The Future of Retirement - AB Response

QN.1 How will the trend for changing retirement patterns and provision affect what:

a. Members need, and

b. Employers want, from DC schemes in the future?

DC schemes must recognise that both members and employers face many future unknowns, and unknowables, be they:

- Specific issues relating to an in individual member or employer
- Legislative changes around state benefits and pension regulation
- General local and global economic issues effecting the wealth of individuals and employers as a whole
- Non-economic issues, such as medical advances effecting both the ability of individuals to keep working but also their likely longevity in retirement.

What this means is that DC schemes of the future need to be flexible enough to evolve in an efficient and timely fashion as the member and employer needs change. Indeed, as demonstrated over the last year, it would be poor risk management to put in place a DC scheme that effectively hard codes what is currently known but which could not be adapted quickly and cheaply should circumstances change.

Further, a wealth of evidence shows that individual engagement with individual members and employers cannot be relied upon for updating of the strategy to take place. Indeed for it to be effective it is likely to be both costly to achieve and untimely in its execution.

Rather an approach that relies on good nudges, such as defaults, is likely to be more efficient and timely in executing changes that are necessary to adapt the design with evolving member/employer needs – but only in our opinion if undertaken by a combination of experts being overseen by a governance group that truly represents, and has the power to act, in the best interests of members and employers.

Best in class DC scheme design of the future should also address whether when decisions are made as a result of member or employer engagement they should, as with auto-enrolment, require regular re-engagement. That is a member should be asked to re-certify their choices on a regular basis and in the absence of this be automatically re-enrolled in the default strategy.

Best practice DC scheme design should, and their all-important default strategies, we believe encompass four key principles:

- Good governance – where individuals with the competence, control and alignment are responsible for making decisions on a member's behalf.
- Robust design – Recognising that there is considerable uncertainty around future individual member needs that cannot be resolved via engagement. Spurious accuracy based on assumptions about members needs should also be avoided for obvious reasons.

- No cost to change – Poorly or unengaged members should not be put into a strategy that is either impractical or costly for them member or the scheme itself to amend. That is members should not be defaulted into anything that they do not have a zero cost option to opt-out of at a later date.
- Avoid unsustainable/unfair cross subsidies – DC schemes should be aware of all cross subsidies that exist within their scheme and look where possible to mitigate their potential impact on outcomes should member or employer behaviour act to select against them

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

The "Freedom and Choice" budget changes fundamentally changed the UK market into one where the majority of private savings (outside the public sector) will now be on a pure DC basis. Prior to this budget private savings were either made on a DB basis only or on DC basis prior to retirement and substantially DB thereafter, whether it was by purchase of an annuity or capped drawdown. The design of DC schemes will need to now recognise this change.

The overarching objective of a pension scheme, to provide income in retirement, did not however change. What did change is how much this will vary by individual member and hence the design will need to robustly cope with this whilst avoiding spurious individual assumptions based on far from complete data about them.

We would recommend that a simple default strategy, that has the objective of not being too wrong for the vast majority of individuals, is best. Importantly complex, and hence costly, strategies that risk being significantly wrong for sizable groups of individual members, whilst providing minimal additional benefit for the few they are right for, should be avoided.

QN.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?

Whilst it is true that NEST members may exist towards the lower ends of the wealth spectrum, changes made to the NEST scheme that removed the contribution cap and transfer-in ban means that its membership is likely to become quite diverse. Hence NEST should avoid making significant design decisions based on assumptions about its future membership based on its current membership.

An additional critical factor, which has clearly been significant in the development of NESTs membership to date, is the likely interaction between NEST and our pension providers and how this will impact on its future membership.

The unique feature NEST has, compared to other providers, is its mandate to charge all members and employers the same. This results in significant cross-subsidies, largely to the detriment of wealthier savers, and puts it at a commercial disadvantage to those providers who can choose their clients. A good analogy is of a car insurer that charges all drivers the same premium no matter what car they drive or their likely driving competence.

This has, and will remain, the key factor influencing NESTs future membership and how employers use it. Indeed the charge cap and the resulting focus it has placed on cost over quality in pension provision is likely to accelerate this trend.

We would suggest that in its forecasts that NEST should assume that best advice in the future will be that members with total accumulated pension savings in excess of £20,000 could be advised to achieve a similar investment approach, at a lower cost, outside of NEST. As such NEST should take into account that, unless members do not get best advice, over the long term very few of its members will ever accumulate significant overall retirement savings.

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

Our research shows that whilst there is considerable heterogeneity around members needs there is arguably considerable homogeneity in respect of how a retirement solution can be developed to meet them. Or to put it another way just because on the face of it the problem is complex this does not always necessitate a complex answer. Indeed for reasons set out in previous answers complex answers are likely to be to the detriment of the future efficiency of change and hence member outcomes.

Our research shows that the vast majority of members need a solution which copes with considerable uncertainties over issues which not only will they not engage with, but even if they do are likely to do so with little expectation of accuracy. For example

- When they will retire
- How and when they will need to access their retirement savings
- How future regulation will changes their needs
- Future investment market performance

In all cases the answer of "I don't know" is probably the right one.

Our research with the PPI suggests that all these needs are consistent with the wishes of members to be invested in a professionally managed default strategy that:

- provides them with flexibility as to how and when they access their pension savings
- does not burden them with decision making
- provides them with the freedom to make a choice, but not the requirement to – definition of genuine freedom, to change their mind without penalty at any time
- that embeds income as well as investment advice beyond retirement

QN.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?

We expect that the inertia and lack of engagement that dominated in the pre-retirement and post-retirement phases in the past will continue to dominate. As such members are likely to go with whatever solution is easiest to buy to meet their immediate needs.

Indeed many members historically purchased annuities when they had many other options because plans made it the simplest to execute option, either via an internal switch or an annuity broker, with no simple option to pursue the alternatives available, as such they were essentially defaulting.

We believe the key drivers of member decision making should be:

- Flexibility – Critical as the way in which individuals access their savings will need to change with evolving personal circumstances, legislation and product availability.
- Tax - Which prior to costs or investment quality will most likely be the key determinant in many cases of the outcome they achieve from their pension savings. This will need to cover not just income tax, but also inheritance tax and the impact of pension assets held in trust on long-term care costs.
- Value for money – Measured not only as the expected net outcome after account is taken for the direct costs incurred but also the indirect costs incurred by the member in time and effort.
- Investment quality – Will one investment provide a better outcome than the next?
- Certainty and control –How certain am I of the outcome that I will achieve and what is my ability to change my mind should my needs change.

We believe an ideal retirement solution for the member should have the following features:

- Simple to buy and monitor – as the cost to the typical member of doing this themselves well are considerable
- Allow them to change their mind in the future – no lock ins
- Provide a good expected net investment outcome
- Does the right thing for them - Makes the hard decisions for them, such as taking more risk than they would necessarily do themselves.
- Does not require future engagement – It should continue to make decisions for them without the need for them ever to engage again in the future.

The Member behaviours under the new Freedoms we would suggest are as follows:

- If in scheme options are available - Most likely
  - Remain invested in the plan until money is needed
  - Move to an in-plan offered income solution (if simple to use)
- If no in-scheme options are offered – most likely to take cash to an easy to purchase non-pension solution e.g. Deposit account, ISA etc.
- If engaged and the in-plan options are either not available or of poor perceived value, a pension based external option. Likely to be the preserve of the wealthy minority.

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

- Inertia and its likelihood to increase in later life.
- Lack of engagement (insufficient resources to spend time or money on making decisions themselves) resulting in taking the easiest option

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

Beyond those already covered:

Compliance risk/costs – these costs become disproportionate making a good pension solution either poor value for money or not available at all. As a result money is taken to be invested in less tightly regulated products/services.

Risk adverse governance oversight – this behavioural bias tends to result in those responsible for making decisions on members behalves being short-term loss adverse to the detriment of long-term outcomes. The analogy would be a doctor who rather than working to make someone better treats only their symptoms to relieve their pain in the short term.

QN.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?

It is important to ask the question what do we expect to get from this engagement? Our research suggests that most savers are ill positioned (which is different to the common market misperception of them being ill-informed) to provide definitive answers to the questions we would like them to answer.

Hence engagement can cynically be seen as a way of a pension provider and its regulator shifting the burden of responsibility for decision making from the trustees to the individual in a manner which is probably not in their best interests.

For example consider the following typical questions providers ask:

- "when are you going to draw you benefits" the genuinely correct answer from a majority of savers is "I don't know" – however we often mistakenly as an industry ask for a precise age/date and design a strategy that is highly sensitive to it . Indeed many retirements often happen as a result of circumstances beyond an individual's control and hence even when a precise answer is given it defines an ambition rather than a certainty
- "how will you use your money in ten years' time" again "I don't know " is probably the correct answer. Who knows what the options will be available to that individual then and also what their personal needs will be.

We believe that because members will most likely through inertia of lack of engagement use a default that this remains the most powerful tool, both before and after retirement in providing good member outcomes. Engagement can most efficiently and effectively be used to identify those individuals for whom the default is likely to be most wrong and NEST should undertake such an analysis and target its engagement appropriately.

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

Research suggests that individuals need to have in place a safety net whereby the responsibility for their savings moves by default to a trustworthy third party. In reality for many of us we believe trustees, such as those at NEST, are ideally positioned to provide this safety net.

Best practice amongst our client is as follows:

- Ensure that the default accumulation strategy continues to be defined and work for all ages up to and beyond state retirement age for those members who never engage.
- On retirement offer an in plan income option that embeds age appropriate investment management and pay-out advice in a low cost fund (our so called “Retirement Bridge” option) that will take them to age 75 - analogous to the pre-retirement journey they have been on. As an alternative they may select a non-age dependent fund (our so called “Evergreen income” option) which seeks to provide income and protect capital. Obviously the income provided by the later approach is considerably less than if the income is set on an age appropriate level.
- At age 75 the member is offered the option to switch to the “Evergreen income” fund, where capital is protected and where the trustees can feel confident that the member is being looked after in an appropriate way no matter what their needs. As this income is lower than what could then be provided by an annuity the annuity alternative should also be provided via a broker for members wishing to maximise their income over their lifetime.
- At all times the freedom for the member to change their mind should remain, however the ability to self-select investments should almost certainly be removed after age 75 for all members except those who have an appointed power of attorney.

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

We believe that there could, as with the accumulation stage, be a significant role for defaults to play. This is because as with the accumulation stage:

- they are cheaper to operate, as all members are buying the same funds and costly engagement is not required
- they address the behavioural biases exhibited by inexperienced investors who tend to buy high and sell low
- they overcome the inertia bias that is prevalent amongst investors who may be initially engaged with at the point of entering a strategy but then become disengaged leaving them in a zombie strategy which is not overseen for by a governance group acting in their best interests
- enables engagement to focus on the more tangible issues about how much they should be saving and what the outcome might be

Importantly in the decumulation stage the default strategy should we believe embed an age appropriate sustainable drawdown rate thereby assisting members not to drawdown their funds too quickly in retirement. Good governance would, as with the investment strategy, require this to be undertaken by a manager embedding it within the default strategy and therefore removing the conflicts and costs associated with this being decided directly by the provider/trustees.

The vast majority of members face a considerable amount of uncertainty in the run up to and the initial phases of retirement. Broadly these uncertainties relate to when they might start to access their savings, how they might use them, their health in retirement etc. It is unlikely in our opinion that early engagement regarding what the investment or access strategy a member is likely to pursue will improve outcomes for the vast majority of members. As such a pragmatic default strategy is likely to be appropriate for all bar a small minority of members. Early engagement would be more efficiently and effectively concentrated, as with the accumulation stage, in identifying the minority members for whom the default is likely to be significantly out of line with their needs.

QN.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?

We would caution against such an approach on a number of grounds:

- The level of heterogeneity in individuals means that the making of assumptions about the appropriate default based on assumptions involving incomplete individual data is extremely dangerous. For example a member with a large pot may be planning to redeem to cash and buy a property investment to pay income or may want the certainty of an annuity. A member with a small pot may have a significant DB pension and be planning to take it as cash but then invest in a stocks and shares Isa or alternatively may wish to leave it invested until such time as they have a need for it. Conversely age and state pension age, the current drivers of the default strategy, are data points that are indisputable.
- Our research with the PPI suggests that members expectations of the default is that it does not target a specific outcome but rather remains flexible both in the age at which it will be accessed but also the manner in which it will be accessed. This suggests a single default that hedges the ranges of possibilities the members have rather than specific targeted defaults is likely to be the most appropriate strategy for the majority and is the one most expert investors would in our opinion choose for their own money.

We would recommend that a single default, as current, is used that meets the members broad needs and that NEST puts in place self-select options that highly engaged members can select if they have a specific view on their needs. Our research suggests that it is likely that less than 20% of the membership will have such opinions. Engagement should seek to make these members aware that these options are available, but not, dangerously, seek to get members to make choices they are not really fully engaged in.

QN.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?

We believe age and/or state pension age is the most important factor in determining a members risk capacity, as it defines the investment horizon (which is not certain but definitely decreases by one each year) over which losses can be recovered and also acts as a good proxy of the relative value of the individuals remaining human capital to their accumulated wealth.

Evidence does show, and has done for some time, that the actual age of accessing savings will vary considerably. As such the default strategy should take this into account in its design and not be overly sensitive to a members age. To this extent we believe that its current NEST design is inappropriate, and should de-risk more gradually, carrying less risk for member from age 55. The precise level of risk at State pension age will depend on the views of the trustee of the membership, but we believe is unlikely to be zero given the decisions already taken by the trustees to take considerable levels of risk at other ages.

QN.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?

Whilst it clearly depends on individual circumstances, most notably the individuals wealth and health, we would recommend that this decision is made no later than age 75 currently because:

- For the typical individual seeking to maximise their income over their retirement this appears to be in the optimal age range.
- We need to ensure we do not delay engagement with the member about this critical issue too late in life.

QN.14 Would iterative purchase, phased unitisation, or fixed term annuities be a better way for DC savers to secure income?

No, all approaches are likely to be extremely costly and complex to explain and administer and hence inappropriate for the average NEST member whose pot is likely to be too small for reasons as set out earlier in this document.

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

No, with the exception of wealthy savers, whom are able to seek individual advice, deferred annuities are financially complex irredeemable products where the potential risk reward trade-off is very poor. As such we would not recommend that they are used by the financially unsophisticated either through choice or in a default manner. In terms of investment only issues:

- If they are to be made suitable for a default strategy then they would need to be redeemable by the member without penalty, a principle that we think should underlie any default, this would add significantly to the cost of the deferred annuity as the insurer would need to take this into account in its pricing.
- The deferred annuity would need to be inflation linked to provide appropriate protection to the saver (otherwise the strategy runs a considerable risk) this is further going to increase the cost of this approach.
- It is highly inefficient to allocate those funds that will be invested for the longest period of time to bonds (a deferred annuity) whilst investing those that are for the nearer term in equities. Indeed such an approach turns a long-term investor into a gambler..
- Most of the economic benefits to the member could be achieved at a far lower cost by making an allocation to long dated bonds of appropriate duration – as is already the case in the default strategy.
- Given the typical pot size of NEST members over the coming years this is unlikely to be of any significant benefit to NEST members

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

Yes, such as withdrawal income guarantees, although few are likely to be beneficial to NEST members with small average pot sizes and a limited budget for implementing them.

QN.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?

Yes. Many of our clients are implementing exactly this approach investing for the period from retirement to age 75 in a default like strategy that embeds an age appropriate sustainable payout rate. This has the following key benefits to the member:

- As in the period before retirement they continue to benefit from the high quality governance oversight of trustees and their scale buying power
- The approach can and should embed age-appropriate sustainable drawdown advice at a low cost
- The member retains flexibility as to how they use their money in retirement, enabling them to more easily cope with their changing needs
- The member has time whilst in retirement to consider their needs before committing themselves to an irredeemable course of action such as an annuity – improving their buying decisions.
- It nudges the members towards a good outcome
- The investment horizon remains long and hence the ability to continue to gain from investment without taking undue levels of risk is significant

QN.18 If you were designing a default drawdown strategy for NEST members, how would you do it?

We believe such approaches will require innovation and are therefore interested in solutions that address the following issues:

- **Governance – including setting pay-out rules**
- **Asset allocation and risk management**
- **Flexibility for members**
- **Incorporation of insurance for market and longevity risk.**

We believe that by definition good governance must be at the heart of any good default.

The basic principle of good governance of the default is that the objective setting and monitoring should be undertaken independently of the strategy design and execution – with the unconstrained power vested in the trustees to make whatever changes they feel are appropriate to those responsible for this design and execution.

Unfortunately we believe these simple good governance principles are largely absent in the UK DC market today. Often trustees not only set the objectives of the default strategy but also make all the important investment decisions, such as asset allocation and individual stock selection (if they choose to invest passively and select the individual indices used). They are then also responsible for reviewing their own investment performance. In some cases they are even constrained as to whether they can make changes to those executing the strategy.

Unfortunately, often the enthusiasm of trustees to act and behave like investment managers comes to the detriment of their ability to provide good independent governance oversight on behalf of members.

We believe that the trustees should clearly set and state the investment objectives and beliefs of the default strategy, including its cost objective if it has one (as is the case for NEST), and then appoint an independent investment expert to design and implement this strategy. The trustees can then effectively independently monitor the performance of the strategy in the best interests of the members.

Any good default strategy is almost certain to look like a multi—asset fund whose asset allocation changes as the objectives, best thinking, legislation and markets evolve. Indeed the target date funds currently used by NEST are precisely this, with the added benefits of being age appropriate and built specifically to meet the trustees investment objectives and beliefs (including their cost objective).

The investment industry has provided significant innovation in the multi-asset space over recent years, be it be total return funds, diversified growth funds or target date funds. These solutions have significantly increased the investment sophistication that DC members can access. Indeed they have improved risk management, reduced costs and provided inbuilt good governance.

When setting the objectives for the default strategy it is important that NEST fully understands the needs (rather than wants) of its membership– indeed we would expect the operation of the default on such a basis to be aligned with the reasonable expectations of the members who have placed professionals in such a position of trust to do what's right for them. This statement of objectives should include how the trustees believe members should best access their savings on retirement based on expert advice they receive from their advisers.

If there is a significant gap between what trustees believe is likely to be the best strategy for a member and their likely behaviour they should seek to firstly address this via their communication strategy rather than expensively encumbering the strategy to pursue an inefficient outcome which may not be defensible at a later date.

One additional key principle a default strategy should embed is the right of the member to choose to exit the strategy at no cost. Essentially this requires the assets of the default to be fairly priced daily but not necessarily liquid, given it is unlikely that significant numbers of members will take this option up.

This would suggest an area of future innovation will be the provision of assets to default strategies that are traditionally illiquid (eg mid-market lending, property and private equity) but provide potentially superior risk adjusted returns to traditional liquid assets.

Insurance guarantees are unlikely to be appropriate for a default strategy given the cost of capital associated with writing the guarantee is likely to mean that a member exiting would be subject to high penalties. Where an insurer reduces these initial costs it is achieved via an increase in the long term cost of the guarantee that would make it poor value for money.

So as a simple process the trustees should at outset:

- Set the investment objectives for the default - encapsulating what they believe is best for their membership whilst recognising the considerable uncertainty they face and any cost constraint (typically representing this as an age based risk profile, return target and suitable outcome based investment objectives eg rpi +, cash + or income/bond +)
- Set the investment beliefs for the default – encapsulating any specific investment approaches (such as ESG/SRI) or risk premiums they believe in (value etc.)
- Appoint investment manager(s) for the default – who choose the weights in asset classes and individual stock selection (subject to the investment beliefs and constraints of the trustees)

And on an ongoing basis to monitor and review:

- The investment objectives and beliefs suitability
- The performance of the investment manager(s) – against the set investment objectives

Rigorously implementing this approach we believe will provide the best outcomes for members of NEST and set a new standard for governance of DC schemes in the UK.

QN.19 Should NEST consider some form of risk sharing as part of a solution for NEST members in retirement? If yes, what sort and why?

No.

Why in theory this would be optimal, the practical considerations and risks involved will be considerable. Most significant is the accusation that such an approach would result in significant transfers of wealth from less wealthy savers to wealthy ones - A risk that can only be mitigated by individual underwriting, but whose cost would be prohibitive.

Longevity risk sharing involves the transfer of value from the short lived to the long lived. Evidence shows that savers in higher social groups live considerably longer (in extreme three times longer) than those from lower social groups and that they proportionally build up a greater level of savings. As such it would not be unreasonable to expect up to 50% of the pots of poorer members to be raided to pay for wealthier members pensions in a risk sharing scheme where no underwriting takes place.

We believe operating such an approach will leave NEST open to future criticism that it is transferring wealth wholesale from poorer members to wealthier members. i.e. NEST would be operating a socially unfair mechanism contrary to its mandate.

We believe that such schemes should only be operated by employers prepared to pay substantially in excess of the auto-enrolment requirements and are poorly suited to minimum compliance auto-enrolment only employees, the core of NESTs client base. Indeed with the removal of the contribution cap and transfer ban on NEST the likely transfer of wealth risk has been greatly enhanced.

These risks could be mitigate, but the complexity of so doing would be significant.

Finally, unless costly and complex safeguards are put in place, potentially with the need to restrict member freedoms, there is a considerable risk of selection against NEST by wealthier and healthier members. This would lead to the unhealthy leaving NEST with a purely healthy group. The need to reserve against this risk means that the pay-out rates will look deeply unattractive and poor value for money versus competitors. Once again NEST would be analogous to a car insurer that charges all drivers the same premium no matter what their car or expected driving competency.

QN.20 Would there benefits in combining a risk sharing approach and pure DC, and if so, what would these be?

Yes but not for NEST given its cost constraints, likely membership and inability to control its customer base.