NEST

The Future of Retirement

January 2015

Allianz
Global Investors

Understand. Act.

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Introduction

Company

Allianz Global Investors is an investment division of Allianz Asset Management AG, a wholly owned subsidiary of Allianz SE, one of the world's largest financial services providers.

AllianzGI Global Solutions is a business unit within Allianz Global Investors with more than £58bn in assets under advice/management for over 100 high-calibre institutional clients around the globe.

We offer an array of investments across a wide range of asset classes to help meet investors' ever-changing needs. Through our joint research together with various academic institutions, e.g. the OECD and the Institute for Mathematical Finance at the Munich University of Technology, we have developed innovative products and solutions for pensions markets across the globe.

We would like to share our views on the questions posed by NEST in the current consultation as a response to the new regulatory landscape.

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?

a) In 2014, Allianz conducted a survey regarding the perception of retirement. The survey was conducted to generate comparable perspectives of younger and older people on their respective futures, in particular their time spent in retirement. The younger cohort comprised individuals aged 30 to 45, the older cohort consisted of those aged 60 to 75.

Some findings from the survey include:

- Almost one-third of individuals aged 52 to State Pension Age are unable to report a range within which they expect their future income from their entire private pension to lie.

- Men report greater certainty than women do.

- Individuals find it harder to predict how much they will receive if the pension is a DC rather than a DB pension.

- DC pension holders' expectation of retirement income appears somewhat optimistic. At current annuity rates the median individual would need to accumulate a further £20,000 on top of their existing DC fund to reach their expected retirement income.

- The median percentage increase in fund value required to achieve the expected pension is 77% (assuming no lump-sum is taken).

- Among DC members who have already retired and annuitised their pension pot, the average realised income equates to 80% of the income individuals previously expected income.

- In case of DB-pensioners this figure is also 80%. DC savers are more uncertain about their future retirement income (this might lead to higher precautionary savings?) and the majority overestimates what they receive as an income from their pension pot.

It is becoming increasingly necessary to provide flexibility for members within their retirement phase. Retirement provision should be able to adjust to cater for unexpected changes in personal circumstances. For example: If a manual labourer is not able to work full time until their specified retirement age due to physical injury, their DC scheme should take this into account through e.g. the reallocation of their pension savings, allowing them to draw an income before age 65, allowing lump sum withdrawals, etc.

Whilst flexibility is an important factor, a framework should be put in place to not overload members with decision-making. Generally, members are not very good at estimating how long they might live and planning their financial requirements accordingly.

For many of the members in the lower half of median income, their assets in DC plans will represent all or most of their entire liquid net worth. They will need help on how to 'think' about these savings from an emotional standpoint in addition to professional financial guidance as they transition into the decumulation phase of retirement.

For more information on the survey, please see: http://projectm-online.com/media/Project%20M/research/demographics/2014/04/security_trust_solidarity.pdf

b) Employers are increasingly viewing member retirement success as an obligation to their workforce. Therefore, the will be an increased emphasis on defining what retirement success is and how to achieve it. Employers have a sense of fiduciary duty to provide their employees with 'best possible outcomes', 'guidance' and a 'sustainable income stream' in the future. This will lead employers towards relying more on outside consultation that allows them to build DC solutions that cover the entire life cycle (accumulation and decumulation) of their members.

From our experience, employers are increasingly looking for a one-stop shop, which takes as much of the time-consuming work in a DC scheme as possible off their hands. Due to the current size of many DC schemes in the UK, it is simply not yet feasible to generate enough economic scale in house to efficiently provide a high quality arrangement for their members.

On top of that, we are also seeing a strong demand for 'smarter' investment concepts. In the current environment of financial repression and low interest rates, strategies offering a high probability of a regular, predictable income at a reasonable cost, are highly sought after.

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

More customisation will be required at the member level especially as they approach 5-10 years from retirement date. This customisation may range from 'smart defaults' (that take into account total assets/income and loss aversion) to one-on-one consultations with a financial consultant.

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?

It is apparent that there is a need for a holistic view of all savings and spending to be able to provide specific individual advice to members.

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

Generally speaking, it is nearly impossible to build a realistic top-down assumption on retirement spending across a pool of individuals; this is truly an individual, bottom-up perspective depending on an individual's work/life choice, lifestyle, health, wealth, taking into account an individual's holistic retirement income (Pillar 1-3), etc.

On a comparative basis, asset management based retirement income solutions are commonly much more flexible than insurance based solutions and can address changing spending behaviours much easier and cheaper. There would typically be no "break clauses" or "exit fees".

Asset management based retirement solutions would mainly be invested in liquid assets which can be accessed according to individual spending patterns and needs.

For retirement income solutions allocated into risky assets it needs to be clear that these may suffer temporary losses.

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?

If UK retirees follow the spending patterns from elsewhere, they will soon splurge on cars and holidays, while others will pay off mortgages or invest in properties to rent, causing housing prices to rise. Australia's decisions in the mid-2000s to include annuity income in the means test for the state pension killed that market overnight. In Malaysia, where people can take their entire defined contributed pension at retirement, 70% spend their lump-sum within the first three years of retirement, says Jens Reisch, CEO of Allianz Malaysia. In the US we are seeing some early anecdotal evidence of members in lower income brackets taking all of their DC savings in the form of a lump-sum distribution (rollover into an IRA) and then spending all of their lifetime savings within a three year period.

Solutions that automatically recommend a portion of a member's savings to a lifelong income product (some form of annuity) may prevent this scenario from happening on a wide scale basis. There is a behavioural aspect to annuitisation. When people are offered the choice between a lump-sum and an annuity in their corporate pension scheme, annuitisation rates are higher if annuities are set as a default.

People can also be 'framed' as behavioural economists describe it, into choosing an annuity. That is, given the exact same circumstance, people will react differently depending on how a choice is presented to them. Jeffrey Brown from the Department of Finance at the University of Illinois and colleagues offered survey participants an annuity with the ability to "consume $650 a month for life" or "a lifelong return of $650 each month." The first approach led to substantially higher annuitisation rates. The findings have been confirmed providing evidence that individuals can be influenced towards buying an annuity by the product description.

People are also overwhelmed by the decision to annuitise. This, rather than a preference for lump sums, may explain the low levels of annuity purchases in some countries. Choosing a lump-sum over an annuity appears the easier option, although those with a higher level of financial literacy do better at evaluating the benefit of an annuity. The way the various retirement options are communicated and the extent to which they can be understood and easily accessed can have an enormous influence over how members are likely to act.

For further information on how preparing for retirement differs between countries, please see our study: http://projectm-online.com/media/Project%20M/research/savings/2013/how-european-savers-prepare-for-retirement.pdf

6 What member behavioural risks do providers need to manage?

Members are extremely loss adverse when they are less than 10 years from retirement. Evidence shows that following the market correction in 2008, a large percentage of members nearing retirement age moved their DC savings out of equities. This locked in the market losses therefore significantly harmed a lifetime of good savings and investment habits.

For a deeper insight into behavioural challenges with respect to making financial decisions, please see: http://projectm-online.com/magazines#/magazines/project-m-10-behavioral-finance-2-0

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

The risks stated in the NEST consultation document appear comprehensive.

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?

Transparency, clarity, simplicity and conciseness of explanations are key requirements when communicating with members.

Automated features (auto-enrolment, auto-esculation, and default investments) seem to work best until a participant reaches the period of 5-10 years prior to retirement, at which time more engagement through varies medium is sought out by members.

It is important to provide enough and the most significant information material to the target audience (not only written forms, but e.g. webinars, factsheets, case studies, helpdesk, and online projection tools with outcome orientation etc. can be useful). Focusing the communication on projecting income with a range of reliability will be important. In developing a better understanding for members it is also useful to avoid investment jargon. A good method could be to provide case studies and samples which the members can relate to.

Our experience shows us that it is important to provide a balanced range of options during accumulation and decumulation, to give members a fair choice. However, too many options or too complex options can easily overwhelm members, resulting in them not making a decision at all out of fear of making the wrong one.

To help members understand better and therefore make better choices, it is important to get the members started early with a focus on 'income' rather than 'account balance'. Educating members before their retirement date on the benefits of guaranteed lifetime income and realities of budgeting during retirement can help them avoid pitfalls relating to decumulation strategies.

For further insights into how communication can help assist members' decisions, please see: http://projectm-online.com/magazines#/magazines/project-m-18-thieves-of-their-own-wallet

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

N/a

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

The purpose of the default does not change: it is ultimately to provide guidance to those who do not make an active choice, to protect their DC pension income from large market shocks and a changing capital market environment.

There isn't one unique or dominant investment solution that can be recommended as a default option. The design of the default option should depend on various factors, including the length of the contribution and accumulation period and the type of benefit pay-outs targeted. For example, members intending to annuitise at retirement should hold a higher allocation of fixed income assets to hedge the interest rate risk inherent to annuities.

Now that restrictions around the use of drawdown have been relaxed, it is important to not only structure the investment up to a specific retirement date, but also throughout retirement. The objective should be to provide the members with a continuous account drawdown with an appropriate default option over their entire lifecycle. Usually, these kinds of strategies will include a small proportion of risky assets at retirement and throughout the drawdown phase to maintain participation in capital markets throughout the entire lifecycle.

The overall goal with respect to the design of default options should be to provide a stable and projectable retirement income; i.e. 'DB-like DC'.

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?

Offering multiple default strategies implies that a) meaningful clusters can be built that distinguish retiree groups; b) a mapping can be made (upon sufficient information).

Members' needs should be differentiated depending on their intended pay-out option and specific member characteristics such as savings/ contribution rates (see question 4).

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?

N/a

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?

N/a

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

N/a

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

N/a

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

There are two components of longevity risk: systematic longevity risk and idiosyncratic longevity risk. Systematic longevity risk (trend risk) affects all individuals collectively while idiosyncratic longevity risk refers to the random fluctuation between individuals' mortality.

The idiosyncratic longevity risk can traditionally be hedged by offering a form of annuity instead of a lump sum. An alternative to annuities would be a collective DC scheme, where individual members can reduce their idiosyncratic longevity by pooling this risk across the individual members.

While the idiosyncratic longevity risk is most relevant in the retirement phase, the systematic longevity risk, in contrast, has to be considered in the accumulation period. It arises from systematic improvements in life expectancies and is even more significant for younger members. While idiosyncratic longevity risk can be hedge by buying annuities, the annuity rate available at retirement is exposed to systematic longevity trend risk i.e. annuity rates will decrease during the accumulation period if the life expectancy of all individuals collectively increases.

Hedging or reducing that systematic longevity trend risk is not straightforward. Deferred annuities would be a candidate to hedge at least a part of that longevity trend risk. However, liquidity and availability is often an issue. Another instrument could be standardised longevity swaps on a general population index. However, these instruments are usually not available to plan members. For that reason there are several discussions why governments should issue longevity bonds on general population indices. These bonds could be used in the strategic allocation of the DC plan in order to control systematic longevity trend risk. Please also see the attached financial study: “Longevity Risk within Pension Systems - A Background Paper to the OECD Policy Report” for further details.

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?

This depends on the size of retirement pot. Annuities may provide a stable retirement income stream but may not be an economic solution for very small pots.

Investing through retirement allows for continual exposure to risky assets throughout the retirement phase. This opens up additional return opportunities which could contribute to improved retirement income but also bears drawdown risks. Appropriate management of the additional risks is crucial.

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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.

As NEST's investment strategy adviser we are happy to directly support NEST in building state-of-the-art, customised drawdown strategies.

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?

One of the biggest risks facing retirees in DC is longevity risk, which can be eliminated by buying an annuity on the open market. We have also seen that longevity risk is related to income (people with a higher income tend to live longer). If a member with a low income buys an annuity on the open market, they are likely to be overpaying for his longevity risk and receiving a lower annuity in payment. Since NEST is predominantly aimed at providing solutions for lower earners, it would be beneficial for the members if NEST were to apply some form of risk sharing across their membership. This should enable them to attain more favourable rates for members as a whole and reduce longevity risks.

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

In the Netherlands, collective DC has become popular over the last decade. It was popular because the employers could account for such a plan as a DC plan under IFRS/Fas etc, whilst employees & unions still received a DB-like plan. Nowadays we are starting to see some of the larger companies offer a hybrid plan (collective DC and pure DC), giving employees the choice to allocate part of their accumulated capital to the collective DC plan, thus not having the transition risk resulting from having to annuitise at retirement.

Some of the advantages of collective DC include:

- Usually more favourable (asset) management fees

- Smooth transition into retirement (especially in countries where annuitsation is (partly) mandatory

- Members can decide themselves to de-risk at any point in time

- From a members' perspective, it may still feel like they have a DB-plan, whilst behind the scenes this is not the case

The main disadvantages of collective DC are the issues faced by schemes in the attribution of annual investment returns, longevity premium etc. In addition, if people transfer their benefits to another provide, issues surrounding transfer values may arise.

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