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NEST consultation response from Dr. Ros Altmann. Independent Pensions Policy Expert

1. How will the trend for changing retirement patterns and provision affect
   a. What members need
   b. What employers want from DC schemes in future.

1a Changing retirement patterns are likely to mean that the traditional 'one size fits all' default products for both accumulation and decumulation need to change.

Retirement is likely to be later than previously expected and may happen in stages, rather than all at once. Therefore, pension funds will not know when the member will actually need to start withdrawing money until much later in life and the idea of setting a pension date when young and targeting that date for many years is no longer sufficient. Trying to 'de-risk' ten years from a pre-chosen pension age will not suit those who decide to retire later, or who have other pensions and want to leave money invested for longer. Switching to bonds may reduce long term returns unnecessarily. Pension products will need much more flexibility in future than has hitherto been offered. In addition, with an end to mandatory annuitisation for all but the largest or smallest pension funds, it is no longer safe to assume that default funds should switch to 'annuity-matching' assets in the run up to a pre-selected pension date. Firstly, savers may not buy an annuity but may want to leave the money invested for longer and secondly they may not retire at the date they had previously assumed. Members therefore need more flexibility and choice to assess the suitability of their pension fund investment options and revisit their choices regularly.

Lifestyle and target date funds are out of date -Defined contribution (DC) pensions schemes will need to reconsider the investment options offered and the default funds used following the Budget 2014 changes. These standard investment funds used by millions of pension savers are 'lifestyle' and 'target-date' default funds, which assume pension savers will buy an annuity at a pre-set age. The fund switches all their investments into cash and bonds by the time they reach what was expected to be their pension age. These investment approaches are no longer suitable for many of those approaching retirement.

In future, many people will not know their retirement date well in advance and, although some will still buy annuities, the majority may not and probably not with their entire pension fund. They will want their pension savings to remain invested after their scheme's official pension age. Others may want to make regular withdrawals. Experience in other countries, such as Australia, suggests the new UK regime will trigger demand for pension schemes that can provide both investment growth and some income during retirement. Therefore, the most successful pension funds may be ones that not only take people up to retirement but can also help them through retirement too.

Lifetime Pension Accounts

Now that the requirement to buy a product for retirement income is being abolished, there is more freedom for both the accumulation and decumulation phases of pension saving. In the new regime, there will actually be no need to move from your pension provider at all if you want to take an income for retirement. Therefore, pension companies could develop 'lifetime pension accounts' which will cater for customers' needs from beginning to end. These funds could be a combination of the 'Pension Growth' funds and 'Pension Income' funds. For the initial years, the fund would roll up all income and aim for strong capital growth. However, once the customer reaches later life, they can just contact their pension provider to ask them to start paying out income. The income paid could be that generated by the assets, or somewhat more, or less, as the customer requires. The timing and amount of income could be left to the customer to request, depending on their own needs. This type of account would fit well with auto-enrolment, could offer different risk grades of fund, could be managed on-line and provide regular statements showing the value of the assets and the income being generated. The account would need to be flexible enough to cater for customers' income needs, risk preferences and product choices, but providers would retain customers more easily due to inertia. These accounts could also provide financial planning help and advice. These accounts could be managed on-line, with an app, and could be personalised to be used as a lifetime savings account into which people transfer any pensions when they leave an employer's scheme and ultimately could hold other investments too, such as ISAs, share schemes and so on.

1b. Changing trends for retirement should not have a large impact on what employers want from DC schemes, since employers should want what is best for members!

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

The trend to later retirement is likely to continue and to accelerate. The trend to retirement becoming a period of part time work, before fully stopping is also likely to spread. This means some people will use their pension fund to top up lower earnings, which others will not need their pension fund until much later in life than would be traditionally assumed. The normal assumption of pensions starting to be drawn down at pension age may not hold. One could envisage the introduction of 'Lifetime Pension Accounts' which stay with the member for life. This account would have a capital growth phase, but then the member could, for example, ask to be switched to an income phase when they are ready to draw money out.

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

There is likely to be a much bigger range of outcomes. Some will take the money at 55, others not till much older. Some will take just the tax free cash and leave the rest. Many might decide to switch other savings into pensions in later years in order to take advantage of the tax benefits. Therefore, designing products for the current client base may not be representative of future customers and demand.

4. Is it possible to reflect the heterogeneity of retirement spending patterns in the design of retirement solutions?

Retirement solutions can be designed to help with varying spending patterns if they rely on members asking for income as and when they require it, but with a set period of notice. It is also possible to offer solutions which have higher income in the early years, then falling income after a time and ultimately also some insurance against needing longterm care. An increase in numbers needing care has not been budgeted for or incorporated into pensions, but NEST is potentially well placed to offer a collective insurance against needing later life care, with higher income payout provided for in such circumstances. Such products do not really exist and would be extremely expensive to purchase individually, however on a collective basis this might be more achievable.

5. How are savers likely to act under the new freedoms, taking account of current retirement decision, what people say they want and the evidence of behavioural biases?

We will see over time how this pans out. It cannot be predicted with any certainty right now. It depends on the Guidance working and whether people understand the issues. Big challenges in communication and understanding to be overcome which NEST needs to address. Perhaps setting up a helpline, or online communications strategy and ensuring people understand the value of advice can help. Perhaps NEST working with Employers to offer staff financial education and for the employer to encourage their staff to take up and engage with the issue of financial planning?

6. What behavioural risks do providers need to manage?

Do providers need to manage behavioural risks, or investment risks? Managing behavioural risks is being achieved via auto enrolment itself, but providers need to then try to engage members, rather than assuming they remain inert. Managing investment risks and returns on their behalf over the long run should be the aim of the pension fund and helping members with financial planning, incorporating pension savings with their other assets and the benefits of working longer could all be explained.

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

There are many risks for DC savers approaching and in retirement. Some of the risks conflict and require different approaches from others. Perhaps providers should focus on the investment risks and returns and try to ensure members with different circumstances can have the best chance of optimising their long term outcome, whether than be in taking the cash or taking an income or just leaving the money invested for the long term even through retirement. For example, some of the money could stay invested and be used to help with long term care costs of needed. Currently, there are no savings plans for care. Eventually, NEST could be in a position to manage funds for millions of people who currently are not in it, because their employer cannot use NEST and they cannot transfer money from other pensions into it. Once those restrictions are lifted, the client base for NEST could change.

8. What works in terms of communicating and engaging DC savers with decision making as they approach retirement? How can we help members make good choices before and during retirement?

Financial education is key here. Make finance fun, introduce new approaches, gamification, apps and so on, while also ending the use of confusing jargon and terms. In the long run, it will be essential to increase the level of national financial literacy and auto enrolment is an ideal opportunity to further this goal. All pension schemes should be obliged to offer financial education to members from early ages. The system of national independent Guidance can be extended to younger age groups too, in order to help people understand the questions they need to consider when planning their finances. Making finance fun, with apps and gamification is essential. Ending the use of baffling jargon and workplace financial education allied to pension auto enrolment would be helpful. In the nearer term, the best method would be to ensure as many people as possible have access to independent financial advice. Even if that has to be paid for, it is a price worth paying to ensure later life financial plans are as good as they can be. Many members will pay to buy a product, via commission, but that money could be far better spent on taking financial advice from an expert after they have had their free Guidance.

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

Is it the role of pensions to deal with mitigating the risks of cognitive decline? Perhaps it would be helpful to think of pension funds partly as care saving plans, so if there is such decline in later life and people need to be looked after, their pensions can provide a source of funding for this. Having a fund that delivers growth and income can help finance later life. The usual response to this question is that people should have a guaranteed lifelong income that they will keep on receiving, so that they will not need to think about it or make any arrangements as they get older, the money will be paid automatically. However that may not be most suitable for all. Not everyone will suffer severe cognitive decline and most older people can manage their money themselves. Whether it is in bank accounts or investment accounts, having an expert to help can be of value, but assuming everyone who becomes old will become unable to manage their money is not necessarily appropriate. Perhaps contingency plans can be put in place for power of attorney or for special arrangements such as regular ongoing income to begin if cognitive function becomes impaired?

10. What is the role of default strategies in the new regime in the run up to and throughout retirement?
11. Should we consider having more than one default strategy for different types of members and which variables should be used to differentiate member needs in the event of no other engagement

Please see response to question 1. Default strategies tend to be 'one size fits all' but this approach will not fit all. Therefore, more than one default strategy will be important. The new pension freedoms mean pension funds are going to be more like investment accounts, with greater emphasis on capital sum accumulation than ultimate income generation. In most cases, I would expect the DC pension fund to be targeting investment returns that can deliver long-term growth, even in the run up to pension age, because it is not clear whether people will actually start drawing on their private pension savings as early as previous years. The problem with default funds that try to match lifestyles without members understanding how they work is that they may not actually deliver for the members who do not have the 'assumed' lifestyle. With the new pension freedoms, there are many tax advantages to pensions which mean that keeping the money in a pension wrapper for as long as possible makes sense.

I believe the best default option is the 'do nothing and assume ongoing investments' option. I think that default strategies could be designed with investment approaches more along the lines of Defined Benefit scheme products, which have downside protection in the form of hedging and much broader diversification than just equities and bonds. This may mean lower liquidity and daily dealing might have to be replaced by monthly or quarterly opportunities to redeem. Having infrastructure, private equity and real estate should deliver better returns than traditional long-only approaches.

Criteria for different default options could be:

- age – as members approach age 55, they should be offered the chance of a default option that has 25% in cash and the remainder invested in broadly diversified assets.
- retirement status - A default strategy once retirement starts and members actually want to take income would be an income generating portfolio of broadly diversified assets.
- health status - Perhaps, if someone is in poorer health, they could notify the pension scheme and investments could be moved to income generating funds, but the member would need to be proactive about this.
- risk appetite? - I could envisage a range of risk-graded default strategies that can be assigned once people join, with members asked to fill in a questionnaire that can direct their investments, depending on their expressed preferences, age and other savings levels.

No engagement - If members refuse to fill in the details, they could be put into a fund with broad diversification and a long-term approach, which has perhaps quarterly redemption to allow for long-term and illiquid investments.

12. Should default target retirement age remain the same as state pension age?

If a default retirement age is required, then state pension age would be reasonable, but I would prefer to see members engaging in the decision as to when they might want to take money out of the fund. I would prefer to see an approach which encourages later retirement and leaving any non tax free cash invested for the longer term in the early stages of retirement.

13. Should purchasing annuity income be part of retirement planning for DC savers? If so at what age?

Once again, this question reflects a one size fits all thought process. The reality is that people's lives are unpredictable and there is no 'right' answer to the best product for retirement. An annuity without any inflation protection is unlikely to provide good protection for those who live a long time, however buying an annuity with part of one's fund can mitigate some longevity risk. However the fund also needs to cope with other retirement risks. Until now, people have been purchasing annuities too young. A 60 year old does not need protection against living to age 61 or 65 as the probability of dying before then is tiny. However, once people reach ages like 80 or 85, they may want to address longevity risk. Annuities do not protect against becoming seriously ill and people need to understand the risks of locking into an annuity at times of record low interest rates. Yes, annuities have a place in planning retirement income, but they only cover one risk. Using the entire fund to protect against just one risk is like buying a house and only insuring it against fire. If the house burns down, that will turn out to have been right insurance to buy. But if it is flooded or burgled and you have no insurance against those events, you will not have made the right decision. Most people would insure against a range of risks, not just one. Therefore, annuities would only be right for part of a pension fund for most people (unless they have plenty of other income elsewhere) and should be brought from later ages. Buying an annuity assumes no desire to improve investment returns, which is ok for part of one's fund but most people who have a 20 year time horizon would not be advised to give up on investment returns altogether. People at age 60 or 65 have potentially long-term investment horizons. In addition, people in good health when they buy an annuity run the risk of becoming seriously ill and then having no protection from their pension income against that eventuality.

14. How about iterative purchases, phased annuitisation or fixed term annuities?

These are all better options than annuitizing at one point in time. This would be working on the principle of pound cost averaging and also leaving options open for future changes in individual or market circumstances. The rest of the fund would remain invested and hope to achieve higher returns and ultimately better income later.

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

In theory these definitely have a part to play in later life income planning. Dedicating a portion of your pension fund to buying insurance against living to advanced old age makes sense. In practice, of course, it will also depend on the cost of buying such annuities and whether they are fairly priced to realistically reflect the risks of the person living to a very old age. That will of course depend somewhat on current interest rates, the persons health status and insurer profit margins.

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

If Governments were to issue longevity gilts there would be a strong case for those but they do not currently exist. Buying critical illness insurance is another possibility or buying long-term bonds themselves could help. However annuities tend to be the most effective longevity hedge for individuals. Whether these could be issued by NEST itself, rather than buying in the open market, is an issue for consideration.

<u>New product ideas to offer some insurance against living a long time, without annuitising immediately</u>

Retaining their pension fund capital, rather than buying an annuity is rather like customers choosing to take on the risk of living a long time and of losing money on their investments, in exchange for keeping upside potential, liquidity, access and flexibility. In the new pension world, the challenge for the pensions industry will be to deliver new products that can help people mitigate the risks of living a long time and protect against the capital losses on investments.

Insurance for advanced life income or capital

Instead of buying a 20 year investment product that includes an annuity in 20 years' time, people could choose to just buy a deferred annuity and retain control of the rest of their fund themselves. The advanced life annuity could take a single premium at retirement which would then pay back an income stream in, say, twenty years' time – a long-term deferred annuity. Alternatively, the product could provide a specified capital sum at the end of the period, that would be higher than the original amount, to reflect the probability of them not reaching that age.

20 year retirement bonds

For the first 20 years of retirement, pensioners should have room for investment growth to enhance their later life income, however from age 80 or 85, buying an annuity or having funds to pay for long-term care will become increasingly attractive. Therefore, products might be developed to provide fixed payouts for 20 years – perhaps based on 20 year bond yields, or a higher amount that hopes to invest in riskier assets but can draw down some capital too to smooth out any periods of poor performance. For example, a £100,000 pension fund could be invested in a 20 year pension bond what pays, say, 4.5% income a year, based on corporate bond yields. After 20 years there should still be capital left. At that point, the customer could decide to purchase an annuity, or to keep the money for care funding. The assets in Pension Bonds would also provide a legacy for those who die before this age.

20 year retirement bonds with increase for care funding

One of the biggest problems of devising a drawdown strategy for retirement is that the period of drawdown is uncertain. As people do not know how long they will live, the length of time they will need income for is unknown. If the investment could be just over a defined period, it is far easier to manage. Products could be designed which take a part of the initial pension fund and use it to purchase an Advanced Life Deferred Annuity that would start paying out a specified income if the person lived for 20 years. The annuity income that would be promised for 20 years' time would be much better value because the probability of living to such an advanced age is smaller, so many people will not be paid at all. If, say, one fifth of the pension fund were invested in a deferred annuity, while four fifths is used to drawdown an income for a fixed 20 years, then the pricing would be much more favourable. This would be a different type of longevity insurance, with the insurance premium being only one fifth of the pension fund, rather than the entire fund. Someone with a £100,000 pension pot could pay £20,000 and then budget their investment and expenditure of the remaining £80,000 over the next 20 years with the certainty of getting a decent lump sum or income stream if they lived longer than this 20 year time span.

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, definitely. Investing allows more flexibility and can help mitigate the other risks that are faced in retirement, such as the risk of becoming very ill, risk of dying young, risk of inflation, risk that interest rates will rise etc. Level annuities do not really protect against these risks, even with a guarantee. Value protection would offer some better protection of course.

What are the retirement issues that your finances need to cope with?

Issue	Possible product solution
Will I live longer than I think?	An annuity
Will I live for less time than I hope?	Investment products that can be passed on.
	Life assurance?
Can I provide lifetime income for my partner?	Joint life annuity?
	Investment drawdown fund?
Will I have some money to help me if I get ill?	Insurance? Investment drawdown funds
Can I leave a legacy?	Investment drawdown funds
Can I help my family/favourite charity?	Investment drawdown funds
Can I cover the risk of needing to pay for care?	Investment drawdown funds
Can I protect my assets from inflation?	Investment drawdown funds
	Inflation linked annuity
Can my money benefit from investment returns?	Investment drawdown funds
Can I protect my money from market downturns?	Unit linked guarantees/capital guaranteed
	Downside protected funds

Drawdown funds could be part of a Lifetime Pension Account, with growth funds and income fund options.

Pension Growth Roll-up Funds

During the early years of pension saving, people are not allowed to take any money out. Before age 55, pensions need to stay locked, which means the assets can be invested to deliver growth, rather than income. Any income received would be rolled up and reinvested. In the new regime, rather than lifestyling or target date funds, providers may offer funds that aim to deliver growth over time and remain invested until the customer decides to either ask for income to start, or chooses to move to a different type of fund. For example, while building up the fund, people could use 'pension growth' products invested in a wide range of assets that could benefit from an investment risk premium such as illiquidity of property or infrastructure. All the income would be reinvested and rolled up each year to ensure further capital growth. Individuals could select their desired risk and asset mix.

Roll into Pension Income Fund

These products would aim to replace employment income with a reliable investment income, possibly from bond assets or also high dividend equities. The challenge is for the asset management industry to develop new 'lower risk' products which pay an income and do not have excessively high charges.

Note of caution: The idea of Pension Growth Funds and Pension Income Funds may remind some people of products that caused problems some years ago. Split capital investment trusts were not run sufficiently prudently. The new products required should help find a balance between the use of capital and income that can provide some long-term security, but these need to be at reasonable prices and without the risk of 'blowing up' as split capital investment trusts or endowment funds have done in the past.

Multi-asset growth funds – volatility controlled

Providers could design a range of professionally selected multi-asset investment choices, rated by risk level and possibly with a target return for low, medium and high risk products. These could show a ranged of expected outcomes, rather than the traditional approach of just one number. For example:

Low risk funds might offer a target return of 2%, but indicate a range of outcomes of 0-4%.

Moderate risk funds may target returns of 5%, but a range of expected outcomes of -5% to +10%.

High risk funds might target returns of 8% a year, with a range of -15% to +20%.

Customers could choose their preferred options from a range of multi-asset funds, with different levels of expected volatility.

Diversified Growth Funds

Private pension products could begin to use investment approaches increasingly adopted by institutional investors in defined benefit pension schemes. The most sophisticated of these schemes invest in a broad range of asset classes, rather than just equities, bonds and cash. These can include illiquid investments, such as property, forestry or infrastructure, because pension investors generally have long time horizons even in retirement. Essentially the investments would be diversified growth funds, but could offer an income component in retirement. The risk level of these funds could be adjusted to account for different risk appetites and it is also likely that there will be increased interest in capital guarantees.

Guaranteed capital unit-linked funds

Increasing numbers of pension investors are likely to want to protect the value of their pension savings against sharp market falls. This need could be met by using guaranteed products such as unit-linked funds, which allow investors to benefit from the upside potential of the markets, often locking in any gains along the way as well, while protecting against downside risks. Guarantees cost money and the more of the fund that is guaranteed, the higher the cost. Like any insurance, there is a premium to pay and customers need to evaluate the cost of the insurance against the potential benefits to them if they have to claim. Instead of protecting all of the capital in a portfolio, it is possible to protect only 90%, or 80%. This will be much cheaper, will still ensure that a basic minimum amount remains in the pension fund and gives some peace of mind.

Guaranteed income unit-linked funds

Instead of guaranteeing the capital value of the pension fund, it would also be possible to guarantee a future income level. Again, the cost of the guarantees needs to be weighed up against the benefits to customers.

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

I would not have just one default drawdown strategy, there should be more than one.

For those who are aged, say, 60-75, There should be an investment income drawdown strategy which I would use a mechanistic annual payout rule, such as 4% of the fund with inflation uplift, reviewed every year or every 3 years to assess affordability. This could be run by NEST itself or an independent group of trustees, with full transparency so that governance issues can be addressed. I would impose some downside risk control, as we see in DB schemes, and this should be a well diversified long term investment portfolio, but having, say, 20% in cash to meet withdrawals if needed. I would not include annuities as they would need to be medically underwritten and those who end up in a default strategy may be unwell.

A new default fund for those aged over 75 would also be broadly diversified, with downside protection as well to insure against market risk, but this could include an element of collective annuitisation for longevity risk. It is not clear how such annuitisation would work, but it could be offered by NEST assets internally to reduce cost.

Other approaches are also possible:

<u>Challenge to devise products that offer some of the advantages of annuities, while protecting against some of the disadvantages?</u>

The positive features of annuities were considered to be that they provide income security, longevity insurance and downside protection against investment losses. However, these benefits are counterbalanced by the fact that many people may also want to retain access to their funds, protect against inflation, have a chance to benefit from strong markets or rising interest rates as well as retaining flexibility to access better products, leave a bequest or have some money for failing health in future.

Mass market products

Designing new products for the mass market is an essential part of the future landscape. Product features that would be popular would allow people to benefit from the possibility of rising markets, retaining some liquidity for unforeseen expenses, leaving a lump sum to loved ones in the case of early death, and potentially offering protection against inflation, offering flexibility to access new products in future. In order to address the fears of being exposed to market risks, products can offer ways of protecting from very poor investment markets with the use of low-volatility assets or explicit guarantees.

There is a need for a revolution in retirement income products – tinkering with annuities will probably not be enough. More people will take advantage of the new freedom to keep their pension fund invested for longer, however many may be concerned about the risks of sharp market falls. They are likely to look to retain investment upside, but also want some certainty of future income. Therefore, there could be an increased role for guaranteed products both for income and for capital.

The MetLife Surveys of financial advisers provide an indication of how the market for new retirement products might develop.

When asked what products customers might want, advisers suggest the following:

- low cost drawdown products

- high income funds specifically for retirement
- flexible annuities with a surrender value
- more emphasis on guarantees for either income or capital.

Financial advisers were asked what innovations or product changes they wold like to see in retirement saving. 60.5% wanted to see guarantees on income. 59.6% wanted guarantees on capital and 32.5% called for care saving products.

Guarantees to address risk of capital loss

There are two types of guarantees that would be increasingly important in the new pension environment – guarantees or insurance against future market falls and guarantees or insurance on an income for life.

Financial advisers believe that the new pension regime is likely to increase the use of guaranteed products, that are more flexible than the complete inflexibility of annuities, but less risky than income drawdown. In the new environment for UK pensioners, there is likely to be an increased role for guarantees. Pensioners will welcome certainty about their future income, or being able to rely on a minimum amount .

In the current low interest rate environment, the cost of guarantees has increased and the prospective investment returns may be less than previously forecast. However, the opportunities for capital growth from ongoing investment are still relatively more attractive than just buying an annuity or holding money entirely in cash and government bonds.

As people begin to retire, perhaps working only part-time, products that pay an income will be needed. The 'pension income' products could pay out all the investment income each year. Additionally, to provide extra income, they could pay out capital as income to ensure returns stay consistent through market cycles by trying to 'smooth' the income payments over time.

19. Should NEST consider some form of risk sharing?

YES for investment risk and perhaps for advanced life beyond age 75 see answer to Qn 18

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

It is not clear how risk sharing of benefit promises would work under the new pension freedoms. I think the inter-generational risk transfers could prove problematic. Pure DC allows member freedom and flexibility. As NEST is not, itself, an employer, it would be hard to assess how CDC could work in such a scheme.