BlackRock

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National Employment Savings Trust
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Submitted via email to: nestresponses@nestcorporation.org.uk

RE: The future of retirement – A Consultation on investing for NEST's members in a new regulatory landscape

Dear Sirs,

BlackRock is pleased to have the opportunity to respond to NEST's Consultation on the future of retirement.

BlackRock is a premier provider of asset management, risk management, and advisory services to institutional, intermediary, and individual clients worldwide. As of 31 December 2014, the assets BlackRock manages on behalf of its clients totalled £2.99 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds.

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BlackRock represents the interests of its clients by acting in every case as their agent. It is from this perspective that we engage on all matters of public policy. BlackRock supports policy changes and regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analysis, preserves consumer choice.

We welcome the opportunity to address, and comment on, the issues raised by this consultation and in this response we have focused on those questions where we have specific experience to share with NEST. We welcome the opportunity to continue to contribute to NEST's thinking on any specific issues that may assist in improving the final outcome.

Key points

Designing future product solutions

We believe the UK Government's ongoing reforms will bring about a more innovative market for retirement income than the predominantly annuity-based market today. We expect to see a large number of new decumulation products offering income drawdown solutions to sit alongside existing annuity options, possibly incorporating some element of protection (against longevity) whilst retaining market risk exposure. A key issue for product providers and guidance providers will be to differentiate between a large array of product offerings and ensure cost transparency.

We believe that future defined contribution (DC) solutions must be designed to:

- meet a wider range of consumer needs, such as providing a predictable level of retirement income with various draw down options,
- keep generating returns as savings deplete over time,
- be easily understood and transparent,
- be cost efficient, and

- provide online guidance throughout retirement (covering topics such as longevity, living costs, investment).

We also underline the continued importance of offering default solutions designed to meet the needs of the majority of savers in both the accumulation and decumulation phases. Where savers do not make or delay making decisions regarding their savings on retirement the default solution will have to operate in the decumulation phase – in effect this would be the new default retirement option unless a saver makes an active decision to tailor their retirement income.

Member communication and guidance

The proposed guidance guarantee at the point of retirement will be of benefit to many savers. However we strongly believe that retirement guidance is not a single event but rather an on-going activity. Providers such as NEST can support this process with clear checkpoints throughout the accumulation phase – particularly important events being:

- At age 55 when benefits can be first accessed,
- the dates five and ten years prior to the date when the individual plans to access their retirement savings in whole or in part, and
- during the decumulation phase where on-going investment choices have to be made.

In addition to member communication itself, additional communication from NEST or government in the form of direct education would also be useful, for example the campaign on auto-enrolment.

Responses to questions

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?

In our view the most fundamental issue is that of framing individual's retirement needs. The shift from Defined Benefit (DB) to DC has placed the three dimensions of retirement investing firmly on the shoulders of participants: savings, asset allocation[1], and the transition into retirement spending.

Today, most individuals equate saving for retirement with accumulating a pot of money for retirement and using this either as a cash lump sum or purchasing an annuity. The transition of accumulated savings instead into an efficient income stream needs to addressed. This is particularly important as the mechanics of this transition and the benefits of potential solutions are also poorly understood by most participants (and indeed are not catered for in traditional product designs). Yet research we have conducted in the US has shown that members with pension schemes that define the income benefit or who have a high degree of certainty about their accumulated savings' ability to generate income, believe they are more prepared for retirement.[2]

What most individuals need is a reliable form of income to fund retirement spending, specifically, to cover expenses such as housing, food, heating and leisure costs, etc. Annuitisation provided certainty in this regard, but with little or no flexibility of income over time.

Wealth accumulation is largely a function of savings rate and market returns. Retirement spending, or rather the obligations that require spending, generally has no relationship to market returns – it is difficult to decrease spending in years when markets are falling because there is an effective spending floor unless specific advice is taken on reducing expenses in adverse market conditions. In the retirement savings construct, individuals seek to fund a set of spending obligations that in most cases have no analogue in the investor's asset portfolio.

The key, therefore, is for product providers such as NEST to combine product design with features to help members understand the connection between their current retirement savings and their future spending power, to help them protect their future income potential, and help manage the impact of market volatility on their portfolio's ability to provide such income. This should ultimately benefit participants in that they can achieve more clarity about their ability to meet their spending obligations in retirement.

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

No comment.

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?

No comment.

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

No comment.

[1] Dalbar Quantitative Analysis of Investor Behavior, 2008
[2] According to the BlackRock 2012 Annual Retirement Survey, participants with a DB plan are more likely to report that they are prepared for (66%) and will have enough money to (62%) retire.

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?

No comment.

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

No comment.

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

No comment.

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?

The scale of changes proposed in the 2014 Budget calls for a fundamental rethink in the way that savers are supported so they can make informed decisions. It also accelerates current trends. In our view, the logical and most suitable bedrock of this approach would be the provision of free and comprehensive guidance programmes where the dominant features would be clear and engaging digital communications (online and mobile based technologies – tools, simple modelers, informative content and the provision of a retirement 'dashboard' enabling members to track their investment, income and glide path needs) with supporting interpersonal services (predominantly telephone-based support with some online direct communication).

The core principles of guidance by pension providers such as NEST should involve:

(1) suitability for the majority of individual savers,
(2) cost effectiveness, and
(3) transparency of the guidance outcome (in particular the default option).

On the first two points, we believe it is important to strike a balance between addressing the needs of the widest possible audience and doing so without increasing the cost of service provision which ultimately reduces investor returns. This, as the Consultation research suggests, requires considering the relative importance of DC savings to the wide membership cohort of NEST. The lowest earners, for whom current State Pension benefits alone are likely to lead to a high replacement income, will likely continue to favour taking their DC savings as a lump sum – the 'default' decumulation into cash is therefore likely to remain appropriate. The proportion of the highest earners relying solely on replacement incomes from DC pensions, are likely to be low and form a relatively small part of the NEST membership. The target audience is therefore a wide range of earners between these extremes, for whom DC pensions are likely to be their largest savings assets and for whom simply annuitising would result in significantly lower replacement incomes upon retirement than they would expect. Conversely if they draw down capital on retirement they would be exposed significantly to the longevity risk of outliving their savings. Technology and scale will be central to providing tools to address the needs of this audience. See also our response to question 13.

On the third point, it will be important NEST to be transparent on how money will be invested in the absence of instruction from the investor (i.e. default options). This is particularly important as scalable guidance cannot cover every possible circumstance but will seek to be appropriate for most instances such as the default options. Then individuals can take the decision as to whether it is worthwhile to pay for further advice from an independent financial adviser or other qualified professional.

We agree that face-to-face financial advice (as opposed to mere guidance) will have a place in those situations where personal financial affairs and taxation implications are more complex and for those that specifically wish to access and pay for such support. In the savings accumulation phase we see a place for workplace access to other forms of support ('face to faces'), e.g. onsite presentations to larger groups of employees, webinars via employer portals etc. as part of an overall NEST to employer support programme. However, employer engagement with post-retirees will not be a feature in most cases and hence achieving direct engagement between provider and individual will be key to providing guidance during the post-retirement phase.

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

An important product feature will be to provide increasing certainty of income with age.

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

As mentioned above we believe it is important to position default solutions as an effective way of providing a predictable retirement income both in the run up to retirement and through retirement (including for members who have retired but not made any decision regarding their accumulated savings).

If positioning or preparing members for retirement income should be one NEST's primary goals, what characteristics should be included in the default solution? The first is that NEST should communicate the investment problem in terms of an income result rather than in terms of asset accumulation – though we accept that this is currently hindered by regulatory requirements on savings illustrations. Determining retirement readiness by looking at an accumulated balance does not reveal an obvious connection to one's ability to spend, primarily because individuals do not know how long they are going to live and typically underestimate the figure. As a result, BlackRock believes that life contingency should be a primary consideration for any solution.

Over time the accumulated balance for most members is likely to be the largest pool of money to which they have access, and as such, can seem inexhaustible. Viewing accumulated savings in terms of its income potential provides a valuable perspective that individuals are more likely to relate to. Income is typically measured in periodic amounts, such as weekly or monthly pay, which is calculated and applied against spending obligations, which are also often in periodic amounts. By translating savings into projected periodic yearly or monthly income, NEST would make it easier for individuals to understand their retirement readiness in a way that is more consistent with how they manage their finances during their working lives.

It is also important that the income solution balances increased clarity about the income result with the flexibility to allow the member to change course should they desire to do so. The solution should ultimately prepare and protect the member's ability to obtain an income stream and do this automatically, but in a way that allows the member freedom of choice to pursue the path that is best for them, should they wish to do so.

The solution must be simple to implement and easy to understand by the member. Constructing an income solution using target date structures or common asset classes helps address both issues, and should leverage the technology infrastructure already in place for implementation without requiring new technology builds.

Perhaps most important is that the benefits of the solution are easy to communicate to the member. In other words, the member needs to understand the benefits of being in the solution during different stages of their lifecycle, particularly in the years leading up to retirement. Specifically, is their ability to spend changing, and what is the relationship between spending and the market value of their savings? Intuitively, more assets equals more spending ability, but it is possible for these two metrics to move in different directions, and members need to understand that. Current information about the solution should also be easily accessible and it should focus on the question of income and spending ability, not simply the market value of their savings. A greater understanding of the benefits could increase the likelihood that the member will remain in the solution and ultimately realise the outcomes NEST is trying to provide.

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?

Yes. At least two cohorts are easily distinguishable: firstly, those members whose age/income/savings rate are likely to lead to accumulated savings of up to £30,000 and who are therefore most likely to take a cash lump sum; secondly, members who will take a tax efficient cash lump sum but also remain in a decumulation strategy post-retirement.

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?

In general we support maintaining the existing ten-year gap between private and state pension ages – such an approach is supportive of phased retirement.

Whilst life expectancy trends continue to impact the sustainability of state pension provision, we are also seeing major shifts in individual attitudes and behaviours. The latter are, at least, partially linked to the realisation that we are generally able to enjoy a healthier life expectancy and will experience a more active participation in society by our older ages.

We expect the traditional view of retirement to continue to erode. For many members this will mean retiring much later but for others it may mean a more flexible and phased approach to retirement and no longer working towards a fixed and final date for ending work, which may extend beyond the state retirement age.

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?

Purchasing an annuity can be a valuable tool in protecting individuals against longevity risk so that they have the certainty of maintaining income throughout their life. In determining whether or when to annuitise or take other measures to protect longevity risk, NEST will need a comprehensive suite of tools to further understanding of the income solution and its benefits.

For example, an online calculator in particular could help members see how their balance in the funds translates into an annuity benefit if they were to annuitise at a specific target date. Our experience indicates that individual investors often respond positively to the idea of partially annuitising their savings because it preserves flexibility with the balance of their portfolio.

Key features of the NEST product solution would then be the ability to annuitise, or provide the characteristics of annuitising, at scale (and cost effectively) during the decumulation phase, increasing the certainty of income for members over time especially if they begin to experience cognitive decline.

Finally, it will be important to ensure that the types of annuity or annuity-like products offer good value for members and that NEST members are truly able to benefit from the scale of its member population

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

We believe that phased annuitisation should be available, but not exclusively so. Alternatives may be needed to reflect individual situations.

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

As members' retirement journeys are likely to be very different with increasing numbers of members likely to enter retirement progressively rather than on a single date, the ability to take a deferred annuity (or take the characteristics of a deferred annuity) will be valuable option for members, especially those who have other sources of income.

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

Please see response to Question 13.

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, please see earlier responses.

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 the way in which the strategy is communicate will be key to its success. While a thoughtful investment solution to delivering a successful draw down strategy can deliver better results for members, its efficacy can be undermined if members do not understand it and thus do not use it properly. Its success can also be undermined if the additional value to members compared to purchasing an annuity is disproportionately eroded by the cost of the solution. It is not critical that the member understand the technical mechanics of the solution, but it is critical that they understand what the solution can potentially achieve for them so they remain invested in it through different market cycles. Most importantly this benefit must be communicated in a way that is easily accessible and conveyed in common terms that are easy to understand and relatable, rather than in terms that are heavy with investment jargon.

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?

This question is directly linked to the Government's intent to allow the provision of 'Defined Ambition' or 'Collective Defined Contribution' schemes (CDC), defined as being "in the middle space between Defined Contribution and Defined Benefit pensions".

Overall we believe that CDC would only provide the full extent of promised benefits if it was very widely adopted and so could provide a sufficiently broad pool of members for risk sharing thereby increasing credibility and stability.

Provided sufficient pooling is in place we see the key benefits of CDC arrangements as:

- the potential for mitigating costs through the pooling of assets;
- better investment returns through more flexible investment strategies. This includes the potential for greater diversification into less accessible or more long-term asset classes with higher return potential.

Other characteristics of CDC can be viewed in a more balanced light:

- smoothing of the pension outcome faced by any one member can be viewed as appealing, however this comes at the cost of greater subjectivity in the outcome and the risk of certain groups of members unfairly subsidising others;
- CDC removes the decision-making for asset allocation and pension provision away from individual members, which could be perceived as desirable given the complexity and importance of these financial decisions.

A key challenge would be to adequately communicate to members that there are no guarantees on benefits. This may also complicate the messaging to members to plan for retirement income – see answer to question 1.

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

We believe that an optimal system would use a collective approach up to retirement, with the benefits of improved governance, cost savings and higher returns. At retirement, members would then have individual flexibility over how to draw their benefits, rather than the fund paying pensions. This would provide freedom to members while limiting the risk of unfair transfers of wealth between generations.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Consultation and will continue to work with NEST on any specific issues which may assist in relation to the retirement debate.

We would welcome any further discussion on any of the points that we have raised.

Yours faithfully,

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