

NEST Corporation
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30th January 2015

THE FUTURE OF RETIREMENT

Dear Sir or Madam,

Please find below our responses to the above consultation.

Q1. 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) It is hard to say with certainty what retirement patterns and income requirements will emerge. We therefore believe that the most important factor is flexibility and regular review of membership needs and expectations. We also believe there is scope for different approaches with a clear default journey for those not making an active choice.

b) We believe that in the context of DC, employers do not necessarily see their duty of care extending to their employees following the end of their employment. It is therefore the responsibility of the scheme trustees to consider the preferences and requirements of the membership.

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

At present we understand that the investment strategy targets cash at retirement date. This suggests that NEST expects its membership to withdraw their full pot as a lump

sum. Our concern is that with rising longevity and the growing need for sustainable income, targeting cash at retirement date (65, or state pension age) sends the wrong message and offers no protection against longevity, based on the changing needs as identified in the consultation.

We expect asset allocation to shift towards targeting a sustainable income. This would necessarily require a more diversified strategy that can outpace inflation without excessive capital risk, where there is an element of duration management against longevity risk.

We anticipate the introduction of 'next generation' target date funds which can be combined with income guarantees, and or forward-start annuities to provide assurance around future income today. We anticipate the introduction of collective drawdown schemes.

Q.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?

We believe that NISA account balances should also be considered.

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

We believe that there should be a clear choice architecture for those making an active choice around targeting a lump sum, an annuity or drawdown. More importantly, there has to be a clear 'default journey' for those not making an active choice.

Q.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 new freedoms?

We believe that savers are likely to have most confidence in the 'default journey' offered by their scheme provider.

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

Excessive choice: cognitive strain from the range and combination of choices available can trigger inertia.

Naïve diversification: asset allocation decisions could be made on simple rules of thumb, eg allocating 50/50 in two options presented, hence choice architecture needs to be carefully considered.

Performance extrapolation: savers could be tempted to chase recent winner funds or asset classes based on media coverage.

Present or status quo bias: the risk of not doing anything.

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

Shortfall risk: the risk of final savings being insufficient to fund expected retirement income

Concentration risk: the risk that a portfolio is overly concentrated in a single asset or asset class

Liquidity risk: by converting to an annuity, savers exchange capital liquidity for income liquidity as a one off irreversible exchange. We believe that retirement income should be more dynamic, and not force savers into a point-in-time decision. Tradable annuities, fixed-term annuities, forward start annuities, or collective drawdown schemes that provide an income stream without the surrender of capital could be considered here.

Q.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?

Communicating the default journey is the priority. Clear signposting using case studies can help explain alternative journeys before and during retirement. NEST has a strong track-record in clearly explaining choices to members.

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

The introduction of some guaranteed income, forward start annuity and trust-based collective drawdown scheme helps protect against this, particularly if operated from a trust-based environment.

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

In the context of inertia, default strategies are essential in delivering outcomes to members who are unwilling or unable to make an active choice. This is likely to be the majority, regardless of the level of signposting, education and engagement attempted. Whereas previously providers have thought of a default strategy TO annuitisation (effectively managing conversion risk), hereon default strategies should be designed to

provide a default investment journey both in the accumulation stage and in the decumulation stage.

Q.11 Should we consider having more than one default strategy for different types of member, and which variables can reasonably be used to differentiate member needs in the event of no member engagement?

Alternative default design can be choice based where there is engagement, or data based in the absence of engagement. We believe that if NEST remains focused on the DWP eligible target group for the provision of automatic enrolment, there is no need for multiple defaults. However if NEST expand its based by targeting transfers in from other schemes, the demographic of NEST's membership could change dramatically. If the membership is diverse, then there could be different types of defaults Based on the principles of lifecycle finance, we think that the key determinants for designing different types of default strategy would be:

- 1) Pot size, salary/contribution rate
- 2) Earnings/contributions
- 3) Stability of earnings: whether intermittent or not intermittent

Members for a given age, with smaller pots, lower contributions and unstable earnings would likely be categorised as more vulnerable than those where the opposites are true. and considering the factors involved in default

Q.12 Based on the member evidence presented should the default target retirement age remain the same as the state pension age? If not what are the alternatives?

Yes it should remain aligned with the state pension age. Typically, the target date of a target date strategy is the date when the savers shifts from paying in to their fund, to withdrawing from it. US convention sets the target date at age 65. NEST assumes the target date is state pension age. Currently, the asset allocation strategy is managed 'to' the target date. It can also be managed 'through' this target date in effect providing an asset allocation until death, which could be some 20-30 years AFTER target date. We believe that NEST should remain with global conventions in fixing the 'target date' as the date when withdrawals are expected to commence.

We believe that for default savers this should be maintained in line with State Pension Age, which is highly evidenced based and contingent on ONS and GAD assumptions. Members should have the freedom to select a different target date if they require.

Q.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?

We think that traditional annuities have a reduced role to play, to part-insure longevity risk, typically the last ten years of life expectancy. Based on current UK life expectancies, this suggests that annuity purchase should be offered to those at age 75.

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

These would help form part of a matrix of solutions, but not comprehensively so. Further, we do not envisage how these could be designed into a 'default journey'.

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

Certainly. Deferred, or forward-start annuities give certainty of future income today (important in light of cognitive decline discussed elsewhere). Certainty is highly favoured by savers. Staggered purchases can be combined with target date funds to build up a known income stream, see Q.16 below.

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

More sophisticated default strategies in the US combined target date funds with a series of forward-start annuities to build up a ladder of secure known income streams, whilst keeping capital invested against inflation and longevity risk. This is cheaper than introducing costly guarantees.

Q.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?

Certainly. For the 20 years or so from state pension age through life expectancy in retirement, annuities cannot provide sufficient income regardless of yield level and certainly at current yields. Annuities were designed to protect against longevity risk for the last ten years or so of expected life expectancy and assume a nil bequest motive. Life expectancy has soared since they were first introduced, and savers expect to have more control over their investments including making a bequest. Investing through retirement has therefore become a necessity, not an alternative.

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

For a ~20 year investment time horizon from state pension age onwards, a multi-asset class approach is required that aims to provide a sustainable income. This should not be confused with an investment strategy that puts capital at risk to seek out an income yield. Income sustainability requires a stable value fund that protects against inflation and longevity risks whilst growing in line with a target depletion rate that could be set using the GAD methodology or a 4% (1/20th) proxy rate. Investment risk needs to be managed in a time-dependent way, reducing as time horizons shorten.

Consideration could also be given to combining this sustainable income strategy with elements of insurance-type solutions such as deferred annuities and capital guarantees around the investment portfolio to introduce higher degrees of certainty, although this might not be affordable within current price constraints, despite members valuing increased certainty highly.

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

Not necessary in the context of Q.18 above, in our view.

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

Not necessary in the context of Q.18 above, in our view.

Please do not hesitate to contact us should you require additional information on any of the matters outlined above.

Yours sincerely

Henry Cobbe, Director
For and on behalf of Elston Consulting Limited