NATIONAL EMPLOYMENT SAVINGS TRUST

The future of retirement

A retirement income blueprint for NEST's members

Contents

Executive summary

1. Introduction

This is NEST's response to its consultation, **The future of retirement – A consultation on investing for NEST's members in a new regulatory landscape**. It follows the publication earlier this year of interim findings.

The interim document focused on **guiding principles** when designing retirement solutions for members who plan to turn their pension savings into a regular income stream.

This response details the NEST Trustee's blueprint for a core strategy that would best meet the needs of a large proportion of NEST members in light of the Freedom and choice reforms.

2. Guiding principles

NEST's guiding principles for designing retirement pathways for the automatically enrolled generation are of particular importance given research showing that a significant proportion of members may be unwilling or unable to pay for financial advice.

The table at the end of the executive summary highlights the key areas where the blueprint for the core strategy to meet our members' needs adheres to the guiding principles.

3. What members want from their retirement incomes

Evidence strongly suggests that a substantial proportion of people want to use their pension pots to generate an income in retirement.

It also suggests that there is significant demand for using retirement arrangements to provide an inflation-protected income. This would be without significant market risk and guaranteed to last for life.

However, people are not only interested in a stable income for life. They also express strong preferences for having access to lump sums and the ability to pass on their savings, particularly in the event of early death.

4. The three phases of retirement

Evidence suggests that for many retirement can be thought of as an experience that goes through three phases:

- Phase one, typically mid-to-late 60s to mid 70s
- Phase two, mid 70s to mid 80s
- Phase three, mid 80s onwards.

In these phases the retiree is likely to accept differing proportions of flexibility, inflation protection and longevity protection.

5. Blueprint for a core retirement income strategy

Any arrangement for NEST members should aim to provide a regular sustainable income for retirement. In addition, it should aim to provide members with the ability to access lump sums without disturbing their regular income stream. It should also be low cost and feel straightforward for the member.

A retirement income blueprint for NEST's members sets out three building blocks to cover three phases of later life, from mid 60s to mid 70s, mid 70s to mid 80s and mid 80s and beyond.

1. **An income drawdown fund**
   To provide a steady income that aims to protect members against inflation, as well as give them full flexibility to change their mind and withdraw some or all of their money.

2. **A cash lump sum fund**
   To be highly liquid so it can be used by members for unexpected events without impacting their core income stream. If market conditions are good then this pot can be topped up with additional lump sums. This would be a fund from which members could move money in ad hoc lump sums into their bank account to use as they like.

3. **Later life protected income**
   To be 'bought' gradually over time through small payments from the drawdown fund. This would remain refundable up to a certain age, at which point that money is locked in to ensure a secure income is available for the remainder of a member's life to protect against the risk of running out of money before they die.

6. Techniques to deliver the blueprint for a core retirement income strategy

NEST will be working with the investment and insurance industries to determine how best a core strategy for members can be delivered. NEST recognises there are challenges and opportunities at play.

The two key risks that will need to be managed in phases one and two are sequencing of returns risk and inflation risk.

Later-life protected income may be provided by means of advanced life deferred annuities or elements of risk sharing. NEST is aware of the current practical challenges. Any technique should be assessed not only on risk management, but also on cost.

7. Next steps

NEST seeks an in-depth conversation with our peers, partners and would-be partners. We want to help stimulate innovation and product development to help our members get access to the arrangements they need for better incomes in retirement.

Meeting the guiding principles

Guiding principle	How our blueprint for the core retirement income strategy meets the principle
1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions.	This blueprint aims to manage longevity risk through the later-life protected income fund.
2. Savers should expect to spend most or all of their pension pots during their retirement.	Phases 1 and 2 of the blueprint would aim to pay out sustainable income. Any excess returns should be paid into the cash lump sum fund. Later-life protected income provides security in phase 3 so no money needs to be 'left on the table'.
3. Income should be stable and sustainable.	By having a clear investment horizon (the end of phase 2) the drawdown investment strategy can be managed with clear objectives. The investment strategy should be balanced and diversified.
4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements.	There should be a clear requirement in the income drawdown fund to manage for volatility and sequencing risk.
5. Providers should look to offer flexibility and portability wherever possible.	A core design principle for this blueprint is that it doesn't lock members in early in their retirement and gives them flexibility with their money when it's most needed. Full flexibility is a key feature of phase 1. This is the most important time for flexibility as work and retirement patterns change and income requirements are uncertain. By phase 3 there will generally be less need for this level of flexibility. It becomes more important to provide reassurance that the money will last as long as it needs to.
6. Inflation risk should be managed but not necessarily hedged.	Inflation hedging is expensive but a well-managed drawdown fund could provide reasonable inflation protection in phases 1 and 2. Inflation protection is arguably less important in phase 3.

1. Introduction

This document is NEST's response to its consultation, ***The future of retirement: a consultation on investing for NEST's members in a new regulatory landscape***. We published our initial consultation paper in November 2014 and an interim response[1] in March 2015.

This consultation response focuses specifically on the design principles for members who plan to turn their savings into a regular income stream. In this document we set out the essential design features of a blueprint for a core retirement income strategy that meets our guiding principles.

The Freedom and choice in pensions reforms announced in the 2014 Budget mean savers in defined contribution schemes have more choice and flexibility in how they access their pension savings.

Box 1.1

About NEST

NEST is a trust based defined contribution (DC) pension scheme that UK employers can use to meet the new workplace pension duties set out in the Pensions Act 2008. NEST is designed to be an easy-to-use, low-charge scheme. It was set-up by government and has to accept all employers of any size that want to use it to comply with their duties.

At the time of publication NEST is working with over 20,000 employers and has around 2.2 million members. A key aim of the scheme is to provide members the benefits of a good value, quality occupational pension scheme, whoever their employer and however much they save.

Throughout this consultation process we have been particularly interested in comment and evidence that recognises the importance of keeping charges low for our members.

[1] The future of retirement: Guiding principles for the design of retirement pathways for the automatically enrolled generation, NEST 2015

The 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.

Many savers may use the new freedoms to access some or all of their pots as cash lump sums. However, evidence presented in our consultation and supported by many of the respondents shows that for most, contributing to a pension is ultimately about generating an income. This will be particularly true in the future, when defined contribution (DC) rather than defined benefit (DB) schemes, will be the dominant form of workplace saving.

Income drawn solely from DC savings will increasingly be required to help replace wages as people move from full time work to working part time, or being fully in retirement. As the National Association of Pension Funds (NAPF) said in its response to our consultation: '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.'

Without suitable and straightforward retirement income products that are easily accessible for the new mass market of DC savers, there is a real risk of people exhausting their savings too quickly. There is also a considerable risk that individuals underspend and deny themselves a better retirement because they are worried about their money not lasting into later-life.

There is, of course, no product design that can compensate for under saving in the accumulation phase, nor excessive cash withdrawals in retirement. We must continue to focus on promoting saving and working to build trust in pensions, while being mindful of people's concerns about investment risk and value for money.

We received a broad spectrum of formal and informal responses to our consultation from asset managers, insurance companies, consumer groups, trade bodies, think tanks, advisers and consultants, as well as overseas pension schemes. A list of formal respondents is in Annex C, and their responses can be found on our website **here**.

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

Purpose of this response document

As we set out in our consultation document, NEST members who are approaching retirement in the next few years will not have had the opportunity to build up large pots within the NEST scheme. For many, the best option will be to take these small pots as cash lump sums and we are in the process of further evolving our approach around this to best meet our members' needs. However, how members access small pots is not the subject of this document.

In the coming years increasing numbers of NEST members will have started to accrue larger pots. Many will also have built up savings in other pension vehicles and it may be advantageous to consolidate their NEST pots with other savings.

The Trustee Members of NEST, as fiduciaries, need to understand the opportunities and challenges presented by the new freedoms. This is so they can develop an appropriate response to meet members' needs in four key areas.

1. Develop likely pathways and products that NEST members will need and expect in the future when they come to access their savings.
2. Provide employers and their advisers with a clear vision of NEST's role in helping workers make the most of their workplace savings.
3. Further evolve our approach to investing in the years up to retirement (the Consolidation phase) to smooth the transition from building up savings to accessing them.
4. Develop the ways in which we communicate to members about their retirement options to help them achieve good retirement outcomes.

In this document we are primarily concerned with points one and two above. However we have also evolved our investment approach in the Consolidation phase. This development is outlined in Box 1.2.

This consultation response focuses on a blueprint for a core income strategy to meet the needs of a large proportion of our membership, in particular those unwilling or unable to access regulated financial advice. It details the NEST Trustee's vision of a retirement income strategy in light of the Freedom and choice in pensions reforms.

We are aware we need to provide a clear direction of travel for employers and their advisers on NEST's approach to the new freedoms.

Our intention for setting out this blueprint strategy is to help in our engagement with the pensions and investment industry over developing products that meet our members' particular needs.

Box 1.2

Approach to investing prior to retirement

Since we published the consultation document in November 2014 we have made changes to the Consolidation phase of our investment strategy. This is to reflect our expectation that fewer members will want to buy an annuity immediately at their State Pension age. The revised text within the **Statement of Investment Principles** reads as follows:

The Consolidation phase *prepares a member's assets for retirement and typically begins ten years before their Retirement Date Fund matures. Investments in this phase are progressively switched out of higher risk assets. The primary objective of the consolidation phase for funds maturing after 2020 is to outperform CPI after all charges whilst aiming to progressively dampen volatility as a member's fund approaches maturity. For NEST Retirement Date funds maturing through 2020 the Consolidation phase objective is to manage the risks associated with converting a member's accumulated savings into a cash lump sum.*

As members' pots get larger we will keep this investment objective under review, to ensure that for the majority of NEST members in the NEST default strategy, their money is being invested appropriately. One of the key risks we are looking to manage in the Consolidation phase is conversion risk, to avoid significant shocks or poor value when moving from accumulation to decumulation.

2. Guiding principles

As set out in the consultation document, evidence suggests there will be a part of our membership who'll wish to take detailed and ongoing financial advice as they approach retirement and be willing to pay for it. We also believe many of our members will wish to access the free guidance available from Pension Wise.

However our research in the UK and looking at experience from overseas suggests a large part of our membership will be reluctant or unwilling to pay for financial advice, on a one off basis or more regularly. This understanding was shared by most respondents to the consultation.

For a large portion of our membership, we expect the Pension Wise service will provide valuable context for their decision making. However we also expect many members will remain hesitant and lack confidence in their own ability to navigate a complicated set of choices. For this group we believe it is essential to have a small number of straightforward options to reflect different life circumstances and, in particular, a single core arrangement that meets many of the key needs of a large proportion of our membership population most of the time.

This consultation response focuses on meeting to the needs of this group. Our responsibility to other members will focus on making sure they get access to good quality decision-making tools, good information on existing market products and clear signposting to available guidance and advice.

Our guiding principles document suggested that in the absence of detailed, regular and affordable advice, good solutions should recognise the following features of retirement.

- 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 complex decisions about how they access their savings.
- A more dynamic work/retirement scenario in which work and pensions income operate hand-in-hand is increasingly replacing the traditional retirement model.

Box 2.1

A note on defaults in decumulation

Default decumulation is arguably an oxymoron, savers will have to make an active decision to access their savings. At the very least, the member will 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, it appears likely there will be a similar need when it comes to accessing their pot.

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

While there was a consensus on the need for a default pathway, we also recognise the need to move the language forward. As such we will often refer to the 'core approach' instead of default. This also highlights the need and opportunity for options in addition to the core approach.

Most respondents to our consultation believe there will be the need for some form of default provision for turning savings into retirement income. There was 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 in the later years.
- **Clear choice architecture**
  The default is one option located within a set of straightforward alternatives that won't overwhelm savers.

As the need for defaults was such a strong conclusion from the consultation, we distilled these into six guiding principles that should steer the design of such default pathways.

The guiding principles

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.

We have tested these principles in the UK and also with designers of pension solutions overseas. It appears that despite different systems and different savings cultures, whether in the US and Australia (both countries with an advanced and relatively mature DC savings industry) or parts of continental Europe, these principles resonate well.

We are encouraged to see international players developing products and strategies that fit within these principles without relying on regular member engagement and ongoing advice.

Box 2.2

A note on choice

The focus of this document is on good design of default or core products that reduce the complexity of choosing between many different products or approaches. However a proportion of our future membership will want a variety of options. This is likely to include easy access to the open market and straightforward and quick transfers to other arrangements. We fully recognise that a one size fits all approach may result in some people being on paths that are less than perfect.

We know that most individuals value choice. However evidence suggests 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 while on the one hand most consumers say they are 'comfortable' with retirement planning, 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 one off or repeated optimal decisions. Research has shown that even the most financially capable individuals can make irrational and sub-optimal choices when it comes to financial matters, or defer making those choices out of regret aversion.

We believe that giving straightforward access to choice will be an important feature of retirement arrangements for the auto 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.

3. What members want from their retirement incomes

We have examined a lot of evidence over the last 12 months about the key drivers for savers when it comes to accessing their pots. Most of the evidence we have seen to date, both in the UK and elsewhere, supports the survey findings we set out in the consultation document, as set out in Figure 3.1.

A large majority of UK savers appear to want solutions or products that provide a steady and reliable income similar to their experience of working and earning a wage. These findings are also mirrored in surveys from other countries. There appears to be a degree of universality about what most people want from a retirement product.

As shown in Figure 3.1, the three top preferences for retirement products are that they are guaranteed for life, offer inflation-protected incomes and don't carry significant market risk. To a certain extent this is a counterintuitive finding for pension providers as a product fitting this description has been in existence for a long time, in the form of an index linked lifetime annuity.

However, even when annuitisation was compulsory, the popularity of index linked lifetime annuities was limited. Figure 3.2 shows that fewer than 1 in 10 purchasers of annuities bought any kind of escalating annuity.

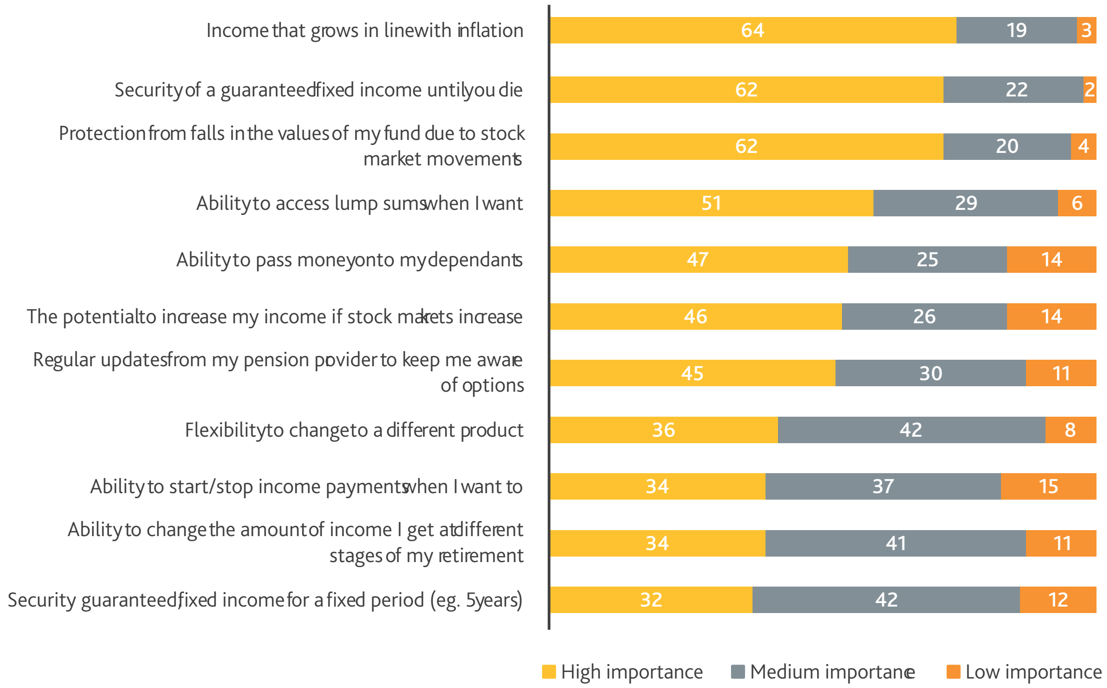
There is a wealth of literature and survey data on why this may be the case. We should also note that it is unlikely that many people who accessed their DC pots in the last 10 years would have been solely reliant on their DC savings in retirement. As we set out in the consultation, and supported by a recent Pensions Policy Institute (PPI) report[2], the current generation of retirees have diverse sources of retirement income. For many, this includes relatively generous defined benefit provision and additional earnings-related State Pensions. On top of this, a large proportion of the current retiree generation own their homes outright and have lower levels of debt than is likely to be the case for future retirees.

For many recent retirees, buying an inflation-protected annuity was simply not necessary, because they were getting steady and inflation-protected incomes from other sources.

The analysis we presented in the consultation, and supported by a majority of respondents, suggests in the coming years this diversity of assets in retirement is likely to reduce. Increasingly, DC savings will be the main or sole source of income on top of the new State Pension.

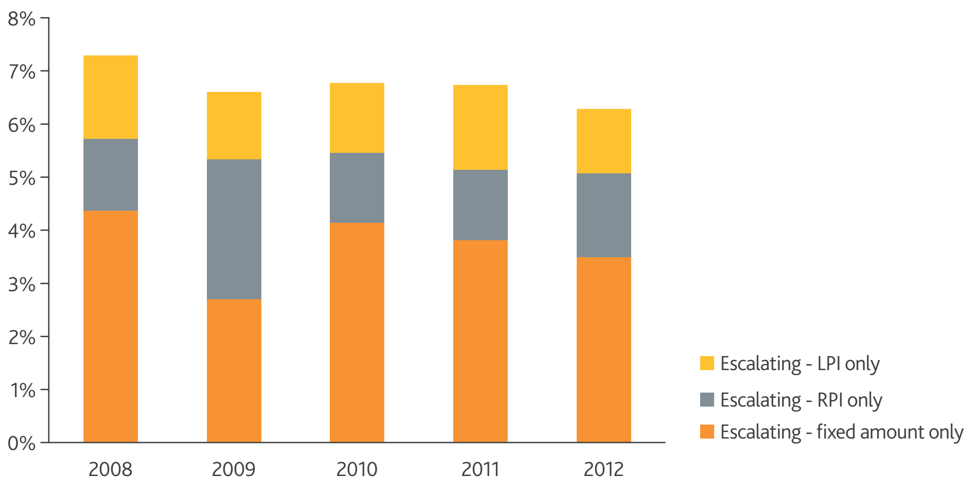
[2] The Pensions Policy Institute (PPI) Transitions to Retirement - 'How complex are the decisions that pension savers need to make at retirement?' November 2014

Figure 3.1 Preferences for retirement products among customers



Source: Ignition House for NEST 2014

Figure 3.2 Proportion of standard annuities with escalating benefits (by number of contracts, excludes enhanced and investment linked annuities)



Source: ABI data cited in Pension annuities: a review of consumer behaviour, Jackie Wells for the FCA, January 2014

There are clearly differences, between non-DC-dependent savers and those retiring in the coming years. Much of the survey data we have collated throughout our consultation process capture the views and preferences of this new DC-dependent generation.

Perhaps surprisingly this new generation of savers has similar reservations to the concept of buying traditional annuity products as their older relatives. This isn't a unique UK experience. Similar challenges have been found in Australia and the US, where consumers say they like many of the features of annuity products yet fail to translate these preferences into a purchase. This phenomenon is frequently referred to as the 'annuity puzzle'. We set out some of the reasons why this puzzle exists in box 3.1.

As the recent survey data set out in figure 3.1 shows, people are not interested only in stable lifelong income. In much of the recent consumer survey work we have seen, the desire to have access to lump sums and to pass on savings to family, particularly in the event of early death, also scored highly.

Features to meet some of these desires have been and are being added to traditional annuity products. However, there is still a general perception that an immediate annuity bought at the start of retirement does not tick enough of consumers' boxes for it to continue to be the main vehicle for delivering retirement income. Savers perceive them as poor value, inflexible and unfair to those who die early.

Box 3.1

Specific barriers to choosing annuities

- Most consumers struggle to assess risk and uncertainty in relation to retirement income.
- There is a perception that annuities are a gamble (that is, taking the risk that you will die early and 'lose' all your money), rather than seeing them as insurance.
- There is a tendency towards placing greater emphasis on the present rather than the future. This tendency results in people over-valuing money today and undervaluing money tomorrow. In the UK it has resulted in choosing non-escalating annuities over inflation-linked annuities, as the former have a higher initial pay out but gradually yield less in real terms. Similarly there has been a preference for single life rather than joint life annuities, and for taking the maximum amount of tax-free cash from pensions.
- A tendency to overestimate low probability events and underestimate high probability events effect attitudes towards personal longevity and leads to people underestimating how long they will live. Many will overstate the probability of dying young (a low probability event) while failing to appreciate that, by definition, 50 per cent of the population will live beyond median life expectancy. This increases the perception that annuities are poor value products and increases the tendency to take as much money upfront as possible.
- People are averse to loss. During the accumulation phase, DC pension customers are focused on their wealth rather than the income it can generate. Annuities can present consumers with the feeling that they are 'losing' their pension pot and in many markets this prevents them buying an annuity.

Source: Jackie Wells for the FCA, January 2014

4. The three phases of retirement

Our analysis of consultation responses, recent consumer research and ongoing dialogue with providers in the UK and overseas points to the importance of recognising retirement not as a one-off static event. Retirement is frequently recognised as an ongoing experience that goes through a number of phases.

The expectations, lifestyles and needs of 65 year olds are on the whole different from those in their 90s. As we set out in our guiding principles document, these different phases need different objectives and contain different risks to be managed.

We have confidence that the over-arching aim of a core or standardised strategy should be to provide a regular income throughout retirement, without requiring regular intervention by the member. To reflect differing needs at different phases of retirement there should also be varying proportions of:

- flexibility
- inflation protection, and
- longevity protection.

Phase 1
Typically mid-to-late 60s to mid 70s

This is when members first start to move out of full-time work and start to need a retirement income. We think the main aim of a retirement income strategy at this stage should be to maximise sustainable income in real terms. However, we don't think this should be at the expense of providing members with access to their savings for ad hoc lump sums.

At any point in this phase the member should be able to change their minds in terms of what retirement product their money is in. Also, if they were to die during this stage their estate, or nominated beneficiaries, should receive all of the remaining pot.

We believe this flexibility is particularly important as the line between full-time work and full-time retirement becomes increasingly blurred. This first phase reflects the reality of the 'newness' of retirement when savers first start to move out of working full time. As they begin to rely on their pension as a main source of income for the first time, we don't think members should have to lock up all their money in one go so early on in their decumulation journey.

During this phase we also think a small amount of the total pot should be gradually set aside in order to secure an income for rest of life. However, we believe these annual allocations towards securing later-life income should remain liquid and accessible in the same way as the rest of the pot, in this phase.

Broadly speaking, we would expect this phase to last around 10 years from mid to late 60s to mid 70s.

Phase 2
Mid 70s to mid 80s

We think the second phase should also focus on providing a steady income that aims to keep pace with inflation.

We think a design principle of flexibility and accessibility will remain important to many members well into their 70s. This means that during this phase the majority of savings should remain liquid. Circumstances can change and the member should have the reassurance that they can pass on their savings in the event of death.

The key difference with this phase is that the money that's been set aside for later-life income would have been locked in and committed to a mortality pool. This provides a greater degree of security and certainty that an income will be paid for the remainder of the individual's life. Also, crucially, the money can then benefit from mortality credits[3] which at this age become significant.

In this phase the strategy should continue to pay a real income from relatively liquid assets with growth potential. We think this phase is likely to last around 10 years running from mid 70s to around 85.[4]

Phase 3
Mid 80s onwards

We expect that the third phase would be focused on protecting the member from all or most investment risk and longevity risk.

The allocations to later-life protected income that were collected in the first phase and locked in in the second phase will have been used to secure an income for the rest of their life. This income would be paid to the individual in phase three.

This phase responds to the evidence that many people have a very strong desire to remove the risk of outliving their savings. At this point in retirement we think trading-off flexibility and access for certainty will be the right balance for the the significant proportion of savers. We also believe, as set out in the guiding principles document that, arguably, inflation protection becomes less important as people move into phase three.

[3] The mortality credit is also known as the mortality yield. With a participating annuity, premiums paid by those who die earlier than expected contribute to gains of the overall pool and provide a higher yield or credit to survivors than could be achieved through individual investments outside of the pool.

[4] It would be appropriate to take stock of individuals' health conditions as they approach the age at which allocations toward their income in later-life are locked in

5. Blueprint for a core retirement income strategy

The core design features that we think will best deliver good outcomes for the three phases of retirement are likely to consist of three distinct building blocks.

The building blocks would be blended together in different ways through the phases of retirement to meet the differing needs and objectives of a lengthy retirement. The member experience of this transition should be seamless. It should provide members with a regular sustainable income for the rest of the individuals life. It should also provide the ability to access a proportion of the total pot as a lump sum or sums without disturbing the regular income stream.

The three building blocks can be described as follows:

- an income drawdown fund
- a cash lump sum fund
- a later-life protected income fund.

Throughout the rest of this document we describe the combination of these building blocks in a single standardised approach as NEST's blueprint for a core retirement income strategy.

Blueprint for a retirement income strategy

At age 65, [5] or when the member needs a retirement income, around 90 per cent of the member's pot would be invested in an income-generating portfolio. This is the 'income drawdown fund' building block.

Each month, income from this fund would be paid into the member's bank account. The intention would be that the investment strategy gives a very high probability of paying a steady income for twenty years, increasing annually to help keep pace with inflation.

The other 10 per cent of the member's final pot would be allocated to a fund invested in cash-like money market instruments. In the first instance it is from this fund that savers would be able to take out lump sums as the need arises. This separate, low risk and liquid fund would be designed to reduce the need to sell assets from the income drawdown fund to provide the member with ongoing access to lump sums.

[5] We believe core retirement solutions need to be workable for a variety of retirement ages from 55 – 75. For descriptive simplicity in this document we have assumed retirement at state pension age.

Keeping this fund separate means any lump sums the member takes, up to around 10 per cent of the initial pot size, will not undermine the sustainability of the income being provided by the other 90 per cent of the final pot. Whilst we would expect reasonable flexibility in accessing this fund, we would expect cash to be transferred to the member's bank account when they need access to it rather than building bank account functionality into the cash lump sum fund building block.

From age 65 to 75, as well as paying out a monthly income, a small allocation would be taken from the pot to go towards securing a later-life protected income. The contribution is set aside and invested with the objective of securing an income later in life. NEST modelling and discussions with industry suggest the level of this contribution should be around 1.5 to 2 per cent of the pot annually.

We believe that describing this as later-life protected income captures the essence of what is intended, managing longevity risk, without using unfamiliar jargon. Crucially, prior to 75, these allocations are still liquid and can be returned to the member's estate or their nominated beneficiary.

The primary goal of the income drawdown fund would be to provide a very high probability of an escalating income up to the age of 85. We are particularly concerned about the impact of poor market performance on the sustainability of this income. This building block would require extensive risk management. In the probable event that this fund outperforms very conservative projections after paying out a steady real income, a prudent level of the surplus would be distributed to the member's cash lump sum fund based on a clear set of governance rules. Members can then decide how to use this money, for example to buy extra income, keep it saved up or spend it straight away.

At age 75, later-life protected income allocations would be locked in. At this point this money would become part of a mortality pool that will pay an income for life at age 85. This mortality pool could be managed in a number of ways, which are set out in more detail in part six.

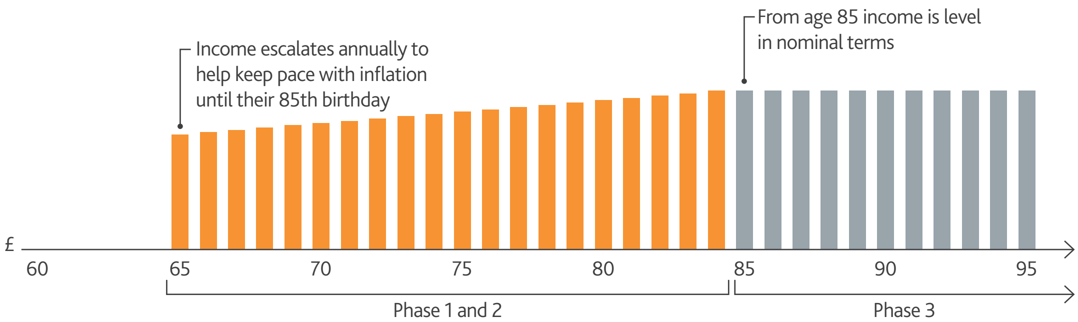
When a member reaches age 85, the income they receive as they move into the third phase of retirement would be broadly the same as in previous phases. The aim would be that the monthly payment one month after their 85th birthday should be the same or similar to the payment on their 85th birthday. In other words, the objective is for members to experience no significant difference to their monthly income as they move from phase two to phase three. However, subsequent payments post age 85 in this blueprint strategy would be the same nominal cash amount each month.[6]

Any money left over that has not been drawn down in phases one and two would be transferred to the cash lump sum fund for members to use as they wish or leave to their estate or nominated beneficiary.

Figure 5.1 Member income profile

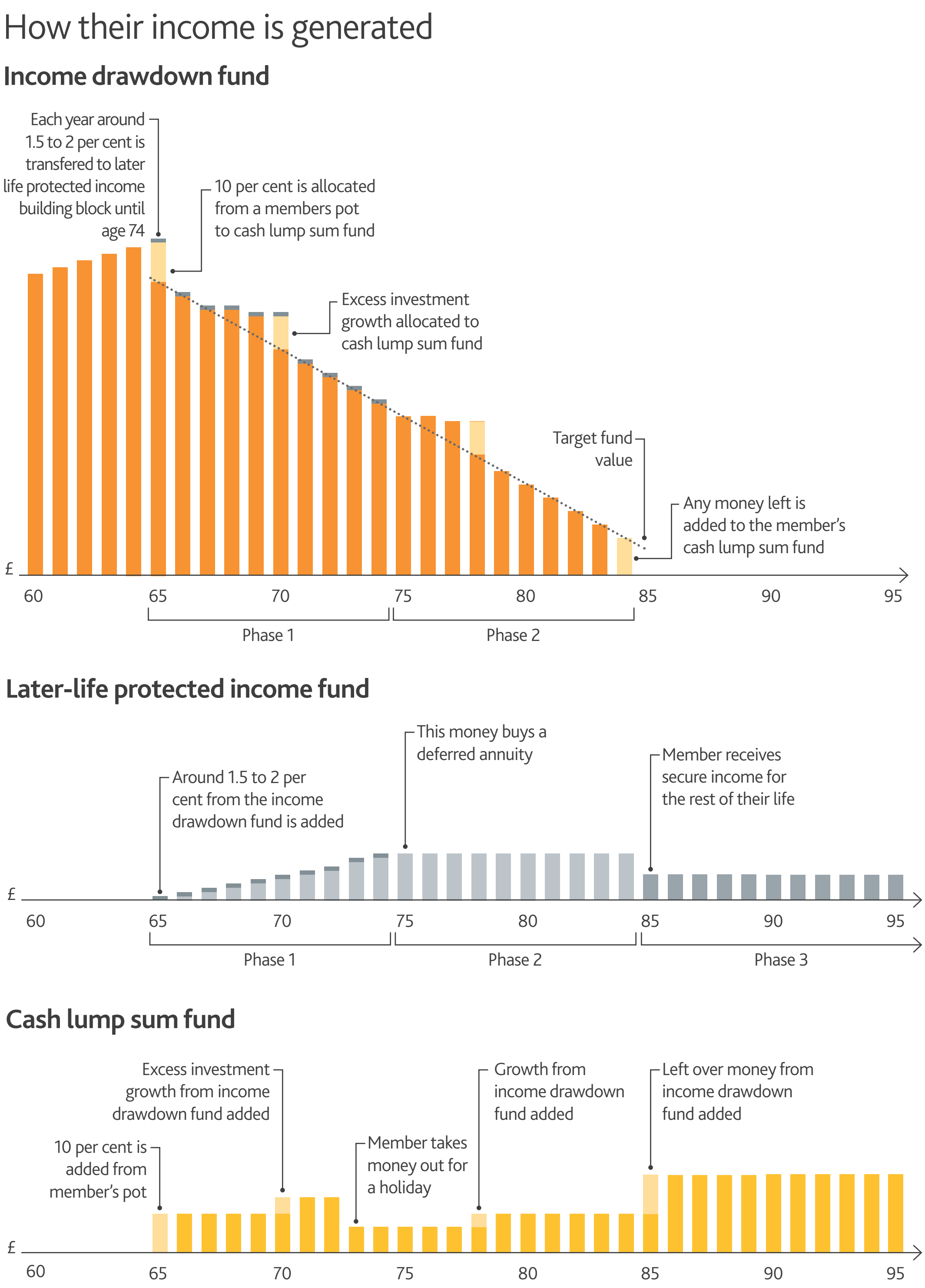
What a member sees

Member's income



[6] See Annex B for the rationale for providing level rather than escalating income from 85

Figure 5.2 NEST's core retirement income strategy building blocks



Box 5.1

Catering for different circumstances

Members' health conditions

In this document we focus primarily on describing the features of a solution for retirees with average life expectancy. We are giving careful thought to what provisions may need to be in place for those in poor health.

Later we discuss medically underwritten advanced life deferred annuities. It should be borne in mind that there may be significant benefits to incorporating specific information on individuals' health at the start of decumulation in order to inform the appropriate level of income. This could mean that someone with a non-critical health condition or a certain lifestyle may eventually secure a deferred annuity at a lower cost than someone in very good health.

For those with more serious health conditions, alternative retirement income solutions such as immediate impaired annuities are likely to be more appropriate than the core strategy outlined in this document. A robust choice architecture at retirement will be as crucial as ever.

How to get appropriate information on retirees' health and reflecting that in their retirement income is something we're continuing to explore. This is clearly not without its challenges, as reflected in the mismatch between potential and actual sales of impaired and enhanced annuities. However we expect this situation to improve as technology improves and consumer awareness increases. These trends may mean that medical questionnaires are able to drive better outcomes for members.

Joint life retirement income

The new freedoms mean retirees should be able to divide their DC pot up in any number of ways to provide for their spouse or leave other bequests when they die.

When investing for a retirement income as opposed to annuitising, the concept of a joint life solution as opposed to a single life one is somewhat different. Income when an individual is alive will help to support both them and their spouse, and remaining assets will pass to their estate when they die.

However later-life protected income may well need to have joint or single life options.

6. Techniques to deliver the blueprint for a core retirement income strategy

The design principles for the core pathway could be delivered in a variety of ways using a variety of techniques. As ever, different approaches are an exercise in trading-off cost, efficiency, certainty and availability. The following section sets out the design challenges and opportunities for the two principle building blocks, which are income drawdown and later-life protected income. We will be working on these techniques with the investment and insurance industry to determine how best a core strategy could be implemented.

Income drawdown building block

The design of the income drawdown building block for phases one and two will be critical for the suitability of this product for our members. The key decision is determining what level of income is sustainable and how it can be delivered over a number of years.

Drawing the money down over a set number of years until phase three, when the later-life protected income kicks in, would be easier to manage than attempting, through pure investment in capital markets, to make the pot last indefinitely.

The two key risks here are sequence of returns risk and inflation risk.

Sequence of returns risk

Modelling of sustainable income distribution rates should not be based on an unrealistic assumption of stable portfolio returns over time. Any solution must recognise that market downturns in the early years can be devastating to the sustainability of an income drawdown portfolio. This challenge is known as sequence of returns risk, or as Milliman has expressed it: 'Market declines combine with portfolio withdrawals in a toxic way.' [7]

Sequencing risk needs to be managed carefully and can be achieved in a number of ways. Box 6.1 outlines some approaches that we believe have merit, either alone or in combination.

[7] The 6 per cent rule: Determining portfolio withdrawal rates using stochastic analysis and managed risk equities. Milliman 22014'

Box 6.1

Managing sequence of returns risk

Volatility management overlays
These reduce exposure to risky assets usually by selling futures contracts as equity market volatility rises. These overlays are increasingly used. This approach seeks to protect the portfolio from excessive and irrecoverable market downturns.

Cash flow matching
This approach matches the required cash flows to pay income to members, with the cash flows provided by the portfolio assets, such as dividend income from equities, rental income from property and coupons and principal repayments from bonds. This approach seeks to avoid being a forced seller of assets at depressed prices in order to generate the required income.

Multi-asset income portfolios
This method seeks to generate sufficient income from a range of assets, while seeking to avoid over exposure to over-valued income generating asset classes.

All these approaches have a significant element of active management in them and therefore the costs associated with the fund management element of this approach are likely to be higher than in accumulation. We believe this additional cost is often worth paying given capital protection is crucial in decumulation, where there is less time and no member contributions to make back losses experienced by market downturns.

Whatever approach is used for paying out a regular and sustainable income, we would need to be convinced it satisfies following three criteria.

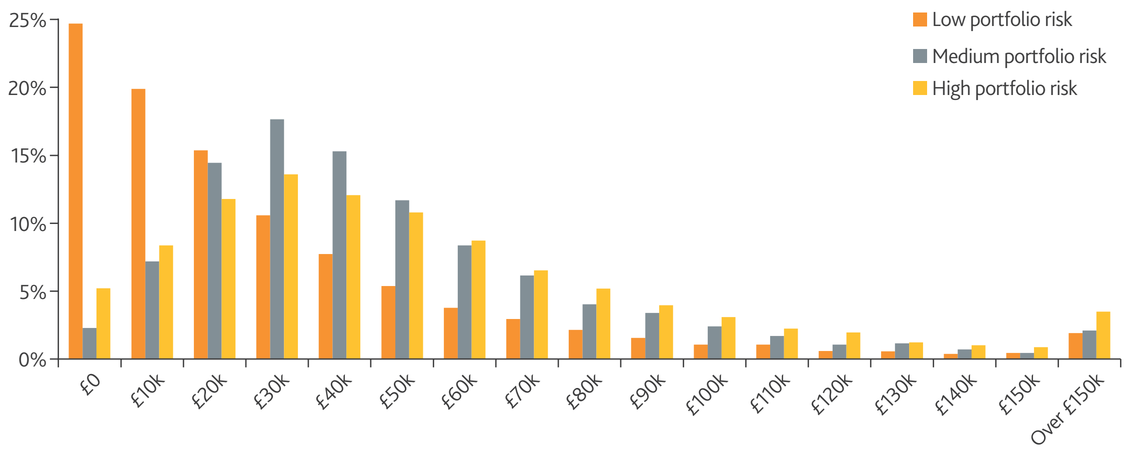
- There is no systemic risk associated with the approach, for example the provider being a forced seller of assets in a falling market with volumes so large that they drive the markets down further.
- That the strategy has sufficient capacity to invest successfully with large amounts of assets.
- That there is no systematic bias to excessively risky or over-valued assets in order to generate sufficient income.

Given that we believe members should expect to spend most or all of their pension pots in retirement, the approach would need to incorporate a running down of capital as well as generating an income.

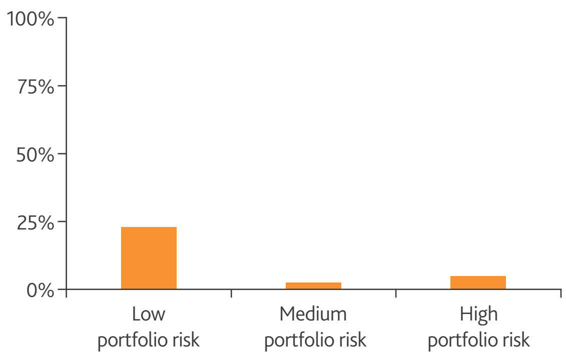
A key design principle of the income drawdown fund would also be to achieve a high probability of generating a sustainable income until the later-life protected income kicks in. In other words the strategy should carry a very low 'risk of ruin'. This would imply a relatively prudent strategy and/or extremely robust risk management.

Figure 6.2 Impact of portfolio risk on income drawdown outcomes

Distribution of pot remaining after 20 years (in real terms) with different levels of portfolio risk



Probability of running out of money within 20 years



Source NEST modelling: Charts generated using Monte Carlo simulation based on forward-looking economic scenarios. Distribution of pot remaining after 20 years equates to cumulative excess money in scenarios where there is some left after 20 years of income drawdown. Model assumes £100,000 is initially invested in the income drawdown fund with an annual income of £4,000 increasing with inflation and taking account of allocations to later-life protected income fund.

Strategies which reduce incomes in payment (perhaps only temporarily) in response to negative shocks may also help to preserve the long term sustainability of that income. We are testing what levels of the probability of money running out is acceptable to our members.

We find that in the majority of scenarios modelled there are likely to be ‘surpluses’ and at times significant surpluses.

Figure 6.2 shows for different levels of portfolio risk, the risk of ruin and the amounts of likely cumulative surplus for a given income distribution rate. As set out in part five, we believe these surpluses could be sensibly distributed at regular intervals into a member’s lump sum fund, rather than be used to increase income, or retained until age 85. Members then have the flexibility to use this additional lump sums as they wish throughout their retirement.

Inflation risk

In the *Guiding Principles* paper we reported a broad consensus from consultation respondents that inflation risk should be managed but not necessarily hedged. This principle is based on the premise that completely guaranteeing inflation protection is expensive, while a well-constructed drawdown portfolio should be able to deliver an inflation linked income in most scenarios. It is our belief that keeping pace with inflation is a reasonable aspiration, rather than a guaranteed outcome.

This does not preclude the possibility that the portfolios for some cohorts would have an inflation hedge, if pricing of such hedges was attractive. However in general the inflation protection would likely be provided by growth assets such as property and equities, as these have some inherent inflation protection built in. We recognise that in extreme scenarios, such as occurred in the 1970s, there will still be risks of not keeping pace with inflation at all times.

Later-life protected income building block

It is very hard for an individual to manage their longevity risk, unless there is a reasonable presumption and expectation that their retirement pot won't be exhausted before death. This implies that the pot needs to be large relative to the income being drawn.

In the coming years as we see the UK's first DC-dependent generation coming to retirement, the income they will require, from generally more modest pots will be a significant portion of its value. Gradually spending down your pot in retirement requires a clear end point for any investment horizon. After this end point is reached an income stream for the rest of life, which is not susceptible to poor market performance is required. We think this end point should be provided by a later-life protected income kicking in at the end of phase two.

We are confident however, that in order to maximise utility from purchasing longevity protection, the crux of the challenge is to neither lock members in too early or to leave purchase of protection too late. Too early, and the flexibility and higher expected returns associated with keeping your money in an income drawdown fund are lost, with only a very modest boost in income afforded by mortality pooling. Too late and the mortality drag takes over. In addition the longer an investor delays buying an annuity, the greater the chance they will no longer have enough money left to buy it.

The obvious approach to securing later-life protected income is to invest for a prudent period until it appears optimal to purchase an immediate annuity. In the absence of ongoing personal financial advice and wealth planning, we don't think this is a strategy that should be relied upon to deliver good outcomes for most of our members.

The first alternative to be considered is the purchase of a deferred annuity, or possibly a series of deferred annuities, at an earlier age, that start paying out at a later age.

These are likely to be increasingly incorporated into retirement income products in the US, where they are known as Advanced Life Deferred Annuities (ALDAs). ALDAs offer members, or their pension providers on their behalf, the ability to secure later-life income well ahead of when it is needed. This gives peace of mind and a more certain future to plan for.

We have given ALDAs a great deal of consideration and respondents to our consultation were broadly supportive of the model. We have looked carefully into how they might be used to optimise a member's retirement journey. We believe that by splitting retirement into the three phases described, a balance can be struck between securing future income for peace of mind, maximising flexibility when it is most valuable and making the most of mortality credits. We set out in table 6.1 how we believe the trade-offs between different approaches and different objectives can be sensibly managed.

Table 6.1 Meeting the different objectives of a blueprint for a core retirement strategy

Phase	Capital market returns vs. mortality credits	Lifestyle and behavioural influences	Potential solution
One	Expected returns from investments much higher than benefits of mortality pooling.	Members entering retirement have little sense of what their consumption needs will be. They are likely to have ad hoc needs until they settle into retirement and aren't focussed on long-term needs.	Remain fully invested in an income drawdown strategy. Use cash lump sum fund for ad hoc needs without impacting their regular income.
Two	Mortality credits become increasingly more valuable overtaking expected investment returns.	Members are more settled into their retirement, have a better sense of their likely future spending needs and are becoming less active. More recognition that they are likely to need a retirement income for longer than previously expected.	Secure a later-life income with a portion of their remaining pot. Remain invested in the income drawdown fund to provide sustainable income in real terms. Use cash lump sum fund for ad hoc needs without impacting their regular income.
Three	Variance of both longevity and value of remaining pots is too high to manage or plan for by using capital markets.	Many members at this age will be less active and less engaged with their finances, preferring instead for certainty in their regular income.	Draw from later-life protected income building block. Use cash lump sum fund for ad hoc needs without impacting their regular income No longer use investment supported income drawdown fund.

As mortality drag rises only slowly up to age 75, but accelerates sharply from then on, our modelling suggests that the optimal time to purchase an ALDA which begins paying out at 85 is likely to be in phase two of retirement, around age 75, given the requirement for flexibility in phase one of retirement.

The practical challenges for later-life protected income and ALDAs

While ALDAs are getting significant attention in the US, the UK insurance industry may at this time struggle to write value for money deferred annuity policies which work for consumers and are attractive from a commercial and risk perspective.

There are at least two reasons for this:

1. The premium paid is relatively small for a deferred annuity and the variability around the expected mortality rate is high in later years. This constitutes a considerably larger risk for a much smaller gain than an immediate annuity purchased at age 65 with a larger premium. In addition, this risk will need to be priced and backed up by capital. Rules around capital and solvency requirements are generally considered tougher in the UK than in the US.
2. Enhanced or impaired annuities are not widespread in the US and therefore the general mortality pool is likely to be less healthy than in the UK. That is, there is more risk of adverse selection in the UK.

As a result, the US model of integrating ALDAs may prove to be unviable in the UK at this time. To the degree that deferred annuity policies will be written, there will likely be a strong preference for full medical underwriting. Indeed, many consumers may prefer bespoke annuity pricing but this will have to be traded off against potentially higher administrative costs, more onerous at-retirement user journeys and potential unintended consequences arising from adverse selection.

During our consultation process, we have sought to understand if the considerable consumer benefits of the ALDA model can somehow be reconciled with the challenging commercial and regulatory environment of those who have the balance sheet and expertise to provide them.

Alternative approaches to managing longevity risk

We cannot yet say that there is a clear or satisfactory existing commercial solution to this problem but there are other avenues to be explored. In a risk-sharing or collective scheme, members could be divided into cohorts, for example, yearly or three yearly tranches and their later-life protected income allocations paid into a collective, but uninsured, mortality pool.

When a member reaches a designated age the later-life protected income would start paying out an income proportional to the premiums paid in. We believe this would, in effect, be a collective defined contribution scheme for decumulation.

In this model, the collective arrangement aims to support incomes through the investments it makes, as well as reserves in the mortality pool. However, it does so on a best efforts basis rather than on a fully guaranteed and underwritten basis.

Such a scheme would not be subject to the same risk-based capital requirements as a life company providing an annuity, and can therefore operate with lower costs, in order to provide deferred later-life income. Furthermore, because the risk is shared within cohorts, this approach avoids the potentially uncomfortable and controversial inter-generational transfers associated with collective DC schemes elsewhere when sharing risk across generations.

The option remains for those managing a collective scheme to use longevity insurance to hedge some or all of the longevity risk for a given cohort. This could be, for example, through a longevity swap arrangement, as is common for defined benefit schemes looking to de-risk. This could be implemented opportunistically rather than systematically, based on prevailing pricing and the manager's view of how well funded any given cohort is.

There is clearly a need for a robust governance framework to fairly pay out the income from an arrangement of this type, although again this should be easier to deliver than for inter-generational collective schemes.

Such schemes are beginning to be designed in Australia, where they already have their first DC dependent cohorts.

Other considerations/features

Inflation protection: Our sixth guiding principle refers to the need to manage inflation risk but not insure this risk. While we believe the aspiration in phases one and two should be to deliver incomes that increase in line with inflation, we believe a level income in phase three is likely to be appropriate. This is because:

- the pattern of retirement spending is likely to change as people get into phase three
- the likely importance to NEST members of the inflation-linked State Pension
- the higher cost of inflation-linked annuities relative to level annuities.

It is our belief that the focus should be on making the income last the rest of the member's life rather than to explicitly hedge inflation. More detail on why we think this is a reasonable approach is provided at Annex A.

Drawdown sustainability: We have already determined that a key design principle behind the drawdown portfolio should be to minimise the risk of running out of money before the later-life protected income kicks in.

However an additional attractive feature of the later-life protected income fund could be to have the flexibility to start paying out one or two years early in the unlikely event that the drawdown pot is exhausted prematurely.

This is certainly possible with deferred annuities in the US and also with collective arrangements. The income level would need to be actuarially adjusted downwards, but this is likely to be a better outcome than a break in the income paid out to members.

Such a feature has the potential added benefit of allowing slightly more risk to be taken in phases one and two. This improves the average expected returns and gives more asset allocation flexibility in times where fixed income markets offer returns below their long term average, as they have recently.

7. Next steps

In this document we have set out a blueprint for a retirement income strategy that we believe has the potential to meet a large proportion of our members' needs, where they are less likely to make active decisions about constructing their retirement pathways.

We think this approach offers a straightforward solution to meet a broad spectrum of member needs. We by no means believe this will be right for everyone, and flexibility and the ability to change minds and retirement paths is a central tenet of the design.

In addition to thinking about what sort of core strategy most of NEST's members will want and need in terms of generating a retirement income that lasts for the rest of their life, we are also carefully considering what alternative or complementary options should be available to meet all of our members' needs.

Just as in the accumulation phase, we would be concerned about expecting our members to navigate too wide a range of choices if they don't plan to use the full open market options. Our experience and the behavioural economics literature would suggest that things like naïve diversification, inertia and availability bias may well be equally prevalent when it comes to making decisions for decumulation. Getting the choice set right and the architecture that supports this choice will be as important as the availability of products themselves.

It's been recognised that one of the barriers to generating engagement with pensions saving is jargon and complex language. NEST and others have been working hard to improve the way schemes communicate and good progress is being made. With the Freedom and choice reforms, many pension savers now face a much broader range of products and choices than previously and, as such, perhaps face a whole new landscape of complex communications. Our hope however is that we can continue to build on the good results we've achieved on plain language in decumulation. As we've touched on in this document; words like 'default' and even 'retirement' may need to be reviewed for their appropriateness in the new world. A major next step for the industry will be to create a more user friendly retirement income space by demystifying the language around it.

This document tries to provide a clear description of what we believe would constitute a reasonable strategy for many of our members as their pots start to get bigger. As set out in section six, however, there are a number of challenges for implementing elements of this retirement income strategy, and it is by its nature inherently complex.

The purpose therefore of setting this blueprint out in detail is to hopefully stimulate innovation and product development to help our members get access to the solutions they are likely to need for more secure retirements. We look forward to ongoing discussion and debate with industry participants and we remain grateful for the support, expertise and good will that have been extended to us through this consultation period. We will continue to share our progress.

Annex A

Emerging evidence from NEST's consumer research

NEST is conducting primary qualitative research into consumer attitudes to the pension freedoms and the different options they might need and want. We've highlighted some of the emerging findings below.

1) People generally want their retirement pot to give them an income, not ad hoc access to cash

Many people see their DC pot as a significant part of their overall retirement wealth. This usually depends on the size of their pot compared to the value of the State Pension and other assets. The picture can be complicated because many people have multiple pension pots of different kinds. However where a DC pot is seen as a significant part of their overall wealth, they generally want to use this pot to provide a regular income rather than to draw cash from it in an ad hoc fashion.

On the other hand, people with smaller pots are looking to access them as one or more lump sums over the short-to-medium term. What is striking is that among respondents, many people with pots under £50,000, and often with pots of lower values such as £20,000, favour some form of lifetime income. This remains true even when they see the relatively low level of income they might receive from a pot of this size.

2) The role of defaults

There has been much discussion of the role of default products in providing a retirement income, to ensure that people get a good quality product even where their level of engagement is low. Our research suggests that, while people don't want a default product as such, they strongly value a standardised approach that they can choose to deviate from if they wish. This is in order to suit their individual circumstances and preferences. Given the complexity of the choices available, people value a standardised product provided it offers them the flexibility to change their mind at a later stage.

3) Cash lump sum at retirement

One preference that appeared dominant before the Freedom and choice reforms were implemented was the 25 per cent tax-free cash lump sum. We have been interested to see evidence that the appetite for taking the maximum tax-free cash at retirement appears to be declining, provided the member is confident they will have reasonably flexible access to lump sums as and when they need them.

For many, early evidence suggests there is no specific need to access a large amount of cash on the day they retire. This suggests that previous behaviour may have been driven by the limited options available to members at retirement.

4) Time horizons

Ideally, people should start engaging with their retirement options in their fifties, as this gives schemes the greatest opportunity to provide them with an investment glide path that suits their chosen product. However, our research supports the results of previous research, including the PPI and State Street findings from 2014[8], indicating that people in their fifties find it difficult to think ahead and pre-commit to retirement choices, beyond a time horizon of a few years.

5) Most people who want to get an income from their pot favour the type of features set out in NEST's core blueprint for a retirement income strategy

At this stage, we only have a small sample to go on, but we've been struck by the consistency with which people favour the blueprint strategy over other options such as conventional annuities or drawdown. Different people have different priorities from their retirement income product – for some it's a guaranteed level of income, for others it's continuing to benefit from investment growth. As a result they may initially be attracted to the features of an annuity or drawdown product. However, when they consider the full trade-offs between a range of different priorities, including flexible access, lifetime income, inflation protection and bequests, they tend to favour the kind of solution described in this document.

[8] 'Pensions Policy Institute (PPI) 'Supporting DC members with defaults and choices up to, into, and through retirement' January 2015

Annex B

The case for a level income after age 85

We believe there is a strong case for later-life protected income to be fixed in nominal terms.

As discussed throughout this document, protecting members' incomes from long-term erosion by inflation should be a critical aspiration. However, we believe that in some cases – particularly over shorter horizons, a higher starting income that declines in real terms at a later stage may be better for members than an income that starts lower and remains flat in real terms.

This trade-off is particularly pertinent for later-life protected income. Members can't get back the implicit cost of inflation protection. Once a deferred annuity has been purchased, or a commitment to a mortality pool made, the promised later-life income is then set in absolute terms.

Minimising the cost of later-life protected income, that is, maximising the ratio of initial nominal income to premium paid, is significant not just in terms of members' behavioural biases. Perhaps more importantly, our modelling demonstrates that the highest whole of retirement income levels at the highest confidence levels are achieved when the cost of later-life protected income is relatively low and more capital can be put to work in the income drawdown phase.

In essence this is due to the fact that for early stages of retirement, equity and other growth assets provide a cheap and effective inflation hedging tool, whereas for lifetime guaranteed incomes, especially where underwritten by a risk averse insurance company, inflation protection will typically have to come from inflation-linked gilts (ILGs). While ILGs are guaranteed to change their coupons with the retail price index, their scarcity value often makes them expensive, as they are today in 2015. In short they offer a real but very low yield.

There are two further factors that lead us to believe that later- life protected income should be fixed and not linked to inflation. First is that consumption generally declines as people enter very old age, and the basket of goods that represents personal consumption evolves as consumer discretionary spending is gradually replaced by things like healthcare. As a result, both the absolute impact of inflation, and the nature of the impact of inflation, will not be consistent with the conventional long-term approaches of consumer price index linking retirement income.

Secondly, a significant proportion of our members will receive a large portion of their income in retirement from the state pension, which is guaranteed for the forseeable future, to rise in line with prices or earnings.

Annex C

List of formal respondents

ABI	Partnership
Age UK	Pensions Management Institute
Alliance Bernstein	Pensions PlayPen
Allianz GI	Pensions Policy Institute
BlackRock	Q Super
Buck Consultants	Schroders
Elston Consulting	Standard Life
F&C	State Street Global Advisors
IFoA	The Open Retirement Club
Investment Association	The Pensions Advisory Service
JP Morgan	TUC
Milliman LLP	Dr. Ros Altmann
NAPF	Peter Holtzer

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