The future of retirement

Response to NEST consultation

January 2015

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Introduction and background

As employee benefit consultants, Buck Consultants at Xerox, are involved in considering the issues arising from the workplace pension freedoms announced in the Budget of 2014, and largely due to take effect from April 2015. We are working directly with our clients to develop solutions that allow them and their scheme members to take advantage of the freedoms where appropriate, but within boundaries that are reasonable and acceptable to sponsoring employers. Work undertaken so far has clearly identified a number of key issues, such as:

- the extent to which individual members need help with understanding not only the specific choices they will be asked to make in this area, but also the wider context and background against which those choices will need to be made
- the cost of making all possible options under the new regime available to every member (which we note is a specific and very important concern in the NEST consultation)
- the wider impacts upon the sponsor’s business, such as employees’ possible increased desire to choose some form of partial or phased retirement.

The nature of our business and the needs of our clients generally require bespoke solutions more than products such as those likely to be offered by providers such as NEST. We are also involved with a number of other industry parties, and see a broadly-based dialogue as mutually beneficial and so are happy to contribute thoughts and experiences to the general collective. It is in this context that we are responding to the NEST consultation, which while revisiting a number of existing issues, does contribute some new thinking that adds to the debate.

We have therefore limited our responses to those questions that are of generally broader relevance.

The future is uncertain

It is also worth noting generally that we are entering a period of great uncertainty. Simply put, no one knows how scheme members will react to the options presented to them. We can perhaps gain some insight through surveys, and also look at the experience in other countries that have had some or all of these freedoms already. However, it is clear that survey results in this area have limited validity because asking people what they want, or what they intend to do, will be against a backdrop of poor levels of knowledge and understanding, and a tendency to follow the lead of others. The experience in other countries will to some extent reflect the social and other cultures of those countries, which will differ from those in the UK.

This suggests that there will be a period initially when we are all learning what works and what doesn’t, and during which we can expect that a lot of mistakes and poor decisions will be made by members and others. Consequently the pensions industry and government will be required to monitor events closely to establish patterns and trends – and react accordingly. On an individual scheme basis, trustees and providers should be flexible and innovative in their approach to design and operation of arrangements in the light of experience.

MEMBER CHARACTERISTICS, WORK PATTERNS AND NEEDS

How will the trend for changing retirement patterns and provision affect what members need, and employers want, from DC schemes in the future?

The figures in the consultation paper seem to confirm anecdotal evidence of a growing trend towards reduced working hours as employees enter the window when retirement becomes possible, with in many cases the resulting reduction in earned income being made up from accrued pension assets. It seems likely that this group consists mainly of those with larger DC pots, where the pot sizes and the flexibility combined with DC makes such a scenario a more practical proposition. This may not reflect the NEST membership – at least for a while until pot sizes grow.

The figures suggest that this scenario is currently more prevalent amongst those whose work is on a self-employed basis. This is not surprising, since then there is no other employer involved whose interests need to figure in the equation. What is not clear however is whether the self-employment has followed a period of employment, and is a result of, for example, the member having been made redundant. If so, the figures will not give an accurate reflection of whether employers are generally embracing (now, or will do in the future) the concept of staged retirement. In our experience, not all employers are comfortable with the uncertainties for the business that such flexibility creates, which may be reflected more generally in a reluctance to encourage unrestricted access to the new pensions freedoms.

Where this scenario has arisen because the member has found themselves unable to secure full-time employment, but they are not yet at an age when they can take an unreduced (perhaps DB) pension and/or have not yet attained state pension age, the consequences may not be as happy as for the member who has chosen this scenario. By drawing income at an early age from the DC pot they are reducing the longer-term income available, perhaps thereby committing themselves to having to undertake paid employment for longer than originally intended. They are also unlikely to be contributing to a pension at the same time, so their potential retirement income will be further impacted. To make matters worse, they are likely to incur the higher costs associated with each of work and leisure identified in the consultation paper. This makes a strong case for early, consistent and significant contributions to a pension arrangement to lessen the likelihood of becoming a victim of unexpected circumstance in later life.

Some employers of course welcome flexibility of working terms for their employees, as reflected for example in the growth in the use of such things as Zero-hours contracts. For those, where their employees have incomes from those employments that take them above the automatic enrolment threshold, flexibility around availability of pension access will probably be welcome. However, they are also unlikely to want to pay the associated administration costs, which they will instead want to be borne from the members themselves, from their generally small pots. This will be a challenge for providers. The solution may lie with simplified generic default arrangements that run members’ retirement income arrangements on a narrow options basis.

HOW DO PEOPLE EXPECT TO ACCESS THEIR PENSION SAVINGS?

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

The figures again confirm anecdotal evidence that from a financial perspective the current generation of pensioners are a privileged group, enjoying greater wealth than those who went before and likely to be better off than many of those that follow. Consequently, their experience will not provide much guidance in developing processes and options for the future, as the consultation paper acknowledges.

We agree that the evolving trends for the pensioner population based upon current social and economic data are towards greater indebtedness, less house ownership, lower savings (including pensions), greater prevalence of DC pensions, and longer longevity not necessarily matched by maintenance of good mental or physical health. There may be a cohort, immediately behind the baby boomers, and ahead of those who will have a long period of private pension accrual thanks to automatic enrolment, where these developments are extreme due in part to not having any private pension accrual.

To address the problems raised by these trends other than through greater direct support from the state, the following factors need to be in place:

- universal private pension provision
- significant contribution levels to build up larger pots
- wide flexibility around decumulation options available from an age when full or partial retirement becomes a possibility
- help around members' exercise of choices, with a practical default as a fallback.

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

There are essentially two main approaches to the provision of solutions in retirement (as with the pre-retirement stage) – requiring the member to make their own decisions, and applying a default process, making decisions on the member's behalf. In practice there may be some shades of grey in between where the process is largely by default, but where the member makes some limited decisions. This could be said to be the case currently where in most cases members of DC schemes are effectively forced into the purchase of an annuity, but are encouraged to shop around for the best deals, and to choose the structure of the arrangement (e,g, single/joint life, level or escalating etc).

Although the objectives behind the new freedoms are to give members extensive flexibilities to fashion a solution in retirement that best fits their particular circumstances, for reasons that have already been well-rehearsed – including in the consultation paper – this flexibility is unlikely to be widely utilised. We agree therefore the premise that there will be a need for one or more default options, either to stand alone, or to be combined with some limited facility for individual member decision in some areas. In this respect therefore the options would in principle be no less relevant or beneficial than the current widely-used annuity route.

The evidence presented in the consultation paper highlights the differences between the needs of different households and consequently the impossibility of producing a single solution that will address all of them. However, there are factors that point to possible design aspects, such as the evidence that household expenditure on necessities is largely unchanged before and after retirement. This suggests that a managed retirement income product could set income at a level that, taken together with the available state pensions payable to members of the household, covers the cost of "necessities" as advised by the member, with future increases linked to a pensioner cost of living index.

Any excess proceeds from the DC pot would then be free for more flexible use by the member as and when they choose to access them, until the "excess" fund is exhausted. If that occurs before the death of the last of the member and any dependant, the consequences will not be serious, because the necessities for living will still be covered.

OBJECTIVES AND RISKS

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?

There will be a broad spread of decisions and it will be some time (probably several years) before patterns emerge that can be taken to provide a basis for the design of post-retirement arrangements. Meanwhile, flexible arrangements subject to affordable costs, alongside default arrangements as described above, will have to suffice. Once patterns start to emerge from experience with actual cases, the designs of arrangements can be revisited.

What member behaviour risks do providers need to manage?

We were unsure as to the issue that this question is addressing, since on a basic level we do not believe that it is the responsibility of providers to manage members' behaviour. However, we can appreciate that trustees have a duty of care towards beneficiaries which may have implications here, and in the light of the current blame culture that is widespread in the UK, there must be a high probability of claims being mounted at some future date against providers by members who are disappointed by their pension outcome. This might arise on the basis that a provider or trustee might be deemed to owe a duty of care to ensure that the member makes a "sensible" decision. The likelihood of such a claim being successful is a matter of conjecture, but clearly the preferred situation would be for such a claim to be impossible to mount in the first place.

Although it could be said that this is a potential issue now, the increase in the number of people saving in workplace pensions, combined with the wholesale move to DC and the requirement for members to take decisions for themselves across a wider spread of issues, increases the risk of legal challenge.

This is potentially a difficult issue to manage, and is clearly a legal one. It seems to us that the most effective solution would be for a safe haven principle to be enshrined in legislation, to protect providers and others in clearly-defined circumstances. However, despite the case for this having been made in consultation responses to the government, it has been rejected to date. There is a strong case in our view for the matter to be pursued further.

Meanwhile, in the absence of such an overriding provision, providers may be able to provide some protection through appropriate scheme design. The default approach covering necessities, with freedom around the use of any excess proceeds outlined above may provide an example.

SUPPORTING MEMBERS WHO ARE LESS ENGAGED

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?

Our experience with our clients is that the most effective approach is to start early and to continue with a “little and often” communications programme, supplemented by more detailed workshops at key moments in the member’s life, and at significant anniversaries and in the countdown to probable dates for retirement-applicable decisions to be made. Consequently, by the time they get to age 55 they will be familiar with the issues, as the messages will have been drummed into them over their working lifetime, and in a number of cases will actually have taken some decisions for themselves previously! This reduces the likelihood of them getting to age 55 and feeling that they have been caught unawares, and looking around for someone to blame if their situation is not as rosy as they were expecting it to be. We believe the best way of facilitating this is through the workplace, with the employer’s support, since statistics show that employers enjoy a higher level of member trust in respect of pension matters than most other parties.

Communications should be supported by the availability of a retirement income modeller which members should be encouraged to use regularly.

Having run such a communication programme through the pre-retirement phase, it is logical to continue regular communication through retirement. This should also include a modeller showing fund values and projections of how long the monies would last on current rates of consumption.

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

The statistics on decline across the breadth of cognitive functions make sober reading. They suggest that the norm should not be to allow or encourage totally unrestricted drawdown throughout retirement in all cases. There are of course individual cases where the financial interests of affected members are looked after by relatives or under protective trusts, but that cannot be relied upon as the norm.

The figures in the consultation document show a fairly steady decline in cognitive ability over time, rather than a cliff edge. Also relevant here is the predicted growth in the number of people suffering from dementia in the UK (up from 850,000 to 1 million by 2025 according to the Alzheimer’s Society).

Consequently that suggests that the route most regularly followed in most cases should involve some degree of protection around the “core” benefit to cover necessities of life, whether secured at outset, perhaps through ringfencing an appropriate part of the pot and/or later through an annuity purchased after a predetermined age.

We recognise that given current average pot sizes, in many cases that will leave little, if any, monies available for discretionary spend items. It would be perfectly reasonable for the state to insist on such a restriction, given the provision of tax relief on pension savings, and the consequent benefit to society generally of people using that relieved money to reduce the potential for them to require further assistance from the public purse in later life.

We also recognise that in the present political climate the introduction of such a restriction by the state is unlikely. However, if providers and other scheme managers – especially NEST, given its likely share of the market - were to apply such a restriction as a term in their products or schemes, that would address a large number of cases. Logically the incorporation of such a term should not produce a push back from members, since that would coincide with one of the features that surveys indicate they value – a predictable income in retirement.

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 do not subscribe to the view that there can only be one default strategy. We consider it is perfectly feasible to segment membership according to basic criteria, and thereby obtain better outcomes for members by making the strategy a closer fit to their circumstances.

Examples of variables that could be utilised in the process, either alone or in some combination include:

- likely pot size
- expected household retirement income and indebtedness
- age and gender
- intended retirement age and whether a cliff edge or graduated move into retirement is anticipated (which could also include input from the employer)
- postcode
- Decisions taken by the member’s colleagues who have retired earlier (peer action is influential)
- The extent to which the member has actively engaged in their pension arrangement in the past (for example if they have “defaulted” through every previous decision point they are more likely to be expecting a traditional approach in retirement)
- The member’s health and that of their relatives.

Although this multiple-default approach should in theory improve the member’s chances of getting a good outcome, there is a risk to the provider in that the more segmented the group, the closer the scheme moves towards being held to have given advice to the member. Therefore such an approach needs to be carefully designed and implemented.

SECURING A RETIREMENT INCOME THROUGH ANNUITISATION

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

We could not say that any one solution would necessarily be better than any other - it depends on the situation of the particular member. As the consultation paper demonstrates, a member could, by using the freedoms and drawdown, manage their own annuity solutions perfectly effectively.

However in the context of a provider such as NEST, it will be necessary to consider such issues in the context of default arrangements, and the demographics of their members. They may therefore consider that the purchase of an annuity is an appropriate action to take as a matter of course. In the default context, if the annuity is to cover the cost of household necessities, it would not be unreasonable for the purchase date to coincide with the member's state pension age, since especially in low-income households the state pension will provide a large proportion of retirement income and so retirement date is still likely to coincide with SPA.

Would iterative purchase, phased annuitisation, or fixed term annuities be a better way for DC savers to secure incomes? Should deferred annuities be included in the toolkit for DC retirement solutions?

Again, we could not say that any one solution would necessarily be better than any other – all are valid, and it depends upon individual circumstances as to which might be preferable. However, we do believe that deferred annuities provide a useful option that addresses several issues.

Are there other ways of helping members hedge longevity risk?

An alternative solution may be to hold member funds in a pooled DC vehicle, as in a CDC, where risks can be managed through the pooling effort.

INVESTING THROUGH RETIREMENT – BALANCING GROWTH AND PROTECTION

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. Given the poor reputation of annuities, and people's propensity to retain ready access to monies (even if they are then spent unwisely) will mean that drawdown, in some guise, is likely to become popular, at least in the early days after April 2015, perhaps until horror stories about the effects of poor assets management by members start to emerge. At that point, there is likely to be a resurgence of interest in annuities

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