Response to NEST's consultation on investing in the new regulatory landscape

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Summary

The new freedom of selecting pension products may easily cause more harm than good. To start saving and to understand the life-cycle investment approach seems easier than to comprehend the variety of risks of a range of pension products and to estimate overall longevity risk. Still, because saving decisions have not turned out to be that easy after all, a gigantic experiment of involving ten million new savers into an accumulation system has started, with the provision of precisely designed default options. To a large degree for the very same audience, leaving all decisions to the individual about how to convert a lifetime's savings into the best value pension product may lead to purchases (or lack thereof) regretted later, and/or to costly advice (for the individual or the taxpayer).

Additionally, as NEST's consultation paper clearly demonstrates, without an anchor regarding the expected / most typical behavior of pension product purchases, creating a default investment strategy suitable for most users is close to impossible. This is one of the serious unintended consequences[1]. Because providing an easy-to-understand, passive choice about the way to save for pensions is a central idea of the ongoing reform, without knowing how to optimise for the payout phase may create a significant pension risk – which is the likelihood of reaching a lower pension than targeted. The fact that in many countries the accumulation strategies (e.g., a life-cycle approach) are similarly de-linked from the payout phase does not imply that NEST should be happy to do the same now.

I am arguing therefore for maintaining as much of the old default solution as possible even after the recent legislative changes. The baseline should be a significant degree of annuitisation. Especially at later ages, living without a longevity insurance should not be a realistic option. However, the new regulations require a more active communication towards, and with, costumers than would have otherwise been rational in an auto-enrolment system.

As a minimum, it must be made clear why a degree of annuitisation is essential and that optimising the accumulation phase requires a good understanding of the planned decumulation method and timing. This is going to be hard to understand for the average NEST costumer, but in the brave new world of pension freedom, NEST will have no other choice but trying hard to make it as user-friendly as possible.

The use of a floor and a cap for annuitisation is reasonable, where too small amounts are not annuitised due to cost factors, and above an adequate guaranteed old-age living standard it is not required. However, such pension projections and calculations should take into account all sources of future pensions, including State Pension and other saving schemes. This makes it even more difficult and requires co-operation of all parties. For the same reason, it will have

[1] As a sidenote, voluntary annuitisation may also lead to adverse selection (those prefer annuities who have some ground to suspect a longer life expectancy, while those expecting a shorter life in retirement go for drawdown). This would not be the case with mandatory annuitisation, and it may increase annuity prices over the board as providers price in higher risks. It is another unintended consequence of the changes.

to be examined which institution should be made responsible for driving the exercise, whether it is NEST, The Pensions Regulator, FCA, DWP or any other authority.

An emphasis on real (inflation-indexed) annuities seems justified. While this leads to lower initial payouts (and more resistance), it is the only tool for value protection. Since health care costs are increasing later in retirement, and based on the demonstration of the consultation paper about people's limited ability to make reasonable decisions especially in those later years, nominal annuities (not to mention drawdowns) are a recipe for poverty for those privileged living long enough.

It also seems advisable that the use of batches of deferred annuities as a part of NEST's investment portfolio should be seriously considered (if insurance market conditions allow – if not, there may be a reason to draw attention to regulatory bottlenecks, including capital requirements, and to request the government to issue longevity bonds for annuity providers to hedge systemic risk). For most users, allocating small instalments continuously into annuities during the saving phase may probably be a part of an optimal strategy – especially in the case when the individual is otherwise free to choose to spend all accumulated savings on day one of retirement.

Finally, alongside the difficult questions of defaults in the accumulation and the payout phases and the expected behavioral issues of NEST's members, it seems that sufficient thinking should be given whether NEST ought to become a default annuity provider. This question has not been made explicit in the consultation but seems to be a part of it. Certainly, many arguments, such as expertise, scale and ease of use for customers, would support such an approach. ATP's experience in Denmark could also be investigated in this regard. As an alternative, a rigorously established and monitored partnership model with external annuity providers could also lead to good value pension products for customers. In any case, it is likely that NEST should not leave its clients without strong support at retirement.

Responses

1. 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?

Members would still need a stable, inflation-indexed old-age income for their lifetime, where the timing of retirement may become less certain but the DC element more important among sources of pensions (except for the poorest deciles). They also need to be relatively certain not to „waste" their savings if dying too early in retirement, otherwise this type of worry would be an obstacle for properly managing longevity risk.

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

DC design should keep on including proper default options, both in accumulation and payout phases. However, the new freedom requires drastically more communication with members so that defaults in both phases may be adequate for most customers.

The basic, partial ingredient of a default pension product could be an inflation-indexed annuity from the age of approximately 75, when a few years of „free spending" by the member have already occured, the tipping-point of good value purchase of an annuity has arrived[2] but diminished old-age decision-making capability is not dominant yet. Such an annuity purchase may be phased-in, and/or combined with money-back or joint-life characteristics. As a rule of thumb, allocating the present 75% of savings for such an annuity seems reasonable, though more thought will have to be given to details.

The de-risking, consolidation phase of the accumulation period could then be designed to fit such a payout product default.

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?

The overall message from the evidence is that customers still need a stable life-long real income source.

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

Providers such as NEST have two options. They may leave every decision to their members who can select the most proper pension product for their individual circumstances. This naturally leaves the design of the de-risking path problematic and the only choice seems to be a „neutral" one concluding to cash at the age of 65-70, when the member is free to purchase any sort of product. This will not be optimal for many clients.

The other option is to leave one default option which, based on further surveys and analysis of future expected behaviour, may fit the needs of the majority. This must be supported by

[2] The mortality cross-subsidy starts to increase somewhere above the age of 75 (male), so annuitisation starts providing real value and becoming essential (source: David Blake's analysis).

strong, interactive communication with members from a relatively young age (definitely not only at 50+), so that they gradually understand what it is about and think about alternatives if necessary. This option seems much harder than the previous but superior to that.

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 the new freedoms?

It is likely that members on average would not behave fully rationally, and would take out more lump sum payments and purchase much less inflation and longevity insurance than necessary. This may not apply to all customers, but probably to many. The case for helping them by proper defaults is strong. State Pension provides a part of the necessary replacement with longevity insurance (especially for lower income workers, the replacement rate exceed 50%), but it still does not provide an appropriate, life-time pension level to a significant portion of the NEST clientele.

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

I can't add to the description in Chapter 2 and responses to other questions.

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

The overall willingness to save (contribution rates, volumes of saving, continuity of contributions) may depend on whether clients see a relatively safe good value in doing it. This may be the strongest potential argument for some return smoothing in a CDC-type approach (see below). If the danger of „saving at the wrong time" may be handled to a certain extent, this may lead to higher savings rates and more pensions on average, whether by fewer members opting-out, or by inducing more voluntary savings, or even by making it easier to increase the 8% contribution rates at a later stage[3].

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?

Members need substantial, easy-to-understand, interactive communication from relatively young ages (30-35) and not only approaching retirement. In the special case of making deferred annuities a part of the investment portfolio from the beginning, meaningful communication in fact should start immediately after joining. These are complex questions where customers require more than one simple letter. At the same time, customers do not read long and complex documents, so the message should be user-friendly, and clients will have to be „trained" to read and understand statements, letters and information available online.

NEST's way to communicate with members, its Golden Rules of communication, the vocabulary used and the Phrasebook provide a very good basis for further developing

[3] The 8% contribution rate is a compromise between being not too high to make the individual opt out (and for the employer and goverrnment match) and still providing a part of the desired replacement. However, for many customers, especially in the medium salary ranges such a contribution rate will probably not lead to pensions, in combination with the State Pension, exceeding 50% of wages. Therefore, after full roll-out in 2018, some increase of contribution rates and/or an auto-escalation feature could be considered.

discussions with members. It should be simple (as simple as possible when discussing such complex subjects as annuities, and the link between optimising the accumulation and payout phases), interesting and interactive.

Most of NEST's customers will not be able to afford costly advice, and the new regulations promise free guidance. NEST should be involved when developing the exact details, which should include easily understandable instructions that most likely prompt adequate action.

While the context is somewhat different, the experience of the Chilean Supervisor (Superintendencia de Pensiones) in communicating with members in a user-friendly and interactive way and prompting them to make important decisions (such as saving more or working longer) may be useful to study. Similarly, TIAA-CREF's close and cost-efficient communication with its members may offer some ideas.

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

Absolutely no active decisions on behalf of customers at such high ages should be required.

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

As reflected in answers above, the role of defaults is fundamental, unavoidable.

11. 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?

In principle, I don't think that applying more than one default option is a good idea. It might complicate things more than what it may help. Only if there is a large degree of confidence in decision makers that such a differentiation may indeed work[4], then perhaps it might be considered. Still, possible legal issues of discrimination should be investigated.

12. 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?

If the default product is a phased-in annuity, kick-in age for that could be around 75.

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?

Yes, absolutely, around 75.

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

[4] Pot sizes seem to be the factor to use.

Phased annuitisation is a good solution for risk smoothing and also for minimising the worries about „dying early". Fixed-term annuities, however, require more continuous engagement, especially at later ages, by which time all product purchase decisions should have been already made. They do not provide real longevity guarantee either. Also, FTA pricing does not seem to provide good value.

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

Deferred annuities are useful elements of pre-saving for pensions. They can help to manage risk factors linked to timing. Not many countries are able to use this instrument due to underdeveloped life insurance markets, but precisely the UK could be one to rely on deferred annuities, given its robust market. If the main constraint is regulatory bottlenecks regarding capital and solvency requirements, this could mean that the industry and regulators should co-operate on working towards necessary amendments. It does not mean that this could be easy, given the European framework and the lengthy procedures of amending solvency rules. However, this can be sequenced, time is on the side of those who are about to develop the most sophisticated pension savings and products regimes in Europe (most of the rest of Continental Europe is likely to learn how to catch up the hard way), and countries such as the Netherlands or Denmark may be important allies in this.

Longevity bonds would also be useful for insurers to hedge risks when providing deferred annuities. It has been promoted for a time but the number and volume of issues is still not significant, and the government has not issued such bonds yet. For several reasons described in the literature[5], it would make sense for the Treasury to start issuing such longevity bonds.

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

Members should be informed about the risks of simple drawdowns and offered easy and cheap default solutions for longevity insurance.

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?

Investing through retirement seems to be a potentially adequate tool mostly for the better-off, better educated, more risk tolerant clients. However, even they would need some reliable, safe income source, so annuitisation at a certain age for at least a certain volume should be a part of the answer also for this group. For the rest of the customers, the risks attached to investing through retirement (such as harmful volatility within a relatively short remaining saving period, risk of losing capital in the initial years) may easily outweigh the benefits.

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

As detailed above, my default strategy would focus on annuities and not drawdowns. Annuitisation from the age of 75, with an emphasis on real annuities, a phased-in and deferred approach, with some money-back guarantees and/or joint-life features would be the core of my default option. Drawdown would be possible before that age but should not be *the* solution. I would leave only minimal market risk for investments in the drawdown period,

[5] See for instance: Blake, David, Tom Boardman and Andrew Cairns: *Sharing Longevity Risk: Why Governments Should Issue Longevity Bonds*, Pension Institute discussion paper PI-1002, February 2013

would not use investment-linked approaches with significant equity proportions, and would focus on real value protection. This reflects cost considerations as well.

As also discussed previously, the more flexibility is left for members as compared to such a strongly recommended default path, the more difficult it will be for NEST to optimise savings even in the accumulation phase, and also the more likely it will be that customers make unfounded decisions.

As for governance, the issue of NEST becoming a central annuity provider should be thoroughly considered. Given its expertise, scale, and the comfort for clients, this could well fit the overall purpose of providing adequate pension products at a good value for money. Alternatively, a strategic partnership with one, or more, reliable external provider(s) could be developed, where NEST's scale would achieve low cost and good value services from the partner(s) to NEST's customers. Judging the benefits and possible disadvatages of these two options requires more thinking.

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

It seems that there is only one type of risk which traditional best practice pure DC schemes and annuity products could not properly manage: having to retire „at the wrong time". All the rest may be handled by quality portfolio strategies including the life-cycle approach, by linking the accumulation and the payout phase, by purchasing the proper life annuities to manage longevity risk, and by having scale and transparency to achieve cheap service.

The fundamental question is whether members would save more (meaning that fewer of them opt out and contribution rates are higher and more continuous) if a narrower but more secure range of possible future pensions is guaranteed, no matter when the member would retire. Whether higher contributions would be induced if members knew that any 40-45 year accumulation period would provide pensions in a pre-defined range (at least X% but not more than Y% replacement rate).

If the answer is positive, then such a tool may be useful for the public good. However, even in this case, the design of the option must be thoroughly analysed. An internal return smoothing mechanism has the advantage of not requiring external parties with added costs, but may turn out to be opaque, and can not rely on external capital (if even the combination of the investment strategy and the smoothing mechanism does not provide the minimum promised replacement in extreme periods, noone can be called upon). Modifying the investment strategy itself to make it more cautious (and to provide a narrower range of outputs) potentially runs a huge opportunity cost as compared to optimal strategies. Finally, purchasing an insurance from an external party may be too costly (or perhaps even impossible).

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

See above.