National Employment Savings Trust
The future of retirement

Response from
The Pensions Management Institute

Response from the Pensions Management Institute to NEST's Consultation "The future of retirement"

Introduction

The 2014 Budget saw the announcement of some of the most significant changes to pension provision for nearly a century. The retirement options open to members of Defined Contribution pension arrangements will be radically changed with effect from April 2014, and these changes present dramatic new challenges for the pensions industry to address.

Criticism of Lifetime annuities has led to a new paradigm in which drawdown vies with taxable commutation as the new orthodoxy for providing retirement income. This will allow pensioners to tailor income streams to fit the changing expenditure requirements commonly associated with contemporary retirement. Changes to tax laws mean that many will have the option of passing accumulated pension wealth on to other family members. However, the new generation of retirees will be exposed to a real risk of exhausting retirement funds during their own lifetimes. Managing the new freedoms effectively will be a major challenge for all stakeholders.

The PMI

The Pensions Management Institute (PMI) is the professional body which supports and develops those who work in the Pensions Industry. PMI offers a range of qualifications designed to meet the requirements of those who manage workplace pension schemes or who provide professional services to them. Our members (currently some 6,000) include pensions managers, lawyers, actuaries, consultants, administrators and others. Their experience is therefore wide ranging and has contributed to the thinking expressed in this response.

PMI as a body does not hold opinions on matters of pensions policy (although its members as individuals may do so). It is focused on supporting its members to enable them to perform their jobs to the highest professional standards, and thereby benefit members of retirement benefit arrangements for which they are responsible. Comments made by the PMI are intended to improve outcomes for the members of those arrangements and should be read in that context.

PMI's response

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?*

We take the view that retirement is becoming a more gradual process rather than a cliff edge of work one day and full-time leisure the next. More members expect to gradually reduce the amount of work they do, or move from the main career to a secondary career as they reach what were traditional retirement ages. Many people see themselves doing some work to age 70, some longer, either because they wanted to, or felt they needed to.

Members will want flexible access to their retirement assets in order to supplement their consumption as incomes from work reduce, and possibly also as a bridge until they become eligible for state pension. They may also want lump sums to consolidate their financial position (e.g. pay off mortgages) ahead of moving to part-time work.

We believe that many people do not understand investing nor are most of them aware how their pension pot is invested or indeed whether it is "invested" at all. We continue to hear people talk about the "interest" that they earn on their pension which leads us to believe they consider pensions as akin to savings accounts rather than investment portfolios. This means that they are likely to consider pensions an extension of their bank savings account and are likely to demand/want to see it function in a similar way e.g. access to it as and when they need it, a regular stream of "income/interest", chance to top up as when they can and no chance of their pension falling in value.

In the absence of a mandatory retirement age, workforce management is becoming a key issue and employers want their members to come off their books when their productivity starts dropping. This is particularly the case as older employees are generally on higher salaries, cost more in benefits (especially health insurance) and may possibly have lower productivity than younger, healthier colleagues. We believe that though the increase in the economic participation of the older workforce is something to be celebrated, the impact on employers and the younger generation of having workers not being able to retire and not being able to work effectively either can be debilitating. Accordingly, in our view, employers are looking for a pension scheme to help their employees plan for retirement as soon as possible, encourage them to increase contributions, execute on the investment strategy in a transparent way and provide value for money: in short leaving the employer to focus on what they do best, i.e. run their business.

Q2: How will the trends identified in this chapter evolve and what does this mean for DC design?
There is a clear cohort effect, where many current retirees and those retiring in the near future, enjoy significant amounts of DB and S2P pension entitlement. See for example the PPI Report: http://www.pensionspolicyinstitute.org.uk/publications/reports/transitions-to-retirement---'how-complex-are-the-decisions-that-pension-savers-need-to-make-at-retirement These DB and S2P entitlements provide retirees with significant protection against inflation and longevity risk, meaning these risks can be given less emphasis in decisions on 'top up' DC assets. As prevalence of these entitlements reduces in the population, inflation and longevity risk will become more important, at least for mid earners and above where replacement rates from the single state pension are low.

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?
Automatic enrolment was intended to focus on the low to medium earners, and so the evidence presented for retirees in this group are most obviously relevant here. Arguably, the area of greatest

concern is the higher housing costs that are expected to be borne by future retirees. If, as predicted, larger numbers of people enter retirement with outstanding mortgage debt or living in the private sector, this will create higher income requirements than is currently the case. The forthcoming retirement reforms could well see many pension scheme members using cash sums to clear debt but suffer reduced post-retirement incomes as a result.

The other area of concern is the increasing costs of long term care. Costs are such that it is unrealistic to suppose that conventional retirement solutions will be adequate to address them, and that products such as equity release are likely to be more common in future.

Q4: Given the heterogeneity of likely spending patterns in retirement, is it possible to reflect these in the design of retirement solutions?
The differences in requirements for retirees is so great that they cannot be adequately addressed by the design of retirement solutions. It is vital that members properly understand the options available to them so that they are in a position to make informed decisions concerning the range of available options. The Pension Wise service has a crucial role to play in facilitating this.

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?
Whilst believing that the future behaviour of UK retirees cannot be fully forecasted, we think that more deep research such as that undertaken by the PPI in Transitions and by NEST itself can help to predict likely actions. We also believe that clues can be found in the behaviour of participants in the more mature and increasingly similar US and Australian markets. On this basis we are optimistic that over time consumers will learn rules of thumb and helpful heuristics that, together with innovative default products and effective guidance, will lead to improved and more flexible outcomes.

Overall, we understand that inertia is powerful and we would expect defaults and the path of least resistance to remain powerful influences on choices and behaviour.

We would note the importance of tracking actual behaviour under the new freedoms as it evolves, and of creating future-proof arrangements that can evolve if and when behaviour and needs change.

Q6: What member behavioural risks do providers need to manage?
To ensure that inertia is put to good use (nudging) rather than leading to inappropriate and undesirable outcomes e.g. members encashing all their pension money and putting it in a bank account, where encashment of their pension will move members to the next tax band, etc. In this case, providers could put in place a policy of contacting members if they received an encashment request of more than £10K or walking members through an online process to ensure that they understand as much as possible the result of their actions and what other options are available to them.

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

No - we regard this list as comprehensive

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?

We believe that members only really form a firm view of retirement prospects one or two years out, suggesting effective and behaviour-changing engagement will be challenging much earlier than that. We believe that most people can only frame their own anticipated retiring date within a 5 year ‘window’ even very close to retirement itself.

While increasing engagement is a positive aspiration, we would stress the importance of well-chosen and well governed defaults to provide good outcomes for those members unable or unwilling to engage significantly with the choices they face or unable to predict their own position in to the future.

Q9: How can we help mitigate the risks associated with cognitive decline as people get older?

The answer would seem to lie in well-chosen defaults and paths that are mapped out in advance, in the earlier years of retirement, that require limited engagement from older retirees. Solutions such as pre-buying deferred annuities or the adoption of enduring powers of attorney may help in this regard.

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

A default investment strategy in the run up to retirement will be required on the basis that members do not form a firm view of how they will use their retirement assets until a short while from retirement. That default needs to be robust to uncertainty of when people will retire and how they will use their assets - hence it will have a hybrid objective rather than be optimised for any single course of action and retirement date.

The possible exception to this is for retirees in the immediate future, for whom encashment of small pots is the most likely course of action, though again there is uncertainty as to when.

Q11: 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?

Only to the extent that auto enrolled members retiring in the near future will have small pots and could be defaulted to a cash objective strategy.

The approach of using member data to split cohorts into different defaults only works effectively if there is a complete, holistic view of their retirement savings and even then, a large number of assumptions will need to be made on the what exactly a member will do with that money and when they will do so.

In general, we have a concern that, in the near-term at least, any multiple-route approach that relies heavily on member engagement well ahead of the retirement date is untenable. Consumers have largely been disengaged in the accumulation phase and we believe this will take a while to evolve. Even if engagement is achieved, a significant barrier is the fact that members just do not know the answers to the relevant questions as to how they may interact with their DC savings in the future.

Q12: 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?
Yes, for the want of any other obvious anchor, but the asset allocation glide path should not be very sensitive to the precise date, to allow for the uncertainty of actual retirement date (e.g. to have a relatively shallow glide path.)

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?

And

Q14: Would iterative purchase, phased annuitisation, or fixed-term annuities be a better way for DC savers to secure incomes?
The combination of mortality drag and the need to manage longevity risk makes the case for a continued role for annuitisation in later retirement. Conversion risk and the nature of cognitive decline make the case for this annuitisation to be done on a phased and/or deferred basis rather than purchase of an immediate annuity at, say, age 80 or 85.

Q15: Should deferred annuities be included in the toolkit for DC retirement solutions?
Yes, with the role as described in 13 above. We would note that the supply side of the market is not currently well developed.

Q16: Are there other ways of helping members hedge longevity risk?
Many of those retiring over the next two decades will have accrued benefits in Defined Benefit arrangements. It should also be remembered that for the low to medium earners who form NEST's target market, the State pension will play a significant part in both achieving a satisfactory replacement ratio and hedging longevity risk.

Perhaps the most radical solution would be for NEST to become a Collective Defined Contribution scheme. The size of the scheme would provide the economies of scale to make this viable, and the use of internally-calculated conversion rates would be expected to provide higher pension levels than would be provided through lifetime annuities.

Q17: Does investing through retirement, as an alternative to immediate annuitisation, have a significant role to play in meeting the retirement needs of DC savers?
Conventional drawdown options, in the form that is to take effect from April 2015, will have a role to play for many retiring members of DC schemes. However, drawdown will only ever be a viable option for members with larger funds; a fund of £100,000 would be the smallest size for drawdown to be a realistic option. Given the nature of NEST’s target market, it is unlikely - over the course of the next decade at least – that many NEST members will retire with funds of this size. The average size of funds currently used for annuitisation is approximately £30,000. This corresponds to the new triviality limit, and for as long as this remains the most common fund size at the point of decumulation, the Uncrystallised Funds Pension Lump Sum (UFPLS) option is likely to be the most suitable alternative

Q18: 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*

One option would require a legislative change as it would in effect involve the re-instatement of a form of capped drawdown. Conversion rates would be based on internal annuity rates calculated by NEST. The default asset allocation would in future assume that members' entire uncrystallised fund would go into NEST's own drawdown and so retain a high equity content up to a pre-determined decumulation date. Members would of course retain full flexibility but would have to initiate alternative decumulation strategies themselves. For the low to medium earners who make up NEST's target market, the payment of the State Pension from SPA should provide an adequate longevity hedge.

Another possible model would be a fully distributing unit trust that provides an income for life through a combination of dividends on the underlying investments, a 'living bonus' (share of monies left behind on death), and a % of own capital invested. This approach can be simply explained and does not have to use all the DC (DB cash?) pot, just a portion, with the remainder in a drawdown account. Access to the capital, within limits, makes it doubly attractive in case life expectancy is suddenly found to be impaired.

Q19: Should NEST consider some form of risk sharing as part of a solution for NEST members in retirement? If yes, what sort and why?
The fundamental principle of Automatic Enrolment is that members’ participation in a workplace pension scheme should provide members with an optimal retirement solution without requiring

them to make active decisions. This principle applies to the initial enrolment, and has also been applied to the de-risking phase. It is logical therefore that the same principle be applied to decumulation. With this in mind, it is appropriate that members' funds be converted by default to income. In the case of NEST, this would be possible were the scheme to become a CDC arrangement. NEST's size makes this a viable option.

Research indicates that scheme pensions provided by CDC schemes in the Netherlands provide higher levels of income than those requiring annuitisation. NEST's own research during the PADA era demonstrated that the scheme's target market is uncomfortable making investment decisions and so a default option which provides an attractive retirement solution without requiring member decisions would be ideal.

The automated provision of a pension without the requirement for any action on the member's part would be in keeping with the ethos of effective defaults. The principle of Automatic Enrolment would be continued as an end-to-end retirement solution that requires no formal intervention by members.

Members would of course retain the right to transfer funds to alternative arrangements should they wish to annuitise or exercise any of the new options available from April 2015. This would however require them to make an active decision which might follow a Pension Wise guidance session and possibly formal advice from a regulated professional.

Q20: Would there be benefits in combining a risk sharing approach and pure DC, and if so, what would these be?

If members retain the option of making retirement options which differ from the scheme's default there would be no obvious need for NEST to consider combining CDC with alternatives such as conventional drawdown.

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