonds, forwards, futures, options and swaps, and annuity securitisation – will take off, and eventually become as familiar as comparable instruments such as credit derivatives are today' (pp. 347-8).

Brown and Orszag (2006) also accept that a longevity risk premium would need to be paid in order to hedge aggregate longevity risk, but they argue that it is not sufficiently high to cause a market failure and hence justify Government intervention: 'we suspect that this risk does exert some upward pressure on annuity pricing, possibly in the range of a few percentage points' (p. 622). They also accept that the intergenerational sharing of longevity risk can potentially improve social welfare. Suppose a scientific discovery improves the life expectancy of all current and future generations. Current 80-year olds would be unable to respond to this by re-entering the labour market and hence would experience a lower standard of living as their remaining wealth would have to be spread over a longer period. Younger generations are more able to adjust to this mortality shock. Hence the financial risk from such a shock could be spread over a number of generations and this would improve social welfare. Since only the Government is able to enforce intergenerational contracts, there is a potential role for the Government in efficiently spreading risk across generations. However, Brown and Orszag believe that it is unlikely that the Government will spread risk efficiently: 'to maximise social welfare, it is not sufficient that the Government move any amount of risk from the current generation to some other generation. Rather, the Government needs to move the optimal amount of risk onto the right generations' (p. 625). Instead, they believe that the Government will favour the current generation of voters, and particularly the large number of vocal grey voters, over generations as yet unborn, by transferring 'more than the optimal amount of risk to future generations' (p. 629).[878]

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. While Dowd, Brown and Orszag highlight some of the difficulties associated with the Government's ability to forecast future mortality improvements, the existence of longevity bonds would provide an incentive for the Government to collect better death records and improve its longevity forecasting techniques, both of which would have wider social benefits. Even if the private sector is better at forecasting than the Government, systematic longevity is a slowly building trend risk and the private-sector issuer of a longevity bond risks insolvency if it gets that trend

[878] Dowd (2003, pp. 346-7) makes the same point: 'The intergenerational argument is open to the objection that governments have an incentive to put the interests of current voters ahead of those of future voters'.

wrong in a way that the Government with its powers of taxation does not. We also need to deal with the possibility that 'more than the optimal amount of risk' is transferred to future generations. However, the total likely issuance of longevity bonds is never going to be sufficient for this to be a serious problem and we should bear in mind that the current generation is getting its longevity risk insurance for free: if longevity bonds were issued, it would have to start paying for it.

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 first attempt occurred when CPI futures contracts were listed on the US Coffee, Sugar and Cocoa Exchange in June 1985. This contract was delisted in April 1987, with only 10,000 contracts ever having been traded. The key reasons for the failure of this contract were: there was no underlying inflation-linked securities market at the time, the underlying was an infrequently published (i.e., monthly) index, and there was no stable pricing relationship with other instruments to attract the attention of arbitrageurs. The second attempt occurred when Treasury inflation-protected securities (TIPS) futures were listed on the Chicago Board of Trade in June 1997 and subsequently delisted before the end of the year with only 22 contracts ever traded. The key reasons for the failure of this contract were: TIPS had only started trading five months before, there was just a single 10-year TIPS trading, the futures contract competed with the underlying for liquidity, and there was uncertainty over the future of the TIPS program. The final attempt was in February 2004 when the Chicago Mercantile Exchange launched a CPI futures contract which is still trading. The reasons for the success of this contract are: inflation-linked securities have gained acceptance amongst investors, TIPs have evolved into recognised asset class, there is a well-understood pricing relationship allowing for arbitrage opportunities between TIPS, fixed-interest Treasury bonds and CPI futures, the US Treasury is committed to long-term TIPS issuance, CPI futures do not compete directly with but rather complement TIPS and use same the inflation index, and liquidity is enhanced by electronic trading on Globex. This experience therefore suggests that it is possible to create a liquid market in an instrument based on an infrequently published index.

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.[879]

The life annuity market in the UK has scale[880] and as a consequence is price competitive with a number of life insurers competing for business. It is relatively easy for pensioners to compare the different guaranteed incomes on offer in exchange for their pension savings.

In recent years, the money's worth of the UK annuity market has been assessed and tracked by Edmund Cannon and Ian Tonks. They were commissioned by the Department for Work and Pensions in 2009 to produce a detailed report on the money's worth of annuities in the UK. Their report examines a time series of pension annuity rates in the UK for the period 1994 to 2007. 'The report computes the money's worth of annuities and finds that, on average, the money's worth over the sample period for 65-year old males has been 90 per cent, and for 65-year old females has been a similar but slightly larger 91 per cent. Taking into account load factors associated with annuity contracts and, in comparison with other financial and insurance products, this implies that annuities are fairly priced'.[881]

Cannon and Tonks' analysis shows that there is some evidence that the money's worth has fallen since 2002. They discuss a number of reasons for this, including: changes in insurance regulation, changes in industrial concentration, an insurance cycle, the pricing in of increased mortality uncertainty, and the growth in the impaired lives market. The last of these is becoming an increasingly important factor in the UK and it has resulted in the money's worth for standard annuities (i.e., those for healthy lives) falling as insurance companies have made allowance for the selection effects caused by the introduction of enhanced rates for pensioners with health impairments that reduce their expected life expectancy. Around 30-40% of pensioners qualify for enhanced annuity rates and life insurers have adjusted the rates on standard annuities to reflect the longer life expectancy of the 60-70% buying standard annuities. The other main reason is that UK insurers have increased the loading for the cost of their risk capital to reflect the fact that they expect to have to hold more capital in a Solvency II world. This trend has accelerated since 2009 in anticipation of the introduction of Solvency II in 2016. In short, the load factor in annuities

---

[879] The money's worth of an annuity will equal 100% when annuity providers have no administrative costs and are making no profits. In practice, the money's worth will be less than 100% due to the presence of administrative costs, risk charges (in form of cost of capital) and the need for annuity providers to make a 'normal profit'. The sum of the costs and normal profit is called the 'load factor'.

[880] At its peak, the UK annuity market was worth about £12bn a year in new business – around half of the global annuity market – sales have fallen by more than 50% since the 2014 Budget.

[881] Edmund Cannon and Ian Tonks (2009, xiii) Money's Worth of Pension Annuities, Department for Work and Pensions, Research Report No 563. Cannon and Tonks' findings are supported by a more recent study by the FCA: Matteo Aquilina, Robert Baker and Tommaso Majer (2014), The Value for Money of Annuities and Other Retirement Income Strategies in the UK, Financial Conduct Authority, Occasional Paper No. 5, December (http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-5.pdf)

cannot take much more strain without adversely impacting the size of the annuity payments.

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. There will be a requirement under Solvency II for annuity companies to hold capital to cover basis risk where they have a hedging instrument that is not perfect. However, given that no longevity bonds have yet been issued,[882] no annuity provider has been in a position to agree the scale of capital required with its regulator. The level of capital will clearly depend on the composition and size of the insurer's annuity population. However, reinsurers who are also caught by Solvency II would be more able to consolidate exposure by pooling portfolios from different providers and therefore experience less basis risk. It is possible that reinsurers could end up using longevity bonds to manage their longevity risk and reduce their Solvency II capital requirement, whilst providing indemnity rather than indexed solutions to insurers with small pools of annuities.

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,[883] but this does not prevent them from providing highly effective – if not perfect – hedges.

### *4.9 Feedback from our interviews and responses to the consultation paper*

#### 4.9.1 Feedback from our interviews

We asked the providers and investment managers that we interviewed about their views on longevity bonds. The question gave rise to opposing views, of which the following are typical:

- 'They would be helpful due to long tail of risk and duration of assets. There are not enough long-term bonds. But the return on government bonds is not attractive'

[882] While not a longevity bond of the kind we have discussed above, we should note that Swiss Re issued the world's first 'longevity trend' bond in 2010. This was designed to hedge the difference in the trend increases in life expectancy in the UK and the US. This bond is discussed in detail in Andrew Hunt and David Blake (2015) Modelling Longevity Bonds: Analysing the Swiss Re Kortis Bond, *Insurance: Mathematics & Economics*, 63(C), 12-29.

[883] Contemporaneous basis risk implies that the hedging instrument is not a derivative of the underlying; time basis risk implies that the maturity of the hedging instrument does not coincide with the maturity of the underlying.

- '[Our company – an insurance company] does not see a demand, but we accept the point that there is currently no market price for longevity risk (and everyone's pricing is based on an actuarial model)'.

### 4.9.2 Responses to the consultation paper

We summarise the responses to Questions 32-40 in the consultation paper here.

32. *What evidence is there of individuals' ability to reliably estimate how long they are going to live?*

33. *How easy is it for individuals to quantify longevity risk? What evidence is available on this question?*

Respondents were unanimous that individuals had problems estimating both life expectancy – with a tendency to under-estimate it – and longevity risk. A minority thought that these problems could be overcome with education or engagement.

34. *Is longevity risk a risk that individual savers are able – and should be expected – to manage themselves?*

The majority of respondents thought that individuals could not manage longevity risk adequately, and pointed to solutions in the form of longevity insurance, annuities and guaranteed drawdown. A minority thought that individuals could manage longevity risk if they received some additional help.

35. *Where people receive tax incentives to save into pensions, should people be required to secure a minimum lifetime income in retirement?*

Respondents were split on whether people who had received tax incentives should secure an income in retirement or not. Just over a quarter said "yes", while just over a third said "no". Others thought that tax relief could be used to encourage people to buy longevity insurance after retirement. Some thought that the use of tax relief in pensions should be reviewed, especially since it did not benefit those on low or modest incomes.

36. *(a) Do you believe that the DC retirement income market could benefit from the introduction of a market in longevity bonds? Explain. (b) Do you believe that a market in longevity bonds is viable (in the sense of having sufficient demand to justify its introduction)? Explain.*

37. *Do you have a preferred design for a longevity bond?*

38. *Is there a case for the Government to issue longevity bonds? Explain.*

There were two interpretations of these questions on longevity bonds. Where longevity bonds were interpreted as products issued by the Government to allow insurance

companies to hedge mortality risk, a majority were in favour of government issuance, although a minority did not believe they would work. Where longevity bonds were intepreted as retail products (i.e., a form of deferred annuity) purchased by individuals (perhaps from the Post Office or National Savings & Investments), many respondents thought that this would be a good idea.

39. *Are there alternatives to longevity bonds to hedge systematic longevity risk? Explain.*

There were only two replies to whether there are alternatives to longevity bonds to hedge systematic longevity risk, one saying "no" and the other saying "yes, but it would probably be expensive."

40. Are *there other ways of helping savers to manage longevity risk?*

Most responses thought that savers could not manage longevity risk without some form of annuity or guaranteed drawdown. A significant minority thought that better education and engagement would improve the chances of individuals dealing with longevity risk.

### *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.[884]

[884] Since longevity bonds are annuity bonds with the coupon payment involving a return of capital element as well as an interest element, the tax treatment will therefore be more complicated than with a conventional bond.

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

> *'Do you mean that you think you can find out the answer to it?', said the March Hare.*
>
> *'Exactly so', said Alice.*
>
> Lewis Carroll (1865) *Alice's Adventures in Wonderland*

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.

### *5.1 Introduction*

The introduction of NEST has been a game changer for the provision of good-valued, well designed and governed pension schemes for low- and medium-income savers in small and medium-sized companies. It has brought institutional standards – in terms of low charges, good governance and a well-designed default investment fund – to the formerly high-cost, poor-value world of retail customers.[885] It has also encouraged the entry of new multi-employer trust-based schemes, such as NOW: Pensions and The People's Pension.[886] However, under current legislation, once members of these and other auto-enrolment schemes retire, they have to go to the retail market to buy annuities on an individual basis. Even under the new decumulation regime introduced in April 2015, those who do not wish to buy an annuity might end up buying a retail income drawdown product, which at present can be very expensive and suffer from both poor investment strategy and poor governance. Could institutional standards – in terms of design, governance and charges – be brought to the retirement income space and what role could NEST play in achieving this?

Two key topics are covered in this Chapter. The first deals with NEST's approach to developing a retirement income strategy for its own members. The second explores the potential for NEST to play a role in the wider market in relation to employers that want to

---

[885] In July 2014, the government announced that in 2017, it would remove the contribution cap and lift the transfer ban imposed on NEST.

[886] Debbie Harrison, David Blake and Kevin Dowd (2012), *Caveat Venditor: The Brave New World of Auto-Enrolment Should be Governed by the Principle of Seller Not Buyer Beware*, Pensions Institute, October (www.pensions-institute.org/reports/caveatvenditor.pdf); and Debbie Harrison, David Blake and Kevin Dowd (2014), *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute, January (www.pensions-institute.org/reports/ValueForMoney.pdf).

offer a third-party retirement income solution to their scheme members, and also to the millions of private sector workers who are self-employed or whose contracts of employment do not entitle them to membership of their employer's auto-enrolment scheme. We begin with a brief summary of NEST and its current membership.

### *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.[887] 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. 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.

While NEST resembles other large master trusts, it is unusual in several respects:

- It is a new scheme, designed specifically for the auto-enrolment market. It opened for business in October 2012 to coincide with the first auto-enrolment staging date for large employers[888]
- Its legal structure is similar to any other multi-trust scheme, but as a NDPB, NEST Corporation is accountable to Parliament through the Department for Work and Pensions
- Members of the Corporation (the chair and up to 14 trustees) are appointed by the Secretary of State for Work and Pensions in line with public appointments guidance
- NEST does not have shareholders (unusual, but not in itself unique) or a parent company that provides new business capital. Instead its establishment and administration costs are funded by a Government (DWP) loan facility. The initial loan was £171m and this had increased to £387m by 2015. Details about the terms and

[887] NEST Annual Report 2015; http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/news/NEST-reaches-2-million-members.html.

[888] NOW: Pensions is also new and shares this characteristic, although this scheme is funded by NOW's Danish parent company, ATP, which is one of the largest pension schemes in Europe.

conditions of the loan are available in a Freedom of Information (FOI) report, although certain sections have been redacted[889]

- In order to repay the loan, NEST has a dual charging structure, whereas most modern schemes have a single annual management charge (AMC) or total expense ratio (TER). NEST has an AMC of 0.3% and a contribution charge of 1.8% - the latter being used to repay the loan. The two charges combined are broadly equivalent to a TER of 0.5% for members who stay sufficiently long in the scheme
- NEST is the only multi-employer scheme with a public service obligation to accept any employer that applies
- Although NEST will accept any employer, many of its employer members are either smaller companies or companies with lower-paid staff and/or high staff turnover
- NEST accepts the self-employed as individual members – by 2015, about 800 have joined
- NEST cannot accept transfers-in until April 2017
- There is an annual contribution cap – again until April 2017. This is the maximum amount that can be contributed to any member's retirement pot in a tax year. The contribution limit for the 2015-16 tax year is £4,700. It is adjusted annually in line with average earnings.

In October 2015, NEST became the fourth occupational DC master trust to obtain Master Trust Assurance Framework (MAF) status. This is a voluntary framework, developed by the Institute of Chartered Accountants of England and Wales (ICAEW) in association with The Pensions Regulator (TPR), to support auditors to provide independent assurance reports for the trustees of master trusts. The other schemes with MAF status at the time were NOW: Pensions, SEI Master Trust and The People's Pension. There are currently around 70 master trusts operating in the UK.[890]

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

Many life companies have struggled to meet the April 2015 deadline for introducing 'freedom and choice' and making available a suitable choice architecture and product range for decumulation. NEST is more fortunate and is well-placed to deal with the new pensions tax regime. Until the 2014 Budget announcement, the scheme had assumed that its members would either take their fund as cash, where it was small enough to qualify under

[889] One section redacted relates to the applicable interest rate. This is because 'the description contained within it could prejudice Government policy in future lending to other public sector bodies and the methodology used by the Debt Management Office in setting interest rates for such loans'. The second redaction has been made 'because we have concluded the information would otherwise prejudice NEST Corporation's commercial interests and has commercial importance to other pension providers'.
See https://www.gov.uk/government/publications/national-employment-savings-trust-nest-loan-agreement.

[890] Reported in Jonathan Stapleton (2015) NEST obtains master trust assurance, Professional Pensions, 15 October.

the trivial commutation rules, or in the form of tax-free cash and an annuity. As it was evident that pot sizes would be small – particularly in the early years – the scheme established a panel of annuity providers that were prepared to offer annuities for pot sizes as low as £1,500.

Following the introduction of 'freedom and choice', NEST has adopted a new short-term strategy. Members coming up to retirement over the next few years will have very small pots – and until 2017 they will not be able to use NEST to consolidate this pot with their other private pensions because NEST is unable to accept transfers-in before this date. Therefore, 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[891] that will be fully invested in cash at the point of retirement.

Furthermore, NEST does not have to deal with legacy books of workplace DC business. Given the recent focus of the FCA's Independent Project Board on treating legacy customers fairly, back books – where policies often have charges that are very high relative to modern schemes – are likely to cause problems for the new independent governance committees of contract-based workplace schemes.[892]

### 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*.[893] 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'.[894] Launching the report, Mark Fawcett, NEST's chief investment officer, said:

> *The new 'freedom and choice' reforms provide a great opportunity to deliver innovative solutions for millions of savers who will be increasingly reliant on DC pots. What we are seeing is a strong consensus emerging on*

[891] See Chapter 2.

[892] FCA (2014) *The Independent Project Board Report: Defined Contribution Workplace Pensions: The Audit of Charges and Benefits in Legacy Schemes - A Report from the Independent Project Board*, December; http://www.fca.org.uk/your-fca/documents/defined-contribution-workplace-pensions.

[893] NEST (2014) *The Future of Retirement: A Consultation on Investing for NEST's Members in a New Regulatory Landscape*, November; https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement.pdf.

[894] NEST (2015) *The Future of Retirement: Guiding Principles for the Design of Retirement Pathways for the Automatically Enrolled Generation*, March; http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/guiding-principles.pdf.

*good quality default retirement income solutions playing a central role in helping these savers achieve better retirement outcomes.*

*Much of the evidence we are analysing indicates broad agreement that helping savers mitigate the risk of outliving their savings will be a key feature for default solutions right for the DC-dependent generation.*

An important insight that emerged from the consultation is that DC savers are just as likely to underdraw as they are to overdraw their DC savings. International experience backs up this finding. The experience in the US is that DC retirees underspend, while in Australia they overspend with the result that many retirees run down their DC savings by the age of 70 (see Chapter 3).

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)
- 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 notes that the language of 'defaults' is somewhat flawed in relation to decumulation options because there must be more than one choice – i.e. cash, annuity, drawdown, and a combination of all three. Despite this, NEST chooses to use the term 'default' to denote the income drawdown default fund and investment strategy. As retirees come to rely increasingly on DC as a primary source of private retirement income, NEST believes that drawdown will represent the most sensible option, provided, as it also emphasises, the decumulation strategy also includes a longevity risk hedge in the form of a later-life annuity.

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.

Respondents also suggested that instead of complex annual statements based on investment performance and fund size, the statement should focus on meeting income targets.[895] It is much more meaningful for retirees to understand their retirement pot as a series of income payments, so the statement should adopt a similar language to that used in annuity income statements, but with the important caveat that the drawdown income is not guaranteed.

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.

   Many people underestimate how long they will live and therefore what they are likely to need to secure an appropriate income in retirement.

   The latest projections for England suggest males born in 2014 could expect to live to 79.5 and females to 83.2.

   Under the previous pensions framework, annuities met savers' need to manage long-life risk. However the new freedoms mean schemes may have a part to play in helping to manage this type of risk.

   In comparison with buying an annuity, many question how appropriate attempting to manage longevity risk by primarily investing in growth-seeking assets is.

   Buying an annuity at a later age can allow individuals to draw a higher income than would be considered sustainable if they were trying to achieve this through a drawdown portfolio.

2. Savers should expect to spend most or all of their pension pots during their retirement.

   DC-dependent savers' pots are likely to be their main source of retirement income, alongside the state pension.

   Using all or most of savers' pots to produce an income should be the main objective of suitable default solutions.

[895] This had previously been recommended in Debbie Harrison, David Blake and Kevin Dowd (2014) *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute.

Other considerations, such as being able to leave money to dependants, should not be a key driver when designing appropriate retirement options for DC-dependent savers retiring in the medium term.

Strategies for managing these savers' money when they retire will be different from traditional drawdown strategies aimed at those with larger pots. These may be managed in ways that allow individuals to both leave what may be left of their savings for others, as well as maintain an income through retirement.

3. Income should be stable and sustainable.

   Those who are dependent on their DC pot for retirement income ought to have access to arrangements that protect them from dramatic rises and falls in that income.

   Their needs will also be met by strategies designed to mitigate the risk of them running out of money, while still aiming to produce a stable income.

4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements.

   For savers who are reliant on income from their DC pots to meet the cost of living, taking advantage of potential investment growth opportunities is appealing. However, minimising the chance of running out of money is likely to be of greater importance for the majority.

   Investment risk will need to be managed to reflect this. Investment strategies should also reflect that, unlike when savers are building up their pots, where there are losses, there is less time to make up those falls.

   Importantly, the impact of falls is exacerbated by the likelihood the individual will be taking money out of their pot. This is particularly an issue when pot sizes are at their largest.

5. Providers should look to offer flexibility and portability wherever possible.

   Savers value choice and are likely to appreciate the freedom to move between different vehicles at and during retirement. Arrangements for DC savers ought to reflect this.

   However, some factors are likely to constrain elements of flexibility and portability. For example, it may be that some savers can access a higher or more stable income if they decide to have a proportion of their pots in illiquid assets or a mortality pool which would not allow them to cash out without it costing some of their pot by moving.

It is these sorts of considerations retirement arrangements will have to assess in designing solutions that meet the expectations of savers while aiming to provide a stable income.

Schemes may also need to reflect that flexibility may be more important during the transitional years from building up your pot to accessing it, than it is in later years.

We suggest there will be many cases where savers will see the best outcomes when they have enough flexibility to respond to changing circumstances. However, they are less likely to get a good outcome if they move too frequently. Moving too frequently means savers' pots will incur transactional costs and lose out on other advantages of staying in the same strategy such as benefiting from mortality cross-subsidies.

6. Inflation risk should be managed but not necessarily hedged.

   Many savers are likely to be in retirement for decades. Over this time, the cost of living is assumed to rise.

   As inflation can have a dramatic impact on income in retirement, this means investment strategies ought to be designed to produce a stable income in real terms.

   This will, in turn, mean balancing the need to keep pace with inflation and provide income without taking undue investment risk.

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. However, Mark Fawcett gave an early indication of NEST's preferences. He accepted that 'for many members, flexibility in the early stages of retirement is key, as they will simply not know what their income needs will be….[But], as retirees get older they need less flexibility and longevity risk becomes the most important risk'. The preferred solution is likely to be a hybrid product that is a blend of drawdown in the early years and longevity insurance in the later years, but with the ability to opt out of this. This would mean fund managers would need to partner with insurance companies to provide deferred annuities that begin at age 80 or 85. Furthermore, costs should be as low as possible in order to give good value to savers: 'One advantage of [the preferred] solution is the drawdown phase is at a similar cost to accumulation but with some additional risk management techniques. One of the challenges in keeping costs low is to encourage insurance companies to compete on price, [for example, using] a panel of providers'.[896]

[896] Reported in Amanda White (2015) Best practice de-cumulatisation - a hybrid approach, Top1000funds, 14 May.

### 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.[897]

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':

- 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
- 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
- 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 issues arising in each phase and the potential solutions are considered in Table 5.1.

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.

[897] NEST (2015) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June; https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement,pdf.pdf

*Table 5.1: Meeting the different objectives of a blueprint for a core retirement strategy*

| Phase | Capital market returns vs. mortality credits | Lifestyle and behavioural influences | Potential solution |
|---|---|---|---|
| One | Expected returns from investments much higher than benefits of mortality pooling. | Members entering retirement have little sense of what their consumption needs will be. They are likely to have ad hoc needs until they settle into retirement and aren't focussed on long-term needs. | Remain fully invested in an income drawdown strategy.<br><br>Use cash lump sum fund for ad hoc needs without impacting their regular income. |
| Two | Mortality credits become increasingly more valuable overtaking expected investment returns. | Members are more settled into their retirement, have a better sense of their likely future spending needs and are becoming less active.<br><br>More recognition that they are likely to need a retirement income for longer than previously expected. | Secure a later-life income with a portion of their remaining pot.<br><br>Remain invested in the income drawdown fund to provide sustainable income in real terms.<br><br>Use cash lump sum fund for ad hoc needs without impacting their regular income. |
| Three | Variance of both longevity and value of remaining pots is too high to manage or plan for by using capital markets. | Many members at this age will be less active and less engaged with their finances, preferring instead for certainty in their regular income. | Draw from later-life protected income building block.<br><br>Use cash lump sum fund for ad hoc needs without impacting their regular income<br><br>No longer use investment supported income drawdown fund. |

Source: NEST (2015, p. 31) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June.

| *Table 5.2: Meeting the guiding principles* | |
|---|---|
| Guiding principle | How the blueprint for the core retirement income strategy meets the principle |
| 1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions. | This blueprint aims to manage longevity risk through the later-life protected income fund. |
| 2. Savers should expect to spend most or all of their pension pots during their retirement. | Phases 1 and 2 of the blueprint would aim to pay out sustainable income. Any excess returns should be paid into the cash lump sum fund. Later-life protected income provides security in Phase 3 so no money needs to be 'left on the table'. |
| 3. Income should be stable and sustainable. | By having a clear investment horizon (the end of Phase 2), the drawdown investment strategy can be managed with clear objectives. The investment strategy should be balanced and diversified. |
| 4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements. | There should be a clear requirement in the income drawdown fund to manage for volatility and sequencing risk. |
| 5. Providers should look to offer flexibility and portability wherever possible. | A core design principle for this blueprint is that it doesn't lock members in early in their retirement and gives them flexibility with their money when it's most needed.<br><br>Full flexibility is a key feature of Phase 1. This is the most important time for flexibility as work and retirement patterns change and income requirements are uncertain.<br><br>By Phase 3, there will generally be less need for this level of flexibility. It becomes more important to provide reassurance that the money will last as long as it needs to. |
| 6. Inflation risk should be managed but not necessarily hedged. | Inflation hedging is expensive but a well-managed drawdown fund could provide reasonable inflation protection in Phases 1 and 2. Inflation protection is arguably less important in Phase 3. |
| Source: NEST (2015, p. 6) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June. | |

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 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.

Table 5.2 shows how the blueprint meets the guiding principles. NEST believes that the guiding principles are of particular importance given that its research had shown that a 'significant proportion of members may be unwilling or unable to pay for financial advice'.

The retirement income and investment strategies post-retirement operate as follows:

1. 10% of the pension pot at retirement will be kept in a cash lump sum fund (which will invest in liquid money market instruments) in case the member wants to make ad hoc withdrawals for a holiday, say.
2. The drawdown phase is designed to pay an inflation-linked income of 4% for 20 years from 65 to 85. With 10% of the pension pot in liquid assets, the remaining 90% of the pot has to produce a return of at least 4.4% to give an overall target return of 4%.
3. During drawdown between 1.5% and 2% of the pot is drip-fed into the protected income (annuity) fund each year. This is a collective fund, not an individual fund.[898]
4. The drawdown strategy is designed to have a 'high probability' of generating a sustainable income until age 85. NEST plans to find out from its members what probability levels would be 'acceptable'. The report shows that a 'high portfolio risk' portfolio (which is dominated by equities) has a 5% probability of running out of money in 20 years, while a 'low portfolio risk' portfolio (which is dominated by liquid assets) has nearly a 25% probability of running out of money over the same period. By contrast, the 'median portfolio risk' portfolio (which is a highly diversified fund)

[898] This is similar to the 'collective individual DC scheme' discussed in the next Chapter. It also has similarities with the one of the 'defined ambition' options considered by Steve Webb when he was Pensions Minister, namely, the 'pension income builder' fund, although that involved making contributions *prior* to retirement.

has just a 2% probability of running out of money in 20 years. Any money remaining in the income drawdown fund at age 85 would be moved into the cash lump sum fund.

The later-life protected income would be provided ideally using deferred annuities, although that is subject to the willingness of the insurance industry to provide these products at a reasonable cost.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[899] 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.

Mark Fawcett said: 'Since the pension freedoms were announced the challenge to industry has been to help savers achieve a sustainable retirement income without removing freedom and flexibility. We believe this is possible but it requires innovation. Many of NEST's members are the first generation of savers who'll rely almost entirely on their DC pots and their state pension in retirement. This makes it absolutely critical that we get this right for them. We've developed an evidence-based blueprint for how to meet members' needs. We hope this will stimulate the innovation necessary for us and others to deliver what members will need and want'.

### *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? There are EU rules on competition and state aid in relation to Government intervention in markets. In 2010, the Government had to present a convincing case that NEST was necessary to ensure the successful implementation of automatic enrolment, i.e., without it there could be a market failure. The Government also argued that it was fair and reasonable to support the scheme through the provision of a Government loan.[900] The loan was justified on the grounds of the cost implications of NEST's public service obligation:

> *NEST will have a public service duty, to accept all employers who want to use the scheme to discharge their duty to automatically enrol workers, irrespective of costs. This means NEST will be required to bear costs other pension providers do not face. In recognition of this, and in order to preserve the scheme's low-cost aims, the Government intend to provide relief to the scheme to limit the overall interest charges scheme members incur on funds borrowed to the Government's cost of borrowing. The Government are currently seeking the European Commission's approval*

[899] This is examined in Chapter 2.
[900] House of Commons Library (2010) *National Employment Savings Trust (NEST) – Background.* Standard Note: SN 04826, November; http://researchbriefings.files.parliament.uk/documents/SN04826/SN04826.pdf

*that this approach is consistent with European rules on competition and state aid. The Government believe that this funding package represents a fair balance between delivering good value to NEST's members, ensuring affordability for the taxpayer and putting NEST on a level playing field with the existing pensions industry.*

As far as EU competition law is concerned, NEST can enter the DC decumulation market if it wishes. If it needs a subsidy to do so, that is when it could require a state aid clearance. If it requires a state subsidy, there is no requirement to show that a market failure has already occurred, only that the Government has a reasonable belief, on the balance of probabilities, that a market failure is likely to occur given the information currently available. It is also open to the Government to define what it considers market failure to be. For example, the Government could argue that a market failure is likely to occur if (a) a significant number of DC savers are mis-sold inappropriate retail drawdown products that are likely to 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 – do not soon become 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.

The self-employed and non-eligible job holders for auto-enrolment could be allowed to participate in such a scheme.

Finally, in terms of the legal framework necessary for NEST to become a national decumulation aggregator, we were informed that: 'In order for NEST to become a general aggregator to the nation, it would have to become a Regulatory Own Fund (like the Pension Protection Fund). We think this could happen. It may well be that NEST remains a master trust to accumulate but has a separate structure – a Regulatory Own Fund structure – for decumulation. This would happen not just because of demands from consumers (fuelled by the pension freedoms) but because this is about the only way that a collective approach to spending (including longevity pooling) is going to work'.

### *5.5 Reactions to the NEST proposals*

There was support for the idea of the Government setting up a national drawdown provider with lower charges, similar to NEST, even before the NEST blueprint was published.

For example, in February 2015, the Trades Union Congress came out in support of the idea of a good default in decumulation and called for the establishment of a low-cost master trust for drawdown, similar to NEST, which would help to establish good practice, good standards and good value to which other products can then be compared. Nigel Stanley, then head of campaigns and communications, said: 'The history of financial services tells us that financial markets don't provide good protection for consumers. The whole pattern is innovation, rip-off, concern, regulation, and eventually you get more on this product. There's a danger that we'll go through that for the new decumulation products as well. … NEST's role in the accumulation stage has been absolutely central. My idea is that we bring exactly the same insight and lessons into the decumulation process. I think the default provider needs to have a public service obligation to accept funds, particularly occupational pensions, run by employers who do not want to look after the decumulation phase. Furthermore, I think it should play exactly the same role in setting standards and it should be based around a model where there is innovation and people have every right to opt out, but still have that choice'. [901]

Similarly, in March 2015, Which?, in a report called *Better Pensions*,[902] said: 'In the same way as it created NEST to enable all consumers to save into a pension, the Government should lay foundations for a low-cost, high value government-backed scheme for consumers to take money out of their pension. Once appointed, that provider should develop product defaults that match consumers' needs (e.g., by managing risk and volatility, offering low charges, and providing some flexibility so that members can adjust to changes in personal circumstances)'.

The report recommends that any 'disengaged' customer should be defaulted into this provider. It also recommends that any default drawdown product sold by any provider (i.e., where the customer does not make an active choice) should have a charge cap in the same way that default funds used in the accumulation stage of auto-enrolment schemes have a charge cap (of 0.75%).

The report goes on to recommend that the Financial Services Compensation Scheme's cover to be increased in the case of drawdown: 'In the event of a product provider going out of business, some funds invested via SIPPs are subject to protection under the FSCS, but only

---

[901] Reported in Stephanie Baxter (2015) TUC warns DC flexibilities will allow 'perfectly legal' rip offs, Professional Pensions, 16 February; and Adam Cadle (2015) Soapbox – The decumulation dilemma, Pensions Age, February.

[902] http://www.staticwhich.co.uk/documents/pdf/better-pensions-report---march-2015-397468.pdf

to a maximum compensation level of £50,000. This level of protection would prove inadequate for many consumers' retirement savings. Annuities, on the other hand, because they are classed as insurance products, are subject to more generous protection'.[903]

Similarly, in a report entitled *Some Suggestions for the New Pensions Minister*,[904] published by the Centre for Policy Studies in May 2015, author Michael Johnson recommends Baroness Altmann to do the following:

- Encourage NEST (and its competitors) to develop a collective drawdown capability to enable retirees to pool their longevity risk
- Establish a not-for-profit national annuities auction house to automate the process of shopping around, adding to pricing tension and transparency.

There were three main industry reactions to the NEST blueprint when it was published:[905]

- 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.

Tom McPhail, head of pensions research at Hargreaves Lansdown, said:[906]

> *NEST's research echoes market experience of the first weeks of the pension freedoms, with investors overwhelmingly favouring drawdown ahead of annuitisation, for now at least. They have some good ideas here, however, their proposals do set a couple of interesting challenges. Insurance companies have shown precious little appetite for developing a deferred annuity market though perhaps NEST's blueprint will now stimulate more interest. They will also bump up against the challenge of communicating drawdown risks to their customers, some of whom are likely to be*

---

[903] The report made a number of other recommendations, including:

- a cooling off period for at-retirement product purchases
- increase enforcement activity against scams and the distribution of unregulated collective investment schemes
- allow pension providers to book an appointment with guidance service Pension Wise on customers' behalf.

[904] http://www.cps.org.uk/files/reports/original/150514105646-SomeSuggestionsfortheNewPensionsMinister.pdf

[905] Reported in Michael Klimes (2015) NEST reveals plan for in-scheme drawdown and deferred annuities, Professional Pensions, 27 June.

[906] Quoted in Jenna Towler (2015) NEST launches retirement income strategy 'blueprint', Professional Adviser, 27 June.

*relatively disengaged. The Financial Conduct Authority is unlikely to look kindly on a solution which involves putting disengaged investors into a risk-based retirement income solution. We also know that to date, investors have shown no appetite for buying deferred annuities, so packaging this up in a way which is attractive to investors could be challenging and complicated.*

*While they have not yet been able to put a price on the deferred annuities, NEST project that this package of measures could deliver an income of 4% a year. This income would be inflation linked up to age 85. For comparison, a level annuity would typically pay about 6% at current rates and a drawdown plan purely distributing the income from the underlying investments would pay about 3.5%.*

*NEST has the luxury of not needing to rush into a retirement income solution for the pension freedom world. Its members typically have only a few hundred pounds in their accounts at present and very few of them are currently making retirement income withdrawals. This could change after 2017 when NEST will be able to accept transfers in from other schemes.*

Mr McPhail's views on the NEST blueprint appear to have mellowed slightly since he made the following comments on the Which? report *Better Pensions* in March 2015: 'Disengaged investors should probably either buy an annuity or take financial advice (or possibly both). Defaulting them into drawdown plans when they don't understand the risks look like a recipe for disaster'.[907]

Immediately following the release of the NEST blueprint, Emma Douglas, head of DC solutions at Legal & General Investment Management, speaking at Pensions & Benefits UK 2015, said that income drawdown may need to be delivered collectively to account for demand from the mass market: 'There is a lot to be said for [a collective solution] in that we are looking at a mass income drawdown market where many cannot afford an adviser. They will want something that is off the shelf, low cost and easy to understand. However, they will need some element of guidance so maybe that could be delivered via a collective solution'. [908]

### *5.6 Feedback from our interviews and responses to the consultation paper*

#### 5.6.1 Feedback from our interviews

A number of the consultants we interviewed supported the idea of a NEST-style national decumulation scheme. One said: 'Yes. This would appeal to a lot of employers because there

[907] Reported in William Robins (2015) Which? calls for Nest-style national drawdown scheme, Citywire, 6 March.

[908] Reported in Helen Morrissey (2015) PBUK 2015 - Collective solutions could deliver mass market income drawdown, Professional Pensions, 30 June.

is an assumption of safe harbour. Advisers – retail as well as corporate – would like this too, because it would give them a home for customers who are not economic to serve separately. This could be better than BT's SIPP solution. I am concerned that the SIPP charges are still too high, even though BT has tried to negotiate them down'.

There was also support from the trade union representatives we talked to, although some were concerned about whether NEST itself should operate the decumulation scheme:

- 'NEST should provide decumulation'
- 'But the worry is that NEST is new. It is very early days. I would not like to see all that good work wither away'
- 'Perhaps we do need a new organisation that operates on the same lines as NEST with a similar public service obligation'.

Providers and investment managers tended to have more doubts:

- 'NEST was introduced because of market failure in auto-enrolment. But is there evidence of market failure in DC decumulation? If not, you are bringing in to the market a government/taxpayer-subsidised loss-making provider as a solution'
- 'Potential for "mission creep" – NEST did not initially offer scheme drawdown for its own members, but it can take transfers in after 2017 and could start to offer drawdown services to this group'
- 'Given that advice is essential, could NEST provide this?'
- 'There is a huge government liability if NEST gets decumulation wrong. If decumulation goes wrong, it goes wrong quickly'.

### 5.6.2 Responses to the consultation paper

We summarise the responses to Questions 41-46 in the consultation paper here.

41. *Should NEST provide retirement income products to its members?*

Half of the respondents (a majority of those that had a clear view on the matter) thought that NEST should provide retirement income products, citing NEST's ability to use its economies of scale, the links between accumulation and decumulation, and pensioner inertia in seeking out good products. However, a significant minority – 35 per cent – were against the idea, mainly on the grounds that there was not yet any evidence of market failure in the provision of retirement income products and that this would also involve NEST operating beyond its original remit.

42. *(a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)? (b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?*

Of the respondents who were happy for NEST to provide retirement income products, 43 per cent agreed that there should be a default or a menu of default opinions, 28 per cent were against, and the rest were unclear. Most thought existing quality standards would be appropriate.

43. *Are there any other ways in which NEST can help savers to access good quality retirement products?*

Most respondents suggested that NEST could provide guidance, advice or something in between, and also signpost customers to appropriate products. One respondent suggested the importance of engaging with pension savers on an on-going basis. There was also a suggestion that NEST might provide an annuity shopping service.

44. *In an aggregator model for stranded pots: (a) Would it be desirable for NEST to act as one of the aggregators? (b) Which other schemes could act as aggregators?*

The vast majority – 73 per cent – of respondents thought that NEST could be an aggregator for stranded pots, but this did not imply that NEST should take on this role. A minority of respondents thought that it was inappropriate for NEST to be an aggregator. All respondents agreed that NEST should not be the only aggregator, but there were relatively few responses to the second part of the question.

45. *Could NEST do more in decumulation for the self-employed and workers excluded from auto-enrolment?*

The overwhelming majority of responses expressed no strong view on whether NEST could or should do more in decumulation for the self-employed and workers excluded from auto-enrolment.

46. *(a) Could NEST become a collective pension scheme? Explain. (b) Should NEST become a collective pension scheme? Explain.*

Respondents were equally divided on whether or not NEST should become a collective pension scheme, with strong views on both sides.

### *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.[909] 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.[910] 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:

---

[909] David Blake, Douglas Wright, Yumeng Zhang (2014) Age-Dependent Investing: Optimal Funding and Investment Strategies in Defined Contribution Pension Plans when Members are Rational Life Cycle Financial Planners, *Journal of Economic Dynamics & Control*, 38, 105–124.

[910] There is, of course, guaranteed drawdown – which is not being offered by NEST – but that is expensive.

- 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'.* [911] *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[912]
- 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

[911] NEST (2015, p.4) *The Future of Retirement: Guiding Principles for the Design of Retirement Pathways for the Automatically Enrolled Generation*, March; http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/guiding-principles.pdf

[912] http://www.ftadviser.com/2015/05/12/pensions/annuities/zurich-offloads-bn-legacy-annuity-book-KkvYMXrPhsan0AyU3fKICP/article.html

    - 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

> *'Well! what are you?', said the Pigeon. 'I can see you're trying to invent something!'*
>
> Lewis Carroll (1865) *Alice's Adventures in Wonderland*

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.

### *6.1 Introduction*

An analysis of the risks outlined in Table 1.2 suggests that these might be more effectively managed if they (or at least those that can be) are pooled and shared. Risk pooling within each generation or cohort of members requires scale and, at present in the UK, all DC pension schemes are individual DC (IDC) schemes with each member having their own individual account. While the contributions of scheme members can be invested in a common diversified investment fund, so that all members in the same fund get the same return, there is no pooling or sharing of other risks. Risk sharing between cohorts of members, in order to make the retirement incomes of each cohort more predictable, requires the agreement of all cohorts.

Collective DC (CDC) pension schemes that pool and share risks were not permitted in the UK until the passage of the 2015 Pension Schemes Act which made provisions for new risk-sharing strategies for DC schemes that aim to improve the predictability of the retirement income.[913] Because collective schemes have economies of scale, we will examine whether this model for collective schemes can also boost incomes in retirement, as well as

[913] This is enabling legislation only and makes provision for regulations to be made in respect of: setting target benefits, valuations, reporting requirements, and governance.

potentially make them more predictable compared with IDC schemes. In doing this, we will need to identify the sources of cost savings and risk pooling/sharing in CDC schemes. We will examine international examples of collective schemes that pool/share risks and hence make incomes in retirement more predictable (at least in principle). We will also consider an alternative type of collective scheme that might be more realistic in a UK setting following the 2014 Budget pension reforms – the collective individual DC (CIDC) scheme. We will investigate how new options might be introduced into the UK, drawing on the lessons from other countries, but recognising the potential problems that might arise when a model that works in one country, such as the Netherlands, is introduced into another. A previous UK Government looked at the possibility of introducing CDC schemes in 2009, but decided against it.[914]

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

The main benefits claimed for 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.[915]

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 IDC schemes, which just manage the former. Each member has a target pension (typically related to career average revalued earnings[916] (CARE)) which increases the longer they are a member (a typical accrual rate is 1% of earnings for each year of

[914] Department for Work and Pensions (2009a) *Collective Defined Contribution Schemes: An Assessment of Whether and How Collective Defined Contribution Schemes Might Operate in the UK*, December; www.dwp.gov.uk/docs/collective-defined-contribution-schemes-dec09.pdf

[915] See, for example: Department for Work and Pensions (2009b) *Modelling Collective Defined Contribution Schemes: A Summary of The Government Actuary's Department Modelling of Collective Defined Contribution Schemes*, December (www.dwp.gov.uk/docs/modelling-collective-defined-contribution-schemes-dec09.pdf); David Pitt-Watson and Hari Mann (2012) *Collective Pensions in the UK*, RSA, July; David Pitt-Watson (2013) *Collective Pensions in the UK II*, RSA, November; Kevin Wesbroom, David Hardern, Matthew Arends and Andy Harding (2013) *The Case for Collective DC*, Aon Hewitt, November; David Pitt-Watson, Nigel Stanley, and Kevin Wesbroom (2014) *Collective Pension Plans*, RSA, June; and Shamil Popat, Chris Curry, Tim Pike, and Ciaran Ellis (2015) *Modelling Collective Defined Contribution Schemes*, Pensions Policy Institute, November.

[916] This means that a member's earnings for each year over their career are revalued to retirement date by the increase in national average earnings and then averaged.

service).[917] 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.[918] It is important to understand that a CDC scheme offers a target pension, not a promised pension[919,920]

- 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. This type of DC asset-liability modelling is not used in the UK at present[921]
- 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, and the asset-liability modelling and management strategies mentioned above, can invest for longer periods in growth assets, such as equities, than IDC schemes, which conventionally only covered the accumulation period. An IDC scheme traditionally invested in a lifecycle or target date fund (TDF),[922] which holds growth assets when the member is young, but has a de-risking glide path which usually begins 5 or 10 years before retirement and ends up on the retirement date with a fund that is invested 75% in bonds and 25% in cash (to provide the tax-free lump sum). Until the 2014 Budget changes, the bonds were most frequently used to buy a fixed-income annuity from an insurer, which is a low-risk bond-based investment that lasts for the member's remaining lifetime. This meant that over the

[917] It should be noted that if CDC schemes are in any way earnings-related, include employer contributions, and smooth payments, or involve guaranteed returns, they will qualify as DB schemes according to the new European System of Accounts, ESA2010, introduced by the Office for National Statistics in September 2014.

[918] For an explanation of the latter, see: David Blake, Andrew J.G. Cairns, and Kevin Dowd (2001) PensionMetrics: Stochastic Pension Plan Design and Value-At-Risk During the Accumulation Phase, *Insurance: Mathematics and Economics*, 29, 187–215; David Blake (1998) Pension Schemes as Options on Pension Fund Assets: Implications for Pension Fund Management, *Insurance: Mathematics and Economics*, 23, 263-286.

[919] The contribution rate into the scheme is set so that the target pension is achieved on a 'best expectations' basis.

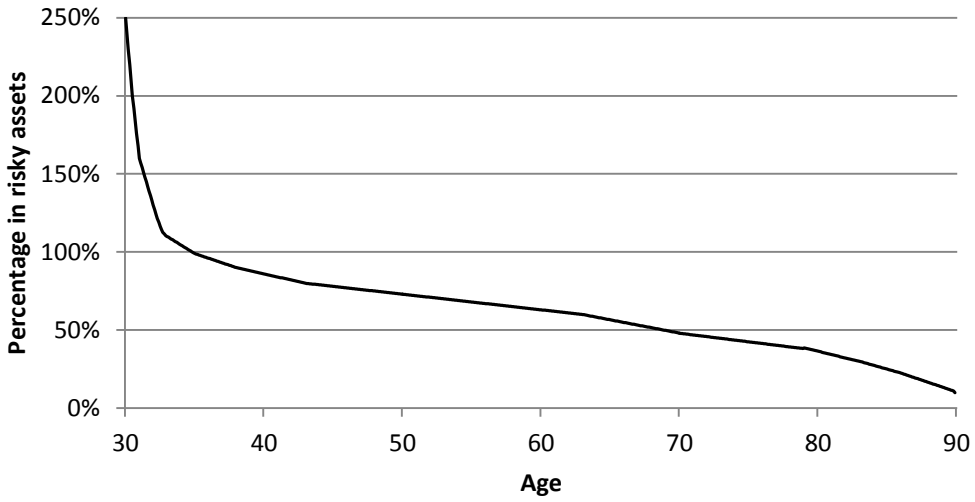
[920] CDC schemes do not have to offer earnings-related target pensions. In Denmark, it is more common to offer a zero-rate minimum guaranteed minimum rate of return (i.e., member get back at least their contributions) or a minimum nominal pay-out.

[921] There have been some recent initiatives considering this, but these are based on individual ALM exercises and therefore are not collective.

[922] These are discussed in Chapter 2.

life-cycle as a whole, scheme members were invested in low-risk, low-return assets for significant periods. 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.

*Figure 6.1: CDC follows an explicit lifestyle de-risking glidepath*




Source: Kees Bouwman (2014), Collective DC versus Individual DC – Lessons from the Netherlands, presentation at a Cardano - Pensions Policy Institute round-table seminar, 17 December.

- 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. When investment returns are very good, the member's account is allocated only a fraction of the outperformance, the rest of which is held in a reserve fund. When investment returns are very poor, the scheme draws on the reserve fund to mitigate the impact of the negative performance. In other words, peaks and troughs are smoothed out.[923] The smoothing in CDC schemes produces an implicit lifecycle exposure to risk assets, as illustrated in Figure 6.1.[924] 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

[923] This, of course, is the same principle as operated in with-profit funds.

[924] Note that individual de-risking glidepaths are not permitted in CDC schemes.

might fall. Nevertheless, the cost of buying retail annuities, and hence paying the insurers' profit margin and solvency capital costs, is avoided.

The most important point about CDC schemes is that risks need to be shared fairly between different generations in the scheme and they need to be pooled fairly between members of the same generation.[925] A key feature of CDC schemes is that they can smooth shocks over more than one generation of members. Inevitably there will be a mismatch between a CDC scheme's assets and liabilities (i.e., the value of the targeted benefits) as the realised investment performance of the assets and the actual longevity experience of retired members differ from expectations. As Cui et al. (2011, p. 4) describe: 'Surpluses or deficits in the funding process are shared among young, old and future generations by adjusting either contributions, benefit levels, or both, which leads to intergenerational transfers. Ex ante, contributions are set such that in expectation, a new entry generation funds its own pension. Ex post, a given generation may be a net payer who leaves a surplus for future generations, but may also be a net receiver who leaves a deficit for future generations. In this way, unanticipated investment [and longevity] risks are shared among many generations over long periods'. [926]

One way in which the working members of the scheme can contribute to this risk sharing is through agreeing to make higher contributions or delaying retirement if investment performance has been poor for a sustained period of time. One way in which the older retired generation can contribute to this risk sharing is through 'conditional indexation': pensions in payment are only uprated if investment performance permits. In very poor financial market conditions, pensions might have to be reduced.[927] One way in which risks can be pooled fairly within a generation is through the medical underwriting of the retirement income.[928] Standard CDC schemes give the same pension to all members (with the same average earnings and length of service) until they die. This is unfair to those members with shortened life expectancies for health reasons. When a young generation of

---

[925] It is important to understand the difference between risk sharing and redistribution. Consider the relationship between different generations of members of a CDC scheme. Intergenerational risk sharing implies that there is no ex ante (i.e., anticipated) transfer between generations, i.e., the expected size of any transfers between generations of members at the start of the scheme is zero. Ex post, depending on realised investment performance, there will be transfers (i.e., redistributions of pension entitlements) between generations – that is how pensions are smoothed across generations. This contrasts with intergenerational redistribution where ex ante there is a planned transfer of wealth between generations.

[926] Jiajia Cui, Frank de Jong, and Eduard Ponds (2011), Intergenerational Risk Sharing within Funded Pension Schemes, *Journal of Pension Economics and Finance*,10(1), 1-29.

[927] In the Netherlands, where CDC schemes first started, pensions in some schemes have needed to be cut by 20%. Others have had no inflation uprating for 10 years. However, the average cut in pensions during the financial crisis was 2-6%.

[928] That is, determining the level of pension to each member after all members have filled in a medical questionnaire about their health status and lifestyle. Those with with reduced life expectancies will receive a higher pension.

members first joins the pension scheme, it will not be known which of them will have below average life expectancies and which will have above average life expectancies at the point they retire. Agreeing to medically underwrite incomes at the point of retirement is therefore ex ante fair, since it means that those with below-average life expectancies would not unfairly cross-subsidise those with above-average life expectancies.[929]

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.[930] 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

[929] The Dutch, however, measure ex ante fairness at the point when someone joins a pension scheme, rather than at the point of retirement. All members of the same age get the same annuity rate when they retire, irrespective of their health status, on the grounds that when they first joined the pension scheme, it will not be known which of them will have below average life expectancies and which will have above average life expectancies at the point they retire.

[930] To illustrate this potential problem, in response to the 2014 Budget changes, NOW: Pensions, the multi-employer trust-based IDC scheme, has changed its investment strategy in anticipation that most of its members will take their pension pot as cash at retirement. Members begin in the diversified growth fund (DGF) and when they are 10 years from retirement they will be switched into a 'retirement countdown fund' which is most suited for those who are going to take cash. The previous de-risking strategy was to switch 75% of the DGF into a 'retirement protection fund' and 25% into a 'cash protection fund'. The first fund hedges the interest risk from buying annuities, while the second fund is invested to maximise the size of the tax-free lump sum. The 'retirement countdown fund' has the same investment strategy as the 'cash protection fund': it invests in a mixture of cash deposits, money market funds, short-dated bonds with low credit risk and interest rate derivatives. It is also possible to opt for a five- or 15-year de-risking strategy as an alternative to the 10-year default (reported in Professional Pensions, 24 July 2014).

implicit deficit.[931] 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[932] 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[933]

- 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.[934] Ponzi schemes come to a sudden stop when new investors refuse to join. There is, of course, the opposite problem that the first generation in the scheme receive less than their fair share due to the trustees being overly cautious. Trustees therefore need to be aware of – and put mechanisms in place – to avoid both possibilities. CDC schemes also face the demographic risk that the working population is too small to pay the pensions of a large and growing retired population.[935] 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

---

[931] This is what happens in the case of with-profit schemes. An implicit deficit occurs when the sum of the promised benefits across all members exceeds the assets in the fund.

[932] The People's Pension, for example, started as an industry-wide scheme in the building and construction industry.

[933] This is typical in Australian superannuation schemes. Debbie Harrison, David Blake and Kevin Dowd (2014), *VfM: Assessing value for money in defined contribution default funds* predict that as a result of consolidation amongst providers five or six trust-based multi-employer schemes would dominate the market by 2020; http://www.pensions-institute.org/reports/ValueForMoney.pdf.

[934] John Ralfe (2012), CDC could lead to Ponzi schemes, Financial Times, 15 April; www.ft.com/cms/s/0/633891dc-848e-11e1-b6f5-00144feab49a.html?siteedition=uk#ixzz33BLFoJOW.

[935] The same problem faces the state pension scheme or, indeed, many other financial products, such as bank deposits, if the early depositors get high returns taken in part from the deposits of later depositors: for example, the Icelandic banking system became a big Ponzi scheme until it collapsed in 2008.

- 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. This could happen if the target pension was turned into a guaranteed pension which resulted in a deficit being created in the scheme which the employer was required to fill. Supporters of CDC schemes argue that the way to protect against this is to have a clause in the scheme rules which automatically triggers a switch in the CDC scheme to an IDC scheme should this happen
- 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 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 make 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 as the following extract from an article published in the Financial Times notes:[936]

> *Regulation is especially important because, unlike DC pots, individual CDC members have no clearly defined property rights. And unlike DB pensions, there is no sponsoring employer standing behind it, so target pensions can only be paid from a CDC's own assets. For members to judge the likelihood of their target pensions actually being paid, it is crucial that they can understand the scheme's overall funding position easily.*

[936] John Ralfe (2014) CDC pensions will work only if strictly regulated, Financial Times, 16 November; http://www.ft.com/cms/s/0/d34f4288-69b8-11e4-8f4f-00144feabdc0.html?siteedition=uk#axzz3JEGVI3Nk

> *The current Bill [now the 2015 Pension Schemes Act], however, says nothing specific about CDC regulation. In particular, CDC trustees, advised by actuaries, are left to decide for themselves how target pensions for all members should be valued, so overall funding can be measured against the market value of assets.*
>
> *This "DIY" approach means there is no objective and consistent benchmark for CDC members to judge the likelihood of their target pensions being paid. "Trust me, I'm an actuary" is not good enough as the basis for a wholly new and untested type of pension.*

It is worth noting that some of the above criticisms have been highlighted in particular by service providers whose underlying fear is that they would be excluded from providing their services to these schemes. This is because CDC schemes manage the investment and drawdown strategies internally and might decide not to make use of external service providers, such as fund managers and annuity providers.

Another criticism relates to timing. The Queen's Speech on 4 June 2014 announced the Government's intention of introducing CDC schemes. This was met with hostility from some commentators which can be summed up in the exclamation: 'oh no, not another policy initiative!'. There have been so many policy changes and proposals in recent years – auto-enrolment, ending compulsory annuitisation, ending contracting out, possible solvency capital for pension funds, 'freedom and choice', charge capping, ending the restrictions on NEST, abolishing the 55% 'death tax', etc – that there might be no appetite for yet another new type of pension scheme, even if it would otherwise be regarded as sensible. In particular, we are only half way through the implementation of auto-enrolment, which is almost entirely IDC and which began with the largest employers in the private sector in October 2012. The implementation process will not end until the smallest employers have reached their staging dates in 2017 and newly established companies have staged in 2018.

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

If the claim that CDC schemes are able to generate outcomes that are 30% or more higher than outcomes from IDC schemes were true, it would be quite a remarkable achievement that one particular DC structure could outperform another to such an extent. We therefore need to carefully analyse this claim.

The IDC scheme behind the claim typically has the following structure:

- An initially high weighting in growth (i.e., equity-type) assets: an asset allocation that is invested 60% in equities and 40% in bonds is typical
- A de-risking glide path in the period (typically 10 years) leading up to retirement (typically at age 65) which switches the pension fund into bonds (75%) and cash (25%)

- The purchase at retirement of an annuity with the 75% of the pension fund that is invested in bonds.

The CDC scheme behind the claim typically has the following structure:

- It maintains the investment in growth assets for the whole of the accumulation phase
- There is no de-risking glide-path
- An annuity is not purchased at retirement, instead the fund remains invested in growth assets and an income is withdrawn from the fund
- A variation on the last point is that an annuity is purchased at some point (e.g., 75), while an income is withdrawn from the fund between 65 and 75.

We have done some calculations using the PensionMetrics simulation model[937] and have generated the following additional returns from the CDC scheme compared with the IDC scheme:

- A 0.5% additional annual return from avoiding the de-risking glide path, totalling 5% over 10 years
- A 1.5% additional annual return from maintaining an investment in growth assets between 65 and 75 and drawing an income rather than buying an annuity which is bond investment: this totals 15% over 10 years[938]
- A large CDC scheme could use its market power to negotiate a better-valued annuity from age 75 (or set up its own annuity business and pass its profits onto members) and this could lead to higher returns of 5-10%.

So it is fairly straightforward to see how a CDC scheme can generate a pension that is 30% higher than that in an IDC scheme. However, this is not at all a fair comparison, since the two schemes are following completely different investment strategies. It is clear that if the 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 they 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

[937] www.pensionmetrics.net

[938] Even without any additional return, a large CDC scheme might be able to run a drawdown scheme at an annual cost of 0.5% p.a. (i.e., NEST's annual charges) compared with a 2% p.a. annual charge that might be extracted from a retail drawdown product, again a saving of 15% over 10 years.

hence the outcomes will be more volatile. Supporters of CDC[939] 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*

The principal costs in a pension scheme are:

- Administration costs, covering items such as record-keeping, communications, governance, etc
- Investment management costs
- Costs of decumulation products such as income withdrawal and annuities.

The principal risks in a pension scheme are:

- Investment risk
- Interest rate risk
- Inflation risk
- Longevity risk.

#### 6.4.1 Accumulation phase issues

In the simulation exercise that follows, we will make the assumption that administration costs are the same in CDC and large IDC schemes. Similarly, there is no reason to suppose that the investment management costs for the default fund of a large IDC scheme will be any higher than those in a CDC scheme. They could actually be lower, especially if the CDC scheme is offering guaranteed returns which are expensive to provide over long investment horizons.

One of the largest cost savings claimed for CDC schemes comes from not having to buy annuities in the retail market. Instead, the CDC scheme provides the retirement income, while keeping the fund invested in growth assets. However, a large IDC scheme using scheme drawdown could equally well provide a retirement income, while also keeping the fund invested in growth assets, and without having to buy retail annuities. Overall, we

[939] For example, Kevin Wesbroom, David Hardern, Matthew Arends and Andy Harding (2013) *The Case for Collective DC*, Aon Hewitt, November; David Pitt-Watson and Hari Mann (2012) *Collective Pensions in the UK*, RSA, July.

should not expect significant cost differences between a large IDC scheme and a CDC scheme.

Let us turn to an examination of the risks, beginning with investment risk. Investment risk – the risk associated with volatile investment returns – can be reduced through diversification. Large schemes, whether CDC or IDC, have the scale to diversify into a larger range of assets. This includes assets that are illiquid, such as infrastructure, which might have higher and more stable long-run returns. A CDC scheme has a single investment strategy, just like a DB scheme. An IDC scheme will offer a number of investment strategies, but 90% of members will typically choose the default fund, which, in a large IDC scheme, can be as well diversified as that in any CDC scheme. So 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.[940] 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.

How does risk sharing between cohorts work? We will take the simplest possible example of a CDC scheme.[941] Suppose 100 people join a new CDC scheme at the beginning of the year and each member contributes one unit. Suppose they will retire at the end of the year and will take their pension pot in full. Suppose the CDC scheme has a target return of 9.651% on the investments in the fund. Suppose further that the investment fund used by the CDC scheme generates a return that alternates between 5% one year and 15% the next year and this pattern then repeats indefinitely.

Assume in the first year the investments happen to generate a return of 5% and so the pension fund is worth 105 units, which is 4.651 units short of the target. In an equivalent IDC scheme, the retirees will take out 105 units, since they have not been offered a target pension. But in a CDC scheme, the retirees will get the target pension of 109.651 units. The 4.651 unit shortfall will come from the contributions of the next cohort of 100 members who join the scheme on the same day that the previous cohort retires. However, the scheme has a deficit of 4.651 units at the beginning of year 2, with assets of 95.349 units and 'liabilities' (i.e., contributions) of 100 units from the second cohort of members.

---

[940] This is confirmed by Jurre de Haan, Zina Lekniute, and Eduard Ponds (2015, p.9) *Pension Contracts and Risk Sharing: A Level Playing Field Comparison*, APG, Netherlands, February: 'the CDC plan with no [inter-generational] smoothing provides the same median replacement rate as the individual plan with an indexed annuity in the decumulation phase'.

[941] Namely, a with-profit scheme.

Suppose that in the second year, the investments generate a return of 15% and so the pension fund is worth 109.651 (= 95.349 x 1.15) units. In the equivalent IDC scheme, the pension fund is worth 115 (= 100 x 1.15) units and members will take the full 115 units in pension. But in a CDC scheme, the members will take out the target pension of 109.651 units. The CDC pension fund is effectively fully funded at the beginning of year 3 when 100 new members join, with assets and 'liabilities' of 100 units (i.e., contributions of 100 units from the third cohort of members). The IDC scheme has an identical balance sheet on this date.

It should be clear that, given the repeating pattern of returns, the CDC scheme is fully sustainable: it can continue to pay the same pensions of 109.651 units to each new cohort of 100 members indefinitely.[942] This contrasts with the IDC scheme which gives the 'lucky' cohort of members 115 units and the 'unlucky' cohort of members 105 units. However, the average pension in the IDC scheme at 110 units is higher than the stable pension of 109.651 units in the CDC scheme. This is an inevitable consequence of smoothing: the smoothed return of 9.651% in the CDC scheme is lower than the average return of 10% in the IDC scheme. This might well be a price that members would be willing to pay, since in the real world, they will not know before they retire whether they will be a member of a 'lucky' or an 'unlucky' generation.

The volatility of the return in the IDC scheme (as measured by the standard deviation of the return[943]) is 5%, precisely the same as the standard deviation of the return on the underlying investments. The standard deviation of the return in the CDC scheme is zero, since in this stylised example each cohort gets the same pension.

The regularly repeating pattern of returns in this example is, of course, unrealistic. We can make the returns more realistic by making them completely random. Suppose we assume that there is a 50% chance of a 5% return each year and a 50% chance of a 15% return. In this case, it will no longer be possible to design a CDC scheme in which the return is constant over time at 9.651%. Instead the return will have to be set each year to ensure that the funding ratio neither systematically increases nor systematically decreases. Suppose we establish the rule that the return in the scheme will be set at 9.651% if the funding ratio[944]

---

[942] That is why the rather precise target return of 9.651% was chosen. This particular CDC scheme has what is called a knife-edge equilibrium. If the target return is just slightly below 9.651% and is always met precisely, the surplus with grow without bounds. If the target return is just slightly above 9.651% and is always met precisely, the scheme will eventually become insolvent.

[943] Standard deviation is a measure of the volatility of returns and can be explained using the following rule of thumb. We would expect actual returns to lie within one standard deviation of the average return in two years out of every three; we would expect actual returns to lie within two standard deviations of the average return in 19 years out of every 20.

[944] Defined as the value of the assets in the scheme at the beginning of the year divided by the liabilities, which in this simple example is equal to the 100 units of contributions paid by the new cohort of members.

lies between 90% and 110% (these are typical limits in CDC schemes before adjustments to the pension are made). Suppose, further, that if the scheme has a funding ratio above 110%, then the return is increased by 1 percentage point to 10.651%. If, on the other hand, the funding ratio is below 90%, then the return is set to equal the product of the funding ratio and the target return (e.g., if the funding ratio is 80%, then the return will be set at 0.8 x 9.651% = 7.7208%). We again used the PensionMetrics model to generate twenty 50-year histories of returns. The average return in the CDC scheme was 9.3977%, while the average standard deviation was 0.7619%. This compares with the IDC scheme in which the average return is 10% and the standard deviation is 5%. The coefficient of variation[945] in the IDC scheme is 0.5 (i.e., 5%/10%), whereas the coefficient of variation in the CDC scheme is just 0.08 (i.e., 0.7619%/9.3977%): the volatility per unit of return in the CDC scheme is just 16% of that in the IDC scheme.

While the example here is very stylised, it is nevertheless useful for demonstrating that CDC schemes can potentially generate more stable incomes across generations than IDC schemes can. Further, we have precisely the relationship we would anticipate between the two schemes: the CDC scheme with the lower risks has a lower average return, while the IDC scheme with the higher risks has the higher average return. Those supporters of CDC schemes who claim that a CDC scheme can generate both higher average returns and lower risks than an otherwise identical IDC scheme have found a CDC scheme that violates the laws of finance!

Jurre de Haan et al. (2015)[946] report similar results using the following simulation exercise involving a smoothing fund. A 25-year old joins either an IDC or a CDC pension scheme, makes a contribution rate of 18%, and retires at 67. The asset allocation is fixed at 23% in equities and 77% in bonds. Equities have an expected return of 7.7% and bonds have an expected return of 3.5%. Wage growth is 2.4% and the average nominal interest rate term structure rises to 2.9%. The target replacement ratio is 70%. Both the IDC scheme and the CDC scheme buy investment-linked annuities, but the CDC scheme has a 10-year smoothing of returns, so that if the funding ratio is 95% in a given year, the CDC scheme will reduce the pension by 0.5% p.a., whereas, in the case the IDC scheme, the pension is reduced by 5%. On the basis of 5,000 simulations, the distributions of replacement ratios for the two schemes are shown in Table 6.1.

[945] Defined as the ratio of the standard deviation to the average return: it measures the volatility per unit of return generated.

[946] Jurre de Haan, Zina Lekniute, and Eduard Ponds (2015) *Pension Contracts and Risk Sharing – A Level Playing Field Comparison*, APG, Netherlands, February.

| *Table 6.1: Distribution of the replacement ratios in an IDC and a CDC scheme* | | |
|---|---|---|
| Quantiles of the distribution of replacement ratios: | Replacement ratios: | |
| | IDC scheme | CDC scheme |
| 99% | 173% | 145% |
| 95% | 136% | 121% |
| Median | 79% | 82% |
| 5% | 42% | 53% |
| 1% | 33% | 43% |
| Source: Jurre de Haan, Zina Lekniute, and Eduard Ponds (2015) *Pension Contracts and Risk Sharing – A Level Playing Field Comparison*, APG, Netherlands, February | | |

While the median replacement ratios are not statistically different from each other at around 80%, the CDC scheme has less volatile (i.e., smoother) replacement ratios, ranging between 53-121% in 90% of simulation trials, compared with 42-136% in the case of the IDC scheme. The benefits of using a smoothing fund – in this case across 10 years or cohorts – are clear.

### 6.4.2 Decumulation phase issues

Investment risk is the dominant risk in the accumulation phase of a DC pension scheme. We now turn to the key risks in the decumulation phase: interest rate risk, inflation risk and longevity risk.

Interest rate risk is a risk associated with the purchase of annuities. When interest rates are low – as they are currently – annuity rates will also be low. This is because when an insurance company sells an annuity, it uses the premium received to buy bonds and the cash flows on these bonds are used to make the annuity payments. When interest rates are low, bond prices are high[947] and fewer bonds can be purchased for a given sized pension fund, which, in turn, means that the pension that can be paid will be low. It is therefore desirable to avoid the purchase of an annuity when interest rates are low if this is at all possible. One way of smoothing out interest rate risk is to purchase the annuities in stages over time.[948] Another is to avoid the purchase of retail annuities altogether and pay the pension from the fund using scheme drawdown. This is what CDC schemes would do.

An inflation rate of 3% p.a. will reduce purchasing power by 50% in 23 years which is the average length of retirement in the UK. Inflation risk is the risk faced by income streams that

[947] This negative relationship between interest rates and bond prices can be illustrated using the simple example of a perpetual bond paying £5 p.a. indefinitely. When market interest rates are 5%, the bond will be priced at £100. But if market interest rates fall to 2.5%, the bond's price will rise to £200.

[948] This strategy is sometimes called staggered vesting.

are not indexed to inflation. It is possible to fully hedge against inflation by purchasing an index-linked annuity. However, the initial payment on an index-linked annuity is only 60% of that on a level annuity.[949] With a 3% inflation rate, it would take 18 years for the payments on the index-linked annuity to equal those on the level annuity and 34 years before the total payments on the index-linked annuity to equal those on the level annuity. Only 5% of the annuities sold are index-linked annuities. Those who do not buy an index-linked annuity are exposed to the risk that inflation in future will be much higher than 3%. CDC schemes typically do not use index-linked annuities to provide inflation protection. Instead, they 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.[950] 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, i.e., does not run out of money before members die.

However, every member of a CDC scheme who retires will get the same pension as every other member who retires with the same average salary, irrespective of their health status and life expectancy. But is this fair to members who have poor health or below average life expectancy? Low-skilled workers on low final salaries tend to have lower life expectancies than high flyers on high final salaries. Final salary DB schemes therefore involve a significant cross subsidy from those on low salaries to those on high salaries. Average salary schemes – and CDC schemes target an average salary pension – are designed to reduce this cross subsidy, but they do not remove it altogether. In contrast, a large IDC scheme, by maintaining individual accounts, might be able to get a better deal for members in poor health or who have below average life expectancies, either by allowing such members to take enhanced withdrawals from the fund, arranging for them to buy enhanced annuities or letting them take a lump sum in extreme cases.[951]

---

[949] Personal Pension and Annuity Trends, *Moneyfacts Treasury Reports*, July 2014.

[950] Most people in Australia take their retirement pot as a lump sum. In July 2014, the interim report of the Australian government's Financial System Inquiry (FSI) found that a quarter of people with a superannuation balance at age 55 had depleted their balance by age 70 (reported in Jonathan Stapleton (2014) 'Will Brits follow the Aussies in blowing retirement cash?, Professional Pensions, 22 July). The FSI is discussed in depth in Chapter 3.

[951] Following the 2014 Budget changes, any member of a funded pension scheme can take a lump sum from 55, but this is not the intention of a CDC scheme which is to provide a lifetime pension.

### 6.4.3 Academic studies

Finally in this Section, we should note a number of academic studies which have shown the benefits of CDC schemes.[952] These studies use an overlapping generations model in which a number of generations of workers of different ages are members of a CDC scheme at the same time. The benefit (or welfare) from being a member of a CDC scheme is measured across all generations. The studies show that CDC schemes are potentially welfare improving compared with IDC schemes. This is because they smooth pensions over time and individuals do not know ex ante whether they will be a member of a lucky or unlucky generation, and so, if they are rational, they will agree to participate in the CDC scheme. Nevertheless, the CDC scheme involves substantial transfers between generations. One of the studies finds that it is optimal to transfer up to one third of any underfunding to future generations.[953]

## *6.5 International examples of collective schemes*

### 6.5.1 The Netherlands

The Netherlands is the home of the second-pillar workplace CDC scheme.[954] 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.[955] 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.[956] The main policy lever to keep the scheme solvent is conditional indexation. The scheme distinguishes between the real 'liability' and the nominal 'liability'. The real 'liability' ($L_R$) is the value of the accrued target

---

[952] Christian Gollier (2008) Intergenerational Risk Sharing and Risk Taking of a Pension Fund, *Journal of Public Economics*, 92(1), 1463-1485; Jiajia Cui, Frank de Jong, and Eduard Ponds (2011) Intergenerational Risk Sharing within Funded Pension Schemes, *Journal of Pension Economics and Finance*,10(1), 1-29; Dennis Bams, Peter Schotman, and Mukul Tyagi (2013) Optimal Risk Sharing in a Collective Defined Contribution Pension System, Maastricht University Discussion Paper, January. See also Samuel Sender (2012) *Shifting Towards Hybrid Pension Systems: A European Perspective*, EDHEC-Risk Institute, March. More generally, Ole Peters and Alexander Adamou (2015) The Evolutionary Advantage of Co-operation, arXiv:1506.03414v1, show that in a large number of biological and economic systems, the pooling and sharing of resources can reduce fluctuations and increase the returns for each co-operator (we are grateful to Dr Con Keating for pointing us to this reference).

[953] One has to question how many British workers would accept that?

[954] They started formally around 10 years ago, although it can be argued that the defined benefit schemes that preceded them, were in effect CDC schemes, since the benefits were, unlike their UK equivalents, not guaranteed, but instead were conditional on the performance of scheme investments and could be cut if necessary.

[955] Kevin Wesbroom, David Hardern, Matthew Arends and Andy Harding (2013) *The Case for Collective DC*, Aon Hewitt, November; Eduard Ponds and Bart van Riel (2009) Sharing Risk: The Netherlands New Approach to Pensions, *Journal of Pension Economics and Finance*, 8(1), 91-105.

[956] One has to question how many British workers would accept that?

pension payments when full indexation equal to the growth in average earnings is awarded: this is found by discounting the pension payments using the real government yield curve net of real wage growth. The nominal 'liability' ($L_N$) is the value of the accrued target pension payments with no indexation: this is found by discounting the pension payments using the nominal government yield curve.[957] The scheme is fully funded when assets equal real 'liabilities' ($A = L_R$). The difference between real and nominal 'liabilities' ($L_R - L_N$) is the required indexation reserve needed to cover the target indexation. The actual indexation reserve is the difference between the value of the assets and the nominal 'liabilities' ($A - L_N$). This might be positive or negative. When the actual indexation reserve is negative ($A < L_N$), there is no uprating of pensions and, in extreme cases, pensions might be cut. When the value of the assets lies between the nominal and real 'liabilities' ($L_N < A < L_R$), pensions will be uprated on a pro rata basis. When the value of the assets exceeds real 'liabilities' ($A > L_R$), pensions will be uprated fully in line with average earnings plus any catch-up arising from previous indexation shortfalls. Dutch schemes typically use a 10-year smoothing window, whereby any reduction in the pension paid is spread over a 10-year period.[958]

This adjustment mechanism has been described as a 'solidarity mechanism' by Frank Husken, managing partner at AF Advisors in the Netherlands who has written a report for the Dutch Government on CDC schemes. He argues that the way the 'solidarity mechanism' works – the way peaks and troughs in returns are smoothed out – must be made clear from the start. A failure to do this properly in the Netherlands has led young people to complain that they are subsidising older members of CDC schemes. Husken explains that 'Young people in universities are coming up with the research and the youth wings of political parties are using it to criticise CDCs. They are right. The measures taken to reduce payouts are too little too late, what is needed is for the solidarity mechanism to be set out in detail, in advance'. Husken points out two further problems with CDC in the Netherlands:

> *First of all there is a lack of transparency. In DB, an individual knows what pension he can expect, in DC, they know the value of the assets they are entitled to.*
>
> *In CDC neither of the two is the case. The pension a member will receive is directly related to how the investment proceeds are distributed over generations.*
>
> *Secondly, the financial crisis taught us that the distribution over generations is a difficult exercise.*
>
> *The investments suffered, which led to a debate in the Netherlands about how much loss on investments can be absorbed by intergenerational risk*

[957] A real funding ratio of 100% implies a nominal funding ratio of around 140%.

[958] Kees Bouwman of Cardano has shown that it is possible to replicate the outcome from a Dutch CDC scheme with 10-year return smoothing using a very specific investment lifecycle strategy in a IDC scheme: see Figure 6.1.

*sharing and how much of the loss should be absorbed by the current pensioners through lower pensions.*

*This debate became political and in some cases the appropriate measures were not taken.*

*In my opinion, the only way CDC and the corresponding intergenerational solidarity could work is by defining in advance how intergenerational solidarity works in practice.*[959]

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.[960] 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.[961]

Despite criticisms of CDC and increased support for CIDC in Holland, large numbers of Dutch people still trust the Dutch system of solidarity and collective risk sharing, according to Bernard Walshots, the chief investment officer of Rabobank's pension fund. Nevertheless, he predicted that the pension reform debate currently taking place in Holland would lead to

[959] Reported in Steve Tolley (2014), Going Dutch: Will Steve Webb's collective DC plans lead to better pension returns for savers?, Money Marketing, 4 June; http://www.moneymarketing.co.uk/news-and-analysis/pensions/going-dutch-will-steve-webbs-collective-dc-plans-lead-to-better-pension-returns-for-savers/2010866.article.

[960] Georgina Beechinor and Corine Hoekstra (2014), CDC Focus: Has CDC already had its day?, UK Plan Sponsor, 25 July; www.ukplansponsor.co.uk/OpinionsArticle.aspx?id=6442495532.

[961] The Dutch CIDC scheme is designed to fund an annuity at retirement.

a move away from collectivity.[962] This view is shared by Gijs van Dijk of the FNV union federation. He argues: 'FNV members are strongly in favour of a collective system. They also value risk-sharing. [In addition], costs are lower and you get better returns, and thus a better pension in the end for members. But there are limits to their sense of collectivity and solidarity. We heard from all sides that members want to be able to see how much money they have saved up. Pension funds have to plainly show them how much money is reserved for them in the pension pot'. Another topic that keeps coming up is having more say in the investment policy: 'Time and again, our members say that they want to know what's happening with their money'.[963]

### 6.5.2 Denmark

Denmark's ATP (Arbejdmarkedets Tillaegs Pension or Labour Market Supplementary Pension) scheme, which was established in 1964, can be interpreted as a CIDC scheme.[964] This is a mandatory funded first-pillar scheme[965] for all Danish employees serviced by a semi-official financial institution called ATP.[966] As a result of mandatory participation, operating costs are very low.

Contributions which are approximately 1% of salary (with one third paid by the employee and two-thirds paid by the employer) are divided into two parts: the guaranteed contribution (80% of the total contribution) and the bonus contribution (20%). The member receives an individual guaranteed nominal pension based on the guaranteed contribution (effectively a deferred nominal annuity).[967] The pension guarantees are fully hedged using long-dated derivatives such as interest-rate swaps. The bonus contribution goes into a collective reserve which is used to provide future indexation of both pensions in payment and accrued pension entitlements on a conditional basis if the funding ratio (total assets divided by guaranteed benefits) exceeds 120%. The collective reserve is invested in return-seeking assets. Given the long-term nature of the scheme, ATP can invest in long-term

---

[962] Reported in Jonathan Williams (2015) Dutch still support pensions solidarity despite criticism, Investments and Pensions Europe, 19 March.

[963] Reported in Netspar Magazine (2015) Pension system must change, but still be collective, Spring.

[964] Jan Bonenkamp, Lex Meijam, Eduard Ponds, and Ed Westerhout (2014) *Reinventing Intergenerational Risk Sharing*, Netspar Panel Paper 40, April (section 4.4).

[965] It is a first-pillar scheme (like the basic state pension scheme in the UK). The second-pillar schemes in Denmark are generally industry-wide IDC schemes.

[966] NOW: Pensions in the UK is a subsidiary of ATP.

[967] In August 2014, it was announced that the nominal deferred life annuity guarantee would be updated every 15 years. A 20-year old worker would have a deferred annuity rate that was guaranteed until age 35. At age 35, the worker would receive a new deferred annuity rate that was guaranteed until age 50. When the worker reached age 50, they would be told the actual level of the deferred annuity they would receive when they retired at age 65, using the yield curve and best-estimate longevity projections at the time. This is to allow for revisions to both inflation and longevity during the 15-year periods and also because it is easier to hedge 15-year return guarantees in the financial markets than 45-year guarantees.

illiquid assets offering higher expected returns, such as infrastructure. The collective reserve is invested on behalf of all scheme participants and individual members have no explicit property rights in respect of this fund.

### 6.5.3 Canada

The Canada Pension Plan (CPP) is partly funded and partly unfunded (pay-as-you-go, PAYG).[968] It is therefore a combination of a CDC scheme and a non-financial (or notional) DC scheme.[969] 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 a first-pillar scheme which was established in 1997 following a Canadian Government Actuary's report in 1995 showing that the current PAYG scheme would require a gradual increase in the contribution rate from 5.6% to 14.2% between 1995 and 2075 to keep it solvent in the face of rapid population ageing, where solvency is defined as having a ratio of total contributions received to total benefits paid of 100%. The Government responded by introducing CPP and increasing the contribution rate immediately to 9.9%. At this rate, contributions will exceed pension payouts until 2020. The surplus is invested in return-seeking assets with the aim of building up a partial fund to pay future pensions. The funding ratio is anticipated to reach 31% by 2075 at which time the ratio of contributions to benefits is projected to be 87%. The CPP is an example of intergenerational risk sharing as investment shocks can be smoothed out over a number of generations.

The CPP is also an example of what is known as either a 'pooled target-benefit (TB) pension plan'[970] or a 'shared-risk pension plan' (SRPP).[971] This has been characterised as follows:

> *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. We distinguish TB from other sustainable approaches, the key difference being that TB pension plan contributions are set first, at a fixed level, and benefits are derived from*

---

[968] Jan Bonenkamp, Lex Meijam, Eduard Ponds, and Ed Westerhout (2014) *Reinventing Intergenerational Risk Sharing*, Netspar Panel Paper 40, April (section 4.3).

[969] Robert Holzmann, Edward Palmer and David Robalino (2012) *Non-financial Defined Contribution Schemes in a Changing Pension World*, World Bank, Washington DC.

[970] Robert L. Brown and Tyler Meredith (2012) Pooled Target-Benefit Pension Plans, *IRPP Study*, No. 27, March; *Target Benefit Plans: The Future of Sustainable Retirement Programs*, Aon Hewitt Canada, June 2012; *Unpacking the Target Benefit Plan: Finding the Right Benefit/Funding Balance*, Aon Hewitt Canada, September 2012; *Delivering on the Target Benefit Plan: Governance and Risk Alignment*, Aon Hewitt Canada, December 2013.

[971] Pensions Policy Institute (2014) *Risk Sharing Pension Plans: The Canadian Experience*, Briefing Note 69, October.

*what can be afforded by that contribution level, with the ability to adjust benefits as experience develops.*[972]

Target benefits are separated into two types:

- Base benefits – typically based on a career-average formula
- Ancillary benefits – such as cost-of-living adjustments (COLA) and early retirement benefits.

A TB plan satisfies five principles:[973]

1. Overall economic risk (variance) must be shared in a manner that is appropriate to the participant (e.g., a worker should not be expected to be an investment expert or to understand life-course investing).
2. Size matters. Plans must endeavour to take full advantage of the significant opportunities and efficiencies that come with large scale.
3. Consistent with principles 1 and 2, there should be a collective approach to risk sharing. That is, the 'law of large numbers' should be used to statistically minimise risk (variance) whenever and wherever possible.
4. Fairness is critical for both employers and employees. In the transition from today's DB and DC pension landscape, whenever participants are expected to cede a right or privilege, plans should attempt to replace the lost attribute with new entitlements. Participants should not see a significant diminution of their future expectations.
5. Any new plan design should be cognisant of market realities and the costs experienced by members and employers. Cost minimisation is critical to extending pension coverage. Proposals that cannot accomplish these goals in a cost-efficient manner should not be considered.

A key feature of a TB plan is sustainability which is defined as 'one that can consistently deliver, through both favourable and adverse circumstances, an appropriate range of benefits within an acceptable range of costs over the long-term. A sustainable approach to providing pensions is based on a solid understanding by all stakeholders of the risk factors involved. This, in turn, would work toward the key objective to avoid severe corrections to both contributions and benefits'.[974] Some TB plans allow for risk sharing between the employer and employees, with an increase in contributions from both parties under some extreme circumstances.

A particularly interesting example of a TB or shared risk plan is that from the province of New Brunswick. This plan will be discussed in more detail in Section 6.6 below.

---

[972] Aon Hewitt Canada (2012, p.3) *Target Benefit Plans: The Future of Sustainable Retirement Programs*, June.
[973] Robert L. Brown and Tyler Meredith (op. cit., p.21).
[974] Aon Hewitt Canada (2012, p.3) *Target Benefit Plans: The Future of Sustainable Retirement Programs*, June.

### 6.5.4 USA

While not the most obvious country for promoting collective schemes, the Centre for American Progress based in the USA has designed SAFE (Secure, Accessible, Flexible, and Efficient) Retirement Plans.[975] These are hybrid schemes which combine features of a DB pension—including regular lifetime payments in retirement, professional management, and pooled investing—with features of a DC pension—predictable costs for employers and portability for workers. By operating on a large scale, the supporters of SAFE plans claim they are superior to individual DC schemes since they (a) eliminate inefficiencies in individual schemes, such as high charges and the failure of members to diversify their investments properly, and (b) share risks among workers and retirees.

SAFE plans are designed to work around the behavioural and other barriers that prevent individuals making optimal decisions about their pension scheme. The key issues covered are:

- Reluctance to start pension saving – employees have a set portion of their pay automatically deducted and contributed to the SAFE Retirement Plan they have chosen
- Reluctance to increase pension saving – this is overcome through auto-escalation, the automatic increase in the contribution rate over a number of years
- Changing jobs: the member stays in the same scheme when they change jobs, i.e., the scheme follows the member which avoids the issues associated with the pot following the member
- Costs: costs are lower than in individual schemes because they are spread across a large number of plan members
- Investment strategy – investments are managed by professional investment managers
- Risk of market losses – 'A SAFE Retirement Plan would reduce the risk of market losses by smoothing out the investment returns from years when returns are particularly high or low. This would be done by creating what is known as a 'collar', which would function as follows. In most years, participant accounts would be credited with market returns, but in particularly good or bad years, the full market return would not immediately be credited. Rather, years of higher returns would be saved away and returned over time in weaker-performing years'.[976] A new SAFE scheme would need to build up a reserve cushion before bonuses could be awarded

[975] Rowland Davis and David Madland (2013) *American Retirement Savings Could Be Much Better*, Centre for American Progress, August; http://cdn.americanprogress.org/wp-content/uploads/2013/08/SAFEreport.pdf.

[976] Rowland Davis and David Madland (op cit., p. 9). This is very similar to what happens in a with-profit scheme.

- Risk of outliving pension savings or annuitising when interest rates are low – 'A SAFE Retirement Plan would minimise these risks by providing an annuitised stream of payments that increases in value over time and cannot be outlived. The SAFE Retirement Plan does this by providing payments out of an annuity fund for retirees that is conservatively invested—primarily in bonds with some stocks to enable payments to keep up with inflation over time—and by spreading out the impact of years of very high and very low returns in a similar manner as is done during the accumulation phase' [977]
- Inflation: the annuity fund would provide cost-of-living increases.

In October 2015, the 300 Club released a report by David Villa, chief investment officer of the State of Wisconsin Investment Board, entitled *The Third Way: A Hybrid Model for Pensions*. The report argues that hybrid schemes can lead to much better governance and investment outcomes than either pure DC or pure DB. In such schemes, risk is shared equally between employer and employees.

The report's findings are based on the hybrid structure that has existed in Wisconsin for the past 30 years. A minimum level of benefit is guaranteed by the sponsor and any extra money in the pot at the point of retirement is split between the sponsor and employee, effectively aligning their interests. According to Mr Villa: 'The risk sharing aspects of this design have profound implications for the governance of the system. Interests are not aligned in DB or DC structures. In the hybrid structure, risk is shared and the alignment of interest that results, contributes to a virtuous cycle of governance'. The hybrid structure gives more stable incomes than DC, but is also superior to DB 'because it creates a more balanced governance structure less susceptible to large shocks that can destabilise the [DB] pension plan'.

The Wisconsin model works as follows. The beneficiary population is divided into two groups. The first group consists of the active employees and the second group consists of the retired employees.

The active employees will accumulate two account balances while they are working. One account balance is calculated using a formula that grants credit for each year of service – at Wisconsin the credit factor is 1.6%. The result is then multiplied by the average of the three highest years' earnings. This level of benefit is guaranteed by the employer once the member reaches retirement. The target return for the guaranteed benefit based on the combined employee and employer contribution is approximately equal to wage growth plus 4%. In order to compensate the employer for taking the risk of the formula benefit guarantee, part of any value created in excess of the guaranteed benefit can be retained by the employer. The second account balance is the employee's contributions compounded by

[977] Rowland Davis and David Madland (op cit., p. 11).

the actual performance of the trust. At retirement, the higher of the two account balances is annuitised at a discount rate of 5% and is established as the base benefit.

Each year, performance of the retiree pool is computed for the previous five years. If the pool earns more than 5% in the five-year period, the monthly benefits are increased. This creates an adjustment reserve that is added to the liability of the system. This reserve represents the growth of the liability above the original base benefit computed at retirement. If the performance of the retiree pool is less than 5%, the monthly benefits can be decreased by reducing the retiree pool adjustment reserve. However, the liability cannot be reduced below the base benefit that was calculated at retirement. Thus, the retirees receive a guaranteed base benefit determined by the 5% discount rate plus a contingent annuity adjustment based on performance above the 5% discount rate. The goal of the contingent annuity adjustment is to compensate for the erosion of the real value of the benefit caused by inflation.

Mr Villa claims that the hybrid scheme is attractive to employers because employees are willing to trade-off greater retirement income security for lower wages. According to a study by the Center for Retirement Research at Boston College, wages are 9.5% lower for state and local workers in the US, after controlling for education, demographic and other factors.[978] After modifications for pension contributions and additional health benefits, public-sector compensation including wages and benefits is about 4% less than that in the private sector. This implies that wages are 5.5% lower to adjust for the value of the pension benefit.

### 6.5.5 Sweden

The Swedish mandatory first-pillar collective non-financial (or notional) defined contribution (NDC) pension scheme was launched in 1999.[979] The contribution rate is 16% of earnings. There is also a mandatory first-pillar IDC scheme which has a contribution rates of 2.5% of earnings. The NDC scheme was introduced explicitly to deal with intergenerational inequities that were perceived to be present in the previous defined benefit system. In short, the scheme has explicitly removed intergenerational risk sharing. Instead, risks are shared within each cohort. The NDC scheme delivers what is called an 'income pension', while the IDC scheme delivers what is called a 'premium pension'.

During the accumulation phase, each scheme member in the NDC scheme has a 'notional' fund which grows with new contributions at a rate of return which equals the average wage growth rate in the economy plus an adjustment arising from an automatic balancing

[978] Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz and Laura Quinby (2011) *Comparing Compensation: State-Local versus Private Sector Workers*, Center for Retirement Research at Boston College, September.

[979] Edward Palmer (2000) The Swedish Pension Reform: Framework and Issues, *World Bank Pension Primer*, Washington D.C.

mechanism (ABM). Defining A/L as the ratio of assets to liabilities in the scheme, the adjustment will be negative if A/L < 1.00. It will be positive if, following a negative adjustment, A/L > 1.10 and this adjustment will be maintained until the system has returned to the same path of indexation that would have been followed had the negative adjustment not occurred. There is no positive adjustment in other circumstances, however, so, in principle, the system could build up a surplus that is never distributed.

In the NDC decumulation phase, the life annuity at retirement that each scheme member receives will equal the individual's accumulated account value divided by an annuity factor that depends on cohort life expectancy at retirement. The initial real growth rate in the annuity was set at 1.6% p.a., with this adjusted (upwards or downwards) to maintain system financial balance. The annuity can be claimed in part or whole from age 61. The worker does not need to leave the labour force to claim it and, as long as he or she continues to work, contributions will be paid on earnings. Also, there is no maximum age at which the pension must be drawn. The Swedish first-pillar scheme has a minimum pension called a 'guarantee pension', financed through general tax revenues, allowing an element of redistribution in favour of poorer retirees. Additional redistribution occurs through non-contributory rights, such as child care rights granted during the first four years after a child is born, also paid through external contributions from the general budget.

NDC schemes have a number of advantages:

- They are compulsory, so the scheme designer can choose and enforce the parameters of the system. For example, the designer can choose an appropriately high contribution rate, one intended to achieve a desirable replacement ratio in retirement. As another example, the designer can specify the minimum guaranteed pension level
- They involve risk sharing within each generation, thereby avoiding the intergenerational inequities of other systems – including the previous Swedish system – that pass deficits down to the next generation. Given demographic changes – increasing life expectancy and declining fertility – these deficit transfers were seen as unaffordable going forward
- They overcome the intragenerational inequities of DB pensions which leave companies bearing longevity risk and are unfair to early leavers – who experience portability losses when they change jobs – and to low flyers – who do not gain from the backloading of benefits in DB schemes
- In addition, the Swedish IDC scheme, which supplements the NDC scheme, with a free choice of investment portfolios from a set of registered funds, has the following characteristics. Its cost of operation is low. Economies of scale are maximised since the state (via the tax authorities) collects contributions and there is a central clearing

house (via the PPM, the Premium Pension Authority).[980] The long-run target charge of around 0.20 % of PPM assets – comprising around 0.04% for PPM overhead costs, 0.15% for fund management fees of FDC assets and 0.01% for contribution collection – is very low compared with typical IDC charges

- There is good access to information. The clearing house provides information on returns, costs, and risk measures for all funds (in the IDC component).

NDC schemes have a number of disadvantages:

- They require the whole country to participate. This, in turn, implies that a high degree of social solidarity is required to make these schemes work
- The assets are very poorly diversified internationally. In effect, the Swedish NDC scheme invests in a single stock called 'Sweden'. This means that Swedish pensions – in the NDC component at least – are wholly dependent on Swedish economic growth rates and Swedish demographic trends
- They cannot deal well with international labour mobility
- The pension assets are not portable in a way that the assets in IDC schemes are.
- The state is a monopoly supplier of services and products (e.g., annuities) and so the scheme is subject to political risk
- Because the annuity factor depends on cohort life expectancy at retirement, the NDC pension is unfair to people with impaired lives.

In short, a NDC pension scheme delivers PAYG pensions, but with a greater degree of built-in intergenerational fairness. The Swedish pension system probably has little to offer the UK except for the following three observations. First, it is possible to have high contribution rates – and hence adequate pensions in retirement – but probably only if the high contribution rates are mandatory. We should bear that in mind when the UK Government comes to review the 8% contribution rate for auto-enrolment in 2018. Second, it is possible to build intergenerational equity into national pension systems, but again probably only if they are mandatory. Third, the Swedish Government is the monopoly provider of annuities in Sweden – and does so without violating EU competition rules.

### 6.5.6 Australia

A number of large superannuation funds in Australia are considering moving to CDC.[981]

The A$17.5 billion Telstra Super fund sees this as a way of smoothing investment outcomes and, in particular, avoiding sequence-of-returns risk for its members. The catalyst is the Financial System Inquiry's recommendation to create the Comprehensive Income Product

[980] In 2011, the PPM became part of the Swedish Pension Agency which administers the entire public pension system.

[981] Reported in Amanda White (2015), Australian funds look to collective DC, Top1000funds.com, 26 June.

for Retirement. Chris Davies, chief executive, says: 'If you've got the core competency around defined benefit and you have a core of members who have been through defined benefit, then you have the culture, you have the ingredients to do something like a collective defined contribution arrangement'. Davis is also committed to offering a sophisticated level of advice, communication and products for its members. Another fund looking at CDC is UniSuper.

An interesting feature of the Australian system is that members tend to join a scheme when first employed and stay with it until they retire. This implies that the scheme follows the member when the member changes job, neatly avoiding the issues associated with the pot following the member.

### *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.[982] 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):

---

[982] Department for Work and Pensions (2013) *Reshaping Workplace Pensions for Future Generations: Public Consultation*, Cm 8710, November (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/255541/reshaping-workplace-pensions-for-future-generations.pdf); Department for Work and Pensions (2014) *Reshaping Workplace Pensions for Future Generations: Government Response to the Consultation*, CM 8883, June (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/322647/reshaping-workplace-pensions-for-future-generations-response.pdf).

- 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).

The PIB is the strategy used in the Danish ATP pension scheme. Part of each contribution into the scheme is used to buy a deferred annuity which is payable from retirement. The level of income secured depends on the level of interest rates at the time and so will fluctuate from year to year. The rest of the contribution is invested in growth assets which allows for the possibility of pension increases and also provides a buffer against increases in life expectancy. The fund accrued with these remaining contributions could be used for drawdown during the initial phase of retirement, thereby enhancing the income from the deferred annuities (once they start paying). Part of the fund could also be used to buy advanced life deferred annuities (ALDAs) which would add to the income in late retirement.

The PIB is an interesting strategy which fully integrates the accumulation and decumulation stages. It has the advantage of expressing the benefit in terms of a future income – which members are more likely to understand – rather than a pot size – which most members find very difficult to convert into an income equivalent. There are, however, some disadvantages. First, deferred annuities typically have a specific date on which they start to make payments. This suggests that individuals would need to have a fairly clear idea about the date on which they are planning to retire when they start to purchase deferred annuities in, say, their early 20s. Standard deferred annuities give little flexibility to change this date. A very large fund like ATP might be able to accommodate a certain amount of flexibility, but a small scheme might not be able to do this. Second, deferred annuities purchased through insurance companies can be expensive on account of regulatory capital requirements. This is because of the potentially large changes in life expectancy that might occur over the 40 or so years of accumulation. Again a pension scheme the size of APT might be able to offer these annuities internally, but if it does underestimate increases in life expectancy, the next generation of members will be cross-subsidising the retired generation.

### 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).[983] So in principle, there is support for some form of collective DC scheme amongst some of the UK's 'social partners'. Further, it is claimed[984] that there is a group of employers who might be interested in setting up CDC schemes and that is those employers planning to close down their defined benefits scheme and wish to offer their employees something more reliable than individual DC schemes (even if they cannot change accrued benefits).[985]

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

[983] The Association of British Insurers (ABI) has come out against CDC. It argues that the benefits are exaggerated and there are 'issues about intergenerational subsidy and transparency which could prove challenging in today's society' (reported in Pauline Skypala (2014) Dutch-style pensions for UK face tough credibility test, Financial Times, 10 June).

[984] See David Pitt-Watson and Hari Mann (2012) *Collective Pensions in the UK*, RSA, July

[985] The HM Treasury report *Freedom and Choice in Pensions: Government Response to the Consultation* (Cm 8901, July 2014, https://www.gov.uk/government/consultations/freedom-and-choice-in-pensions) would appear to offer a way around this. Companies could use an enhanced transfer value process to move workers out of a DB scheme into a CDC scheme and in the process reduce if not eliminate any scheme deficit.

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.[986] 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 the principles underlying a new pension model. Table 6.2 lists 10 principles around which a consensus might be built, with the three key principles being 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.

Different SRPPs were proposed with different benefit features. The performance of each plan was simulated using stochastic modelling under 1,000 different economic scenarios over a 20-year time horizon. The aim was to select the investment strategy and contribution rate needed to satisfy the stress tests set out in Table 6.3 and which met the taskforce's three key principles. 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 adjustment that needs 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 – see Table 6.3) 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 – see Table 6.3) 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

[986] Pensions Policy Institute (2014) *Risk Sharing Pension Plans: The Canadian Experience*, Briefing Note 69, October.

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.

*Table 6.2: Principles for the reformed New Brunswick Pension Plans*

1. Pension plans must be subject to robust risk management, and be checked annually, including stress tests, to ensure that the plan complies with that task.
2. A pension plan must provide benefit security. This means:
    - Risk management targets are focused on delivering a high degree of pension security for members and retirees; and
    - The Plan must be governed by an independent trustee(s) who can force employers and employees to increase (or decrease) contributions when appropriate, subject to realistic and manageable limits.
3. A pension plan should be able to demonstrate that it will be sustainable over the long term.
4. A pension plan must be affordable, which means that contributions must be stable and affordable for both employer and employees.
5. The Plan must be equitably designed – no single age cohort should unduly subsidise another, and no one should be able to 'game' the system.
6. The Plan must be transparent. The pension goals and risks must be clearly stated up-front; who shares the risks and rewards and by how much must be clear and pre-established.
7. Benefit changes as a result of conversion will apply only in the future; everyone keeps the amount that has already been credited.
8. There should be no sudden shocks to members and retirees' retirement plans.
9. All groups of employees should be treated consistently, including part-time employees.
10. At inception, the actuarial assumptions must be closely related to market benchmarks, such as International Accounting Standards 19.

Source: Chart 3 in 'Risk Sharing Pension Plans: The Canadian Experience', Briefing Note 69, Pensions Policy Institute, October 2014.

| *Table 6.3: Risk Management Requirements in the New Brunswick Shared Risk Pension Plan* |
|---|
| New Brunswick SRPPs are required to undergo annual stress testing using asset-liability modelling. At the outset of the plan, the contribution levels are set such that the plan can satisfy the legislated risk management requirements.<br><br>The specific requirements that must be met when the plan is first set up are that:<br><br>• there is a 97.5% certainty that base benefits will not be reduced over a 20-year period (the primary risk management goal); and<br>• there is a 75% certainty that certain ancillary benefits will be paid over a 20-year period (the secondary risk management goal). |
| Source: Chart 4 in 'Risk Sharing Pension Plans: The Canadian Experience', Briefing Note 69, Pensions Policy Institute, October 2014. |

A particular aspect of the New Brunswick legislation is that it allows for existing DB plans to be converted to SRPPs and existing DB benefits can be converted to 'base benefits' and it is even possible for accrued or vested 'base benefits' to be reduced. These possibilities have not been legislated for in the SRPPs of other Canadian provinces and are not currently permitted in the UK. It is also interesting to note that smaller employers have joined multi-employer SRPPs. Members can leave a SSRP by taking a 'termination value'. This is calculated as the larger of (a) the member's own contributions plus the scheme's investment return on these contributions and (b) the value of the member's accrued benefits multiplied by the funding level of the plan (similar to a cash equivalent transfer value from a DB scheme in the UK).

The New Brunswick SRPPs must have independent governance through a trustee board or a not-for-profit organisation. Typically, the trustee boards have equal numbers of employer and union representatives. They are responsible for establishing the investment and funding policies, the annual actuarial valuations and stochastic modelling, and administering the plan.

Given this international experience, how could collective schemes be introduced in the UK? David Pitt-Watson (2013, pp.13-14)[987] has recommended that the following areas are addressed if collective pensions are to be safely introduced:

> *The first concerns **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. We would therefore strongly recommend that:*

[987] David Pitt-Watson (2013, pp.13-14) *Collective Pensions in the UK II*, RSA, November.

*1. CDC pensions, like DB pensions should only be introduced under trustee management; that is where the governance of the fund owes loyalty only to its beneficiaries.*

*2. That the primary duty of the trustees is to represent the interest of the members. The trustee body should have amongst its members adequate expertise to manage the investment and benefit issues they will confront.*

*3. The trustees should make public their investment and benefit policy, and their proposed response to known risks. These should be made available to all beneficiaries.*

*4. There should be clear rules as to the decisions which can be made by the trustees and those which need the authorisation of the regulator.*

*The second area concerns the **management** of the enterprise. …[T]here need to be guidelines as to:*

*5. The appropriate investment policy and the charges a pension fund can make. These should not be onerous, but they should stop abuse.*

*6. The actuarial assumptions upon which payments are to be made; that these are not unduly optimistic or pessimistic.*

*7. Proper custody arrangements being in place.*

*8. 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.*

*9. 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.*

*10. It may also be sensible to suggest that any CDC pension plan has an adequate number of members to make it worthwhile. The fundamental question here is whether the pension fund is able to generate scale and thus exploit economies of scale, as well as to share risk effectively.*

*The third area is how this can be made **attractive 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. One reason that employers are unwilling to sponsor pension schemes is that they feel in the past to have been victims of "legislation-creep", with the law forcing them into ever greater responsibilities. Therefore the legislation should:*

*11. Clarify that this is a defined contribution framework and that the sponsor will not be responsible for any liability beyond their annual*

*contribution to the plan and therefore no liability under Section 75 of the Pensions Act 1995.*

*12. A 'Henry VIII' protection would act as a safety valve. That would be a protection which ensured that should any liabilities be imposed through changing legislation to the employer, they would have the ability to revert out of the scheme.*

*The further consideration is to try and trigger the development of a pension system which has* ***other positive characteristics****, such as low costs, easy pension transfers and so on. To achieve this, we might suggest that:*

*13. All CDC plans should be licensed on the basis of their having an appropriate cost structure and adequate flexibility.*

*14. NEST be allowed to offer collective pensions.*

*15. Various social partners (NAPF, CBI, TUC, perhaps even the RSA or others) be asked to establish one or more fiduciary bodies which can be entrepreneurs for the establishment of multiemployer collective pensions.*

*Finally, a regulatory body, possibly part of the Pension Regulator, should be charged with overseeing the new CDC regime, and licensing those undertakings which provide collective pensions.*

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 were sufficient appetite amongst scheme members.

### *6.7 Feedback from our interviews and responses to the consultation paper*

#### 6.7.1 Feedback from our interviews

While a number of the risks listed in Table 1.2 can be most effectively hedged by pooling and sharing them, suggesting that there are potential benefits from looking at collective solutions, there appears to be very little appetite amongst employers for exploring this option at the present time. This is likely to be due to a combination of reform exhaustion and the previously made point about employers losing interest in occupational pension provision per se. According to our interviews with employers' representatives, employers are 'absolutely not interested' in CDC. They also said that everything the Government has done recently – in particular the 2014 Budget – works against the collective principles of CDC.

By contrast, there was general support for some form of collective scheme from trade unions:

- ‘CDC can be more efficient than individual DC’
- ‘Many arguments against CDC are about the role of the trades unions. CDC is essentially saying there needs to be trust-based schemes with good governance. The advantage of CDC is about risk sharing and longevity pooling’.
- ‘You need capital to set it up’.
- ‘NEST required capital to get going’.

### 6.7.2 Responses to the consultation paper

We summarise the responses to Questions 47-75 in the consultation paper here.

47. *What should ‘collective’ mean in the UK context (e.g., collective in terms of scale and governance, and collective in terms of risk-sharing)?*

The vast majority of responses suggested that risk sharing of some form or another was the defining feature of a collective DC scheme. However, there was disagreement about which groups should be pooling risk.

48. *What are the main benefits of CDC schemes over individual DC schemes?*

There were a variety of responses and there was no dominant view on the main benefits of collective versus individual DC schemes. Twenty-one per cent of responses either did not think that collective DC schemes were better than individual DC schemes or did not think that they could work. Among those responses that were more positive, economies of scale were mentioned by 26 per cent of responses and risk sharing by another 26 per cent. On the investment side, it was mentioned that CDC – in contrast to an individual DC scheme – had the ability to invest in a wider range of illiquid long-term investments to obtain a liquidity premium as well as the ability to avoid the separation between the accumulation and decumulation phases.

49. *What are the main disadvantages of CDC schemes over individual DC schemes?*

Sixty-four per cent of respondents thought that the main disadvantage of CDC over individual DC schemes was how to share risks between individual savers, particularly in a contracting CDC scheme. Some thought that this made the long-term sustainability of CDC doubtful. Many raised the issue of explaining risk sharing to members who might struggle to understand it, especially the notion that the actual pension might be lower than the target pension. Twenty-nine per cent pointed to the reduced flexibility for members compared to individual DC.

50. *CDC schemes may be able to generate incomes that are higher than individual DC schemes as the latter are currently operated. (a) Are there reasons why an individual DC scheme could not follow the same investment or decumulation strategy as a CDC scheme? (b) Would trustees of an individual CDC scheme be willing to accommodate the greater*

*investment risk, given the need to enable members to transfer out and to take their pension pot with them?*

Half of the respondents thought that CDC could out-perform individual DC, due to economies of scale, risk sharing (within or between) generations – enabling investment in higher-risk, higher-return assets – and the avoidance of a de-risking glidepath which moves towards less risky products as a member approaches retirement. However, 30 per cent of respondents thought that CDC could not generate higher returns than individual DC and that the claims that they could were misleading. In terms of trustee attitudes, most respondents thought that trustees would be unwilling to take on greater investment risk due to the issues of transfers out of the scheme (such transfers were seen as problematic).

51. *(a) Would a CDC scheme have any additional risk-sharing advantages over a large master trust DC scheme which followed the same investment and decumulation strategies where possible? (b) Can the benefits from any additional sources of risk sharing available to CDC schemes be quantified?*

Forty per cent of responses thought that CDC would not have any additional risk sharing advantages over a large master trust DC scheme, although other responses noted that the two types of scheme would follow different investment strategies. The small number of respondents who answered the second part of the question about quantifying the additional benefits thought that it was possible to do so through appropriate modelling.

52. *(a) What is your preferred design for a CDC scheme, in terms of targeted benefits?* (e.g., a CDC scheme that is intended to replace a DB scheme and hence would be earnings-related (specify accrual rate, earnings measure, pre-retirement indexation rule, post-*retirement indexation rule); or a CDC scheme that is intended to replace an individual DC scheme and hence would be with-profit and a target return, unit-linked and a target return, etc.). (b) Explain why.*

There was considerable variety in the responses about the appropriate design of a CDC scheme and many respondents were agnostic or unsure themselves, suggesting that there is no consensus view on the target benefits. The most common response (by forty-four per cent of respondents) was that there should be some form of a target pension (essentially a DB-minus view of pensions). The main differences between the proposals were the differences in the acceptable degree of risk sharing across generations. Some said there should be little inter-generational risk sharing, with one suggesting that it would be easier to have inter-generational risk sharing if some of the contributions were explicitly from the employer. One response suggested that the DB-minus view of pensions was closer to what DB pensions used to look like before protections were added. Nevertheless, two respondents preferred DC-plus on the grounds that it was cheaper than DB-minus and hence likely to be more widely provided.

53. *(a) What is the best estimate contribution rate to achieve the target benefit? (b) How should the contribution rate be shared between employer and member?*

Respondents did not provide numerical figures on the best estimate of the contribution rate because of the variety of factors needed to be taken into account. A number of respondents noted that the higher the share of the contribution from the employer the greater the scope for inter-generational risk sharing.

54. *(a) Can a CDC scheme work with a planned contribution rate that is fixed independent of a member's age or is an age-dependent member contribution rate required? (b) If the latter, is a change to equality legislation required?*

Most respondents suggested that either the contribution rate or the target benefit had to be fixed but not both. However, it was recognised that, while it was possible to fix both, this would involve cross-generational subsidies, which really required (possibly variable) contributions from employers to be feasible. In the case where a scheme wishes to operate with age-related contributions, one respondent said that there should be an express exemption from equality legislation.

55. *What investment strategy would be appropriate for CDC schemes: (a) in accumulation and (b) near retirement and (c) in decumulation?*

Respondents suggested that the investment strategy would not be constrained by its liabilities, but would probably look like a DB scheme without costly asset-liability management – consistent with the target pension view of what CDC was trying to achieve – although the optimal strategy would depend on the composition of scheme membership.

56. *What are the main benefits of a CDC scheme in terms of intra-generational risk pooling?*

Respondents suggested that the main intra-generational benefit of a CDC scheme would be sharing of longevity risk within the pool. One response made the caveat that transfers in or out should be medically underwritten to preserve the risk sharing.

57. *What are the main benefits of a CDC scheme in terms of inter-generational risk sharing?*

Most respondents suggested that the main inter-generational benefit of a CDC scheme would be smoothing of investment returns. One respondent also suggested that this risk pooling increased the ability to invest in higher-risk assets and obtain a higher expected return. Only one respondent referred explicitly to inflation risk and longevity risk.

58. *(a) Over how many generations should risk be shared? (b) Explain why this is optimal.*

There were relatively few responses to the issue of how many generations should share the risk in a CDC scheme, but, of those who did respond, there were widely divergent answers, ranging from risk-sharing between all generations (including those not even in the workforce) to risk sharing over a 10-year period (as in the Netherlands).

59. *How should the risk-sharing rules in a CDC scheme be defined?*

All respondents suggested that the most important issue was that the risk-sharing rules be clear and transparent.

60. *How much discretion should a CDC scheme's managers have when it comes to smoothing or adjusting benefits to target benefits, or should the rules be fully transparent?*

With a relatively small number of responses to this question, there was an almost equal split between respondents arguing for CDC scheme managers having no discretion to them having very wide discretion. One respondent thought that there would always be need for discretion, while another respondent suggested that the rules should be set by the regulator.

61. *(a) If the actual pension is above the target pension, when should adjustments be made? (b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?*

62. *(a) If the actual pension is below the target pension, when should adjustments be made? (b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?*

Among the relatively small number of responses to Questions 61 and 62, most thought that adjustments should be made annually and they agreed that adjustments should be made first to indexation and second to the level of the pension. One respondent was explicit in saying that contributions and investment strategies should not be altered.

63. *What mechanisms are needed to ensure that no CDC scheme becomes insolvent? For example, a CDC scheme might try to use a high target return to attract more customers.*

Forty-three per cent of respondents noted that CDC schemes could not technically be insolvent, but that they could over-promise (and hence under-deliver) to their members. Mechanisms needed to be put in place to deal with this and suggestions included actuarial reviews, regulation, transparent rules and good trusteeship.

64. *Is it necessary for a CDC scheme to start with or build up a reserve fund to give it credibility?*

Seventy-eight per cent of respondents thought that there was no need for a reserve fund, while the rest said that there was such a need. However, many responses thought that a reserve fund might be helpful, especially initially, to cover set-up costs and provide scale and credibility.

65. *CDC schemes in other countries (e.g., Holland) have virtually no flexibility with respect to member choice (e.g. contribution rate, investment strategy, retirement date, form of decumulation (i.e., pension). Do the freedoms and flexibilities introduced by the 2014 Budget render CDC schemes unfeasible or more risky in the UK? Explain why not or, alternatively, how freedom and flexibility would need to be tailored in the context of CDC schemes?*

Responses were fairly equally divided on whether member choice was compatible with CDC schemes, some believing it was possible if not desirable, while most thought that too much flexibility would make it hard to run a CDC scheme, or that such flexibility was inappropriate and not really wanted anyway (since pensioners who wanted more flexibility had other options).

66. *One of the biggest growth areas prior to the 2014 Budget was the medical underwriting of annuities and the growth of enhanced annuities. But in a standard CDC scheme, everyone gets the same pension irrespective of health status. (a) Would it be feasible in a CDC scheme to medically underwrite the pension in retirement? (b) Would it be desirable to do this?*

Sixty-three per cent of responses suggested that medical underwriting of the pension in retirement was feasible for a CDC scheme, although some noted that such underwriting was not really feasible before the age of 50.

67. *How should a CDC scheme best be organised: (a) on a company-wide basis, (b) an industry-wide basis, or (c) a nation-wide basis?*

Seventy-one per cent of responses thought that a CDC scheme could be operated on any of the three bases suggested, while a minority thought that it should be done on the largest scale possible.

68. *What is the minimum number of members in a CDC scheme to make it viable? Explain this figure.*

There was no consensus answer to this question. The small number of responses gave widely differing views on the minimum number of members in a CDC scheme, ranging from forty (one per generation) to 10,000.

69. *Effective regulation, governance and quality standards will be crucial, given the absence of member property rights (which apply in standard DC schemes) and also the absence of a sponsoring employer that guarantees benefits (which applies in DB). (a) What*

*regulation is required to protect members' benefits? (b) What governance mechanisms and quality standards are needed in CDC schemes, especially to ensure inter-generational equity?*

No clear conclusion emerged from the varied responses to the first part of the question concerning what regulation is needed to protect members' benefits: 38 per cent noted that CDCs did create property rights (which might be based on contributions or with actuarially set surrender values), some stressed that all member types (pensioners, actives, deferreds) should be treated equally, while some said that regulation should be under trust law resulting in strong trustees. The vast majority of responses to part (b) agreed that valuation should be on a best-valuation basis for CDC schemes to ensure inter-generational equity.

70. *Could CDC schemes operate both on a trust basis and a contract basis? Explain.*

Eighty-six per cent of responses preferred a trust-based scheme, although many thought that either a trust or contract basis would be possible.

71. *Could a 'for profit' organisation run a CDC scheme? Explain.*

Responses were divided as to whether or not a CDC scheme could be run 'for profit': 43 per cent said "yes" so long as it was appropriately capitalised, 28 per cent thought a trust-based scheme would be better than a 'for profit' scheme, and one response was unambiguous that 'for profit' CDC schemes would be inappropriate.

72. *What communication strategy would be appropriate for CDC schemes (a) in accumulation and (b) near retirement and (c) in decumulation?*

Eighty per cent of responses thought the appropriate communication strategy for a CDC scheme would be an annual report.

73. *What measures should the Government take to make CDC attractive to: (a) potential sponsors, and (b) potential members?*

The small number of responses emphasised that sponsors need appropriate regulation. Government involvement via NEST might also help things get started.

74. *How should transfer values be treated in CDC schemes, both in and out?*

Most respondents suggested that transfers in or out of CDC schemes had to be for bona fide reasons to avoid gaming.

75. *Is it possible for a CDC scheme to work within a charge cap of 0.75%?*

All respondents thought that a 0.75 per cent charge cap was feasible, although not all thought that it was necessarily desirable.

### *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.[988]

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.[989] 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

[988] Colin Richardson (2014), *Collective DC 2016 Proposal – Is it an effective tool to pool longevity risk?,* PTL, June; ptluk.com/files/2014/06/BLOG-Collective-DC-2016-proposal-@-02-June-2014.pdf.

[989] As NOW: Pensions is doing.

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'.[990]

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'.[991]

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:[992]

> *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*

[990] Reported in Taha Lokhandwala (2015) Defined ambition not just an 'academic exercise' – Steve Webb, Investments & Pensions Europe, 8 June.

[991] Reported in Louise Farrand (2015) David Willetts: 'Pure DC ends up with too much risk being borne by the individual', Pensions Insight, 16 March.

[992] NEST (2015) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June; https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement,pdf.pdf

*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.*[993]

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.[994] 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'.[995] Similarly, Nigel Waterson, the former Tory shadow Pensions Minister, hoped the new minister will resist the temptation of trying to do too

[993] Tim Sharp (2015) Collective DC is far from dead, Pensions Insight, 2 July. We would argue that the NEST blueprint is more akin to a CIDC scheme than a CDC scheme, but is no less good for that and, indeed, has a more realistic chance of being implemented in the current climate.

[994] http://www.publications.parliament.uk/pa/cm201415/cmselect/cmworpen/668/668.pdf

[995] Fidelity Worldwide Investment (2015) *A Ten-Point Plan for the New Pensions Minister*, May.

much: 'That means leaving on the back burner ideas like collective defined contribution and defined ambition'.[996]

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'.[997]

### 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.

[996] Nigel Waterson (2015), A time for consolidation – why Altmann must avoid 'initiative-itis', Professional Pensions, 27 May.

[997] Reported in Helen Morrissey (2015) Altmann: CDC is not abolished, Professional Pensions, 16 October

**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

*Humpty Dumpty sat on a wall,*
*Humpty Dumpty had a great fall.*
*All the king's horses and all the king's men*
*Couldn't put Humpty together again.*

Lewis Carroll (1871) *Through the Looking-Glass, and What Alice Found There*

*'Oh, I've had such a curious dream!', said Alice*

Lewis Carroll (1865) Alice's Adventures in Wonderland

The key lesson from our research and discussions is that we need a national narrative on pensions if we are going to build a consensus around retirement income provision. The alternative is to live in a Tower of Babel with any sensible messages drowned out by a cacophony of mixed and often contradictory signals that will just confuse the majority of pension scheme members in the retirement phase of their lives. The dream of a comfortable retirement could easily turn into a nightmare. We identify five key factors that need to make an appropriate contribution if the objective of a national consensus is to be achieved: the pensions industry itself, national media, the regulatory system, the political system, and the pension tax system (and the implications this has for the level of pension savings built up prior to retirement). We make a number of recommendations that will help support the objective.

### *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 a case for fixing them.

The simplest fix would have been to reduce the minimum income requirement (MIR) from £20,000 to a lower figure, such as £14,000.[998] This would have allowed many more people

[998] As a comparison, the full single tier state pension coming into effect from April 2016 will be around £8,000 (£155.65 per week). In a written statement to the House of Lords on 22 July 2015, the Pensions Minister, Ros Altmann, disclosed that only 37% of people would receive the full amount of new state pension in 2016.

to have greater flexibility over their retirement spending, while still ensuring they did not run out of money before they die. In two reports written in 2010, the Pensions Institute recommended a MIR of £14,000 (£280 per week) as being the level needed to keep people from claiming any means-tested benefits.[999] These reports were said to have influenced Treasury policy, although the Treasury decided to set a much higher 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'.[1000] 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. It involves not only pension assets, but also non-pension assets and decisions have to be made about inheritance, taxation and long term care, etc. If mistakes are made and the assets are invested unwisely or spent too quickly, retired people do not generally have the option to re-enter the labour market to earn some more money in the way that younger people do. Further, these decisions might have to be made in the presence of reduced mental capacity, as is the case with someone with dementia, for example.

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.

Further, there is a real danger that people forget they face a lifetime budget constraint on what they can do. There seems to be a whole range of people who have not saved enough for their retirement, but still expect that their pension pot can be used to pay off pre-

---

[999] David Blake, Edmund Cannon and Ian Tonks (2010) *Ending Compulsory Annuitisation: What are the Consequences?*, Pensions Institute, July (www.pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences.pdf);
David Blake, Edmund Cannon and Ian Tonks (2010) *Ending Compulsory Annuitisation: Quantifying the Consequences*, Pensions Institute, September (www.pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences2.pdf)

[1000] For example, Allister Heath (2015) Business Comment, Daily Telegraph, 18 April.

retirement debts, dip into whenever they like, deliver a life-long income, and also make bequests to their descendants. It just doesn't add up, as many will find out in due course.

This brings us to the issue of consumer vulnerability. This 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. They also face 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 – and these risks are in addition to the importance of recognising that the pension pot cannot be spent twice. 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. If not, we will end up living in a Tower of Babel, with no signal and just a lot of noise, with a different narrative for each retiree. This cannot possibly be in the best interests of most retirees, especially the most vulnerable, since it will almost inevitably lead to poor outcomes and high charges. Anyone who seriously objects to this either believes in an unrealistic model of human behaviour or is pursuing a vested interest. We know that a national narrative works in other countries, e.g., Holland, where there is an accepted national narrative based on social solidarity between social partners. We also know that it can also happen in the UK, if only temporarily, as in the case of the consensus built around the Pensions Commission's reports in 2004-05.

So what can be done to help establish a national narrative and build a consensus around retirement income provision? Each of the following need to make an appropriate contribution:

- The pensions industry
- The national media
- The regulatory system
- The political system
- The pension tax system and the level of pension savings.

### *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. All are important for delivering the best products and services for pension savers in the new world of 'freedom and choice'. 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 – who are fighting a turf war over the control of

pension assets in decumulation – and between providers and advisers – who are fighting a turf war over access to clients. Yet all these parties are needed to provide appropriate, effective and good-valued retirement income solutions.

Well-designed retirement income solutions have both an investment component – to provide stable inflation-adjusted returns and flexibility over withdrawals – and an insurance component – to provide a longevity hedge. But the products sold by investment managers do not have a longevity hedge and the products sold by insurers, while offering the necessary longevity protection, have low returns and little flexibility. But at present, there is no clear agreement on what an optimal retirement income solution might look like. There is no effective collaboration between investment managers and insurers in designing products that can be combined to provide solutions that offer both spending flexibility and protection against inflation and longevity risk.[1001] Similarly, there is no agreement on what a reasonable charge for this solution should be. We are just told that market forces will sort this out.

Further, parts of the industry, especially the insurance industry, have not in the past treated their customers fairly, as they are supposed to do. We were told by an industry insider that 'the insurance industry has a lot to answer for' and cited a 2008 Financial Services Authority study which reported an example of a company that said that the ABI code was a threat to its business model since it wanted to maximise internal annuity sales – rather than have its customers use the open market option – and gave bonuses to sales staff for doing so. The insider also went on to say 'if people make mistakes, this actually profits the industry, so what incentive does the industry have to stop this?' Clearly, this type of attitude by key players in an industry with many vulnerable consumers is not acceptable. Customers are told that they will be treated fairly and industry business practices must be consistent with this.

There is also a lot of thinly disguised hostility between providers and advisers concerning the appropriate level of advice for different market segments, how it should be delivered, the appropriate pricing model for advice in the different segments, and even about who should give that advice. Providers want to be able to give advice to scheme members. While this is allowed under US regulations and welcomed by US employers, it is frowned upon in the UK by advisers and regulators as not being 'independent'. In turn, advisers who are in the process of rebranding themselves as wealth managers believe that they can advise on and put in place retirement income and inheritance solutions for their clients without involving providers.

These divisions have been long standing and are, in part, the result of normal competitive pressures, compounded by the fact that most pension savers are disengaged from the

[1001] The NEST blueprint discussed in Chapter 5 is a notable exception.

pension saving process, do not understand the risks that they face, and are generally not skilled enough to exercise their sovereign rights as consumers to demand that producers and advisers provide them with the best designed and the best valued products and services.

On top of this, we need to recognise that professional services firms are prone to over-service their clients to build up fee and those operating in financial services are no different. There are some in the financial services industry who believe that there should be a tailor-made plan for every retiree. But, as we discussed in Chapter 3, this is an example of the 'interior decorator fallacy', namely the idea that retirement income strategies should be designed to reflect attitudes to, say, risk in the same way that interior decorators attempt to reflect the personal taste of their clients. [1002] For all but the most affluent, such a tailor-made plan would be far too expensive. We accept that one size doesn't fit all, but then neither does a bespoke plan with annual reviews for someone with a £50,000 pension pot when the charge is 0.75% p.a. Something much more simple and focused is required. If anyone is thinking of questioning this, they should remind themselves that the new single-tier pension has a capitalised value of around £200,000 and no one appears to be setting up shop to advise pensioners how to spend their state pension.

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 their customers, 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, 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.

---

[1002] See Peter Bernstein (1992*) Capital Ideas*, Free Press, New York.

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, meet minimum design standards in terms of efficacy, and deliver clear 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).

Some industry practitioners are aware of the consequences of the industry getting it wrong. For example, Phil Loney, chief executive of Royal London, has said: 'George Osborne's pension reforms have the potential to become famous for helping people to improve their retirement incomes, but without plentiful and affordable financial advice they risk becoming an infamous example of political bungling. The reforms have been introduced too quickly and the population had so far failed to understand what it means for them. I fear that many will make the wrong, often irrecoverable decisions about their retirement and this will result in some very poor outcomes. The simple fact is that many people, perhaps most, have not engaged with pension freedom and lack the basic financial knowledge to take the next steps'.[1003]

### *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-

[1003] Reported in Jenna Towler (2015) Pensions freedom risks becoming 'infamous example of political bungling' – Royal London, Professional Adviser, 12 February.

term approach which is generally prevalent in financial services press and among advisers and providers'.[1004]

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 conseqences 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-priviledged 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 (TPR) regulates trust-based schemes and the Financial Conduct Authority (FCA) 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 individual customer protection as its focus. TPR is concerned more about giving guidance to trustees and employers at the level of the scheme'. See Table 7.1 for more details of the differences.

*Table 7.1: Respective Strengths of the contract and trust-based regimes*

| Activity | Contract-based regime (FCA) | Trust-based regime (TPR) |
|---|---|---|
| Rigour of regulatory regime | Requirement to meet threshold conditions to conduct regulated activities. Ongoing monitoring including:<br>• Supervision<br>• Thematic reviews | It relies on trustees and other professionals to report any breaches and to comply with their statutory whistleblowing duties. |

[1004] Quoted in Aileen Lynch (2015) Handle with care: Dealing with insistent clients safely, Retirement Planner, 18 November.

| | | |
|---|---|---|
| Communication with members | Requirement for communications that reflect where individuals are on the retirement journey.<br><br>Prescriptive around the information provided to members – in some cases, this may make it more difficult for organisations to present information in the most useful way (e.g., if they are required to provide information that will not be used by the member). | Schemes able to tailor their communications to their members.<br><br>Communications may be designed at the level of the scheme membership and may not reflect an individual's position on their retirement journey. |
| Compatibility with workplace pensions | Employees do not typically have a choice of pension scheme, this is down to the employer | |
| | FCA's requirement to promote consumer choice of their pension provider is not as relevant under automatic enrolment where it is the employer who chooses the pension scheme.<br><br>This suggests that some of the information, such as the provision of information to help members make choices) provided, may not be used and that this may distract members from other important information. | Schemes have the leeway to provide information relevant to the members' situation – that can reflect the fact that the employer chooses pension schemes under automatic enrolment. |
| Activity | Contract-based regime (FCA) | Trust based regime (TPR) |
| Cost (including monetary costs and time) of managing pension schemes | Compliance entails a higher volume of work and cost than required by the trust-based regime.<br><br>Pension providers must receive authorisation for certain activities. | Compliance requires lower volume of work – for example, lower levels of contact with the regulator.<br><br>Trustees have the freedom to make decisions if they judge these to be beneficial to members. |
| Source: Melissa Echalier and Sarah Luheshi (2015, Table A) *Comparison of the Regulatory Frameworks for DC Pensions*, Pensions Policy Institute, October. | | |

Problems that have been identified with the current system include the following:[1005]

- TPR and the FCA constantly need to consult one another on a range of activities. According to Malcolm McLean, senior consultant at Barnett Waddingham: 'This is not only inefficient it is positively dangerous…With both auto-enrolment and the pensions freedom at critical stages of development, it makes no sense to proceed as we are. …A single regulator would be less confusing for consumers, would help to plug gaps in the current arrangements and provide greater consistency of treatment between trust-based and contract-based schemes…[It would also] provide a clear focus for direct action and early intervention where necessary'[1006]
- The two regulators are regulating very similar products for very similar consumers, but there are different protections for both. One example is the different approaches to retirement risk warnings.[1007] In January 2015, the FCA said that providers of contract-based DC schemes should issue tailored risk warnings that depended on an individual's circumstances assessed via a list of 11 questions to ensure consumers make well-informed decisions. By contrast, TPR encourages trustees to provide only generic risk warnings to scheme members and to direct them to Pension Wise
- Another example relates to a confusion in the proposed rules on transferring from DB to DC schemes when there are benefits with guaranteed annuity rates (GARs). The FCA states that a GAR turns a money purchase scheme into a safeguarded benefit, which means members with a GAR will need to take advice if they want to transfer. However, TPR defines a GAR as a money purchase benefit until it is taken, which means there should be no requirement for trustees to ensure advice is taken.
- There is also potential confusion when it comes to compensation. On the surface, everything appears to be clear-cut. The Financial Services Compensation Scheme covers 100% of the value of an annuity in the event that the insurance company providing the annuity defaults, £75,000 of the value of bank deposits, and £50,000 of the value of retirement and investment savings. But this compensation applies to individuals not to schemes and also depends on whether the FSCS treats the pension pot as an investment or a long-term insurance arrangement:

---

[1005] Some of these come from our interview panels.

[1006] Reported in Jenna Towler (2015) MPs push for single pensions regulator to protect post-freedom retirees, Professional Adviser, 10 March.

[1007] 'While both regulators have identified similar types of risk, their approaches are different with TPR focusing on enablement and education. It is also less prescriptive than the FCA in terms of its guidance, particularly around communication to pension savers. In contrast, the FCA is more pro-active in monitoring pension schemes' activities. This difference reflects the fact that it is the trustees who are responsible for playing a supervisory role in the trust-based regime' (Melissa Echalier and Sarah Luheshi (2015) *Comparison of the Regulatory Frameworks for DC Pensions*, Pensions Policy Institute, October).

- For example, if a trust-based scheme invests via an insurance company, there are cases where it will not be covered by the FSCS. To illustrate from Standard Life's *Trust-based Pension Plan Key Features* document: 'Your plan is classed as a long-term contract of insurance. The trustees will be eligible for compensation under the FSCS if Standard Life Assurance Ltd (SLAL) becomes unable to meet its claims and the cover is 100% of the value of their claim. If your plan is invested in one of our funds that invests in a mutual fund run by another firm (including Standard Life Investments Ltd), the trustees are not eligible for any compensation under the FSCS if that firm is unable to meet its claims. SLAL is not able to make a claim on the trustees behalf, so the price of a unit in our fund will depend on the amount we recover from the firm. If your plan is invested in one of our funds that invests in a fund run by another insurer, the trustees are not eligible for any compensation under the FSCS if that insurer is unable to meet its claims. SLAL is not able to make a claim on the trustees behalf'.[1008]
- Similarly, with a self-invested personal pension scheme. A SIPP comes under the FCA because it is contract-based, but if it is not set up as a life office wrapped product, the FSCS treats it as a pure investment which has a lower level of compensation.

- While it is very unlikely that a UK life office will become insolvent, the same cannot be said of the plethora of small master trusts that have emerged following the introduction of auto-enrolment. The entry and capital adequacy requirements for master trusts have been described to us as 'derisory'.[1009] While compensation for trust-based schemes comes under The Pensions Regulator and its compensation scheme, the Pension Protection Fund (which also runs another compensation scheme for cases of fraud, the Fraud Compensation Fund),[1010] this has not yet been seriously tested in the new world of auto-enrolment. NEST has its own separate regulations which again do not necessarily give full protection to members: 'Because NEST has been set up as a trust, our members are the owners of all the assets we hold on their behalf. If anything goes wrong their retirement pots remain their property. Member funds are not fully covered by the Financial Services Compensation Scheme. However, we invest some of our member's assets in contracts of insurance which are covered by the FSCS in certain circumstances'.[1011]

[1008] http://library.standardlife.com/tbp17.pdf
[1009] http://www.ft.com/cms/s/0/a0eabc40-732c-11e5-bdb1-e6e4767162cc.html#axzz40EwqWETE
[1010] https://www.gov.uk/workplace-pensions/protection-for-your-pension
[1011] http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/selecting-a-good-quality-pension-scheme,PDF.pdf

- Rajiv Jaitly states: [1012]

> *'..[I]t can be argued that multiple regulators weaken their regulatory reach. They are weakened because differences in objectives, functions and powers of enforcement between them create loopholes. The need for liaison between them creates bureaucracy and delay. These weaknesses create the potential for regulatory arbitrage. For example, three regulators police DC pension schemes and the financial services firms that provide investment funds for them: the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), and the Pensions Regulator (TPR). Each regulator has different powers in terms of intervention and fines. In particular, while the FCA and TPR share the role of regulating DC pensions, the former appears to have much wider powers than the latter. Despite the memorandum of understanding (MoU) between the FCA and TPR in relation to DC pensions, this asymmetry in power might tempt providers of automatic enrolment pension schemes to 'choose' what they perceive as a 'regulation light' 'trust' structure regulated by TPR rather than the FCA. Furthermore, the level of fines the regulators can impose – even by the FCA – might not be considered punitive by firms. With regulators having to abide by principles of proportionality, fines may be treated as no more than 'the cost of doing business.*
>
> *Retail investors who wish to challenge a firm's behaviour face a confusing process because the three regulators do not normally deal with consumer complaints. Complaints about firms regulated by the FCA are directed to the Financial Ombudsman Service (FOS), while those about pension schemes regulated by TPR go to the Pensions Ombudsman. There is also a grey area of overlap between them, for example in the case of transfers of members' money from defined benefit (DB) schemes to DC arrangements. The jurisdiction of compensation schemes such as the Financial Services Compensation Scheme (FSCS) and the Fraud Compensation Scheme (FCS) is also confusing.*
>
> *It may of course be possible to challenge an investment management contract through the courts, but the options are limited due to the way contracts are structured and shortcomings in the legislation on unfair contract terms.*

[1012] Rajiv Jaitly (2014) Collective Investment Schemes - Costs and Charges - Implications For Consumers - A Report For The Financial Services Consumer Panel; https://Www.Fs-Cp.Org.Uk/Sites/Default/Files/Investment_Jaitly_Final_Report_Full_Report.Pdf

The following is a sample of the comments of those we interviewed:

- 'The contract based-regime prioritises shareholder interests over savers' interests, whereas the trust-based regime gives absolute priority to savers. The FCA's regulatory duties are structured so that any attempt to move away from relying on information and competition only to remedy market failures would be crippled by judicial review, so it repeatedly fails to do anything useful in the pension space. The FCA is captured by the industry in a way TPR is not. The FCA does not want to do anything, whereas TPR culturally would like to in intervene if it was given more powers'.
- 'The failings at the FCA were exposed on 17 December 2014 at the Work and Pensions Select Committee where they unwisely said "you cannot stop fools acting like fools". The committee said this was an abdication of responsibility. The FCA are supposed to enforce TCF [treating customers fairly], but their own analysis showed that they were not doing this, e.g., they were aware that bonuses in insurance companies were linked to increases in internal annuity sales. The FCA finally listened on 17 December and rushed in the "second line of defence" [now called "additional protection"]. This move followed calls by a range of consumer organisations and providers including [our company], as noted in the Work and Pension Select Committee report'.
- 'The FCA is sometimes too prescriptive and sometimes not bold enough, e.g., it was forced by industry to bring in the emergency "second line of defence"'.
- 'The FCA needs to give providers more leeway'.
- 'TPR is all at sea and well behind the curve'.
- 'There is inconsistent and conflicting decision making at the EU level, e.g., between the European Parliament, the European Commission and EIOPA'.

According to Darren Philp, head of policy and market engagement at The People's Pension: 'We need to have more joined up policymaking to ensure no matter what pension scheme you're saving in, you get the appropriate level of protections and avoid confusing messages and a confusing regulatory landscape'.[1013] A similar view is held by Stephen Lowe, director at Just Retirement: 'Many retirees have a combination of trust-based occupational and personal pension plans, so the rules needed to straddle both regimes in order to ensure clarity and consistency. It's in the interests of the consumers, the regulators and the industry that we avoid the problems caused by trying to operate a two-tier system'.[1014]

---

[1013] Reported in Luisa Porritt (2015) Trustee briefing - Retirement risk warnings, Engaged Investor, 2 April.

[1014] Reported in Natasha Browne (2015) Government drops mandatory advice for small DB transfers, Professional Pensions, 27 January.

Martin Wheatley, then chief executive of the FCA, said he could 'sympathise' with the industry's frustration over the twin regulatory regime. He accepted that 'There are two sets of decision-makers putting out slightly different views. We are clear it must be tailored without being advice. TPR hasn't given that kind of precision'. He agreed that it was important to have 'reasonably common standard delivery' and argued for the same definition of guidance to protect people from receiving mixed messages. He also said that moving to a single regulator was a decision for policy makers.[1015]

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?

The idea of a single regulator is supported by the Work and Pensions Select Committee in its report *Progress with Automatic Enrolment and Pension Reforms* published in March 2015.[1016] The report said that the potential increased risk to pension savers from mis-selling and fraud following the introduction of the new pension flexibilities from April 2015 strengthens the case for combining the regulators.

Dame Anne Begg MP, Chair of the Work and Pensions Committee at the time, said:

> *The new pension flexibilities give savers the freedom to use their money in the way they choose and have the potential to make retirement saving really attractive. But savers need to be properly protected from being ripped off in frauds or scams, or suffering financial loss from making the wrong decision about how to use their pension pots. The pensions industry has not always done enough in the past to help savers make the right decisions.*
>
> *What savers really need is a strong, single regulator to act in their interests. We are not convinced that the FCA is sufficiently focused on pensions. The comment made in evidence to us that it can't 'stop fools*

[1015] Reported in Natasha Browne (2015) FCA 'sympathises' with frustration over twin pensions regulation, Professional Pensions, 12 March.

[1016] Fourth Report from the Work and Pensions Committee: *Progress with Automatic Enrolment and Pension Reforms,* HC 668;
http://www.publications.parliament.uk/pa/cm201415/cmselect/cmworpen/668/668.pdf

> *acting like fools' does not inspire confidence in the FCA's willingness to be proactive in protecting savers. The Government is coming round to our way of thinking about the need for a single regulator. We believe that the big shift to the new pension flexibilities in April means that it is now time to make this change, which we originally recommended back in 2013.*

The report said a single regulator would have a clear focus on the entire retirement saving process: 'Savers would have clarity on who was responsible for providing guidance and redress, and employers and the pensions industry would have a single body to advise and supervise them'.

Nevertheless, combining the regulators would not be straightforward as pointed out by Melissa Echalier and Sarah Luheshi (2015), due to, e.g., the volume of contract, tax, trust and pension law needing to be changed to accommodate a move to a single regulator; and it is not clear where a single regulator should sit – whether this would be in the Department for Work and Pensions or Her Majesty's Treasury.[1017]

### *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?

---

[1017] Melissa Echalier and Sarah Luheshi (2015) *Comparison of the Regulatory Frameworks for DC Pensions*, Pensions Policy Institute, October.

One way of achieving a national narrative as well as dealing with the myopia of the political business cycle 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 relating to pensions, long-term care 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.[1018] Since no generation can, during its working life, store for its retirement the goods and services it will consume in retirement, each generation depends on the next generation to provide those goods and services in a way that is not widely recognised. Models for how the PCSC might operate are the Low Pay Commission (LPC), the Office for Budget Responsibility (OBR), the Monetary Policy Committee (MPC), and the Committee on Climate Change (CCC).[1019] The PCSC would report directly to Parliament.

There is widespread support for such a commission and we consider some examples.

The Work and Pensions Select Committee report *Progress with Automatic Enrolment and Pension Reforms* cited earlier also called for an independent pension commission to build public confidence and long-term stability in the system.[1020] The commission would look at the following issues:

- 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 report 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

---

[1018] In January 2016, the Work and Pensions Select Committee launched an inquiry into 'inter-generational fairness' over concerns that the state pension and welfare system is unfairly favouring pensioners at the expense of younger workers (http://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/inquiries/parliament-2015/intergenerational-fairness-15-16/).

[1019] https://www.theccc.org.uk/about/. For a risk assessment report which includes a chapter on Ethics by Lord Rees (pp 134-136), see http://www.csap.cam.ac.uk/projects/climate-change-risk-assessment/

[1020] Fourth Report from the Work and Pensions Committee*: Progress with Automatic Enrolment and Pension Reforms,* HC 668; http://www.publications.parliament.uk/pa/cm201415/cmselect/cmworpen/668/668.pdf

- 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 AE to smaller employers, the level of minimum contributions for employers and employees, and how currently excluded groups, such as the self-employed and those in multiple low-paid jobs, can be brought into pension saving more effectively.

Dame Anne Begg MP said:

> *The scale and pace of recent changes in pensions policy have completely changed the retirement saving landscape. It is necessary to draw breath and review the extent of the changes and their implications.*
>
> *A new independent pension commission would be able to identify any emerging risks, and explore with stakeholders how these can best be addressed. The Turner Commission brought political consensus, full involvement of stakeholders, and detailed consideration of the wider impacts of major pensions policy changes. The successful introduction of auto-enrolment is a product of this. The current reforms have not always benefited from the same careful approach. A new commission is now needed to provide coherence in pensions policy and to build public confidence and long-term stability in the system.*

Also in March 2015, the Association of Consulting Actuaries (ACA) released a seven-point *Retirement Income Manifesto.*[1021] The ACA wants the Government to establish a long-term consensus by setting up and taking regular advice from a new standing Independent Retirement Income Commission. This would be charged with 'promoting the active extension and betterment of private retirement income provision and making recommendations on the future of state and public sector retirement provision'.

The ACA proposed the following remit for the Independent Retirement Income Commission:

- 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)

[1021] www.aca.org.uk/files/ACA_issues_Retirement_Income_manifesto-12_March_2015-20150312125512.pdf

- 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 (within 6 months) 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.

In June 2015, David Fairs, Chairman of the ACA, renewed the association's call for an Independent Commission which 'would help support joined-up decision making and we hope the new Pensions Minister, Baroness Altmann, and the new Economic Secretary, Harriett Baldwin MP, might persuade their colleagues that such a step would improve the long-term success of these fundamental pension reforms'.[1022]

In a report published in April 2015 called *The Case for an Independent Retirement Savings Commission*, the National Association of Pension Funds (NAPF), the Association of British Insurers (ABI) and the Trades Union Congress (TUC) call for an independent retirement savings commission.[1023] The NAPF sponsored a national survey[1024] which showed that 'an

[1022] ACA says pressures on pension system underscores need for an independent commission and tax pause, press release, 11 June 2015.

[1023] NAPF, ABI, and TUC jointly call for an Independent Retirement Savings Commission, NAPF press release, 30 April 2015.

overwhelming majority of people (84%) agreed that an independent commission should be set up by a future Government and a similar proportion said it should be politically neutral (85%), impartial in its recommendations to Government (85%), and should focus not just on pensions, but include the wider range of issues that affect both when people retire and the kind of retirement they have (87%). Eight in ten (83%) were in favour of a permanent commission – one that would last more than one parliamentary term, would endure through future political cycles and provide independent, expert advice to all future UK Governments, regardless of their political make-up'.

Joanne Segars, chief executive of the NAPF, said: 'Today's report shows the breadth and depth of support that exists for creating an independent retirement savings commission. A new standing commission will help make sure the long-term interests of savers, not the short-term interests of politicians, are at the heart of pensions policy. That matters because someone starting work today will see eight or nine General Elections before they start to draw their pension – eight or nine potential swings of the pensions policy pendulum which will do little to build saver confidence. This support for a standing commission stretches well beyond the people who work in pensions to the everyday savers who will rely on their pensions for a decent income in retirement. The idea of such a commission is not a new one but it has yet to become a reality – our report shows there is growing chorus for that to change, and soon'.

She continued: 'We need to go back to first principles and agree a collective vision for what a good retirement savings system looks like for the long-term'. She also argued that the success of the original Pensions Commission, chaired by Lord Turner, built on:

- A shared understanding of the problem, namely that voluntarism meant too few people saving enough for old age
- A shared building of the policy solution – and a collective vision of what needed to change.
- A shared responsibility for the delivery and success of that solution – not just that the delivery of automatic enrolment should be shared between private sector and Government, but more importantly the shared acknowledgement that automatic enrolment could not fail.

She ended by saying that: 'The Commission's process of decision making – thoughtful, evidence-based and inclusive – laid the foundations for a consensus which has delivered one of the most far-reaching public policy interventions in recent decades across any part of

---

[1024] Populus surveyed 1,015 adults aged over 18 in the UK online between 31 March and 2 April 2015. Data were weighted to be demographically representative of all adults in the UK.

Government. It is now unthinkable that any Government of any colour (or colours) would undo automatic enrolment, or that the social partners or industry would peel away from its core tenets. It is a part of the pensions landscape that is here to stay'.

Further support comes from:

- The International Longevity Centre – UK which published a report in February 2015 called *Consensus Revisited* in which it called for a pension commission 'divorced from the trappings of Government' to rebuild consensus-based policy making in pensions and, in particular, deal with the challenge of inadequate incomes in retirement. The commission would concentrate on three issues:
    - Defining target outcomes for retirement savings and extending working lives
    - Monitor progress against these targets
    - Consult on its findings and decide if there needs to be a policy update.
- The Savings and Investments Policy Project, managed by the Tax Incentivised Savings Association (TISA), published a report called *Our Financial Future* in March 2015, which recommended that the Government create a 'savings minister' with the responsibility for promoting savings initiatives, consumer guidance and financial education.
- Age UK has also called for an independent retirement savings commission was needed. Jane Vass, head of public policy, said: 'There is debate over the exact form it should take, but it needs to be independent and it needs to look at pensions in the round – including state pensions, private saving and retirement income'.[1025]
- Pensions Age's Unchaining Pensions from Politics (UPP) campaign. Supporters of the campaign 'wanted the commission to recommend long-term policies as a "road-map" to future pension development, taking into account the country's demographics and the needs of different generations. It should also establish what a "good" target outcome is for retirement saving and therefore provide savers with confidence. The commission should scrutinise and suggest proposals to change legislation. Suggestions were also made to expand its role and provide greater clarity of the interaction between retirement and health care needs, along with promoting flexible retirement and flexible working to manage the transitions from work to non-work/less work'. Jackie Wells, NAPF head of policy and research, said: 'The commission would be a purely advisory body, not a policy-making vehicle, and would make recommendations to Government based on independent, collaborative analysis of the best available evidence, which the Government would be free to reject. Ultimately, the aim of the commission would be to help future Governments

[1025] Reported in Stephanie Baxter (2015) Independent pensions commission demanded by July, Professional Adviser, 10 March.

ensure that policy decisions have the needs of savers – including their constituents'.[1026]

- Respondents to the Consultation Paper:
  - There was strong support from 82% of respondents for a permanent pensions commission in some form or another. Only 9% were opposed to a pensions commission.
- All the groups that we interviewed:
  - Providers and investment managers. While it is accepted that ministers must make final choices, especially if taxation is involved, all proposals should have been developed and examined in a measured and structured way. Examples of poor decisions that need to be avoided in future include: (a) the 2014 Budget, (b) the introduction of a charge cap half way through the auto-enrolment process, and (c) the political parties salami slicing the existing tax system (e.g., the Labour Party's proposals in the 2015 General Election to transfer resources to lowering student fees). There are some important issues that the Pensions Commission could deal with:
    - The current fragmentation of decision making in Government with HM Treasury (in relation to tax), the DWP and the Health Department all having a say.
  - Trade unions:
    - 'With some of the changes of the last few years, it would have been very helpful to have an independent commission opining on it. There is merit in ensuring it is statutory, as well as having a definite remit and an independence of its own'.
    - 'Charges, contributions rates, the statutory retirement age. What is a sensible draw down rate? There could be quite a few things it could do. Look at what are the right contribution levels. Everyone knows they should be higher'.
    - 'It could look at predicted long-term investment growth. It could provide a recommended amount of drawdown. You have got life expectancies and investment growth from a portfolio. You could say the recommended amount you can take out is £X. The problem with

[1026] Reported in Laura Blows (2015) Industry concerned politicians would 'sabotage' an independent pensions commission, Pensions Age, 28 April. See also Laura Blows (2015) Open letters sent to DWP and Treasury calling for independent pensions commission, Pensions Age, 2 June. The letters were signed by: Mike Allen, Director of Pensions, LPFA; Laura Blows, Editor, Pensions Age; Emma Douglas, Head of DC Distribution, LGIM; Dame Karen Dunnell, Chair, Longevity Science Panel (Legal & General); David Fairs, Chairman, ACA; Ammo Kambo, Charted Financial Planner; Kevin LeGrand, Head of Pensions Policy, Buck Consultants at Xerox; Ronnie Morgan, Strategic Market Insight Manager, Royal London; Darren Philp; Alan Pickering, Chairman, BESTrustees; Carolyn Saunders, Head of Pensions, Pinsent Masons; Rachel Vahey, Independent Consultant; and Jackie Wells, Head of Policy and Research, NAPF.

drawdown is the impact of the first five or six years is a big determinant of future years'.

- However, the model proposed for the Pensions Commission in the consultation paper – along the lines of the MPC – was not welcomed:
    - 'I do not think the MPC would be a very good model. You could have a Pensions Commission that makes big public recommendations to Government and hard for them to ignore. The Low Pay Commission (LPC) might be a better analogy. Also the social partnership basis on which it is based. For example, hearing evidence in public. It is very evidence-based. It is hard for the Government not to accept an LPC recommendation'.
    - 'For the LPC, the Government sets the remit. The remit of the LPC has been shaped by different political complexions of Government, but it has retained stability while being sensitive to the changing political environment'.
    - 'It is difficult for the minimum wage to go up without recourse to the LPC. They would not want to do that because of precedent. With pensions, there is the question of what the commission would look at. For LPC, it is quite tightly defined wage rates'.

Dr Yvonne Braun, director of long-term savings at the ABI, believes that one of the key responsibilities of the PCSC would be to consider intergenerational equity. Writing in *Retirement 2050: Identifying the Challenges of a Changing World*, published by the ABI in February 2015, she said (p. 29):'The long-term nature of pensions and retirement income mean that policy-making should take a long-term view as much as possible, with policies lasting beyond a single Parliament. An independent body (an 'Office for Intergenerational Responsibility' or a 'Retirement Commission') could have an important part to play in informing the policy debate and shaping a national long-term savings strategy, so the implications of the ageing society are assessed holistically, rather than by individual departments'.[1027]

This theme was taken up by Michael Johnson, research fellow at the Centre for Policy Studies, in briefing note published in June 2015 entitled *The Case for an Office for Inter-generational Responsibility*.[1028] He argues:

---

1027 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Pensions/Retirement%202050%20Identifying%20the%20challenges%20of%20a%20changing%20world.pdf

1028

*The UK's debt mountain, combined with the risk of an anaemic long-term rate of economic growth, poses a serious threat to Generation Y's future economic wellbeing.*[1029] *This, a generation already faced with unaffordable housing, college debts, fragmented careers, earnings stagnation, relatively thin occupational pension provision, and a rapidly retreating state pension age.*

*An Office for Inter-generational Responsibility (OIR) should be established to co-ordinate the production of Inter-generational Impact Assessments and to scrutinise all tax reliefs and exemptions. It could reside alongside (or within) the Office for Budget Responsibility (OBR), and could fruitfully liaise with the (now expanding) Office of Tax Simplification.*

*An OIR should exude an ethos of fiduciary duty towards current and future taxpayers, and aspire to having a reputation for independence akin to that of the OBR. If it were to achieve this, it would help close what is currently a significant accountability gap between Parliament and the people (particularly future taxpayers). In addition, all tax reliefs and exemptions could be subject to a five year sunset clause, after which they would cease. Lobbyists would be required to present their cases directly to the proposed OIR, placing blue water between vested interest groups and ministers.*

Politicians were less keen on having a PCSC. While recognising the problems that the commission would be trying to address, politicians said it was the responsibility of Government to deal with these. Steve Webb, when still Pensions Minister, called for the creation of a Department for Pensions and Ageing Society at a Resolution Foundation event in February 2015. This would bring together care, the ageing society and long-term savings in one department. He said:

*Your pension outcome depends on every aspect of your life. It depends on your life expectancy, on what sort of education you've had, what your career path is, what sort of firm you work for, whether you're single, or married, or divorced. It depends on everything. So everything affects pensions. And that's what makes it so unendingly fascinating to me … that to get pensions policy right, you can't just think about pensions. You've got to think broadly. But what do we do in Government? I'm going to invent a word here … siloise. We don't see people, we see policies. Combining care, the ageing society and long-term saving in one place could solve the problem, with joint ministers bridging the gaps. Think about your needs in retirement. We focus on income needs but what about care needs, and*

---

http://www.cps.org.uk/files/factsheets/original/150616121816-ThecaseforanOfficeforIntergenerationalResponsibility.pdf?utm_source=Michael+Johnson+contacts&utm_campaign=bbea3fa3f8-pensionsminister&utm_medium=email&utm_term=0_d781b4fd08-bbea3fa3f8-303590773

[1029] Generation Y: those born between c.1980 and 2000, i.e. aged between 15 and 35 in 2015, also referred to as 'millennials'. They are preceded by Generation X (early 1960's to 1979 births).

*what about the overlap between the two? Because presumably you need resources in retirement to live off and you need resources in retirement to meet your care needs, potentially. Do we have an integrated financial product for care and for pensions yet? Not in a meaningful way. Why not? Partly because we siloise.*

Many industry practitioners agree that a more joined up approach to pensions and long-term care is a good idea. For example, Darren Philp said: 'What we are seeing more and more is a lack of a joined up strategy when it comes to pensions policy and more widely. You have got a number of Government departments which are responsible for various aspects – the Treasury, the DWP, other bodies like HMRC, the FCA, the PRA, TPR, and it's all in a bit of a muddle. I think that, while it's quite good to have some healthy tension between different departments with different objectives, what we're seeing is policies that directly contradict each other and things not pulling in the same direction. To take one example, a lot of work was done on collective DC and defined ambition. The next minute, they open the whole retirement freedom market with the Budget reforms. The two don't really go hand in hand. Collectivisation and individualism are two very distinct things. For me, we need a long-term strategy that joins this up'.

Similarly, Malcolm McLean said: 'I understand Webb's frustration….I also understand what he means about working in silos. You speak to someone in the department and find out that they deal with one thing, but not with something else. I had an occasion to speak to the DWP about the state pension and had to speak to one person about the statements and the forecasts, somebody else about the qualifying conditions, somebody else about the new schemes'.

However, neither Mr Philp nor Mr McLean agree that overhauling governmental and regulatory structure is the best way to achieve more clarity and consistency. Philp says: 'The important thing is that when it comes to manifestoes and developing policies, they're done within a coherent framework and on the basis of evidence. That's one of the reasons why we've said that it would be good to have an independent pensions body, like an OFPEN, the Office of Pensions Responsibility, that analyses the evidence and holds the Government to account against its stated objectives'.

McLean argues that Webb's suggestion is impractical: 'To achieve what he wants, you would have to have one department covering the entire operation of Government, which is just not practical … The bigger the department, the more it subdivides down. Over the years, I think people have recognised the overlap that pensions have with a whole raft of other things. Social care is coming into focus now as something that should be linked into it. But I don't think you'll ever get to a situation where you'll be able to say we have everything

confined into one department. It might be an aspiration, driven by some frustration about some of his experiences, but I don't think it's practical to cover everything'.[1030]

Nigel Waterson, the former shadow Pensions Minister, while accepting that 'some long termism in pensions and savings policy is what is needed, and the stability that only a broad political consensus can deliver', appears to be doubtful that a pensions commission is needed: 'Contribution levels must increase; auto-escalation must also be in the frame. All the current talk about decumulation is pretty academic if we don't get up contribution levels. We don't need a pensions commission to tell us this!'[1031]

Lord David Willetts, the pension expert and former MP, also believes politicians will be reluctant to surrender control of certain aspects of pension policy, but was more supportive of the idea of a pensions commission having some role:

> *I've looked at this from time to time and the fact is that the Treasury is never going to relinquish the lead on tax decisions, so then the only option becomes [delegating pensions policy to the Treasury] and that would be a very peculiar arrangement. So I personally think that a Treasury and DWP shared responsibility is the best that we can hope for, given the nature of the pensions issue.*
>
> *I remember the original Turner commission on pensions and I thought that part of his effectiveness came from the way it assembled a large amount of data that hadn't been properly brought together before. I think there is a case for a long-term commission to provide material evidence so that you've got a solid, analytical base, especially as it is shared across at least two Government departments.*
>
> *However, looking back now on my political career over 20 years, every area that I've worked in, the elite wisdom has been "Take the politicians out of it, hand it over to a commission". Voters actually expect when they vote to be changing the Government, they don't vote for power to be continuously in the hands of a group of arm's-length commissioners. I don't think that somehow decisions won't be taken by elected politicians – that's what a democracy is.*[1032]

We support the idea of having a standing Pensions, Care and Savings Commission. Such a commission could be justified on any number of grounds as discussed above. But perhaps the simplest justification would be to help avoid in future the kind of problems that have

---

[1030] Reported in Louise Farrand (2015) Webb: End pensions silos and create a bigger department, Engaged Investor, 12 February.

[1031] Nigel Waterson (2015) A time for consolidation – why Altmann must avoid 'initiative-itis', Professional Pensions, 27 May.

[1032] Quoted in Louise Farrand (2015) David Willetts: 'Pure DC ends up with too much risk being borne by the individual', Pensions Insight, 16 March.

emerged with the introduction of 'freedom and choice' without any consultation with industry, as raised in our interview panels:

- 'The Pension Commission had an evidence basis for its policy recommendation – auto-enrolment – namely, the success AE as a nudge in the US to increase DC savings. There was no evidence basis for "freedom and choice"'
- 'Even supporters of these proposals could not deny that they failed the test of having an impact and risk assessment. Further, they are a clear example of short-term political populism at the expense of long-term stability'.
- 'Failure by Government to put in place both success criteria – in particular, a definition of 'what good outcomes are' – and methods of measuring and monitoring outcomes in response to the new flexibilities, resulting in a complete data vacuum'
- 'Coupling of flexibility and choice which disregards any understanding about how real people choose'
- 'Lack of member engagement – a disconnect between auto-enrolment at the front end and "freedom and choice" at the back end. Engagement is not necessary for AE – it is critical for "freedom and choice" to work'
- 'Whoever does it, it is crucial to have information and discussions with employees in the workplace to engage them. A workplace visit is the holy grail but is not commercially viable in small companies. But smart electronic communications can replace face-to-face meetings. Communication, information, education, simplified advice are all needed for engagement. Pension Wise does not deliver this'
- 'Adequate financial education not in place for Flexiday; for example, most people are incapable of converting a lump sum into an income equivalent, believing that £50,000 is a 'large' lump sum, when it is only one third of the value of the new single-tier state pension of £8,000 p.a.'
- 'Failure to put guided pathways with defaults in place for Flexiday'
- 'No clarity on charge structures, unlike auto-enrolment'
- 'Insufficient protection in place for consumers who are at risk of mis-selling or 'rip off' charges'
- 'Failure to understand that safeguards only work if people are engaged and understand the risks'
- 'Failure to recognise the likelihood of scams – criminals can now directly target individuals who can readily be fooled (even if they are also generally smart). The Insurance Fraud Taskforce has noticed that the criminals involved with trips & slips, whiplash and the claim management companies (dealing with PPI) have moved to pension liberation. You don't actually have to be a criminal, just someone who recommends an unsuitable investment. Fraud might actually fall, because it is legal to promote high risk investments. But people will face cliff edge outcomes – either the investment performs very well, or you lose everything. The worst case would be to lose the entire pot and then have to pay tax on this'

- ‘No impact assessment on additional state spending if people spend all their money’
- ‘Failure to deal with the overarching need to encourage more saving’
- ‘Failure to recognise the consequences of “freedom and choice” for employers and their retirement management policy’
- ‘Failure to recognise the long-term consequences for occupational pension provision of the reduction in tax breaks – it reduces the incentive for employers to set up a pension scheme. Directors can no longer see a benefit in setting up a pension scheme, since they do not benefit as much as in the past. Lower income people just want the pot and not a pension. A whole range of people with higher incomes are likely to find themselves with considerably poorer pension arrangements than the baby boom generation’
- ‘Failure to recognise the complete lack of engagement by small employers’
- ‘Pensions are now just a savings product, so why not outsource the whole lot?’

In short, there is no longer a coherent national narrative about what pensions are for, just a lot of noise around a series of short-term policy initiatives. This prompted the following remarks from our interviewees:

- ‘What are we trying to achieve with pensions – there is no narrative?’
- ‘People want access to cash – more than ever now. Why? Because there are no well-established social/cultural norms about what to do at retirement’
- ‘We need a consensus – to get people to understand that pensions are there to provide an income and people still need an income in retirement. The worst thing would be for the lump sum to become the norm’
- ‘We are a long way from establishing good social norms and cultures in decumulation’
- ‘There is a complete lack of legislative and regulatory clarity’
- ‘Trustees are reluctant to help members – far too risky. Trustees are concerned about getting involved due to the regulatory vacuum. They can’t do the right thing in case they get sued. They can’t offer scheme drawdown without employer approval – which they won’t get’
- ‘What will IGCs do to encourage engagement and participation?’
- ‘Why would anyone bring a product to market at the present time? The reforms were horribly rushed – regulated providers will bring more products online in time, but the pension industry was not set up to deliver such freedoms, so the danger is that people will go elsewhere. This is the biggest short term danger’
- ‘There is no clear differentiation between regulated and unregulated businesses. In recent years, regulated businesses have improved capital adequacy, professionalism and reporting, so there is now a growing gap with unregulated businesses’
- ‘What is tax relief trying to achieve?’

The pension reforms that followed the 2014 Budget would not be the first example of what Anthony King and Ivor Crewe called 'cultural disconnect' in their recent book *The Blunders of Our Governments*.[1033] By this they meant a set of assumptions that look obvious to well-educated, middle-class politicians and officials but which collapse when tested in the real world. Perhaps the most famous example of cultural disconnect is the poll tax. King and Crewe argue that: 'The man in Whitehall not only did not know best; he did not know that he did not know that which he badly needed to know'. Since all the men in Whitehall paid their taxes, they assumed that everyone would too. The warning cry from a junior official 'Try collecting it in Brixton' went unheeded. The minister subsequently brought in to clear up the mess said: 'It needed exceptionally clever people to produce anything so stupid'.[1034]

The people who conceived the 'freedom and choice' regime appear to have very little understanding of longevity risk. We were told at the time that the only piece of information that people need to be aware of is their life expectancy. Yet around 50% of 65-year olds will live beyond their life expectancy, often by many years.

A new type of commission is needed to reduce the risk of anything like this happening again.

### *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.

#### 7.6.1 The original system of pension taxation[1035]

The system of pension taxation in the UK used to be fairly straightforward. It was based on the exempt-exempt,-taxed (EET) framework:[1036]

- Exempt – the pension contributions by individuals and employers receive tax relief and employer contributions are exempt from national insurance contributions
- Exempt – no tax is charged on investment growth from pension contributions, and
- Taxed – pensions in payment are taxed as other income, but individuals are able to take up to 25% of their pension fund as a lump sum on retirement.

---

[1033] Anthony King and Ivor Crewe (2014) *The Blunders of Our Governments*, Oneworld Publications, London.

[1034] Other blunders discussed by King and Crewe include: the reforms that led to pensions mis-selling in the 1980s, entry into the Exchange Rate Mechanism, Individual Learning Accounts, the Millennium Dome, the Assets Recovery Agency, the Child Support Agency, changes to the insurance industry that led to payment protection insurance mis-selling, and the failed National Health Service data base.

[1035] The appendix to this Chapter shows how the system of pensions tax relief has developed since A-Day in 2006.

[1036] HM Treasury (2010) *Removing the Requirement to Annuitise by Age 75,* July, para 2.3.

The 2010 Conservative-Liberal Democrat Coalition Government introduced a set of five pension taxation principles consistent with the EET framework:[1037]

1. The purpose of tax-relieved pension saving is to provide an income in retirement.[1038]
2. Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.
3. Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.
4. In line with the EET model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available.
5. On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.

The EET framework provides generous tax incentives to save for a pension and is also designed to be broadly tax neutral over the life cycle. The tax relief that is granted during the accumulation phase of a pension scheme is reclaimed when the pension is taxed during the decumulation phase, so that the same income is not taxed twice. This recognises a long-standing principle of taxation in the UK, namely that tax relief is given at the same marginal rate as income is taxed. There is an anomaly in that 25% of the pension pot can be taken as a tax-free lump sum. But broadly speaking, the EET system is generally regarded as fair at the level of the individual.

While the EET system might be broadly fair in the sense of being tax neutral over an individual's life cycle, it nevertheless favours higher rate tax payers at the expense of standard rate tax payers, and especially those who are higher rate tax payers in work and only basic rate tax payers in retirement. In 2013-14, the total cost to HM Treasury of pension tax relief was £34.3bn (although around £13.1bn was offset by income tax deducted from pension payments).[1039] A 2013 study by the Pensions Policy Institute[1040] showed that around 20% of tax relief was paid to additional rate taxpayers, who make up only 1% of UK taxpayers. Some 80% of UK taxpayers pay the basic rate of income tax but benefit from only 25% of the tax relief on pensions'. The PPI report states that 'there are

[1037] HM Treasury (2010) *Removing the Requirement to Annuitise by Age 75*, July.
[1038] Not a lump sum.
[1039] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/463101/September_2015_Pensions_publication.pdf (see PEN6)
[1040] Melissa Echalier, John Adams, Daniel Redwood and Chris Curry (2013) *Tax Relief for Pension Saving in the UK*, Pensions Policy Institute.

concerns that tax relief is expensive, poorly targeted and does not achieve its policy objectives'.[1041]

### 7.6.2 The new system of pension taxation

The pension reforms, introduced by the 2014 Budget, ended the requirement to annuitise pension wealth – the fundamental rationale of a pension scheme. Further, the 2014 Taxation of Pensions Act which – by ending the 55% tax charge on pension death benefits if the member dies before 75 – allowed pension assets to become inheritable. Both these measures have completely distorted the EET model and bring into question the whole system of very generous tax relief currently granted to pension savings and investment.[1042]

Tom McPhail, head of pensions research at Hargreaves Lansdown, believes the current system is now 'in a complete mess'. He said the five principles of pension taxation introduced in 2010 – in particular that a pension should be for retirement income and the state would reclaim tax benefits on death – had been 'torn up' by the Government that introduced them in the space of one parliament.[1043]

The abolition of the 55% tax charge on pension death benefits has conferred massive tax benefits on a small group of very wealthy people.[1044] They received tax relief on pension contributions and investment returns at the highest marginal rate in the accumulation stage and will be able to transfer those benefits tax free to their descendants if they die before 75. John Ralfe's letter to the Financial Times of 8 October 2014 stated: 'the…Government has created a simple way for the richest to avoid paying income tax and pass on wealth tax free to their grandchildren'. Andy James, head of retirement planning at Towry, said 'The new regime will bring pensions into overall inheritance planning for wealthy people. You can pay the maximum into a pension, currently £1.25m, and it could pass down the generations tax free….Sadly, the changes to the tax charges on death for pensions will not help those who are still struggling to build up sufficient funds to pay for their retirement'.[1045]

The ending of the 55% tax charge will have further serious unintended consequences as Craig Berry points out: 'At the moment, people are rightly able to bequeath DC pensions pots when they die. But those inheriting these pots are, rightly, heavily taxed when they do,

---

[1041] The report goes on to consider some alternatives to the current system, such as 'changes to the tax-free lump sum and using single rates of tax relief rather than relief given at the saver's marginal rate'.

[1042] The appendix to this Chapter shows how pensions tax relief restrictions have developed since A-Day in 2006.

[1043] Reported in Jenna Towler (2015) Govt must clean up pension tax mess and scrap LTA - Tom McPhail, Professional Adviser, 5 June.

[1044] The 55% rate was set to recover the tax relief that a 40% tax payer received on contributions and investment returns during the accumulation phase of a pension scheme, taking account of the 25% tax free lump sum. This rate therefore made a pension scheme tax neutral over a higher-rate tax payer's life cycle.

[1045] Reported in Josephine Cumbo, Alistair Gray and George Parker (2014) UK pension death tax abolition seen as benefiting the wealthy, Financial Times, 29 September.

reflecting the significant tax relief that supported the savings being accrued in the first place. From now on, however, these restrictions will be virtually abolished. This has two immediate implications. Firstly, it further biases the pensions tax relief system towards the wealthiest savers, that is, those likely to leave inheritable pots behind. Secondly, and most importantly in terms of the economics of pensions provision, it means individuals will be encouraged to keep their savings invested in their pensions scheme. … In fact, not only is annuitisation no longer compulsory, for the wealthiest savers, it is now being significantly disincentivised. This brings us to the crux of the matter, and the most important long-term implication: all of this makes annuities more expensive. If insurance companies cannot rely on a steady stream of wealthy retirees buying annuities, they lose scale efficiences, and will have to make their products more expensive for the mass market. In two swift strokes, auto-enrolment begins to unravel. The historic compromise that led to DC pensions being universalised has been hugely undermined…… The only way that "ordinary savers" are going to be affected by this is that they are going to have to pay more to get those annuities. In short, they will be considerably worse off'.[1046]

Tom McPhail agrees that the abolition of the tax charge has reduced the attraction of annuities: 'The whole direction of government policy is going against allowing retirees to benefit from mortality cross-subsidy,[1047] which is one of the most valuable and economically-sound factors that can influence their retirement outcomes. The mortality cross-subsidy is a highly efficient way of maximising your retirement income. The current direction of policy is significantly undermining the stability of the pension system. I feel uncomfortable at the way the Treasury has suggested 18m people in DB schemes will be able to benefit from the new freedoms. That is an irresponsible attitude. People will want to transfer out and schemes will collude with them on this. They will offer maybe 95 per cent of the value of benefits, and people will take them up on it. I think it is cynical on the part of the Government to position this in this way'. [1048]

Natalie Holt, editor of Money Marketing, argues that the new regime provides a clear incentive to reduce inheritance tax: 'Whereas previously pensions were about providing for savers in their retirement, they may now be about sheltering assets beyond the person's lifetime'.[1049] According to Chris Marshall, technical officer at Hornbuckle, 'the change to IHT proposed by the Conservatives [which raises the threshold on primary homes to £1m] will disproportionately benefit the well-off (IHT currently affects only 8% of estates, and, according to the Institute of Fiscal Studies, the changes would mean limiting it to the top 6%), [whereas] the theme of changes to pension tax relief since 2009 has been to reduce

[1046] Craig Berry (2014), Pensions: End of the road for 'auto-enrolment' business model?, 30 September; http://touchstoneblog.org.uk/2014/09/end-of-the-road-for-auto-enrolment-business-model/
[1047] Also known as a mortality premium.
[1048] McPhail attacks 'irresponsible' Treasury reform agenda - Corporate Adviser, 29 September 2014.
[1049] MM leader: Look what happens when politicians are too hasty, 2 October 2014.

the cost to the taxpayer by getting those at the top of the income ladder to pay for it, or at least to limit the amount they save into pensions, and thereby decrease how much tax relief they get'.[1050]

Nevertheless, inheritance planning cannot be explicitly used to avoid paying inheritance tax on pension assets. As Michelle McGagh states: 'pensions are now being seen as a way to pass on money to the next generation tax efficiently. This means wealthier pensioners who do not need their pensions to live on can ring-fence their savings for their family. However, there is a concern that HMRC will not look kindly on those it believes are gaming the system'.[1051] For example, if someone makes extra large contributions or consolidates a number of pensions and then dies within two years, HMRC could view under the 'disposition of assets' rules and levy IHT if it believes individuals are using pensions to shelter money.

In the Autumn Statement in November 2015, the Treasury clarified the situation. It said it would legislate to ensure an IHT liability will not arise when a pension scheme member designates funds for drawdown, but does not draw all of the funds before death, with the change backdated to apply to deaths on or after 6 April 2011.

### 7.6.3 What is the role if any of pension taxation relief?

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'.

In March 2015, the ACA published a consultation paper, *Creating a Sustainable Pensions Tax Framework*, which called on all political parties to cooperate with industry in a fundamental review of pension taxation that will lead to a sustainable pension taxation system that can be readily understood and can properly incentivise retirement savings.[1052] The ACA said it had significant concerns that further reductions will be made to pension tax relief whichever party or parties form the next Government and that the changes will be placed on an already overly complex system.

---

[1050] Chris Marshall (2015), Assessing the Tory IHT/pension tax relief pledge, Professional Adviser, 14 April.

[1051] Michelle McGagh (2015), Using pension to dodge IHT could land you tax bill, Citywire, 11 May.

[1052] www.aca.org.uk/files/Creating_a_sustainable_Pensions_Tax_Framework-4_March_2015-20150304075543.pdf

The paper's main recommendations are:

- There should be no 'knee jerk' changes to the pension taxation system after the General Election. The ACA notes that even a reduction in the Lifetime Allowance (LTA) might look a simple change – but it brings a new range of individuals into a potentially complex net and creates a new 'protected case' for schemes to have to deal with – so its impact should not be underestimated
- The next Government should initiate a fundamental cross-party review of the pension taxation system working closely with employers, pension providers, consultants and administration providers to ensure the new system is practical
- The review should ensure that full details of the current reliefs, and their distribution between various constituencies, are understood
- Changes to pension taxation should have cross-party support so that any new framework can endure
- Any new framework should be given an appropriate lead time so that those who manage schemes can change systems appropriately and employers and individuals can plan properly for any new change
- Once in place the new framework should not have any changes made to it for many years.

The ACA argues that any significant reduction to the amount of tax relief granted on contributions could lead to a withdrawal from pension savings which is counter to recent government policies, such as auto-enrolment, which are designed to encourage greater participation. It believes that complexity results in individuals being put off saving for retirement, employers are deterred from establishing and maintaining pension schemes beyond the minimum enforced by auto-enrolment, and, for individuals who do save diligently (and for employers supporting this), the costs of ensuring compliance with current tax law means ultimately that there is less money available for retirement savings.

The tax system could also be used to provide appropriate incentives. An example of this would be to scrap stamp duty for older people to help them move out of under-occupied homes, a proposal made by Legal & General in June 2015.

The insurer has published a report called *Free up Housing Stock – Report into the Last Time Buyer Market*.[1053] The report focuses on 'last-time buyers' (LTBs), those aged over 55 who are sitting on housing wealth of £820 billion that is forecast to increase to £1.2 trillion by 2020. It estimates that 5.3 million last-time buyers live in under-occupied homes with 7.7 million spare bedrooms, equivalent to 2.6 million family homes. However, 3.3 million last-time buyers want to downsize, typically from a four-bed to a two-bed property. While a third of older people considered downsizing in the last five years, only 7% did so. This has

[1053] http://www.legalandgeneralgroup.com/_pdfs/press-release/LTB_Front_Cover_Report_Final.pdf

had the effect of stalling the property market as younger families can neither find nor afford suitably large homes. To get around this, L&G believes LTBs should be offered tax breaks, such as scrapping stamp duty 'to incentivise right-sizing' and to encourage people to sell their home and downsize in later life, freeing up family-size properties for younger generations.

L&G also wants to deal with the 'chronic undersupply of age-specific housing', given that just 2% of the UK's housing stock is classified as retirement housing. Another problem is that the majority of the retirement properties available in the UK are sold on a leasehold basis which will not be attractive to many buyers. The report says: '[We need] increased volumes of homes across all tenures, including freehold, shared equity and rented options, [that] would allow the system to cater to a wider variety of needs and offer flexibility as people's needs change in later life'. The report would also like to see a larger 'new homes bonus' given to those buying retirement-specific property or a 'council tax holiday for new retirement homes' for the first three years.

L&G has set out a 10-point plan to make downsizing easier. Its recommendations are:

- Government to support provision of age-specific housing
- Housing connected with infrastructure, social and health systems
- Retirement housing shouldn't just be leasehold properties
- More mid-market supply on top of affordable housing
- Public policy should support urban locations for retirement villages
- Greater tax reliefs to encourage downsizing
- Consolidate benefits, which influence retirement housing
- Planning authorities should standardise approaches
- Remove development levies imposed by planning system
- Government should encourage use of equity release.

Nigel Wilson, chief executive of L&G, said: 'Helping young people to get onto the housing ladder through initiatives like Help-to-Buy is important, but enabling older people to realise their downsizing dreams could have a far greater impact in terms of unlocking family housing stock for people to buy'.[1054]

Michael Johnson, in a report entitled *Who Will Care for Generation Y?*, published by the Centre for Policy Studies in June 2015, again considers the question of intergenerational fairness.[1055] He estimates the size of the tax burden being passed to the next generation. His calculations show that the gap between the UK's liabilities and assets grew by an

[1054] Reported in Michelle McGagh (2015) Retirees need tax breaks to downsize, says insurer, Citywire, 2 June.
[1055] http://www.cps.org.uk/files/reports/original/150602131332-WhoWillcareforGenerationY.pdf

'unsustainable' 51% in the five years to end-March 2014, to £1,852 billion. At 111% of GDP, this is equivalent to £70,000 per household. If the state pension, the largest of all unfunded liabilities (roughly £4,000 billion) is included, the burden per household rises to £221,000. The report warns that Generation Y could be the first generation to experience a quality of life below that of its (baby boomer) parents.

Mr Johnson comments: 'Baby boomers have become masters at perpetrating inter-generational injustice, by making vast unfunded promises to themselves, notably in respect of pensions. Indeed, such is their scale that if the UK were accounted for as a public company, it would be bust. In any event, Generation Y will have to foot the bill.... Reining back on unfunded promises means either stop making them, or fund them now, which would require higher taxation (or additional cuts in public spending)'.

To improve transparency and put a brake on deferring costs, the report outlines six proposals:

1. The UK's Whole of Government Accounts (WGA) balance sheet should include a liability to represent future State Pension payments [which they currently do not do], based upon a realistic expectation of the future cash outflow, discounted using the UK gilt yield curve.
2. Draft legislation which, if implemented, would produce unfunded spending commitments, should be accompanied by an Inter-generational Impact Assessment to quantify the impact on the young, i.e., future taxpayers.
3. An Office of Fiscal Responsibility should be established, under the aegis of the Chancellor, to scrutinise the effectiveness and value for money of all tax reliefs and exemptions.
4. All tax reliefs and exemptions should be subject to a five year sunset clause, after which they would cease. Lobbyists should be requested to present their cases directly to the proposed Office of Fiscal Responsibility, to ensure blue water between vested interest groups and ministers.
5. Departmental budgets should be set both gross and net of expenditure on tax reliefs and exemptions, to ensure transparency as to the true level of financial support to each area of public policy.
6. The Prime Minister should embellish his doctrine of personal, professional, civic and corporate responsibilities by adding a fifth category: inter-generational responsibility.

In October 2015, Michael Johnson published another Centre for Policy Studies report entitled *An ISA-Centric Savings World*, in which he proposed replacing the EET pension tax system with one similar to the TEE system of ISAs.[1056] In particular, he proposed that:

- All income tax and National Insurance Contributions (NICs) relief on pensions contributions be scrapped, to be replaced by a more redistributive 50p Treasury incentive per post-tax £1 saved. This should be paid irrespective of the savers tax-paying status, thereby nailing the conundrum that because income tax is progressive, tax relief is inevitably regressive. A 50p incentive would significantly help realise the Pension Commission's vision for median earners to have a two-thirds total combined earnings replacement rate.
- Employer contributions, taxed as employee income but eligible for the Treasury incentive, would be paid into a Workplace ISA, operating within the auto-enrolment arena. Withdrawals would not be permitted until the age of 60, thereby trapping the incentive, along with income and net capital gains. Thereafter, they would be, ideally, tax-free.
- Auto-enrolled employee contributions, paid post-tax but attracting the Treasury incentive, would go into an employee's Lifetime ISA.
- The Workplace ISA and Lifetime ISA could reside within an ISA warehouse, alongside other segregated ISA cells dedicated to specific saving purposes (Help-to-Buy, long-term care, etc.). The ISA warehouse could become a universal, all-purpose savings vehicle to serve everyone from cradle to grave. Simplicity to the fore.
- Each ISA cell would have its own (tax-based) incentives and deterrents, to reflect prevailing policy objectives. They would share a modest annual allowance, such as £8,000, subject to Treasury modelling confirmation. A smaller incentive, for example, could accommodate a higher annual allowance.

The report introduced the idea of an ISA Pension, secured with Workplace ISA assets, from the age of 60. Mr Johnson argues: 'The primary driver for moving from pensions' EET framework to the TEE world of ISAs is the inflexibility of pension savings prior to 55. This is at odds with how those in Generation Y, in particular, are living their lives. Many eschew pension saving, thereby missing out on tax relief, but engagement with ISAs is high. Ready access and flexibility is valued above tax relief: EET is patently failing the next generation. In addition, a single TEE tax framework for savings would represent a marked simplification of the savings arena. ..Given the individual and societal benefits of annuitisation, a Treasury-funded inducement should be considered, such as a 25% income uplift. Indeed, this approach could be extended to today's ISA suite. Participation would be optional, consistent with 2014's pensions' liberalisation'. He described the current system pension

[1056] http://www.cps.org.uk/files/reports/original/151007092342-AnISACentricSavingsWorld.pdf

tax relief as 'expensive, incompatible, inequitable, illogical, incomprehensible and, crucially, an ineffective use of Treasury funds'.

### 7.6.4 The Government's consultation

The newly elected Conservative Government released a consultation paper on pension taxation in July 2015.[1057] 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.

The Government said the key principles any reform should meet are:

- It should be *simple and transparent*. The Government said it believes that greater simplicity and transparency may encourage greater engagement with pension saving and strengthen the incentive for individuals to save into a pension
- It should allow individuals to take *personal responsibility* for ensuring they have adequate savings for retirement. It should encourage people to save enough during their working lives to meet their aspirations for a sufficient standard of living in retirement
- It should *build on the early success of automatic enrolment* in encouraging new people to save more
- It should be *sustainable*. Any proposal for reform should also be in line with the Government's long-term fiscal strategy.

One option to be examined is bringing the tax treatment of pensions into line with ISAs (i.e., replacing the EET system with a TEE system) along the lines proposed by Michael Johnson who has estimated that such a move could save the Government £10bn a year. In launching the consultation in the Budget on 8 July 2015, the Chancellor, George Osborne, said: 'Pensions could be taxed like ISAs. You pay in from taxed income – and it's tax free when you take it out. And in-between it receives a top-up from the Government. This idea, and others like it, need careful and public consideration before we take any steps. So I am today publishing a green paper that asks questions, invites views, and takes care not to pre-judge the answer. Our goal is clear: we want to move from an economy built on debt to an economy built on the more secure and productive foundations of saving and long- term investment'.

The idea of having a consultation was welcomed by industry. For example, Hugh Nolan, chief actuary at JLT Employee Benefits, said 'We welcome any genuine consultation to put

[1057] HM Treasury (2015) Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July;
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/442159/Strengthening_the_incentive_to_save_consultation__print_.pdf

pensions onto a sound footing for the future, recognising that it's just one form of overall saving'.[1058]

However, the proposal to tax pensions like ISAs was criticised in some quarters. An early critic was the Pensions Minister Ros Altmann who said 'a pension is not an ISA' and a switch could be 'dangerous' for retirees, claiming pensions under the new regime would be 'too easy to spend too soon'. She said: 'I do fear that making pension withdrawals tax free at a relatively young age (60s and 70s is not old these days) offers dangerous incentives to stop locking the money in for later life. Policy must be mindful of offering the right incentives not the wrong ones….Just saving from taxed income isn't attractive…It's important to ensure money is kept in pensions for longer'. Under Mr Johnson's proposed framework, employer contributions would be locked in until retirement, while only the employee contributions would be accessible at any time.[1059] Another critic was Steve Webb, the previous Pensions Minister. He argued that a move to pension ISAs would be a 'fallacy' and a huge step into the unknown' which could undermine long-term saving: 'The taxation of pension incomes provides a "brake" on the Lamborghini. Having to pay tax makes you think twice about withdrawing the lot in one go; if pensions are tax free, what would hold you back?'[1060]

A number of providers, asset managers and advisers have also come out against the proposal, claiming it would damage the savings culture:

- Zurich said that, according to a survey it conducted, tax relief on contributions is the most powerful way to incentivise people to save for retirement, with more than two-thirds of over-55s surveyed agreeing with this. Gary Shaughnessy, chief executive of Zurich UK Life, said: 'A move to ISA-style pensions could reverse the early success of auto-enrolment. If individuals are taxed on employer contributions, there is a very real concern that they would opt out to avoid a hit on their take-home pay'.
- Royal London CEO, Phil Loney, believes savers would not trust the system, concerned that the Government would have changed its mind about offering tax-free cash by the time it comes to their retirement.
- Axa Wealth head of retirement planning, Andy Zanelli, argued that the proposals would lead to more people taking out accessible savings products and drawing their cash before retirement and hence running out of money. He said: 'If you are trying to address the savings issue by allowing them to put money into something accessible it won't work. It's counterproductive. If ISAs and pensions do the same

[1058] Quoted in Natasha Browne (2015) Summer Budget - Government eyes scrapping tax relief on pension contributions, Professional Pensions, 8 July.

[1059] Reported in Josephine Cumbo and Jim Pickard (2015) Pensions minister questions Osborne plan, Financial Times, 16 July.

[1060] Quoted in Katie Morley (2015) 'Pension Isas' will encourage pensioners to buy Lamborghinis, Daily Telegraph, 29 September.

thing people might promote the ISA in place of the pension. People would be tempted to draw money in times of a "crisis" and everybody defines "crisis" differently. If there is one allowance for both products nobody would go for the pension'. [1061]

- Aviva published research which said that two-thirds of companies believe that a shift to an ISA system would lead to employees saving less into their pension.
- AllianceBernstein said a move to an ISA-style system 'would represent such a significant shift as to undermine long-term confidence in the robustness of pensions – savers would lack confidence in locking their money up in a system which could potentially change the tax treatment without prior notice'. Further, it would not improve the incentive to save, but instead make it 'considerably more complex' for employees currently paying a higher rate of tax, and would be 'highly costly' to introduce across the industry.[1062]
- A survey of 170 advisers by A J Bell found that there was only 4% support for ISA style pensions, with 59% saying they did not think the pension tax relief system needs to change.
- Almost half of advisers – 42% – thought it is right that tax relief is received at the rate tax is paid, while 40% said there has been enough change and a period of stability is required. Only a third of the advisers questioned said they would like to see a flat rate incentive, the majority of which supported one set at 30%, in between the basic rate of 20% and the higher rates of 40%-45%. About 8% favoured a system of matching Government contributions on a two for one basis.[1063]

Zurich, AXA and Aviva agree that the pension tax system should be simplified rather than unified with ISA tax relief. They propose that the Government introduces a flat rate tax relief of 33% – a £1 top-up to their pension for every £2 saved – and removes the current £1.25m lifetime allowance. [1064]

The National Association of Pension Funds (NAPF) has argued that ending tax relief on contributions by switching from EET to TEE would not necessarily save the Government money and could instead cut the tax take by 15%. It said: 'Modelling a central scenario, which assumes different proportions of contributions from different types of taxpayer — both before and after retirement — the tax take for TEE would be 15% less than under the current system'. The NAPF also said it was a 'myth' that higher-rate taxpayers benefited

[1061] Reported in Carmen Reichman (2015) Zurich warns against shift to 'ISA-style' pension tax relief, Retirement Planner, 15 September; Carmen Reichman (2015) Axa Wealth: ISA-pension merger would 'harm savings culture', Retirement Planner, 14 September.

[1062] Reported in Andrew Pearce (2015) Buyside urges pensions reform rethink, Financial News, 30 September.

[1063] Reported in Carmen Reichman (2015) Advisers shun govt plans for ISA-style pensions and flat rate tax relief, Professional Adviser, 19 October.

[1064] Reported in Jenna Towler (2015) Aviva urges govt to scrap unfair pension tax relief, Retirement Planner, 14 September.

more from the current system than basic-rate tax payers: 'Under the current system, pound for pound saved before tax, higher earners generally get a lower amount of pension to spend and pay more tax on their pension savings than lower earners. Non-taxpayers and basic-rate savers who drop a tax bracket in retirement do well out of the current system. They would lose from a shift to TEE, but would be winners under a single rate of tax relief of 25%'.[1065] Joanne Segars, NAPF chief executive, said in a statement on 30 September 2015: 'The Government says it wants to incentivise saving but it also wants to increase the revenue to the Exchequer – but these two objectives are incompatible and lead to quite different courses of action. There is a very real risk that to increase the tax take in the short-term, the Government will gamble away the long-term interest of savers'. The NAPF chairman, Ruston Smith, went further and said that the proposed Government changes to pensions tax relief threatened to turn pension revolution into pension implosion': they could 'literally dig up and smash the foundations set to create a society of lifetime savers – putting pressure back on our ageing society'.[1066]

In October 2015, the National Institute of Economic and Social Research (NIESR) published *An Economic Analysis of the Existing Taxation of Pensions (EET) versus an Alternative Regime (TEE)* and found that under TEE, personal savings would fall, resulting in lower consumption, a lower capital stock and productivity and a higher interest rate. There is also a 'dynamic inconsistency problem inherent in TEE' as a future Government could reverse the policy or re-introduce taxation on pension income.[1067]

The Government said it would announce its new policy on pensions tax relief decision in the March 2016 Budget.

### 7.6.5 The effectiveness of pension tax relief

While providing an incentive to save for those who understand pension tax relief, a survey of 1,794 working adults aged below 65 conducted by YouGov and published by The People's Pension in September 2015 revealed that 74% of pension savers do not understand (59%) or have not heard of pension tax relief (15%). The provider suggested the Government's consultation into tax relief was an opportunity to raise awareness about it and encourage people to save more. Darren Philp said: 'This research confirms that tax relief is not well understood and calls into question whether it is really acting as an incentive to save. Incentives only work where they are clear and understandable. Unfortunately, the current

[1065] Reported in Josephine Cumbo (2015) Pension body opposes shift to ISA-style taxation, Financial Times, 23 September.

[1066] Reported in Helen Morrissey (2015) NAPF 2015: Changes to tax relief could bring pension implosion, Professional Pensions, 14 October.

[1067] Reported in Rebecca Shahoud (2015) NIESR says TEE is not sustainable long-term, Professional Pensions, 28 October.

system is just not up to the job'. The survey also revealed that 62% would be more likely to increase the amount they saved if the Government matched their contributions.[1068]

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.

It is also important to recognise the two principal types of individual decision makers, 'econs' and 'humans'. As we discussed in Chapter 3, 'econs' are fully rational lifecycle financial planners. They perfectly understand and value the role of pensions in redistributing consumption over the lifecycle from the work phase to retirement. 'Econs' will start and optimally manage their own pension schemes regardless of any tax incentives.

[1068] Reported in Michael Klimes (2015) People's Pension: three quarters don't grasp importance of tax relief, Professional Pensions, 22 September.

'Humans', by contrast, have behavioural traits and face behavioural barriers which inhibit them from behaving optimally. In a pension context, a particularly important behavioural trait of humans is a poor understanding of the time dimension of their lives. Many humans have a good understanding of the present and the near future, but have very little comprehension of the distant future. The idea of thinking about their older self in 10 years', 20 years' or 30 years' time is completely alien to them. This leads to a practice known as hyperbolic discounting which implies that people exhibit short-term impatience and long-term patience. The classic illustration of this is that, given the choice between one apple now and two apples tomorrow, most people choose the apple now (short-term impatience or the desire for instant gratification). But given the choice between one apple in 100 days and two apples in 101 days, most people choose the two apples (long-term patience or a willingness to exhibit deferred gratification). Transposed into a pension context, humans can see the benefits of saving for retirement if it is explained to them (deferred gratification), but since they only live in and comprehend the present, they never start the pension plan (i.e., without a pre-commitment device, they never get to that 100th day in the future where they would exhibit long-term patience and see the benefits of deferred gratification), since they are unwilling to give up current consumption (short-term impatience and instant gratification always dominate). Another related behavioural trait is inertia: people see the benefits of saving for retirement, but never get around to starting their pension plan. Another one is lack of willpower: again people see the benefits of saving for retirement, and may even start a pension plan, but they do not have the willpower to maintain it over the long investment horizon required.

Now let us look at the role and effectiveness of pension tax relief with these two different types of decision maker. The position with econs is straightforward: they will plan their pension plan optimally regardless of any tax incentives. In fact, pension tax incentives are not needed for econs. However, the evidence suggests that the proportion of econs in the population is low. Most people are humans.

The role and effectiveness of pension tax relief in the case of humans depends on how severe their behavioural barriers are. If the barriers are low – people understand the value of pensions, and are willing to save for a pension, but suffer from inertia – then people just need an incentive or a nudge to get started. Tax relief provides such a nudge. UK pension tax policy is predicated on idea that most people are humans and need some encouragement to start a pension scheme. Governments have, however, differed in their view about how severe the behavioural barriers are. Before 1988, people were obliged to join their employer's pension scheme as a condition of employment, although they still received the tax relief. This suggests that prior to 1988, Governments believed that the behavioural barriers were sufficiently high that nudges alone would not be adequate and that compulsion was needed. However, between 1988 and 2012, there has been no compulsion to join a company pension scheme. The Government's argument in 1988 was that people should be free to choose how they spend their money, suggesting they thought

that most people were in fact econs. The declining membership of workplace pension schemes, especially in the private sector, since 1988 provides evidence that this is not the case and that most people are indeed humans. This has been accepted by all Governments since the Pension Commission recommended auto-enrolment (a classic example of the use of inertia to help humans overcome a behavioural barrier) in workplace pension schemes in 2005. AE was introduced with all-party support in 2012.

With this in mind, we can now examine the potential reform of pension tax relief in the light of the five aims of Government pension tax relief policy above:

1. The cost of the tax relief here depends on both the chosen target standard of living for each individual (essential, adequate, or desired) and the number of individuals covered. Clearly, the more generous the target, the more generous the tax relief and the less the Government has available to spend elsewhere. The number of individuals covered will also depend on the success of auto-enrolment. If auto-enrolment is successful in bringing more people currently without pensions into the pension system, then total tax relief will rise. If auto-enrolment fails, an alternative way – possibly the only way – of getting more people to join a pension scheme is compulsion. This would, in turn, reduce the need for such generous tax relief.

2. The current situation with long-term care provision needs to be resolved. Most people do not seriously prepare for the possibility of long-term care until it is too late, with the result that 50,000 people a year are forced to sell their homes to pay for care. This has led to the following question being asked: Why should people make sacrifices to pay off a mortgage if they are going to be penalised in this way, when those who did not bother to buy a home get their care costs paid by the state? Currently, annual care costs vary between £30,000-50,000 depending on the extent of nursing care required. The 2011 Dilnot Commission on Funding of Care and Support recommended that: the amount any individual should be required to contribute to the cost of their social care should be capped at between £25,000 and £50,000 (excluding normal room and board costs) and that the means-test threshold be increased to £100,000. The total cost to the Government was estimated to be £2.2bn.

   One in five of us will need care for an average of two years. This means that long-term care is a classic insurance problem with a standard insurance solution. Above a certain minimum income level, individuals could be encouraged to take out long-term care insurance, possibly by diverting some existing pension tax relief for this purpose. If we all did this at a young age, the annual premiums would be fairly modest. But there is a free rider problem to consider. If the scheme is voluntary, some people will choose not to participate, despite the tax relief, in the belief that since everyone else is covered, they will be able to slip through the net if they need

care which they might not. The young in particular are likely to believe that they will never need to draw on the insurance policy. There is a danger that sufficient numbers of people will not participate for these reasons. So compulsion might be the only effective way of dealing with the free rider problem, in which case again tax relief is not necessary.

3. The net cost to HM Treasury of pension tax relief (tax relief on pension contributions, on investment income of pension funds and lump sum withdrawals less tax liable on pension payments) was £22.8bn in 2012-13.[1069] It is impossible to tell from this figure whether it is consistent with tax neutrality over the life cycle, but we can say that we are not currently in a state of tax neutrality, since there has not so far been a year in which pension tax relief has not exceeded pension taxes. This might happen in the future as more baby boomers retire and if taxes exceed relief. But the taxes would have to exceed the relief by a substantial margin in the years ahead: the net tax relief between 2000-01 and 2009-10 alone was £168.7bn. A tentative conclusion, therefore, is that the current system does not lead to tax neutrality when aggregated over individual life cycles within one age cohort: the structure of tax reliefs is too generous compared with the taxes subsequently collected. Pension taxes could be reformed to rectify this. They could also be reformed to make post-retirement work more attractive (the Government's decision in the 2012 Budget to remove the higher income tax thresholds for older people militates against this, however).

4. If the Government wants to cap the total cost of tax relief, especially if the pension tax system is not neutral over the life cycle – a fact that benefits the better off – then one solution favouring greater equity is to make the system less generous for the better off. This can be done on both the contribution and benefit side. In terms of contributions, the Government has already severely capped the level of contributions which attract tax relief. It would not be sensible to reduce this cap any further, since this would greatly penalise people who do not start a pension scheme until late in their working life and hence need to make very high annual contributions to catch up. So a better way might be to remove higher rate tax relief on pension contributions and only allow tax relief at the basic rate or a new flat rate of, say, 33%.[1070] In terms of benefits, the (currently tax-free) lump sum could be taxed above a certain level. A more extreme solution would be to remove the tax-free lump sum altogether. This, of course, would be extremely unpopular. Also the lump sum plays an important role in providing a rainy day fund for people in

[1069] http://www.parliament.uk/written-questions-answers-statements/written-question/commons/2015-02-10/223929; see also https://www.gov.uk/government/statistics/registered-pension-schemes-cost-of-tax-relief

[1070] This would, however, break a long established principle of the UK tax system that income is taxed and any offsets are tax relieved at the same marginal rate.

retirement: many people are not able to finance big ticket expenses, like boiler or car repairs, from their pensions. Nevertheless, while politically unpopular, the proposed reforms here would not only deal with equity issues, they would also help the system move closer to tax neutrality over individual life cycles.

5. Finally, the issue of intergenerational equity: no generation is entitled to unfairly burden generations which do not yet have the vote or which have not yet been born. It is also unwise for them to try and do so, as these later generations can choose not to honour the obligations that have been placed upon them and which they have not agreed to. This becomes more likely if the later generations are smaller in size and poorer than the earlier generations, a possibility that seems increasingly likely in the UK and other parts of the developed world – unless there is mass immigration, a possibility which now seems equally likely. This reinforces the argument that the pension tax system should be tax neutral between generations and should not involve the tax liabilities of one generation being passed on to future generations.

To summarise, 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:

6. 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.

7. 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.)
8. 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).
9. 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.
10. 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 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'.[1071]

---

1071 Ros Altmann, Pensions Minister, quoted in in Jenna Towler (2015) Pension fraud 'increasingly linked' to investment scams, Professional Adviser, 7 August.

*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.

***Appendix: The Professional Pensions guide to how pensions tax relief restrictions have developed since A-Day in 2006.***[1072]

| *Pension tax allowances since 2006* | | |
|---|---|---|
| Tax Year | Annual Allowance (£) | Lifetime Allowance (£) |
| 2006-07 | 215,000 | 1,500,000 |
| 2007-08 | 225,000 | 1,600,000 |
| 2008-09 | 235,000 | 1,650,000 |
| 2009-10 | 245,000 | 1,750,000 |
| 2010-11 | 255,000 | 1,800,000 |
| 2011-12 | 50,000 | 1,800,000 |
| 2012-13 | 50,000 | 1,500,000 |
| 2013-14 | 50,000 | 1,500,000 |
| 2014-15 | 40,000 | 1,250,000 |
| 2015-16 | 40,000 | 1,250,000 |
| 2016-17 | 40,000 | 1,000,000* |
| * Indexed to CPI from April 2018 | | |

## Budget 2009

The first major tax relief restrictions since A-Day in April 2006 began with Alistair Darling's 2009 Budget, when he announced he would restrict higher-rate tax relief on pension contributions for people with incomes over £150,000.

Restrictions had previously been governed by the A-Day reforms, which gave an absolute lifetime allowance of £1.75m and an annual allowance of £245,000 (limits for the 2009/2010 tax year).

In his 2009 Budget, Darling said that, from 2011 and for incomes above the £150,000 level, the value of pensions tax relief would be tapered down until it is 20% for those on incomes over £180,000 - making it worth the same for each pound of contribution to pension entitlement as for a basic rate income tax payer.

In addition, Darling said that, in anticipation of this change, he was also introducing legislation to prevent individuals taking advantage of the pensions tax relief while it is still

[1072] Jonathan Stapleton (2015) How pensions tax relief has been slashed since 2006, Professional Pensions, 17 March; http://www.professionalpensions.com/professional-pensions/news/2162378/budget-2012-guide-tax-relief-restrictions

available to them at a higher rate - and making substantial additional pension contributions prior to the restriction taking effect.

Darling said: ‘It is difficult to justify how a quarter of all the money the country spends on pensions tax relief goes, as now, to the top 1.5% of pension savers’.

## Pre-Budget Report 2009

In his pre-budget report of December 2009, Darling announced higher-rate tax relief restrictions - originally announced in the April 2009 budget - would now include employer contributions and affect those with relevant income of £130,000 and over rather than the previously announced figure of £150,000 and over.

This would have effectively meant anyone with income of £130,000 or more would not receive higher-rate tax relief on their contributions.

It was believed as many as 150,000 people could be caught out by this extension of higher-rate tax relief restrictions.

A statement by HM Treasury at the time confirmed: "From April 2011 tax relief on pension contributions will be restricted for individuals with gross incomes of £150,000 and over, where gross income incorporates all pension contributions, including the value of any benefit funded by, or eventually funded by, an individual's employer.

‘Tax relief will gradually be tapered away so that above £180,000 it is worth 20%, the same rate received by a basic-rate income taxpayer. To provide more certainty for individuals around whether they are affected, and to reduce administrative burdens for schemes, this will be subject to an income floor at £130,000 of pre-tax income (excluding the value of any employer pension contributions)’.

## Budget 2010

In what would be his last Budget, Darling rejected industry pleas to change the way it was going to implement pensions tax relief restrictions.

Darling confirmed: ‘Tax relief on pensions will be restricted but only for those earning £130,000 a year’.

HM Treasury also published a summary of the responses it received on its consultation on implementing the restriction of pensions tax relief - and outlined the Government's response and the next steps for developing the restriction ahead of its proposed introduction in April 2011.

But it rejected pleas from the pensions industry to reduce the annual or lifetime allowance instead - saying such a move would hit lower earners.

It said: "A reduction in the annual or lifetime allowance would potentially apply to pension savers with much lower incomes, particularly in DB schemes. Furthermore, it would allow high-income individuals to continue to benefit from a higher rate of tax relief than other pension savers.

‘In addition, alternative options could not be implemented fairly without making significant adjustments to the pensions tax system that would also add their own complexity’.

It continued: ‘The Government does not propose any changes to the annual allowance or the lifetime allowance at this stage’.

And the Treasury remained adamant that restricting tax relief was the right thing to do.

It said: ‘The Government remains clear that the restriction of pensions tax relief is proportionate and necessary, and many stakeholders agreed that action to restrict the amount of relief going to those on the highest incomes is appropriate.

‘The measure also represents an important part of the Government's consolidation of the public finances. In restricting relief on pension contributions, the Government's objectives are to rebalance the pensions tax system to ensure that pensions tax relief remains affordable, and to address the disproportionate levels of relief going to those on the highest incomes, around 2% of pension savers’.

The Budget also announced further decisions on how the restriction of relief would be applied and delivered - noting that deemed contributions to defined benefit pension schemes will be valued using the age-related factors method.

And it said the restrictions would primarily be delivered through self assessment - noting tax returns would be modified to report additional information to HMRC and to calculate the restriction of pensions tax relief.

It said, where individuals are affected, HMRC will collect a recovery charge reflecting the restriction of relief through self-assessment.

A cost-benefit analysis, published at the time of the Budget, revealed that HM Treasury had trebled its estimate of the one-off costs that pension schemes, employers and individuals would incur as a result of the tax on higher earners' pension contributions.

The new impact assessment said the one-off costs incurred during the transition to the new regime will total £900m - or around £3000 for each of the 300,000 taxpayers affected - compared with the £305m estimate published in December.

The increase is particularly pronounced for employers, whose one-off costs are now expected to be £330m rather than £40m. Annual costs are now expected to be £115m, rather than £90m.

## Emergency Budget 2010

In his Emergency Budget - held just after the coalition Government came to power - Chancellor George Osborne announced he would work with the pensions industry on 'alternative ways' to implement pension tax relief restrictions - and was considering reducing the annual allowance to as little as £30,000.

Osborne said: 'Many businesses are alarmed at complexity. I have listened to those concerns, however, I must also protect £3.5bn revenue it would create.

'I will work with industry on raising same amount of revenue - potentially by reducing the annual allowance'.

In a Treasury document - published alongside the Budget - the Government said 'provisional analysis suggested an annual allowance in the region of £30,000 - £45,000 might deliver the necessary yield'.

The document also confirmed the Government has 'reservations' about the approach adopted in Finance Act 2010 - saying it could have 'unwelcome consequences for pension saving, bring significant complexity to the tax system, and damage UK business and competitiveness'.

It said the Government wanted to engage employers, pension schemes, experts and other interested parties to determine the best design of a regime - looking at a wide range of issues that will need further consideration.

National Association of Pension Funds chief executive Joanne Segars feared the proposals as they stood would cost between £2.5bn to £3bn to implement and lead to senior corporate decision-makers disengaging from workplace pensions, eroding employer interest in the schemes.

The trade body suggested reducing the amount of pension contribution eligible for tax relief from £255,000 to about £50,000, which will limit the tax relief available to high earners, but in a way less harmful to pension provision.

'This will be less damaging to pension saving and cost far less to implement', Segars said.

## Treasury announcement - October 2010

In October 2010, the Treasury confirmed the annual allowance would be cut from £255,000 to £50,000; the lifetime allowance reduced from £1.8m to £1.5m, and the factor for valuing final salary benefits increased from 10 to 16.

It said this would replace the 'complex proposal' legislated for by the Labour Government.

The Treasury said the measure would raise £4bn a year - but would be targeted at those who make the most significant pension savings

It said these new allowances will for the time being be frozen - with options for indexing to be considered from 2015-16.

Pension benefits for deferred pensioners will be exempt from the annual allowance regime.

The Treasury estimated the changes would affect 100,000 pension savers - 80% of those will have incomes of more than £100,000.

However, the Government said it was committed to protecting individuals on low and moderate incomes as far as possible.

It said to protect individuals who exceed the annual allowance due to one-off "spike" in accrual, the Government would allow individuals to offset this against unused allowance from the previous three tax years.

The Treasury said it would also introduce a CPI exemption - which would mean only pay rises in excess of CPI inflation would be taken into account for final salary benefit calculations.

In addition, it said it would consult on options enabling people to meet tax charges out of their pensions.

The Treasury said in order to protect the public finances it was necessary to introduce the reduced annual allowance from April 2011. The Government said it planned to introduce the reduction in the lifetime allowance from April 2012.

Financial secretary to the Treasury Mark Hoban said: ‘We have abandoned the previous Government's complex proposals and developed a solution that will help to tackle the deficit but not hit those on low and moderate incomes. We have taken a tough but fair decision.

‘The coalition Government believes that our system is fair, will preserve incentives to save and - compared to the last Government's approach - will help UK businesses to attract and retain talent’.

## Budget 2011

In his 2011 Budget, Osborne confirmed the planned £50,000 annual allowance for tax free pension contributions.

It confirmed the move, first announced on 14 October, last year would come into force from 6 April 2011

The document also confirmed the lifetime allowance would be £1.5m.

## Budget 2012

In the run-up to the the 2012 Budget, a cut to the annual allowance emerged as the ‘strong favourite’ to be announced by the Chancellor.

The Liberal Democrats had been calling publicly for cuts to higher-rate tax relief to fund a hike in the income tax threshold to £10,000.

At the time it was said three options were on the table: a cut in the higher-rate tax relief from 40% to 20%, a further reduction in the annual allowance or changes to the size of the tax free lump sum available on retirement.

Industry commentators believed it was ‘75% likely’ a cut in annual allowance would be included in the Budget but hoped the Government would leave tax relief ‘alone entirely’.

In the end, the Government decided to make no further changes to tax relief.

## Autumn Statement 2012

Chancellor George Osborne announced he would cut the annual allowance from £50,000 to £40,000 and reduce the lifetime allowance from £1.5m to £1.25m from the 2014/15 tax year.

The Chancellor said the cut to the tax-free allowance would save the Treasury £1bn a year by 2017/18.

He said 98% of the population have less than a £1.25m pension pot and noted the median pot in the UK was £55,000 with 99% of savers' annual contributions less than 40,000.

Osborne said the average annual contribution was less than £6,000.

The Autumn Statement said that in 2010-11, tax relief for pension savings cost the Government around £33bn - with over half of this relief going to higher rate taxpayers.

And it said, even with changes made to reduce the cost of pensions tax relief, the Government was still likely to forgo around £31bn in tax revenues this year, rising to £35bn in 2015-16.

## Budget 2013

The Government has confirmed it would end tax relief on contributions to schemes set up for employees' spouses or families as part of a clampdown on avoidance.

HM Treasury revealed in the budget that it would include legislation on the practice in the Finance Bill 2013.

It said: ‘As announced at Budget 2012, legislation will be included in Finance Bill 2013 to remove the tax and NICs incentives for employees and employers respectively from

arrangements where an employer pays a pension contribution into a registered pension scheme for an employee's spouse or family member as part of their employee's flexible remuneration package'.

## Autumn Statement 2013

The Chancellor announced he would abolish the 55% tax charge levied on beneficiaries of individuals who die under the age of 75 with a joint life or guaranteed term annuity.

In a widely anticipated move, the Government said beneficiaries would be able to receive any future payments from such policies tax free where no payments have been made to the beneficiary before 6 April 2015.

It said the tax rules would also be changed to allow joint life annuities to be paid to any beneficiary.

If the annuitant dies after the age of 75 then the beneficiary will pay the marginal rate of income tax, or 45% if the funds are taken as a lump sum payment. Lump sum payments will be charged at the beneficiary's marginal rate from 2016-17.

The announcement will bring tax treatment for annuities in line with income drawdown. The original proposals would have weighted the decision-making in favour of the riskier - but more flexible - income drawdown option.

## Budget 2014

The Government announced it would scrap restrictions on how people take pensions income as part of a radical overhaul of tax relief.

From 27 March 2014, the Government said it would slash the minimum income requirement for retirees entering flexible drawdown from £20,000 to £12,000 and raise maximum GAD limits for those in capped drawdown from 120% to 150%.

In a widely anticipated move Osborne also raised trivial commutation limits from £2,000 to £10,000 and the trivial commutation lump sum limit will increase from £18,000 to £30,000.

However the Government said it planned to be even more radical - saying that from April 2015 it would allow anyone over the age of 55 to take their entire pensions pot as cash, subject to their marginal rate of income tax in that year.

The Government also said it would raise the age at which an individual could take their pension savings under the tax rules from 55 to 57 in 2028.

And said it would offer all DC scheme members access to free and impartial face-to-face guidance on the range of options available to them at retirement.

Delivering the changes Osborne said: ‘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’.

Budget documents revealed the move would increase tax income by £1.2bn a year by 2019.

The Government estimated the move would raise £320m in 2015/16, £600m in 2016/17; £910m in 2017/18 and £1.2bn in 2018/19.

## Budget 2015

Chancellor George Osborne confirmed the lifetime allowance would be reduced from £1.25m to £1m from the 2016-17 tax year, netting the Treasury an extra £600m a year.

But he said he would index the lifetime allowance from the 2018-19 tax year - and also ruled out making any further change to the annual allowance.

Delivering the Budget, Osborne said: ‘From next year, we will further reduce the lifetime allowance from £1.25m to £1m. This will save around £600m a year. Fewer than 4% of pension savers currently approaching retirement will be affected.

‘However, I want to ensure those still building up their pension pots are protected from inflation so from 2018 we will index the lifetime allowance’.

This comes after Labour leader Ed Miliband revealed his party would cut the lifetime and annual allowances in an effort to reduce university tuition fees if it wins the general election.