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The future of retirement

Guiding principles for the design of retirement pathways for the automatically enrolled generation

Introduction

This document sets out some of the high level themes emerging from responses to *The future of retirement: A consultation on NEST's approach in a new regulatory landscape.*

The freedom and choice in pensions reforms announced in the 2014 Budget mean many savers in defined contribution schemes will have more ways of accessing their pension savings.

These new freedoms offer the opportunity for providers and pension schemes to develop new and innovative approaches that better reflect how savers experience work and retirement in the 21st century.

While many may use the new freedoms to access more of their pots as cash, evidence presented in our consultation and supported by many of the respondents is that for most, contributing to a pension is about generating an income. This is income required to replace wages as individuals move from full-time work to working part-time, or being fully in retirement.

As the NAPF said in its consultation response, 'Taken together, the findings of NAPF research and other pieces of analysis suggest that many pension savers will continue to see their pensions as a means to retire and a means of generating an income in retirement.'

We have also seen little evidence to suggest people who have spent years saving are likely to tend towards spending their pots quickly when they come to access their savings. Indeed, the challenge may be more about making sure individuals don't underspend and leave themselves less comfortable in retirement than they need be.

NEST will be publishing a detailed consultation response document later this year. This will set out the NEST Trustee view on how we plan to develop an approach in four areas:

- the likely pathways and products NEST members will need and expect in the future when they come to access their savings
- how we should further evolve our approach to investing in the years up to retirement to smooth the transition from building up savings to accessing them
- the ways in which we communicate to members about their retirement options to help them achieve good retirement outcomes
- how we can provide employers and their advisers with a clear vision of NEST's role in helping workers make the most of their workplace savings.

However before we dive into the details of what good looks like for NEST members in the longer term, we feel it is important to share where there is clearly emerging consensus.

There are a number of product design and development themes where there appears to be broad agreement on how the needs of the new mass market of defined contribution savers might be met.

There are three themes where agreement is near universal from respondents. We believe these will become central tenets of product development for large groups of savers in the future:

- the need for some form of default retirement income solutions for large groups of savers
- the need for flexibility in the design of approaches
- the need to manage the risks of people exhausting their savings because they lived longer than they expected.

We received a broad spectrum of responses from asset managers, insurance companies, consumer groups, trade bodies, think tanks, advisers and consultants, as well as overseas pension schemes.

We would like to thank respondents for their contributions which we have found to be insightful, thought-provoking and represent a collective wisdom that encourages confidence that savers will be well-served in the future.

As well as drawing on evidence gathered through consultation responses, in this document we also draw on the latest primary research published since the launch of the consultation.

We see NEST's consultation process as part of a general movement where industry and consumer groups are approaching the challenges and opportunities presented by the reforms in a collaborative and thoughtful way.

How this document is structured

Part one outlines respondents' views on the main factors shaping how savers' needs and preferences can be met within the new regulatory regime.

Part two sets out a broad consensus on the design principles for any default pathways savers might be able to use to access their savings.

What we mean by 'DC-dependent savers'

Defined contribution (DC) pensions are currently not the primary source of income for most people in retirement.

In 20 years, with the rapid decline of defined benefit (DB) pensions, DC will be a much more significant component of savers' income in retirement. This means what this group decides to do when they come to take their money out of a scheme will have a much greater effect on their retirement wealth and wellbeing than is the case now.

Though pension membership before auto enrolment was falling, with only 36 per cent of people over 16 years of age contributing to a pension, past pension membership among older age groups was high. In 2010 to 2011, 83 per cent of men and 61 per cent of women aged 52 and over had at some point saved into a private pension.

Pension membership has been in decline from the 1970s and in rapid decline during the 2000s. This coincided with the closure of almost all private sector DB schemes to new members, and the closure of many schemes to existing members continuing to build up their pots through these schemes.

The decline in occupational provision is being reversed by auto enrolment. DC pension participation is set to increase significantly and is likely to be the primary type of occupational pension available for the private sector. By 2018 between 12 and 13.5 million people could be saving in private sector DC workplace pension schemes.

Alongside this shift in occupational provision will be the difference in what younger savers are building up via the State Pension. The new State Pension will be the primary or sole state provision for many of these savers in the future.

As ABI director of long term savings, Yvonne Braun, said in launching the recent *Retirement 2050*[1] think piece, 'We want to start a debate about how we move beyond today's baby boomers challenge and start meeting the longer-term needs of Generations Y and Z who simply will not have the assets of their parents, and will need different solutions to their retirement challenges.'

There will be a spectrum of DC-dependency across cohorts:

- people retiring in the next few years are likely to have other sources of retirement income
- people retiring in the medium term will be highly reliant, but may not have built up very large pots
- savers in the longer term are likely to be totally reliant on DC savings, but will have built up larger pots.

[1] Association of British Insurers Retirement 2050 think piece, 2015

A note on defaults in decumulation

Default decumulation is arguably an oxymoron, as in most cases savers will have to make an active decision to access their savings. At the very least, the member will also have to provide details of the bank account into which their money will be paid.

However, in the same way that defaults in the accumulation phase support members unable or unwilling to make decisions about how their money is invested, there could be a similar need when it comes to accessing their pot.

This approach is taken in a number of Australian superannuation funds. Members make an active decision to move from accumulation to decumulation, but they don't have to make a decision about which option they should take. In the absence of an active choice, individuals are provided with a default decumulation strategy.

Part one – the needs of auto enrolment savers

We are seeing a broad consensus emerge on the implications of understanding the characteristics, preferences and needs of the DC-dependent generation.

The areas of broad agreement include:

- Members are diverse in terms of their willingness to engage with their savings and their abilities to navigate the different options available to them.
- Individuals value choice, but many don't want to have to make decisions about how they access their savings.
- A more dynamic work/retirement scenario in which work and pensions operate hand in hand is increasingly replacing the traditional retirement model.

Most respondents to the consultation believe there will be the need for some form of default provision for turning savings into retirement income.

There is broad agreement on some of the key features of such defaults:

- **Simplicity** - defaults should aim to broadly meet a range of needs for most of the people most of the time.
- **Value** - defaults need to provide good quality and value for money. Value for money is a likely consequence of solutions being designed to deliver good outcomes for the majority, as opposed to being highly bespoke and more expensive to deliver. Solutions that work for the majority will also benefit from economies of scale.
- **Freedom to opt out** - default arrangements should not lock individuals in, but flexibility may be more of a priority in the earlier years of retirement than it is in the later years.
- **Clear choice architecture** – the default is one option located within a set of straightforward alternatives that won't overwhelm savers.

Diverse members

There was broad agreement with the market segmentation analysis we presented in the consultation document in terms of willingness and ability to engage with often challenging decisions about retirement choices.

The segments are:

- **Segment one** – high financial capability and experience. These individuals are likely to be engaged with their pension saving and have a clear plan for their retirement. They're likely to seek professional financial advice and be prepared to pay for it, providing their pot size warrants it.
- **Segment two** – less financial experience and less likely to want to pay for professional financial advice. These members may well want to engage but they're likely to find financial decision making daunting and worry about making the wrong decisions. Providers will need to give these members straightforward options and decision making tools to guide them to suitable choices.
- **Segment three** –very little financial experience and low levels of engagement. These members will need a lot of support from providers, probably in the form of default strategies.

The objectives and risks savers face as they approach retirement may well be similar for all three groups. There was broad agreement from responses however that the second two groups may require a more interventionist approach from providers.

This may mean that the choices presented to them are more manageable than those aimed at segment one. It could also mean making decisions on behalf of those who don't engage.

It is for segments two and three that there is broad consensus of defaults being an important part of future retirement solutions.

'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 into the future.'

Pensions Management Institute

'The questions received on TPAS's helpline provide an indication of likely behaviour. Common themes include: members wishing to take their pension as cash; concerns about paying for advice; lack of knowledge of pension issues; being overwhelmed by complex documents from schemes/providers; dealing with small pots; leaving decisions too late; uncertainties of tax liabilities.'

TPAS

'A default strategy will, by necessity, be a fairly blunt instrument but it needs to reflect an approach which is reasonable for the broad sweep of members until such time that individual decisions are made. In the absence of an initiative which will deliver a sea change in member engagement well in advance of retirement the preferences of many members with regard to how they will access their retirement funds seems unlikely to be known with any degree of confidence.'

Milliman

Individuals value choice, but many don't want to have to make specific decisions about how they access their savings

In the consultation, we included evidence around individuals valuing choice, even if they don't use it.

Consumer reactions to the Budget changes that give greater freedom and control have been positive. At the same time evidence suggests that on the one hand most consumers say they are 'comfortable' with retirement planning, but many also say they are not confident about their ability to make choices.

Our analysis suggests that in the new regime, good outcomes should not be dependent on all savers having to make optimal decisions for themselves. Research has shown that even the most financially capable individuals can make irrational and, in hindsight, sub-optimal choices when it comes to financial matters.

The PPI's second Transitions[2] report also showed there was consensus that different circumstances and lifestyles in retirement might mean that there would be a need for some choice outside of a default option. The suggestion is that between three and six choices in total feels about appropriate. This reflects how individuals recognise their difficulties in coping with too many retirement choices.

[2] Transitions to Retirement - 'Supporting DC members with defaults and choices up to, into, and through retirement' PPI, 2015

Our analysis would suggest that providing choice should be an important feature of retirement arrangements for the automatically enrolled.

Where savers exercise choice, the balance of opinion supports the idea that they will want their options filtered down to a manageable set of meaningful choices.

'There is a risk of overwhelming individuals if they are required to collate significant amounts of information and then use this information to make complex decisions involving unfamiliar concepts. If individuals are overwhelmed in this way, there is a risk that their engagement in decision making will reduce.'

Institute and Faculty of Actuaries

'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.'

OpenRetirementClub

'Members value choice but many are not in a position, either due to lack of knowledge or pot size, to be able to take advantage of it. By catering for and indeed promoting choice many schemes may be in reality increasing the potential for poor member outcomes.'

Schroders

'We know from our own lives that we don't always make decisions that are in our own long-term best interests, and there's no reason to believe that DC pension holders will be any different. In fact, given the vast array of psychological, cognitive and emotional barriers inherent in making decisions about retirement, it is highly likely that many of them will make choices they will later come to regret.'

ideas42, in reference to ABI-commissioned report Freedom and Choice in pensions: a behavioural perspective

'Our experience shows us that it is important to provide a balanced range of options during accumulation and decumulation, to give members a fair choice. However, too many options or too complex options can easily overwhelm members, resulting in them not making a decision at all out of fear of making the wrong one.'

Allianz Global Investors

'The NAPF believes that Freedom and Choice would work much more efficiently, enable better choices and deliver a greater sense of freedom if savers were presented with a default option (or maybe a very small number of alternative options) when they turn to their pension scheme and say 'I want my money'. The simple insertion of a default option, selected by trustees and, possibly, Independent Governance Committees acting in the interests of the saver, would greatly improve the journey through Freedom and Choice and reduce the potential for decision paralysis and detrimental choices.'

NAPF

More dynamic work/retirement patterns

Retirement is no longer a one-off event. The challenge to providers and trustees is how can they meet the seemingly unpredictable needs that arise when people move from work to retirement in different stages and in different ways.

'The trend to later retirement is likely to continue and to accelerate. The trend to retirement becoming a period of part-time work, before fully stopping is also likely to spread. This means some people will use their pension fund to top up lower earnings...others will not need their pension fund until much later in life than would be traditionally assumed. The normal assumption of pensions starting to be drawn down at pension age may not hold.'

Dr Ros Altmann

'The figures in the consultation paper seem to confirm anecdotal evidence of a growing trend towards reduced working hours as employees enter the window when retirement becomes possible, with in many cases the resulting reduction in earned income being made up from accrued pension assets.'

Buck Consultants

'We believe DC members will increasingly 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 the state pension. They may also want lump sums to consolidate their financial position, for example to pay off mortgages, ahead of moving to part-time work.'

State Street Global Advisors

'It is not realistic to expect people many years before retirement to accurately predict when they will retire and how they will take their benefits. Much effort from the industry is put into this in creating tools and statements but in reality there are too many unknown factors for people to be able to make a firm plan.'

F&C Investments

Need for robust defaults

In its first Transitions[3] report the PPI concluded decisions about accessing DC pensions are considered one of the most challenging of all financial decisions in people's lives.

The PPI's second Transitions report presented findings from in-depth qualitative research with individuals approaching retirement aged 55 to 70 and for whom DC savings make up the majority of their private pension savings.

The headline finding was that the Budget freedoms are popular with DC savers. However once they begin to understand the full scale of choices and trade-offs involved in deciding how to access their DC pension pots at retirement, they can quickly become daunted.

This suggests that disengagement and inertia amongst some savers in the future will be a risk.

The idea of their pension scheme or existing provider offering a default investment or drawdown option into retirement resonated with DC savers. Some savers involved in the research believed that providers had a 'duty' to offer this.

The role of defaults as an essential feature of the offer to auto enrolment savers at retirement was a common response to NEST's consultation.

'Creating suitable default options is challenging but vital. Defaults are likely to be necessary to cover income withdrawal, as well as investment strategies for both crystallised and uncrystallised funds.'

Age UK

'Default strategies perform the same role in the new world as they did in the old – they are how providers show leadership to those who are unable or unwilling to lead themselves.'

Pension PlayPen

'Based on experience and observation of member behaviour when faced with wide choice we tend to construct strategies on the basis that members will be reasonably rational and conservative. They are also remarkably willing to follow default paths of course but these are constructed to be rational and conservative so in some ways it is not surprising.'

QSuper

'Three quarters of savers and 99.9 per cent of NEST members accept default options in accumulation, suggesting that they want others to make difficult decisions that they fear they may get wrong.'

TUC

3 Transitions to retirement - How complex are the decisions that pension savers need to make at retirement? PPI 2014

Simplicity, value, freedom

While the evidence would suggest a strong consensus around the inclusion of defaults, what is also clear is that 'defaults' mean different things to different parties.

Nevertheless, responses would suggest that they should have three key features. Defaults should feel straightforward to the saver, represent value for money and not lock savers in.

'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.'

OpenRetirementClub

'We would recommend that a simple default strategy, that has the objective of not being too wrong for the vast majority of individuals, is best. Importantly complex, and hence costly, strategies that risk being significantly wrong for sizable groups of individual members, whilst providing minimal additional benefit for the few they are right for, should be avoided.'

AllianceBernstein

'[It will be important for] NEST to be transparent on how money will be invested in the absence of instruction from the investor (i.e. default options). This is particularly important as scalable guidance cannot cover every possible circumstance but will seek to be appropriate for most instances such as the default options.'

BlackRock

'Poorly or unengaged members should not be put into a strategy that is either impractical or costly for the member or the scheme itself to amend. That is members should not be defaulted into anything that they do not have a zero cost option to opt-out of at a later date.'

AllianceBernstein

Part two – the needs of auto enrolment savers

Part one of this paper sets out an emerging consensus for straightforward, value for money and flexible default solutions for many auto enrolment savers.

In this section we set out the themes, both from our research and the evidence presented in the consultation responses, on what design features default arrangements might best include to meet the needs of automatically enrolled DC savers.

We've identified six principles to inform the design of default retirement solutions for DC-dependent savers.

These principles may be in tension with each other in different ways and at different times as people get older and their needs change. Providers will need to prioritise and understand the trade-offs between different principles, such as the choices between levels of security and flexibility.

The six principles are:

1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions
2. Savers should expect to spend most or all of their pension pots during their retirement
3. Income should be stable and sustainable
4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements
5. Providers should look to offer flexibility and portability wherever possible
6. Inflation risk should be managed but not necessarily hedged

1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions

Many people underestimate how long they will live and therefore what they are likely to need to secure an appropriate income in retirement.

The latest projections for the UK suggest males born in 2014 could expect to live 90.9 years on average and females 94.2 years.

Under the previous pensions framework, annuities met savers' need to manage long-life risk. However the new freedoms mean schemes may have a part to play in helping to manage this type of risk.

In comparison with buying an annuity, many question how appropriate attempting to manage longevity risk by primarily investing in growth-seeking assets is.

Buying an annuity at a later age can allow individuals to draw a higher income than would be considered sustainable if they were trying to achieve this through a drawdown portfolio.

So, as people in retirement get older, entering a mortality pool by some means looks appropriate.

'The guaranteed income for life that an annuity provides, would be among the certainties favoured by many within NEST's member profile and we believe that an annuity would continue to be an appropriate option for many. For example its secure income could sensibly be replicated as a default feature of any drawdown option for those reaching age 80.'

Standard Life

'Longevity risk is particularly difficult for an individual to manage.'

TUC

'Advanced life deferred annuities could offer an attractive way of limiting long-term longevity risk. Because mortality rates increase exponentially, only a small proportion of the pot at retirement is needed to provide longevity insurance, with the remainder being available to be drawn down.'

JP Morgan Asset Management

'In our view, 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 issues of cognitive decline suggest that annuitisation should be done on a phased and/or deferred basis rather than the purchase of an immediate annuity at, say, age 80 or 85.'

State Street Global Advisors

2. Savers should expect to spend most or all of their pension pots during their retirement

DC-dependent savers' pots are likely to be their main source of retirement income, alongside the state pension.

Using all or most of savers' pots to produce an income should be the main objective of suitable default solutions.

Other considerations, such as being able to leave money to dependants, should not be a key driver when designing appropriate retirement options for DC-dependent savers retiring in the medium term.

Strategies for managing these savers' money when they retire will be different from traditional drawdown strategies aimed at those with larger pots. These may be managed in ways that allow individuals to both leave what may be left of their savings for others, as well as maintain an income through retirement.

'Most of our current members approaching or in retirement will have insufficient funds to support their desired standard of living through an extended retirement even with top ups from social security. We then are advocating a recognition that they should expect to spend most or all of their financial savings during their retirement.'

Q Super

3. Income should be stable and sustainable

Those who are dependent on their DC pot for retirement income ought to have access to arrangements that protect them from dramatic rises and falls in that income.

Their needs will also be met by strategies designed to mitigate the risk of them running out of money, while still aiming to produce a stable income.

'With a drawdown product that does not provide any guarantee, there is a clear need to address the risk of fund exhaustion. The consumer is highly unlikely to know what level is optimal for balancing their current income needs, and so the fiduciary or product provider is likely to need to provide an advisable rate of drawdown, that is clearly communicated not to be a guaranteed rate.'

Milliman

4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements

For savers who are reliant on income from their DC pots to meet the cost of living, taking advantage of potential investment growth opportunities is appealing. However, minimising the chance of running out of money is likely to be of greater importance for the majority.

Investment risk will need to be managed to reflect this. Investment strategies should also reflect that unlike when savers are building up their pots, where there are losses, there is less time to make up those falls.

Importantly, the impact of falls is exacerbated by the likelihood the individual will be taking money out of their pot. This is particularly an issue when pot sizes are at their largest.

'An effective default strategy is likely to be a mass-market (non-advised) multi-asset fund whose asset allocation actively changes as best thinking, regulation and markets evolve.'

The Investment Association

'We agree that a risk management and asset allocation approach that provides a degree of capital protection is a critical part of being able to support a sustainable drawdown strategy.'

Milliman

'DC members using such a strategy face sequencing risk, where early poor returns can have significant negative consequences for the sustainability of income. Hence, it is very important to manage volatility, for example through active asset allocation or explicit, low cost, volatility controls.'

State Street Global Advisors

5. Schemes should look to offer flexibility and portability wherever possible

Savers value choice and are likely to appreciate the freedom to move between different vehicles at and during retirement. Arrangements for DC savers ought to reflect this.

However, some factors are likely to constrain elements of flexibility and portability. For example, it may be that some savers can access a higher or more stable income if they decide to have a proportion of their pots in illiquid assets or a mortality pool which would not allow them to cash out without it costing some of their pot by moving.

It is these sorts of considerations retirement arrangements will have to assess in designing solutions that meet the expectations of savers while aiming to provide a stable income.

Schemes may also need to reflect that flexibility may be more important during the transitional years from building up your pot to accessing it, than it is in later years.

We suggest there will be many cases where savers will see the best outcomes when they have enough flexibility to respond to changing circumstances. However, they are less likely to get a good outcome if they move too frequently. Moving too frequently means savers' pots will incur transactional costs and lose out on other advantages of staying in the same strategy such as benefitting from mortality cross-subsidies.

'The Investment Association is a long-standing supporter of greater flexibility in the provision of retirement income, allowing pension savers access to the right product at the right time in their lives.'

The Investment Association

'...when flexibility is granted, saving and withdrawal patterns are much more varied and volatile than most typical DC modelling would suggest. Our research, 'Safely crossing the retirement finishing line', highlights that a significant driver of DC success is how the size and timing of cash inflows interact with the size and timing of portfolio returns. This volatility in member-controlled cash flows, particularly in terms of accumulation and withdrawal risks, can amplify the volatility a member experiences.'

JP Morgan Asset Management

6. Inflation risk should be managed but not necessarily hedged

Many savers are likely to be in retirement for decades. Over this time, the cost of living is assumed to rise.

As inflation can have a dramatic impact on income in retirement, this means investment strategies ought to be designed to produce a stable income in real terms.

This will in turn mean balancing the need to keep pace with inflation and provide income without taking undue investment risk.

'We expect asset allocation to shift towards targeting a sustainable income. This would necessarily require a more diversified strategy that can outpace inflation without excessive capital risk, where there is an element of duration management against longevity risk.'

Elston Consulting

'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.'

Partnership

'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.'

Peter Holtzer, international consultant

'More sophisticated default strategies in the US combined target date funds with a series of forward-start annuities to build up a ladder of secure known income streams, whilst keeping capital invested against inflation and longevity risk. This is cheaper than introducing costly guarantees.'

Elston Consulting

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