

Consultation Response

The future of retirement

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About this consultation

This consultation by the National Employment Savings Trust (NEST) is being run to gather views on the effect of the ‘freedom and choice’ pension reforms on how NEST members will want to access their savings as they approach retirement.

Key points and recommendations

- It is essential to achieve good retirement outcomes for the first cohort of automatically enrolled DC savers – failure to do so would exacerbate the negative image of pensions and risk disengaging people from saving for their retirement.
- Good defaults will be important to help disengaged pension savers navigate the complex retirement income product marketplace. However, at present it is not clear precisely what these will look like.
- There are insufficient safeguards in place to protect people from making the wrong decisions for using their Defined Contribution pot. Age UK’s eight point plan sets out a series of recommendations for government and regulators to help the reforms become a success.
- We do not, at present, understand enough about consumer spending patterns throughout retirement to design product pathways to match.
- NEST and other pension schemes have a key role to play in helping DC savers understand at-retirement decision making.

Introduction

The upcoming pension reforms pose both an opportunity and a threat for individuals. People will have the scope to use their pension saving in a more flexible way that suits their personal needs; but a notoriously complex marketplace, with pension savers often unaware of retirement options, is likely to make it hard to put this theory into reality.

As the first cohort of auto-enrolled DC savers approach their retirement, it is imperative that a system is in place that allows lower net worth savers to access to suitable retirement products and has appropriate safeguards in place to ensure reasonable outcomes. Failure to do this risks undermining the success of automatic enrolment and pension saving more generally – if people experience problems at retirement then it is likely to be detrimental to pension saving.

Question 1: How will the trend for changing retirement patterns and provisions affect what a) members need, and b) what employers want from DC schemes in the future?

With the success of automatic enrolment, we believe that inertia will continue to be a powerful tool for helping people build their retirement savings. Research to date suggests that people value the flexibility that the pension reforms will bring,ⁱ and they are more likely to save as a result.

Decumulation, however, is less straight forward. The reforms will allow for a wider range of choices for DC pot holders, which create a number of significant challenges for members, the pensions industry, regulators and employers. The roles and responsibilities of each are as yet unclear.

Active choices will need to be made, and many people, particularly those who have been disengaged, are likely to find it difficult to understand what the best option is for them. This gives rise to the need for safeguards to protect people from making bad decisions with their savings. Age UK recently published its eight point plan for ensuring the reforms allow lower net worth savers to enjoy reasonable outcomes throughout their retirement.ⁱⁱ This is summarised below under question 7, and the recommendations are supported by the independently-written ‘Dashboards and Jam Jars’ report, published by Age UK in December 2014.ⁱⁱⁱ

We hope that Pension Wise will help people understand their choices, but even with the so-called ‘second line of defence’ there will still be some people who do not take up the guidance or who emerge unaware of their retirement options. In this context, greater onus is likely to be placed on other stakeholders, including NEST and employers, to ensure that decent outcomes are achieved at – and throughout – retirement.

While major employers and pension funds are likely to be well-placed to offer this support, small or medium-sized employers (SMEs) may not be. Lessons should be learnt from the successes and failings of automatic enrolment for maximising engagement with SMEs.

With changing working patterns leading people to hold a higher number of smaller value pots, it will also become increasingly necessary for schemes to have a role in helping their customers understand the full range of their retirement income. This supports the case for industry collaboration in developing an effective ‘dashboard’ allowing individuals to have a ‘single view’ of their retirement income. We hope moves to help people to aggregate small pots will also continue, although Age UK does not feel the ‘pot follows member’ model is the right one, preferring the aggregator model.

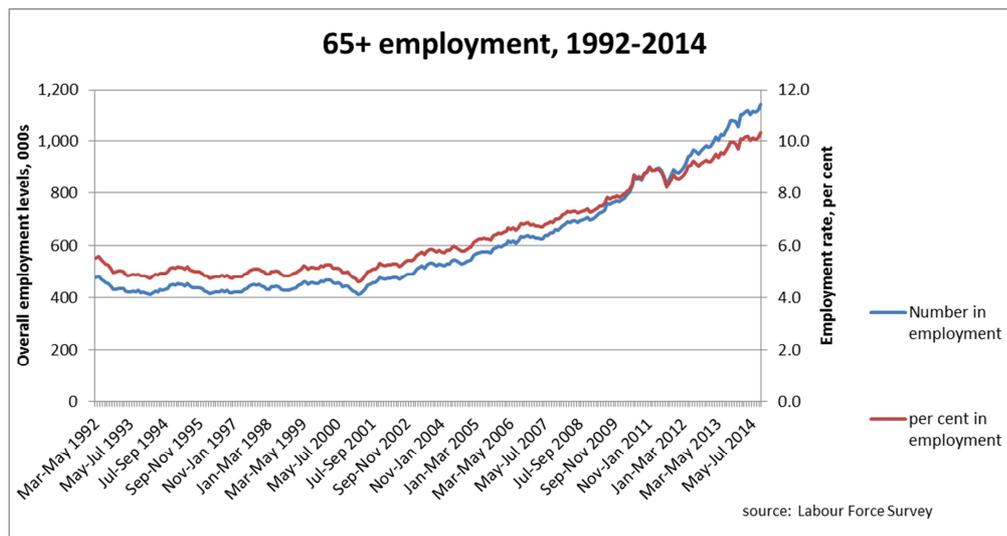
In addition, people who decide not to annuitise will need ongoing support throughout retirement. In the past, major defined benefit schemes often had welfare departments which could support pensioners, but it is unlikely that will continue in a more fractured labour market. It is essential that advice agencies and/or Pension Wise are resourced to fill this gap.

2. How will the trends identified in this chapter evolve and what does this mean for DC design?

Finding best-fit decumulation strategies, especially ones that may be able to act as defaults, will be difficult. Changing employment patterns and retirement income needs bring new challenges.

1) Employment

Even through the recent recession we have seen a consistent increase in the number of people working past 65 (see chart below), which looks set to continue. This indicates a shift in retirement patterns and expectations, which in turn will mean that the design of DC schemes, including pre-retirement investment strategies and decumulation options, needs to adapt to reflect this.



However, it is important to note that different groups of people are likely to work for longer than others. For example, higher skilled professionals are much more likely to keep working than lower skilled workers, in part because of better health and also because of greater access to flexible working options. Involuntary labour market exit is still costly for many people aged 50+, who often fail to get another job once unemployed.^{iv} This can

have lasting consequences for income and pension saving, as well as necessitating a different strategy for accessing pension savings.

In sum, this means that while the broad patterns of working longer are changing, it is affecting different cohorts in different ways. This means that where possible, DC schemes will need to look for such characteristics as they try to construct decumulation strategies and defaults.

2) Investment

It may not be prudent for people who are approaching retirement to leave their money invested in default funds. Pension schemes will need to find a way to manage a diverse range of investment needs.

3) Defaults

Creating suitable default options is challenging but vital. Defaults are likely to be necessary to cover income withdrawal, as well as investment strategies for both crystallised and uncrystallised funds. In the longer term we want to see new products or combinations of products that do not require people to take active decisions later on in life.

3. What conclusions should be drawn from the evidence presented on spending, housing wealth and debt for the needs of future NEST members in retirement? What other data on consumption and wealth should we be taking into account?

4. Given the heterogeneity of likely spending patterns in retirement, is it possible to reflect these in the design of retirement solutions?

It is difficult to reflect spending patterns in retirement solutions at present. Not enough detail is known about consumer spending among older people in order to design products around the particular needs of different cohorts. In particular, there is an absence of longitudinal data, which is necessary for taking informed decisions in this context.

Similarly, expenditure shocks (e.g. your boiler breaking down) are often unpredictable and can make planning very difficult. Clearly these can have a severe impact on lower net-worth savers.

We believe it will be possible to create 'income pathways' that meet the needs of people throughout later life, but that at the moment neither the products nor sufficient knowledge about spending patterns exist. This does not mean that Age UK would advocate waiting to design default solutions. Pension savers' choice are already framed by the choices that

their providers offer or do not offer, and it is important that these choices include a default option which is not irreversible and which offers a reasonable solution.

5. Taking into account current retirement decisions, what people say they want and what the evidence says about behavioural biases, how are savers likely to act under the new freedoms?

6. What member behavioural risks do providers need to manage?

7. Are there other risks and objectives to be taken into account for DC savers approaching and in retirement?

Many savers are likely to find aspects of the reforms difficult to engage with. This is likely to exacerbate inertia, and may mean that people sleepwalk into poor value products or inappropriate investment options.

Some of the more significant behavioural biases include:

- A tendency to underestimate life expectancy
- Placing a higher value on short-term spending rather than longer term needs
- Inertia - a lack of engagement resulting in sub-optimal decisions being taken
- Tendency to take a lump-sum regardless of whether this is in the individual's best interests
- Risk aversion – a possible tendency to hold funds in cash or other vehicles that fail to generate sufficient returns^v

The pensions industry, including NEST, needs to work with the Government, regulators and consumer groups in order to devise the best mechanisms for tackling such biases.

However, it is not just about consumer biases. There will also be external pressures, and in particular from creditors.

In December we also published a discussion paper, 'Dashboards and Jam Jars', which looked in more detail at the particular issues facing those with more modest pension savings, with a focus on good value, and providing good outcomes for those who know little about financial products.

This paper raised particular concerns about the vulnerability of people who fail to engage, and the consequences of making the wrong decision, which we have used as the basis for our own 'eight point plan' for making a success of the reforms:

1. Tools to help people avoid running out of money or paying too much tax
2. Integrated decision making with State Pensions and other benefits
3. Quality standards for income drawdown products
4. Guidance to ensure lenders treat people with small Defined Contribution pots fairly
5. A strong lead agency to combat scams
6. A 'second line of defence' for those who do not take up guidance
7. Suitable defaults to reduce the risks of making poor (or no) decisions
8. A duty on Government to report regularly on the outcome of the reforms^{vi}

8. What works in terms of communicating and getting DC savers to engage with decision making in the approach to retirement? How can we help members make good choices before and during retirement?

Age UK supports calls for a pensions 'dashboard' to help people understand their private and state pension provision, and facilitate planning for later life. One possibility might be to develop proposals around aggregation of pension savings to develop a 'single view' of all pension provision – including State Pensions – and extend this to other sources of income, for example other savings held, where possible.

9. How can we help mitigate the risks associated with cognitive decline as people get older?

Pension schemes could consider encouraging people to take out a Lasting Power of Attorney and complete an expression of wishes; making people aware of scams and financial abuse; and improving communications to make them as accessible as possible, while also improving their administrative support services.

They should also consider what role defaults should play in helping get the best outcomes for people suffering from cognitive decline. Some people might also benefit from a referral to an independent advice agency, such as Age UK.

10. What is the role of default strategies in the new regime and the run up to and throughout retirement?

11. Should we consider having more than one default strategy for different types of member, and which variables can be reasonably used to differentiate member needs in the event of no member engagement?

12. Based on the member evidence presented should the default target retirement age remain the same as state pension age? If not what are the alternatives?

Defaults will need to be at the heart of the future pensions system. See question two for further detail.

13. Based on the evidence presented, should purchasing annuity income be part of retirement planning for DC savers? If so - on average - what age should this purchase happen?

14. Would iterative purchase, phased annuitisation, or fixed-term annuities be a better way for DC savers to secure incomes?

We support proposals that would enable pension savers to have at least some guaranteed income in retirement, but they need further exploration, both in terms of individuals' preferences and the products that can be developed by the pensions industry. Perhaps the most pressing issue is the lack of options available for lower net worth DC savers, for whom annuities have in the past offered poor value, and the industry should address this in the first instance. For example, we have seen suggestions that some pension schemes might attempt to reduce their costs by encouraging small savers to take the cash. While this may offer a good option for some people, for others it could be exactly the wrong thing to do, exposing them to unnecessary tax, or even abusive practice.

In developing default products, we recommend that the options are tested against the following considerations:

- Suitability for people with different pot sizes, particularly those with small pots
- Some form of reversibility or flexibility, so that the default can be implemented with the reassurance that if it is the wrong option for that individual it can either be unwound or altered without too much loss. The sense of an 'irrevocable decision' is one reason why annuities proved so unpopular
- Reasonable comprehensibility and transparency. It must be possible to explain to the disengaged saver what is happening to their money
- Ensuring that people are not deterred from actually drawing their pension
- If someone has more than one pension fund, how the default will work across all their savings
- A clear interaction with state benefits and the care system. A particular concern for Age UK is that the people might be encouraged to draw and spend their pension

early in order to avoid the means-test for care (without being aware of the deprivation of asset rules), or conversely spend it on care without being aware of the possibility of state support, leaving themselves or a surviving partner short of income later in life

- The impact of bankruptcy on the savings
- Sustainability across the marketplace. A very wide diversity of different types of default offered by different types of scheme could undermine consumer trust and increase complexity.

15. Should deferred annuities be included in the toolkit for DC retirement solutions?

Deferred annuities should be included in the toolkit.

16. Are there other ways of helping members hedge longevity risk?

Some method of hedging longevity should be incorporated into standard retirement pathway (or default) designs.

In addition to the risk of people running out of pension saving, there is a risk that some people will fail to spend their pension savings. Approaches that help people maximise utility from their pension saving across their whole retirement need to be considered. For example, the 'jam jars' approach discussed in our report, which would help people budget and spread expenditure more effectively, is likely to be helpful, as would improving individuals' understanding of life expectancy.

17. Does investing through retirement, as an alternative to immediate annuitisation, have a significant role to play in meeting the retirement needs of DC savers?

Older people are not a homogenous group, and so it is likely that for some savers this will be attractive. But there are also many downsides, notably the impact of fluctuations on investment performance, particularly in the early days. We note the experience with home income plans in the late 1980s, where older people were encouraged to borrow more than they needed immediately and invest it. They were extremely badly affected when the stock market and housing market both crashed at the same time in 1987 and the home that they had counted on as their nest egg not only failed to provide them with the income they were led to expect, but also left many in negative equity (this was before the days of 'no negative equity' guarantees).

ⁱ 87% of respondents said it was important to have flexibility, Pensions Policy Institute (2014), briefing note 72

ⁱⁱ Available at http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/getting_most_from_government_private_pension_reforms.pdf?dtrk=true

ⁱⁱⁱ http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/dashboards_and_jamjars_helping_modest_savers_December_2014.pdf?dtrk=true

^{iv} PRIME (2014), The Missing Millions

^v Such behavioural risks are outlined in a variety of sources, e.g. Pensions Policy Institute (2015), Supporting DC members with defaults and choices up to, into, and through retirement; International Longevity Centre UK (2014), Freedom and choice in pensions: risks and opportunities

^{vi} Age UK (2014), Getting the most from the Government's private pension reforms: Age UK's eight point plan