OpenRetirementClub response to the NEST Consultation on "The Future of Retirement"

OpenRetirementClub is a division of Owen Pensions Limited providing pension information and guidance to its members.

Summary

1. **The OpenRetirementClub commends NEST and its trustees for striving for better outcomes for its members;**

2. **We believe the new pensions regime is radically different from before and therefore requires new thinking. In particular, NEST members are making tax efficient retirement savings that they can draw on to supplement other forms of income from age 55; this is unlike the previous requirement to convert savings into prescribed forms of pension income;**

3. **We believe NEST trustees should develop a new default for members through and post-retirement. To require members to transfer to another provider in order to access the freedoms now allowed would be wrong;**

4. **We believe the new default should provide both income payments and the necessary liquidity for payment of lump sum requests from age 55;**

5. **There should be the option to turn income payments off until required; there is no need for the payment of income to be linked to the State Pension age although we believe many members will remain opted in after they start to receive their State Pension.**

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?*

Evidence suggests a significant change in retirement patterns in the coming decades. The previous cliff-edge retirement supported by final salary pensions and the State Pension from age 65 is being replaced by a more phased approach. And in the workplace, jobs-for-life are being replaced by job changes through life and the growth of self-employment and part-time work in later life.

We believe the next cohort aged 55 and 75 will be the new "middle age". They will lead healthier more economically active lives. Financially, they will rely on more diverse sources of income than traditional "pensions". These sources of income might generically be called "retirement income".

As they move through a phased retirement, changing jobs even after age 55, paying off mortgages later in life, picking up the State Pension later - they will need their NEST retirement savings to supplement other income and to provide flexibility in meeting unexpected/unplanned expenditure.

During this period, employers will want their DC scheme to provide clear incentives for employees to save as much as possible and to communicate retirement income benefits clearly. Employers will increasing need to manage a workforce that includes more older workers who may be hesitant about withdrawing from the workplace and remain uncertain about their financial future. A modern, high quality DC scheme will give confidence to employees and will help employers make the most of those employees who are performing well while managing out those who are not.

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

Many more people will experience a career change at age 55. This date becomes more important for pension plan design. People may start to access their pension pot from 55 to supplement income as they wind down careers by working part time, self-employed or even moving overseas.

DC design should also take into account the increased attractiveness of pension saving that will encourage more middle-age self-employed and owners of SMEs to save between 55 and 75.

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?

It looks like NEST retirees will continue to have spending characteristics in age 55 to 75 similar to their younger years. They may need to work full time or part time while drawing income and lump sums from their NEST pension pot periodically.

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

DC schemes will need to be designed to cater for the new flexibility allowed in drawing from the scheme. For many more members, this will start from age 55 and continue periodically until annuity purchase or the pot runs out. Key is therefore cash access, liquidity management and allowing members the maximum flexibility that the new rules have given them.

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 unlikely that the new cohort of NEST retirees will become better at financial planning for retirement. And in any case, most people do not act rationally in financial planning or in investments. Without the necessary financial experience, most NEST retirees will continue to rely on experts delivering good "default" solutions. Through inertia, most members will not "opt-out" of the default.

As a trusted "expert" we believe the NEST Trustees should offer a "retirement income" default solution for members.

Other than this, members are likely to seek flexible lump sums from the NEST scheme to meet unexpected/unplanned expenditure.

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

The main behavioural risk that NEST Trustees should consider managing is "certainty bias".

Most members will continue to have little understanding of investing and the relationship between investment risk and reward. Trustees should focus communication on "outcomes" rather than annual investment performance. A member who has no understanding of investing will NOT understand annual investment performance data. It would be better to report whether the member is "on track" to a planned outcome.

In retirement income, most NEST members will benefit from the new State Pension to give certainty of income to meet most basic spending. It is natural for members to have a bias towards complete certainty of income in retirement however we think this is unnecessary. NEST Trustees should consider how to provide an "assurance" of income to members to supplement the State Pension and other income sources without incurring the unnecessary expense of structuring a "guarantee" with a third party.

Giving members limited investment choice will give members perceived control but should be balanced by an attractive default solution that most will adopt through inertia.

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

We believe an additional trustee objective might be "to encourage maximum saving". There is evidence that the current low contribution rates are seen as "sufficient" by members as they have been set by "experts".

We believe the 8 objectives set out in the consultation need to be re-weighted as follows:

Conversion risk: less important if the trustees provide income as part of the new default;

Inflation and Growth: these risks are generally over-stated for NEST retirees for whom the State Pension will provide inflation protection for basic spending needs;

Longevity: this risk is best met by the insurance industry or government;

Flexibility: the MOST important objective in the new regime;

Investment risk: the use of a good default mitigates this;

Market timing risk: managing cash and cash equivalents for income drawdown and lump sum requests becomes much more important in the new regime;

Clarity: as before

Cost: as before, but people will value certainty and pay for "golden years" insurance.

The most important objective should be providing for flexibility and liquidity in the default investment strategy.

We believe the trustees should design the default to provide both income payments and the necessary liquidity for payment of lump sum requests from age 55. There should be the option for members to turn income payments off until required.

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?

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We believe the key ingredients to re-engaging NEST members in “retirement planning” are

1. **Early communication. This should be no later than age 55.**

2. **As NEST trustees already know, it is vital to use the right words to communicate. We believe the old words of “pensions” and “annuities” should be replaced. Our suggestion is always to refer to “retirement income” in DC schemes and for annuities to be re-branded as “golden years” insurance. You can only engage people if you use words that are relevant to them.**

3. **People prefer “face-to-face” guidance. Recent research by the Chartered Insurance Institute has shown this.**

The methods of the OpenRetirementClub are an example of the above. The OpenRetirementClub provides guidance on an ongoing basis at a cost of just £150 per annum. Its subscribers benefit from the ability to attend quarterly Members’ Forums and other events at which they can revisit their financial plans while also updating information and knowledge that is relevant to their changing circumstances. We encourage married and civil partners to engage in the guidance process together.

We believe “engaging” and taking “personal responsibility” for financial planning are two sides of the same coin. They require an unspoken acceptance

by the individual of a lifestyle choice that they can and are willing to make decisions based on knowledge and understanding.

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

a) Most NEST members would adopt a quality modern default during the consumption phase with "assured" income from trusted experts. A good default is the best way to mitigate the risk of poor decisions as people get older.

b) The Government might also consider more Pensioner Bonds. For example bonds for 75+ and for 80+ and including much longer maturities that can be passed on free of IHT.

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

We believe NEST trustees should develop a new default for members through and post-retirement. To require members to transfer to another provider in order to access the freedoms now allowed would be wrong.

Defaults are perceived to be a recommendation conceived by experts. They are an essential part of DC design in the run up to retirement and, in the new regime, they are equally important from age 55 and through retirement.

The new NEST default through retirement should offer some measure of "assured income" plus it should provide flexibility around taking lump sums.

Both in the run up and through retirement, trustees should frame the solution around "tax efficient retirement savings" and flexibility in drawing from the retirement savings pot and NOT focus on traditional pensions and conversion risks.

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?

No. There is a risk of being challenged if defaults are differentiated based on assumptions about median member characteristics.

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?

NO. The notion of a "target retirement age" has little sense in the new regime. NEST members are likely to continue working while "phasing" into retirement.

The new default should pay a level of "assured" income from age 55 while giving members the option of setting the level of income to "zero" until required. NEST should consider the feasibility of income payments escalating each year starting from a low base.

We believe most NEST members would value income paid in this way. It would be an attractive feature that could deter the drawing of larger lump sums. We believe only a few members would "opt-out" of income payments after they had reached their State Pension age.

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?

In our opinion, annuities should play a part in retirement planning by providing longevity insurance against the risk of living longer than was expected.

Insurance policy annuities should no longer be viewed simply as a default "retirement income" product.

We suggest rebranding annuities as "Golden Years" insurance.

We consider an "assurance" of income to be better value than "guaranteed" income for people in their middle years of 55 to 75. Beyond age 75, annuities will play a valuable role in "longevity insurance" based on the same principles as now of "mortality cross subsidy".

We are concerned by the way insurance companies are moving to "individual underwriting" as this undermines the principle of risk sharing normally associated with insurance.

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

NO. As stated above, we believe annuities should be an insurance product for later life (age 75 plus) rather than a "retirement income" product for age 55 to 75.

NEST Trustees should consider offering "pension income" that is assured but not guaranteed. This can be supported either by investment strategy that has the generation of an "assured" income as a main objective or by backing the "pension income" with bulk annuity purchase by the trustees but which remains invisible to the members.

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

Yes, deferred annuities or "Golden Years" insurance should be part of the tool kit. It is a concern that insurance companies believe these are too expensive to deliver in the UK when they are available in other major markets like the United

States. Perhaps, investment banks might structure longevity swaps for trustees like NEST in same way as they have been doing in the DB market?

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

The Government could expand on Pensioner Bonds with issues for age 75+ and 80+. Longer maturities might also be considered. Bonds should be passed on after death without incurring Inheritance Tax.

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?

Emphatically, YES.

1. **Risk can be managed in intelligent defaults using Liability-Driven Investment (LDI) techniques.**

2. **Cost - these can be constrained by using pooled LDI funds. Although costs may still be higher than the current default, we believe these still compare favorably to the unknown cost of annuities.**

3. **We believe "income drawdown" delivered by NEST will not require expensive advice or engagement.**

4. **Capped drawdown still remains a sensible and attractive alternative to annuities for DC members.**

18. 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.

The OpenRetirementClub believes the United Technologies Companies - Lifetime Income Strategy is a good example for the NEST Trustees to follow but that it should not be necessary to outsource the generation of a minimum income by bulk annuity purchase.

The OpenRetirementClub would urge the Trustees to consider using Liability-Driven Investment techniques. Part of the default investment portfolio should be used to purchase Gilts to be held to maturity in order to provide the necessary cash flow to provide assurance of income. The remainder of the portfolio should be invested in a very diversified portfolio of highly liquid investments.

This approach might be termed "Drawdown Driven Investment"

Return target - 4% or 5% constrained primarily by timing of liquidity needs

High cash or cash equivalent to prevent selling into falling markets

Base retirement income provided by NEST.

NEST to encourage the insurance industry to provide "golden years" insurance from age 75 via the wholesaling of advanced life deferred annuities.

NEST and others can fill the income gap between age 55 and 75 with the promise of "assured" income without the costs associated with annuities or other "guaranteed" sources of income.

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?

No comment

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

No comment