## The Future of Retirement:
## A consultation on investing for NEST's members in a new regulatory landscape
## Submission from Partnership Assurance Group plc (Partnership)

### About Partnership

Partnership is a long established UK insurer specialising in the design and manufacture of financial products for people whose health and lifestyle means that their life expectancy is likely to be reduced. Partnership aims to offer higher retirement incomes than traditional providers through undertaking a detailed assessment of people's health and lifestyle conditions. It is a leading provider of enhanced annuities; typically, our average customer will receive approximately 18% extra income for life, compared to a standard annuity provider, and for those with more serious conditions, potentially much more. We estimate that over 50% of people at retirement could qualify for one of our annuities.

Medically underwritten annuities allow insurers to take into account a person's lifestyle and medical history to determine the probability of them living through each future year and, therefore, the rate at which they can be provided with a retirement income when they buy an annuity. An enhanced annuity can potentially offer consumers significantly higher levels of guaranteed income in retirement.

### Introduction

Partnership welcomes the opportunity to respond to NEST's consultation 'The Future of Retirement'. As a provider of enhanced annuities, this submission focuses on the importance of annuities as part of the retirement landscape.

**Q3. 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?**

As outlined in the consultation paper there are a number of areas which people will increasingly have to consider as they approach retirement, including housing costs, debt, day-to-day spending, and care costs. However, we believe that one of the most important decisions that people will need to make is how they ensure that their minimum income needs are met throughout their retirement.

Research conducted among Partnership's policy holders in 2012 (to ascertain what they spent the additional income received from an enhanced annuity on) demonstrated that a significant proportion spent the extra money on higher food bills (61%), heating and electricity (57%) and on meeting the costs of higher council tax and other bills (53%). In addition to this, recent research we have undertaken suggests that just 12% of over 40s said they could manage on the New State Pension of around £8,000 a year.

Although the evidence above suggests that for a vast number of retirees money will be tight, our research suggests that 10% (389,483) intend to use their tax free pension lump sum, and 5% (199,069) plan to use their pension, to repay the outstanding balance on their mortgage.

As future generations grapple with rising living costs and getting onto the housing ladder at a later date, more will need to be done to ensure that they are able to contribute enough to their pensions and savings to enable them to have adequate funds in retirement.

However, for those now at the point of retirement, it is essential that they are encouraged to think about their outgoings and how these may change in the future. It is critical that they have a guaranteed source of income to pay for essentials such as food, heating and electricity, and for meeting the costs of higher council tax and other bills. Although some costs may be covered by the flat rate state pension, it is important to recognise that many people will not qualify for it in full at outset.

**Q5. 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?**

Partnership welcomes the new pension freedoms announced in the 2014 Budget as we believe that more flexibility for those entering retirement is a positive step that will increase choice and should encourage people to save for, and enable them to make informed decisions in relation to, their retirement income.

However, there are a number of issues that will need to be addressed in order to support people to make decisions which best suit their needs throughout their retirement. As outlined in the response to question 3, it is crucial that people have a guaranteed source of income to pay for essentials such as food, heating and electricity, and for meeting the costs of higher council tax and other bills. Many believe that these will be covered by the flat state pension. However, it is important to recognise that many people will not qualify for it in full, particularly at outset.

The choices which have to be made at the point of retirement around funding an ongoing income for life are some of the most complex and important financial decisions that people will have to make as adults. However, reports which have emerged over recent months suggest that low levels of financial literacy can make the decision making process more difficult. A recent OECD report *'OECD Pensions Outlook 2014'* suggests that while the reforms might increase pensioners' control of their money, they could be "detrimental to both retirement income adequacy and incentives to work" because of "myopic behaviour and insufficient financial literacy".

In addition to this, the PPI have recently published a report ("*How complex are the decisions that pension savers need to make at retirement*") which found that many people believe they don't have sufficient knowledge or skills to make decisions about pensions.

The report ranks accessing DC savings hardest compared to other informed financial decisions including: decisions regarding work and retirement; accessing DB entitlement; accessing non-pensions income savings and assets in retirement; buying a house; education v work; buying life insurance; accessing the State Pension; and with the easiest being buying a car. The report also suggests that numeracy is correlated with the ability to make 'good' decisions about accessing pensions savings.

Overall numeracy levels in the UK are low among adults. It has been suggested that around 4 in 5 adults have a low level of numeracy (below GCSE grade C level), and nearly 1 in 5 people cannot correctly identify the balance in a bank statement.

Alongside this, a recent report published by the ILC-UK suggests that:

- Only half of those with a DC pension said they understood what an annuity is quite or very well;
- Only 20% of those with a DC pension pot said they understood what an enhanced annuity is quite or very well;
- Just 33% said they understood what a joint life annuity is quite or very well;
- Just 35% said they understood what income drawdown is quite or very well;
- In contrast, over 90% said they understood what a mortgage is.

If we are to encourage people to save more into their pensions, we must improve the levels of financial literacy and overall engagement in terms of retirement knowledge. However, we appreciate that this is a challenge given that people have other priorities in their working life, including saving for a house. In the long-term, we would like to see future governments do more to improve financial literacy levels among *all* age groups. In the meantime, the guidance guarantee should help to address some of these issues and NEST should therefore ensure that members who are at or approaching retirement are fully aware of the Pension Wise Service.

Policy makers should also look to international models to find examples of how savers might end up behaving. A report published by CPA Australia [one of the world's largest accounting bodies] in 2013, found that "*lump sum superannuation benefits are being treated as a windfall and being used to pay for the lifestyle that's being lived now instead of being put aside to provide income for retirement."* The report suggested that consumers view retirement savings as an increase in wealth and people are therefore more inclined to use debt to fund a current higher standard of living. In addition to this, the report found that compulsory superannuation has not closed the gap between retirement expectations and reality.

**Q7. Are there other risks and objectives to be taken into account for DC savers approaching and in retirement?**

Among the risks outlined in the consultation paper, we believe that predicting longevity is a significant risk for DC savers approaching and in retirement. The new pensions' landscape means that retirees may now assume the responsibility of managing longevity, credit, investment and inflation risk to ensure that they are able to successfully manage their funds throughout their retirement years.

In the USA, 51% of the workforce has some form of pension plan, with the vast majority in the form of DC 401(k) schemes. Reports suggest that 35% of those leaving their jobs in 2013 cashed out their 401(k)s outright despite the tax incentives to defer withdrawals. However, Fredrik Axsater from State Street Global Advisors has claimed that "only 19% of the US make a withdrawal from their DC retirement pots in the first five years of retirement, as they are trying to figure out their retirement lifestyle." It has been suggested that 62% of people in the USA underestimate their life expectancy. This has resulted in more than 40% of 'baby boomers' being likely to run out of money before they die, while 46% of people die with less than $10,000 (£6,312) in assets.

It is incredibly difficult to judge life expectancy and it is for this reason that we believe that annuities will remain an important part of retirement planning for people who value the security and certainty of a guaranteed income. Annuity providers take on the investment, credit and longevity risk for the consumer and offer an income that will last for life regardless of changes in circumstances or investment markets.

Savers should be encouraged to consider how they guarantee a source of income to pay for essentials such as food, heating and electricity, and for meeting the costs of higher council tax and other bills.

**Q8. 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?**

Partnership strongly supports the FCA's recent recommendation for the development of a 'Pensions Dashboard' which would enable people to view all their lifetime pension savings (including the state pension) in one place. We believe that such a mechanism would empower people to make more considered and informed decisions in relation to their retirement income, and also encourage active engagement throughout the savings process. With a growing number of people having multiple pension pots, a dashboard would help people better understand how much they have to fund their retirement. Whilst this is being developed a pension passport should be implemented for each pension pot the consumer has. This information then can, over a period of time, be added to the Dashboard.
People should also be engaged in the saving period about retirement income planning. We believe that engagement **5 years,** or even potentially **10 years**, before the earliest access age may be particularly useful. At its most basic this should, at least, involve a simple "wake up" communication offering people the option to 'call in' to start planning their retirement choices and highlight the need to ensure a suitable investment strategy is in place, for instance a service like the free 'age 50 NHS health check.' This should be supported by interactive web services.

Six months before their retirement date the consumer should be contacted by the guidance provider by letter (followed by telephone). These communications should explain what the guidance process is and why it is important.

**Q10. What is the role of default strategies in the new regime and the run up to and throughout retirement?**

To respond to this question, policy makers should look to international models, and in particular Australia, where the Financial System Inquiry (Murray Review) has within the past few months published its final report. The report suggested the introduction of a '*Comprehensive income product in retirement – to provide peace of mind that their income will endure through retirement*'. The review recommends that the needs of retirees would be better met if superannuation trustees were required to "pre-select a comprehensive income product in retirement for members to receive their benefits, unless members choose to take their benefits in another way". It is the inquiry's belief that <u>such a move could increase private incomes for many in retirement and provide them with peace of mind that their income will endure throughout their retirement</u>.

The report suggests that such a pre-selected option should be a comprehensive retirement product which has minimum features determined by Government:

- A regular and stable income stream
- Longevity risk management
- Flexibility

**Q13. 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?**

Partnership strongly believes that purchasing an annuity income should be an essential part of retirement planning for DC savers. The age at which this should be purchased should be determined by the time they need the income or at least age 75.

It is crucial that people have a guaranteed source of income or a guaranteed longevity underpin to pay for essentials such as food, heating and electricity, and for meeting the costs of higher council tax and other bills. Many falsely believe that these will be covered by the flat state pension. However, in reality many people will not qualify for this in full, particularly at outset. In addition to this, recent research we have undertaken suggests that just 12% of over 40s said they could manage on the New State Pension of around £8,000 a year.

**Q14. Would iterative purchase, phased annuitisation, or fixed-term annuities be a better way for DC savers to secure incomes?**

We believe that phased annuitisation could play an important part in the retirement planning of wealthier pensions. As they age this would enable them to secure important levels of guaranteed income and de-risk their retirement investment portfolio. In addition the older people get the greater the likelihood that they could qualify for an enhanced annuity, for health or lifestyle purposes, which will offer them a superior rate compared to standard annuities.

For those with average DC funds, one would imagine that the priority for them must be to ensure that essential costs of living are covered and guaranteed throughout retirement.

**Q15. Should deferred annuities be included in the toolkit for DC retirement solutions?**

Partnership believes that deferred annuities should be included in the toolkit for DC retirement solutions. Deferred annuities are becoming increasingly popular in the US.

**Q16. Are there any other ways of helping members hedge longevity risk?**

Partnership believes that annuities – which guarantee an income for life - will remain an important element in retirement planning. We therefore welcome the recognition from HM Treasury that "*annuities will remain the right product for some*". In addition to this, we are pleased that the FCA recently concluded in its retirement income market study that "*for people with average-sized pension pots, the right annuity purchased on the open market offers good value for money relative to alternative drawdown strategies and may therefore be a good option for those with low risk appetites".*

Underpinning the concept of pension saving is the wish to provide income security for the whole of retirement and to ensure that those retirement funds do not deplete before death. This security and sound financial management is also fundamental to a pensioner's 'peace of mind' and for their families. A recent report by the ILC-UK suggests that nearly 70% of all those with DC pots favoured their pension to deliver a secure guaranteed income for life over anything else.

Annuity providers take on the investment, credit and longevity risk for the consumer and offer an income that will last for life regardless of changes in circumstances or investment markets.

Medically underwritten annuities allow insurers to take into account a person's lifestyle and medical history to determine the probability of them living through each future year and therefore the rate at which they can be provided with their retirement income when they buy an annuity. An enhanced annuity can potentially offer people significantly higher levels of guaranteed income in retirement. A typical client of Partnership will receive around 18% extra income for life, compared to standard annuities, and in some cases much more. It is estimated that at retirement over 50% of people could qualify for our products.

**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**

Any new drawdown product should be composed of three main elements:

- Essential spending: this should be a secured minimum income for life to ensure that the individual can afford essential costs (e.g., heating and eating). This could be a mixture of annuity and state pension.
- 'Everyday spending': This element would cover other costs, such as holidays, going out with friends and presents for grandchildren. This could be achieved through drawdown.
- One off spending: This could be a lump sum to cover a big trip or renovations etc.

These three tiers would provide stability in terms of covering essential costs, but would still allow the individual flexibility with their pension funds. It is however important that consumers, particularly those with modest funds are fully aware of the risks that they are exposed to when engaging with retirement strategies.