PENSIONS POLICY INSTITUTE
PPI

PPI submission to NEST Consultation: The future of retirement - A consultation on investing for NEST's members in a new regulatory landscape

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

2. This submission does not address every question in the consultation, rather the response sets out key evidence from PPI research where it is relevant to the question asked.

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?

Q2. How will the trends identified in this chapter evolve and what does this mean for DC design?

3. Decisions about accessing DC pensions are difficult as they often require understanding of complex and uncertain economic and market concepts such as inflation, investment risk and longevity risk. From April 2015, greater levels of flexibility will further complicate the decisions that DC savers must make as they will increase the number of available options, push the burden of managing risk further onto pension savers, and, in some cases, extend the need for ongoing decision making into retirement.

4. People reaching SPA over the next ten to fifteen years vary considerably in their pension and non-pension savings and asset portfolios. Some people will require greater support than others as a result of reaching retirement more reliant on their DC savings to secure an adequate income and potentially lower levels of ability to make financial decisions. The

challenges for this group will be compounded over the next few years as the industry is still responding to the reforms and adjusting to a new type of pension saver who will be allowed to access their savings more flexibly. The defaults in place for these groups may either be actively developed in response to the reforms (for example, new drawdown strategies offered directly by a pension scheme or provider) or may be the "path of least resistance option" (for example, taking the DC pension as cash, or buying an annuity from their current provider). At this early stage it is unclear which options will be most popular.

5. Around 5.7 million people currently (2014) aged between 50 and SPA will have some private pension savings or entitlement at their SPA. Of the 5.7 million:
   - half of these people will have DC pots of £6,300 or less, including those who will have no DC savings. Around three quarters of this group will have DB entitlement.
   - Half will have DC pots of £6,300 or more and around a quarter of these will have DB entitlement.

6. PPI modelling of ELSA[1] data indicate that around 12% of people currently aged 50-SPA in England (694,000 people) will be at "high-risk" of making poor decisions when they reach SPA if they are not offered support through either guidance and advice or suitable defaults. These people will have between £19,400 and £51,300 in DC savings (and little or no additional DB pension to fall back on). A further 29% (or 1.6 million) people aged 50-SPA in 2014 will be at "medium risk" of making poor decisions. These are groups with anywhere from £6,300 to above £51,300 in DC savings and little or no additional DB (Chart 1).[2]

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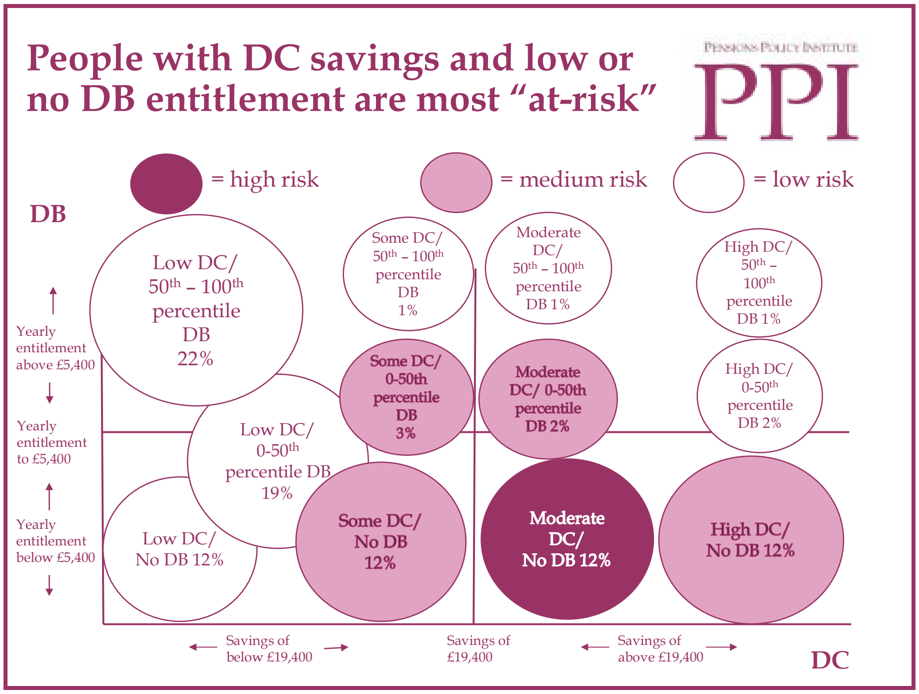
[1] English Longitudinal Study of Ageing, Wave 5

[2] PPI (2014) *How complex are the decisions that pension savers need to make at retirement?* PPI

Chart 1[3]



7. This means that around 4 in 10 retirees will need significant support over the next ten to fifteen years because they will be dependent to a significant degree on the income from their DC savings in retirement to supplement their state pension, have little other savings and assets to fall back on, have low levels of financial skill and engagement on average, and are less likely to already use a financial adviser or be actively targeted by financial advisers in the current market given the size of their pension pots. There is a particular correlation between having low levels of numeracy and low or no DB savings.

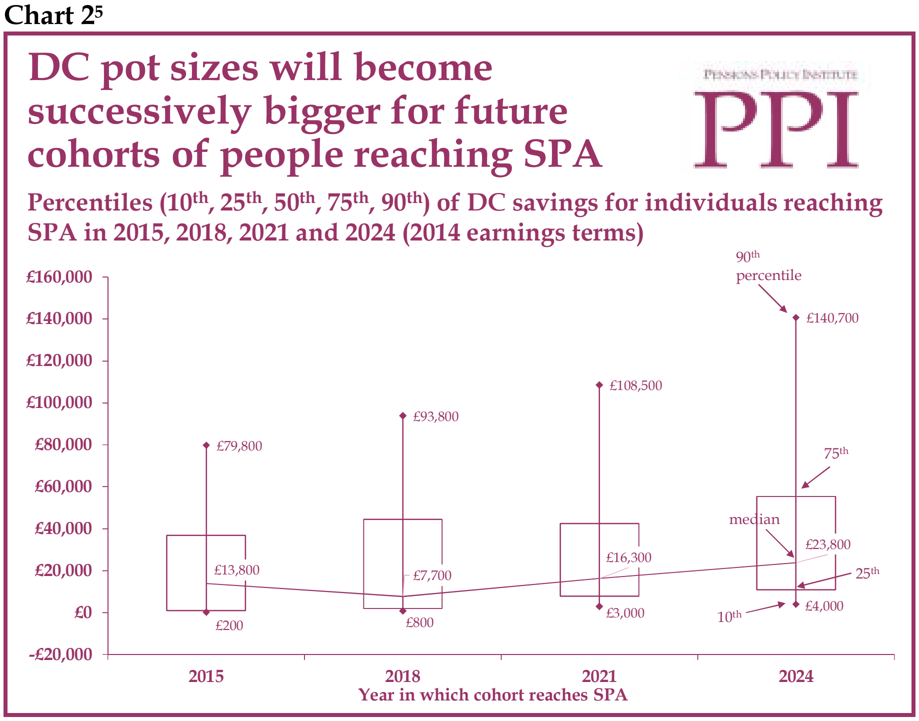
8. The Guidance Guarantee, which will offer the provision of free impartial guidance to those reaching retirement with DC savings will be operational from April 2015, however there are significant concerns regarding what the take-up of the guidance may be, whether the guidance will be able to meet the level of need and the complexity of the different individual and household circumstances, and the likelihood that individuals will follow up on the guidance they receive with timely and appropriate actions. There are intrinsic issues with engaging with people around pension decision-making that are impacted both by their own high levels of

[3] PPI Dynamic Model

uncertainty around their retirement planning and by behavioural barriers which can lead to inertia and a reluctance to actively engage and take decisions. There were already concerns in place about the availability and quality of guidance and support offered to pension savers prior to Budget 2014 and the announcement of the new flexibilities. It is clear that a large number of people will require even more support and assistance once these new flexibilities are in place.

9. PPI research has identified around 40%, 2.3 million, people approaching retirement in England with private pension savings over the next ten to fifteen years who will be most in need of assistance and for whom access to these services will be particularly critical if they are to make the most of their available DC savings to support their retirements. The number of people retiring with DC pots is expected to grow as more people are brought into pension saving through auto-enrolment, but average pot sizes are likely to remain relatively low over the next few years, with the median DC pot size, for those age 50 to SPA, in 2015 at £13,800 and growing to £23,800 by 2024 (Chart 2).[4]

Chart 2[5]



[4] PPI (2014) *How complex are the decisions that pension savers need to make at retirement?*
[5] PPI Dynamic Model

10. It will be critical that the people reaching retirement with DC savings over the next few years are given support. Independent and trusted guidance and advice services, beyond the Guidance Guarantee, will need to be made available to people in these medium to high risk groups. The people in these groups will need special targeted support to engage with and act on advice and guidance or they will be at risk of making decisions that could adversely impact their retirement incomes. Strong defaults, which mitigate risk must also be in place for those who cannot or do not want to make active and informed decisions.

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?

Q4. Given the heterogeneity of likely spending patterns in retirement, is it possible to reflect these in the design of retirement solutions?

11. One of the challenges over the next few decades will be ensuring that people save enough in order to achieve an income in retirement that they would consider adequate. One way of measuring income adequacy in retirement is by using replacement rates which would allow people to replicate working-life living standards in retirement. These vary for people of different income levels. A median earner might require a gross retirement income of around 67% in order to replicate working life living standards, though the proportion of income needed could change as a result of policy changes to, for example, pensioner tax allowances. The amount of contribution required to achieve a target rate also depends on scheme charges and the type of fund or investment strategy used.

12. An 8% contribution (the minimum required under automatic enrolment) may not be sufficient to allow people to replicate working-life living standards in retirement. PPI stochastic modelling indicates that a median earner who contributes 8% of salary[6] between age 22 and SPA will only have 49% chance of achieving a target replacement rate. In reality, it is unlikely that many people will contribute to pensions consistently between the ages of 22 and SPA, and would therefore have a less than 49% chance of achieving a target replacement rate if they contributed at this level. However, 51% of those who do contribute at this rate are unlikely to

[6] PPI (2013) *What level of pension contribution is needed to obtain an adequate retirement income?* PPI

achieve the target replacement rate. For those contributing between age 22 and SPA a contribution rate of between 11% and 19% may be required to meet a target replacement rate. The actual proportion is sensitive to investment approach, market performance, scheme charges, and the value of the state pension and its inflationary index (Table 1).

Table 1[7] Level of contributions needed to have a two-thirds or three-quarters chance of meeting a replacement rates using different investment approaches, charging structures and inflationary index for state pension

		New State Pension triple-locked		**New State Pension earnings linked**	
Probability of achieving the target replacement income	**Investment approach**	**AMC: 0.5%**	**AMC: 1%**	**AMC: 0.5%**	**AMC: 1%**
Two-thirds	Traditional lifestyle	11%	12%	14%	16%
	First alternative	12%	14%	16%	17%
	Second alternative	10%	12%	14%	15%
Three-quarters	Traditional lifestyle	13%	15%	17%	18%
	First alternative	14%	15%	17%	19%
	Second alternative	12%	14%	15%	17%

13. It will therefore be important for employers and providers to engage early on with scheme members in order to promote understanding and awareness of income needs in retirement, as well as how longevity, inflation and changes in health or household structure could affect income needs in retirement. Participants in recent PPI focus groups struggled both with estimating how much income they would need in retirement, which they tended to overestimate, and how long they might live on average, which they tended to underestimate.[8]

[7] PPI and King's College London modelling analysis

[8] PPI (2015) *Supporting DC members with defaults and choices up to, into, and through retirement: Qualitative research with those approaching retirement* PPI

14. It is important to include income and assets other than pensions when assessing people's abilities to meet their income needs in retirement, but the PPI hasn't done sufficient modelling of this to allow for a detailed breakdown of how different levels of non-pension wealth may impact people's abilities to support themselves in retirement.

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?

15. It is not possible to know exactly how people will behave after April 2015, however, focus groups conducted on behalf of the PPI[9] found that many participants formed an initial intention of taking their DC pot as a lump sum and re-investing it elsewhere. However, when the tax implications of this and other considerations such as longevity and inflation were discussed and explained to them, participants felt that some sort of risk-hedging through retirement income products might be attractive.

16. Participants rated risk-mitigation, ease of access and flexibility as the factors they considered most important when determining their choices around drawing down their pension pots. However, while there was support in principle for purchasing longevity insurance (as a product or in the form of a deferred annuity) participants were reluctant to lock substantial portions of their savings away. Some saw the value of longevity insurance but still felt they'd rather risk running out of money before their death than lock any away in a deferred annuity or longevity insurance product. However, there was some appetite for paying yearly instalments for longevity insurance, with yearly payments of between £500 and £1,000 being considered reasonable for a product which pays out a lifetime income, e.g. £5,000 per year from age 85.[10]

Q6. What member behavioural risks do providers need to manage?

17. Decisions people make at retirement are affected by both internal (behavioural and cognitive) factors and external (structural) factors. This encompasses a host of influences. The most influential are the following:

18. **The tendency towards inertia:** Many people display a natural tendency towards inertia which impacts pension decisions by manifesting as a

[9] By Ignition House
[10] PPI (2015) *Supporting DC members with defaults and choices up to, into, and through retirement: Qualitative research with those approaching retirement* PPI

reluctance to seek information or make active decisions. Natural tendencies towards inertia are further exacerbated by the complexity and uncertainty surrounding decisions about pensions and retirement. A general lack of trust in the sustainability of the state pension and in the providers of private pensions reinforces fears and uncertainty, though trust in employer-sponsored pensions is higher than it is for third-party run pensions.

19. Inertia can also arise from competing priorities taking precedent, a lack of funds making people feel that there is no point trying to make decisions, or intimidation at the prospect of making decisions. Interestingly, the tendency towards inertia decreases just before retirement, when most people have more motivation to make a decision, but can increase again afterwards. Inertia rising from intimidation about pensions decisions tends to disappear during retirement, after which many retirement decisions might have already been faced or taken, but inertia arising from other factors can remain throughout retirement.

20. **Cognitive abilities:** Levels of numeracy in particular have been found to have correlations with people's ability to understand pension arrangements. In the UK levels of numeracy among adults are low. In 1999, around 20% of adults (around seven million) were found to have more or less severe problems with basic skills, in particular with what is generally called 'functional literacy' and 'functional numeracy':
    - In 2011, 43% of adults were found to have literacy skills below a GCSE "C" grade and 78% with numeracy skills below a GCSE "C" grade.
    - Nearly one in five people cannot correctly identify the balance in a bank statement.
    - Only around one person in ten has the ability to calculate compound interest.[11]

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

[11] PPI (2014) *How complex are the decisions that pension savers need to make at retirement?* PPI; DWP (2012) *Extending Working Life: behaviour change interventions* DWP www.nationalnumeracy.org.uk/what-the-research-says/index.html

21. The following conclusions on default design are based on the outcomes from focus groups done on the behalf of the PPI:
    - Having a default investment or drawdown option that could be utilised at some point at or during retirement resonates with DC savers – though they recognise the importance of wider individual and household circumstances and the need for there to be choice for those who want it. There is a degree of commonality, once thought through, in the desire for a vehicle in which to grow pension savings post retirement and willingness to sacrifice some capital protection and/or flexibility to achieve this.
    - Given the existing lack of understanding around the underlying investments in default funds, and what the funds are seeking to achieve, it will be important that any defaults and alternatives offered are clearly branded and communicated in terms of objectives and risk-level.
    - DC savers are generally reluctant to make up-front commitments about the point in time at which they might be willing to lock their money in to a particular strategy. They are also reluctant to hand over significant sums of capital in the early years of retirement to another party. Whilst this reluctance may act as a barrier to the take up of some forms of annuities, concepts like longevity insurance and the payment of ongoing premiums resonated with the majority of those interviewed, and they were willing to make some sacrifices in income in early years to ensure they had a secure backstop should they live to longer ages.

22. It is important to note however that while the design of defaults is important and can have an impact on outcomes, other factors such as the level of contributions paid into the pension fund and the length of time spent contributing are likely to have a greater impact on outcomes.

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

23. The Government is introducing new legislation to facilitate the development of shared risk and collective benefit schemes in the UK. The bill contains measures to allow the development of new structures offering collective benefits that allow for the pooling of investment, inflation and longevity risks between members within a workplace pension structure,

and allows for pensions in payment to fluctuate. These schemes do already exist, or are in development, in a number of other countries, including the Netherlands, Nordic countries and Canada

24. The PPI conducted two case studies of the experience of running Collective Defined Contribution (CDC) schemes in the Netherlands and Canada. The experiences of both countries highlights issues that should be considered if plans with similar risk-sharing or collective elements that are to be established in the UK.

25. **Netherlands:** CDC schemes are generally successful in the Netherlands and reflect the values that Dutch people place on intergenerational sharing and solidarity. There is high pension coverage in the Netherlands; 90% of employees are members of a pension scheme. However, Dutch CDC schemes have suffered recent deficits and recovery measures have caused some concern amongst the membership. The following lessons from the Netherlands may be pertinent to the UK Government or anyone wishing to set up a scheme in the UK
    - The need for contractual agreements and members' expectations to be fully aligned from the outset, and for there to be explicit communications upfront about the potential risks to members indexation and benefits and the measures that will be taken by trustees (or other decision makers) to address changes in the funding position;
    - The need for clearly-defined individual property rights at fair market prices in a pensions landscape without mandation and with freedoms for members to stop their contributions or exit the scheme altogether;
    - The collective 'benefits' of scale that can be delivered through DB and DC schemes, whether risks are being shared or pooled between the members or not;
    - The potential for innovative ways of pooling individual longevity risk for the in-retirement benefits for schemes, either in a fully collective scheme, or in a scheme which is DC in the accumulation phase but has collective elements in retirement.

26. **Canada:** CDC schemes have been recently introduced in Canada as a response to deficits in DB schemes and worries that private sector DC schemes don't provide enough protection against risks. The following factors may be relevant to the Government or any organisation exploring options for setting up a scheme in the UK.
    - the potential for shared-risk or collective benefit arrangements to extend to relatively small employers and pension plans if the significant governance overheads can be shared;

- the challenges in persuading employers to set up shared risk or collective benefit arrangements where they need to meet certain requirements (under UK legislation) to convert existing DB rights over to these new pension plans;
- the need to establish trust, transparency and inter-generational fairness between different groups of workers in a landscape where workplace pension participation is not compulsory (unlike in Canada and the Netherlands);
- the desire for "freedom and choice" from both employers and employees—with private sector employers likely to be attracted to different levels of contributions and benefits for their workers, and with employees likely to want to retain the option announced at Budget 2014 to access their pension savings from age 55 onwards;
- the appropriate tax and accounting treatment for these plans—with the tax treatment of target or collective benefits that can potentially be changed in future (subject to the funding position of the plan) yet to be confirmed.