Consultation Response

Independent Review of Retirement Income

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About this consultation

The Independent Review of Retirement Income, led by the Pensions Institute at Cass Business School, was commissioned by the Labour Party to examine some of the key issues arising from the pension reforms. It examines how Defined Contribution (DC) savers can achieve the maximum possible income in retirement and how income can be more predictable than that provided by existing schemes.

Key points and recommendations

- 'Good' DC schemes should aim to deliver the maximum value for scheme members at point of retirement, as well as assisting them to make the right product choices at retirement or signposting to appropriate services.
- This needs to include having suitable defaults in place to support more disengaged savers. These need to be particularly relevant for smaller savers and be based on a set of sound principles.
- A 'Retirement Savings Commission' should be established to evaluate all aspects of pension saving, including decumulation.
- There is a substantial risk associated with people underestimating their life expectancy – many people could spend their pension savings too quickly and as a result run out of money.
- Conversely, there is a risk that some people might fail to fully utilise their savings because of a fear of exhausting their resources. Helping people understand longevity risk should be a fundamental part of the 'at-retirement' system.
- All pension schemes and decumulation products must be subject to high governance standards, while a charge cap for some decumulation products needs to be carefully considered.
- Age UK favours the aggregator model of dealing with small pots, and does not support the pot-follows-member approach.
- There is a need to refresh the debate on income adequacy in retirement, to ensure that how people spend and want to spend in retirement is in line with public policy objectives.
- We believe there is scope for NEST, or a similar purpose built organisation, to deliver decumulation products and would like to see this option explored in further detail.

Introduction

The current reforms to pension decumulation are the most important changes for a generation. Age UK broadly supports the reforms, but we are concerned that there is a significant risk that people will make poor decisions that will have a lifelong impact on their finances, as well as their health and wellbeing.

We therefore believe that action needs to be taken to prevent consumers – particularly smaller savers – from losing out, for example imposing minimum standards on products, improving governance, and introducing safeguards to minimise the risk of people making ill-advised decisions. Such measures are set out in Age UK's 'eight point plan'[i] and in the 'Dashboards and jam jars' report.

Consultation questions

1. (a) What should be the primary aims of a 'good' DC scheme? Please explain.
(b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined?
(c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?

Predictable income

Providing a predictable retirement income is likely to be an appropriate aim for DC schemes in many, if not most, circumstances. However this will not necessarily always be the case. Different people will want to take their money in different ways, for example one person may make a rational and informed decision to take most of their DC fund in cash to pay off a high interest loan, while someone else might wish to use theirs as a 'rainy day' account to supplement a regular DB income.

However, securing a predictable retirement income will undoubtedly be in the interests of some savers.

Different people suffer different circumstances and, in theory, being able to use DC pension saving for different purposes can optimise a lifetime of saving.

It is therefore difficult to pursue such a headline objective without considering the whole range of retirement income, and spending requirements, of scheme members.

Furthermore, savers with smaller pots may have insufficient funds to generate a significant regular income that lasts throughout retirement (whether through drawdown or purchasing an annuity).

Therefore, ‘good’ DC schemes should aim to deliver the maximum value for scheme members at point of retirement, as well as assisting members to make the right choices to help achieve a predictable income throughout retirement through defaults or signposting to appropriate services, where that is in the individual’s interest.

Defaults
In the post-April environment, this is likely include having suitable defaults in place to help members avoid making poor decisions. With the retirement product marketplace for lower net worth savers still in an early stage of development, we believe it is too early to set out specific default options or pathways. Instead, defaults should be based on the following considerations:

- **Suitability** for people with different pot sizes, particularly those with small pots
- Some form of **reversibility or flexibility**, so that the default can implemented with the reassurance that if it is the wrong option for that individual it can either be unwound or altered without too much loss. The sense of an ‘irrevocable decision’ is one reason why annuities proved so unpopular
- Reasonable **comprehensibility and transparency**. It must be possible to explain to the disengaged saver what is happening to their money
- Ensuring any defaults do **not deter people from actually drawing their pension**
- If someone has more than one pension fund, **how the default will work across all their savings**
- A **clear interaction with state benefits and the care system**. A particular concern for Age UK is that the people might be encouraged to draw and spend their pension early in order to avoid the means-test for care (without being aware of the deprivation of asset rules), or conversely spend it on care without being aware of the possibility of state support, leaving themselves or a surviving partner short of income later in life
- The **impact of bankruptcy** on the savings
- **Sustainability across the marketplace**. A very wide diversity of different types of default offered by different types of scheme could undermine consumer trust and increase complexity, especially for people with multiple pots. It is also vital that we do still have an annuity market, offering reasonable value, for those who need it.
- **Support people with declining cognitive health** to make the right choices for their needs

Value for money

Value for money is of course important in delivering a ‘good’ DC scheme. Regulation of charges and other costs, as well as ensuring good governance, are important means of achieving this. It is difficult to define value, giving changing norms, but Age UK believes that there is still room for costs to fall further, and in addition we would like to see a competitive marketplace, without significant outliers. There is no ideal cost structure as different people will be better off under different structures, but on balance we think the benefits of simplicity mean that there would need to be compelling reasons to have any structure other than a straightforward Annual Management Charge.

However, charges for savers are one issue. Equally important, and so far largely neglected, are the following issues:

- Charging complexity in the retirement income market. For example, for a drawdown product there may be initial fees, annual fees, advice fees, fund charges, exit fees and so on. It is almost impossible for an ordinary consumer to understand, let alone assess, all these varying layers of cost.
- Charges on legacy products[ii]. The audit published at the end of 2014 recommends an implementation plan by the end of 2015 and a progress report by the end of 2016. Ensuring that these deadlines are met must be the priority of any new government.

2. (a) Do you agree with the breakdown of risks listed in the Introduction?
(b) Are there any important risks we have not identified?
(c) To deal with political risk, would it make sense to have an independent Pension Commission to set pension policy (similar to the independent Monetary Policy Committee)?

Two risks that are not adequately reflected are:

- ‘health’ risk. Longevity alone is not the key factor – if health declines, then income needs may well increase, while the ability to manage money actively may well fall.
- ‘family’ or ‘partner’ risk. The pension system has moved towards individual entitlements, but many people still plan as a couple, and women are still disadvantaged in the labour market. This leaves some surviving partners at great risk if their partner dies early.

Otherwise, the risks identified seem to be broadly comprehensive. However there could perhaps be more emphasis on ensuring sufficient engagement between the scheme and its members, for example about framing communications in a helpful way; and more detail explored on what are classed as ‘behavioural risks’ – there are a range of different human factors that can contribute to this and are broader than simply short-termist behaviour.

There should be an independent retirement savings commission or regular independent reviews to advise the Government on any further changes to private pensions and income in later life. The consensus around the development of automatic enrolment proved very effective, and we are keen for this to be extended to a Commission looking holistically at retirement savings and decumulation. This could be set up on an on-going basis to continue monitoring and evaluation, and to independently oversee pension policy making.

3. (a) Do you expect products with longevity insurance (e.g., a lifetime annuity) to remain an essential component of a well-designed retirement programme?
(b) How should those individuals who continue to buy lifetime annuities be assisted to obtain the best value products for their circumstances?
(c) If individuals do not purchase lifetime annuities, how does an individual hedge their longevity risk in retirement?

Yes. A recent ILC-UK paper[iii] found that nearly 70 per cent of people with a defined contribution pension would prefer their pension to deliver a secure guaranteed income for life over anything else.

Our recent publication ‘Dashboards and jam-jars’ highlighted the risk of people failing to hedge their longevity risk and running out of money too soon. Based on a 65 year old with a £29,000 DC pot with no other private pension provision drawing down £3,000 per year, it estimated they would run out of money aged 75.[iv]

It is therefore important that products are available to help people manage their longevity risk. Recent Pensions Policy Institute research investigated individuals’ views on such products, and found that while people were resistant to the idea of automatically purchasing an annuity at a fixed point in time, as well as to high up-front costs, they were interested in the idea of making gradual payments each month or year to secure themselves an annual income later in life.[v] These focus groups did include people with higher than average DC pots.

More fundamentally, people are likely to need help understanding their likely longevity. Most people underestimate how long they are likely to live for, meaning even if they plan their retirement income perfectly rationally they may still empty their pension fund.

Conversely, there is also likely to be a problem with some people being risk averse and failing to optimise their retirement income owing to a fear of exhausting their resources.

From both perspectives, many people are likely to need help with understanding their longevity and health risks and with securing maximum value from their DC savings across their retirement.

6. (a) Should decumulation default products provided by, say, large-scale master trusts, be subject to the same trustee-based governance and quality standards that apply to the accumulation default fund?
(b) Where decumulation products are offered by contract-based schemes, should they be included in the requirements for the new Independent Governance Committees to provide governance and quality standards and to assess value for money?

8. (a) Should scheme default drawdown products be subject to the charge cap?
(b) Should this be the same as for accumulation (i.e. 0.75%) or is there a case for a higher cap? If higher please explain why and what the difference might be?

All pension products should be subject to high governance standards. In our response to the FCA consultation on IGCs, we argued that incorporating decumulation, in particular income drawdown, products under Independent Governance Committees' remits will help ensure that such products are managed and delivered to a higher standard.

We are pleased that the Financial Conduct Authority has agreed to consider extending the IGCs remits in future – this consideration should be changed into a firm commitment to do so.

We believe there is a strong case for controls on the costs of drawdown and other alternatives to an annuity. Consideration should also be given to how charges – and other costs – are levied against drawdown products. However, this is not straightforward because of the very wide range of charges that may be levied. A simple percentage charge cap is unlikely to capture all costs. We believe transparency needs to improve considerably as the current array of such charges is very difficult for consumers, many of whom will have had minimal engagement with their pension saving, to understand. Once all costs and charges have been identified, some sort of overall cost measure may be the best way of ensuring good value. In the meantime, the FCA needs to be tracking costs on new products as they arise, and acting quickly if products are launched with charge structures or levels that are not transparent and fair.

16. What are your views on U-shaped or J-shaped annuities?

At present, there is a lack of knowledge about consumer spending in retirement. While a U-shaped spending curve is intuitive, and may be correct, there has not yet been a sufficient analysis of longitudinal spending data to confirm this.

Also, as most people's expenditure has to date been restricted to taking a tax-free lump sum and the subsequent purchase of a level or index-linked annuity, this may have led people to spend in a particular way that may not have met their needs.

We therefore need a better understanding of how consumers spend – and want to spend – throughout their retirement before designing products that may or may not fit peoples' needs.

There is also a need to re-examine the existing debate on income adequacy. The current debate is framed around the replacement rate bands used by the Pensions Commission, but these are only a rough proxy for an adequate income and are not a sufficient basis on which to base public policy decisions.

Using these replacement rates, results of modelling often show that it is in fact higher earners who are under-saving for retirement, For example, research by the Pensions Policy Institute shows that a lower earner starting to save at 22 and claiming their pension at 65 has a 63 per cent chance of reaching an adequate income, compared to a 40 per cent chance for a higher earner.

This highlights the problem of using replacement rates alone and draws the public policy focus away from where it could potentially have the greatest impact. Adequacy measures need to be re-evaluated to ensure correct focus is given.

17. Should DC retirement products and decumulation strategies be linked to the single tier state pension? If so, how?

The issue of the interaction between state and private pension provision is one raised the 'Dashboards and jam jars' discussion paper. In planning for retirement it is important that all sources of retirement income are accounted for, including state pensions.

In some circumstances, deferring your state pension or buying additional state pension can provide more income than buying an annuity. People approaching retirement and who are at or near state pension age should consider how to maximise income from all sources, and this should be reflected in default strategies.

This raises two further issues for public policy:

- How individuals can look across all their expected pensions income, public and private. We would like to see a single ‘dashboard’ covering all pensions. The possibility of a single pension forecast has been explored in the past, and should be re-visited in the light of recent changes and the introduction of the new state pension. In addition, we wonder whether it would be possible to use moves to aggregate pension pots during working life (as recently proposed by the Government) in order to create an infrastructure that would allow this.
- The need for certainty in the state pension system. Any changes need to be introduced with sufficient time and publicity for people to be able to plan ahead. In particular, we would like to see the triple lock enshrined in legislation so that tomorrow’s pensioners can be sure that the state pension has maintained its value when they come to retire.

21. (a) What is the best way to deal with stranded pots? Explain.
(b) Two approaches have been put forward to date: ‘aggregator’ and ‘pot-follows-member’. Do you have preference for one over the other? Explain.

The primary objective in tackling these issues must be to improve retirement incomes by reducing the risk of losing small pots and reducing the costs of handling small amounts.

Moving pension pots in this way may not be in members’ interests. Although some issues of moving from a scheme with low charges to one with higher charges has been addressed to some extent by the introduction of the charge cap, we still have concerns over the costs (and scope for error) of this approach. Any scheme accepting automatic transfers must meet strict standards on charges, investment strategies and governance, which should be proactively enforced by the FCA or The Pensions Regulator.

In previous responses to Government consultations, Age UK favoured the aggregator model, whereby a limited range of aggregator schemes could consolidate pension contributions, as it would be much easier to ensure these are operating in members’ interests.

Part 2

22. It is now recognised that many people face a number of behavioural barriers which prevent them behaving optimally. When it comes to decumulation, what are the key barriers?

23. We need to recognise that retirees: have different expenditure needs during different phases of their retirement; need to pace their spending throughout retirement in order to optimise the use of their lifetime assets and income and their ability to make intended bequests; and need a choice architecture that reflects the market segment to which they belong.
(a) What is your understanding of the regulatory consumer market segmentation and is this appropriate in relation to the needs of DC retirees?
(b) What nudges and choice architecture do people need to deal with these issues and overcome the behavioural barriers they face?

Various pieces of recent research have outlined some of the more significant behavioural biases. These include:

- A tendency to underestimate life expectancy
- Placing a higher value on short-term spending rather than longer-term needs
- Inertia - a lack of engagement resulting in sub-optimal decisions being taken
- Tendency to take a lump-sum regardless of whether this is in the individual's best interests
- Risk aversion – a possible tendency to hold funds in cash or other vehicles that fail to generate sufficient returns[vi]

There is a role for all parts of the retirement system, including pension schemes and the Pension Wise guidance service, in helping individuals manage these.[vii]

As already outlined in question, there is a role for defaults in helping deal with biases and help minimise poor choices.

And as discussed in our answer to question three, we are concerned that many people are likely to outlive their retirement funds either because they underestimate life expectancy or because they are short-termist and spend money too quickly. Conversely others will find the opposite problem where they do not spend all their money. Optimising retirement expenditure over the period of retirement is likely to prove challenging for many people.

Research in the USA shows the impact that framing decisions can have. For example, framing in terms of ‘spending’ rather than ‘investing’ increased the likelihood of someone taking out an annuity. As this suggests, it is important that new systems are properly tested for behavioural impacts before major changes are made. The impact of associated areas of policy, such as tax and care funding, must also be taken into account – for example, consumers may spend down their pension savings quicker than anticipated if they are encouraged to draw their savings as lump sums which are then included in the means-test for care.

26. What are your views on the guidance guarantee and how effective it will be?

27. (a) Will other forms of guidance and advice be needed?
(b) For DC savers who prefer to make their own decisions, what is the best way to build on the guidance guarantee to help individuals avoid buying retail products that are inappropriate (e.g., in relation to risk) and/or poor value (e.g., in relation to price)?

We welcome the launch of Pension Wise and appreciate the speed with which it has had to be set up, but it is too early to assess how successful it will be. Areas of concern at the moment are:

- How we can ensure that people manage their savings safely over the whole of their retirement, not just at outset.
- Take-up rate: there are differing estimates of how many people are likely to use the official service. The second line of defence is welcome and will help ensure people that do not choose to access the Pension Wise service are prompted to consider the main implications of their decisions. However it is not a substitute for good quality advice and guidance.
- Whether the service will be sufficiently tailored to individual needs
- Links across to other areas where guidance may be needed, such as tax and care funding

The link between Pension Wise and other sources of advice is also important, and key issues to be resolved in the short term include:

- Availability of regulated advice at a cost that makes does not deter people with modest savings
- Advice for transfers from DB to DC. It is clear from our post bag that there is considerable interest in this and we are concerned that people with smaller DB savings pots will not be able to afford regulated advice.

We therefore think that the Government must ensure that Pension Wise is monitored and evaluated effectively and independently, and the service is continuously improved. There also needs to be an understanding of the likely impact on other advice agencies such as Tax Help for Older People and Age UK. It is vital that they are adequately resourced to deal with the extra workload that is bound to arise

28. (a) What specific risks should regulatory safeguards aim to address in relation to financial decisions made at retirement?
(b) At what point does individual choice cease to be a regulatory concern/responsibility?

At no point should people cease to be a regulatory concern. If these reforms are not successful, the impact on public trust in financial services and financial regulation will be sever. The regulatory safeguards should aim to minimise the risk of people taking poor decisions both as they approach retirement and later on. While we welcome the commitment to implement a second line of defence, there are other measures that need to urgently be considered too. For example, developing minimum quality standards for products; looking into appropriate defaults; and ensuring that standards are in place to govern lenders' behaviour in relation to debtors' pension pots.

There is more detail in our 'eight point plan' for ensuring that smaller savers get reasonable outcomes from the reforms, available on our website.[viii]

29. Some DC customers might draw down all their pots in the early years of retirement, a decision they might subsequently regret. What is the most effective way of assisting DC customers to act in their best long-term interests?

31. Are there other ways of supporting pension savers to make the right choice at retirement for them and their family?

As explained in our response to question 1, we are concerned about the potential scale of this problem and that it will mean considerably worse outcomes for many people in later life. It is, of course, unknown at present exactly how many people will be affected, and it may not become clear for several years.

In the US, one survey found that in West Virginia, a state with a relatively low average income, 78 per cent of those near retirement and 67 per cent of those at retirement would be likely to outlive their financial assets. Workers with lower incomes are most at risk.[ix] A recent US national study found that by the 20th year of retirement, more than 81 per cent of people with incomes up to $27,000 would run short of money, as would 38 per cent of those earning up to $42,000, and 19 per cent of those with incomes up to $65,000.[x]

Research has consistently shown that people prioritise the short term over the long term. Tackling this presents a particular problem and is likely to need a multi-pronged approach, including for example helping people understand their longevity and are nudged to consider products that can guarantee an income in later life, such as a deferred annuity.

We support the 'jam-jars' approach to budgeting set out in our discussion paper. This would involve pension providers developing new tools to help people manage their money, for example by receiving alerts when they are overspending or at risk of moving into a new tax bracket, or helping them plan expenditure so they know exactly how much money to withdraw each year. However, no system is failsafe, and there will always be the need to make sure people are optimising use of their DC pension saving.

Automatic enrolment has proven inertia to be a powerful force, and this need to be harnessed in the decumulation phase too. Default products and pathways are likely to play a role in ensuring people spend their money appropriately, while advice and guidance will also be important.

32. What evidence is there of individuals' ability to reliably estimate how long they are going to live?
33. How easy is it for individuals to quantify longevity risk? What evidence is available on this question?
34. Is longevity risk a risk that individual savers are able – and should be expected – to manage themselves?

The Institute for Fiscal Studies found that women underestimate their life expectancy by about four years, and men by about two.[xi] Other research broadly corroborates this.

We are concerned that understanding and managing longevity will be impossible for most people to do, particularly over what could be a 30-year period during which health could decline. There are also very few ways to do this apart from active management of a portfolio (difficult and potentially expensive), buying an annuity, relying on the state or through potential products. However, innovative income products have not always worked well for consumers in the past – as the experience of 'structured capital at risk' products shows. There therefore need to be mechanisms in place to spread this risk, whether that is through incorporating industry and government e.g. optional annuity purchases, other insurance products or state funding, or other methods of pooling risk such as Collective Defined Contribution schemes.

It is also important to consider in this context long-term care funding. With greater longevity, and potentially reduced amounts of private finance (especially if many people do spend their DC pension fund too quickly), the care system is likely to be put under further strain, and this must be accounted for in the Government’s long-term planning.

35. Where people receive tax incentives to save into pensions, should people be required to secure a minimum lifetime income in retirement?

Age UK would like to see pension tax relief should be reformed to provide better and fairer incentives to those on low and modest incomes. Requiring people to secure a minimum lifetime income would not be appropriate for everyone. For example, smaller savers might not have sufficient funds to generate a reasonable return, and might be better off taking a cash lump sum.

41. Should NEST provide retirement income products to its members?
42. (a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)?
(b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?

We are concerned that the mass market may fail to deliver high quality and good value products to consumers with smaller DC funds, and believe that NEST or a ‘sister’ organisation could play an important role in driving innovation and competition.

[i] Age UK (2014), Getting the most from the government private pension reforms, available at: http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/getting_most_from_government_private_pension_reforms.pdf?dtrk=true

[ii] https://www.abi.org.uk/News/News-releases/2014/12/Defined-contribution-workplace-pensions-The-audit-of-charges-and-benefits-in-legacy-schemes

[iii] *Making the system fit for purpose,* ILC-UK, Jan 2015

[iv] Lindley D (2014), Dashboards and jam-jars: helping consumers with small DC pots make decisions about retirement incomes', Age UK. This assumes an investment return of 3 per cent and is calculated before charges.

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

[vi] Such behavioural risks are outlined in a variety of sources, e.g. Pensions Policy Institute (2015), Supporting DC members with defaults and choices up to, into, and through retirement; International Longevity Centre UK (2014), Freedom and choice in pensions: risks and opportunities

[vii] It is perhaps more pertinent to say 'manage' rather than 'overcome' as the latter is very difficult to achieve.

[viii] http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/getting_most_from_government_private_pension_reforms.pdf?dtrk=true

[ix] http://www.herald-dispatch.com/homepage_feat2/x1103454390/Study-Two-thirds-of-W-Va-retirees-likely-to-outlive-retirement-savings

[x] http://www.ebri.org/pdf/notespdf/EBRI_Notes_06_June-14_ShrtFlls-HSAs.pdf

[xi] http://www.ifs.org.uk/comms/r73.pdf