Institute
and Faculty
of Actuaries

The future of retirement: A consultation on investing for NEST's members in a new regulatory landscape

Consultation response to NEST

30 January 2015

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The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

NEST
St Dunstans House
201-211 Borough High Street
London
SE1 1HA

30 January 2015

Dear Sirs

IFoA response to The future of retirement: a consultation on investing for NEST's members in a new regulatory landscape

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to NEST's consultation on how it is investing its members' funds in the new regulatory landscape. In preparing this response, we have consulted with our members who work in DC schemes, both as consultants and for providers.

General Comments

2. Many of NEST's members will be new to any form of long term savings vehicle, have lower incomes than traditional occupational or private pensions savers and, importantly, may have continued to contribute due to inertia, as opposed to making an active decision about their retirement saving. We welcome NEST's consultation and support its purpose – to examine how to ensure this demographic of savers have access to an appropriate range of products; and that communications are developed to support individuals to make informed choices that are more likely to lead to good outcomes.

Question 1: How will the trend for changing retirement patterns and provision affect what:
a. members need, and
b. employers want, from DC schemes in the future?

3. The evidence on AE suggests there will be an increasing number of people with DC pension pots and an increase in the size of these pots.[1] As more people become increasingly reliant on DC pension wealth, it will become increasingly important that their needs are adequately provided for and that members of DC schemes have good outcomes from their savings. Engagement facilitates good outcomes as it helps members make an active decision. However, where members are unable to, or do not, engage and make an active decision, it is important that a suitable default option is available. This should offer members an income throughout retirement, without locking them into a potentially inappropriate product.

4. It is important that members who do engage have access to products that offer value for money, are transparent, and enable them to plan for their full range of potential income needs in retirement. Employers will also likely want assurance that providers have suitable

[1] DWP (2013) *Automatic Enrolment evaluation report 2013*

London 7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel:** +44 (0) 20 7632 2100 · **Fax:** +44 (0) 20 7632 2111
Edinburgh Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel:** +44 (0) 131 240 1300 · **Fax:** +44 (0) 131 240 1313
Oxford 1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel:** +44 (0) 1865 268 200 · **Fax:** +44 (0) 1865 268 211
Beijing 6/F · Tower 2 · Prosper Centre · 5 Guanghua Road · Chaoyang District · Beijing China 100020 · **Tel:** +86 (10) 8573 1000 · **Fax:** +86 (10) 8573 1100
Hong Kong 2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +11 (0) 852 2147 9418 · **Fax:** +11 (0) 852 2147 2497
www.actuaries.org.uk

decumulation products for their employees, not only because they are making contributions to these savings, but also because there is likely to be an impact on their employees' working patterns as they approach retirement. An increasing number of people may retire later and/or phase their retirements to secure an adequate income in retirement and it is likely that these individuals would benefit from tools that enable them to consider future risks to their financial security and how they might be mitigated.

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

5. 99 per cent of NEST members currently rely on default funds and appropriate default pathways will continue to be important.[2] Current default strategies will need to be evaluated, not least because future retirees are more likely to retire later (possibly with phased retirement becoming more common), live longer and will be likely to need to mitigate the financial implications of long term care needs in the latter stages of their retirement.

6. Underestimation of life expectancy may lead to some individuals drawing down their pension wealth too quickly. Even where people do understand life expectancy calculations, there remains a significant amount of uncertainty around what that means at an individual level as people start planning their retirement. Individuals need sufficient information about their longevity and the financial consequences of not mitigating longevity risk as part of their retirement income strategy.

Question 3: What conclusions should be drawn from the evidence presented on spending, housing wealth and debt for the needs of future NEST members in retirement? What other data on consumption and wealth should we be taking into account?

7. Data on consumption and wealth that NEST might consider include:
   i. Potential tax implications dependent on how an individual chooses to withdraw their pension.
   ii. Interaction with means-tested benefits – such as funding social care or consequences for Housing Benefit eligibility.
   iii. Potential long term care needs.

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

8. There are already income drawdown products in the market that enable individuals to shape their retirement incomes to match their expected expenditure. Further innovation to make these products accessible to more retirees is likely, as long as providers anticipate sufficient demand.

Question 5: Taking into account current retirement decisions, what people say they want and what the evidence says about behavioural biases, how are savers likely to act under the new freedoms?

9. The IFoA welcomes changes to pensions that reduce barriers to choice and incentivise individuals to consider a broader range of options as they prepare for retirement. We also recognise that greater flexibility could increase the likelihood that not all scheme members will reach outcomes that are in their best interests. As stated in the consultation paper (CP), there is a gap between consumers wanting choice and consumers having the confidence to

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[2] Rainey, N. (2013) NEST: 99% of members in default fund

make choices. Having too many options might lead to poorer decision making, particularly where there is a lack of information and guidance.

10. From a policy perspective, AE's real innovation lies in its adoption of behavioural economics as a means to 'nudge' employees towards greater participation in workplace saving. The evidence so far suggests that capitalising on inertia can have a positive impact upon savings for retirement. However, AE is unlikely to be a pensions panacea, as it only addresses part of the broader retirement savings challenge.

11. There is arguably a distinction between the policy approaches taken for accumulation and decumulation; whilst AE has capitalised on the inertia that manifests in the face of complex financial decisions as a means of nudging people into saving for their retirement, at the point of retirement, a policy of 'freedom and choice' is founded on an expectation that people will effectively manage that complexity and take a proactive approach to financial decision making. As the first generation of auto-enrolled employees reaches retirement, it will be important that appropriate support is available to counteract the inherent inertia. In addition, there would be implications if the transfer of an employee's fund into a default decumulation arrangement is inappropriate and binding, and these need to be thought through in detail.

12. As this CP states, the use of the OMO for annuity purchase amongst DC members has increased since the Budget announcements. While this trend is encouraging, it is vital that consumer behaviour continues to be monitored and explanation is sought. This will help Government and providers to understand how they can further encourage consumers to shop around.

Customer engagement

13. Research by the IFoA's Consumer Information Working Party indicated that individuals are more likely to engage in financial decision making if they believe their efforts are worthwhile and will ultimately lead to positive outcomes.[3] The report suggested that this can be achieved through clear illustration, at an individual level, of how a person's current financial circumstances might impact their future situation. For example, providing an individual with a projection of retirement income, based on their current assets and savings, relative to their retirement income goals would be one way of demonstrating potential risks and rewards of their financial decisions.

Underestimate life expectancy

14. As a profession, actuaries are experts in analysing mortality experience and the consequential life expectancy. However, estimated life expectancy based on a large and relatively stable population cannot be used to determine the actual future lifetime of any individual within that population. It is therefore important for individuals to understand both the concept, and the likelihood, of their actual lifespan being very different from their expected lifespan. In particular they should be made aware – especially if they are in better health - that they could live well beyond the expected average lifespan and given an indication of the likelihood of living longer. This should help individuals to prepare for this possibility.

15. The risk of insufficient capital to support retirement in the later stages of life will remain substantial as long as individuals underestimate their expected longevity and the variance around that longevity.

[3] IFoA (2012) [Transforming consumer information: a discussion paper]

Spending patterns under the new freedoms

16. Recent research into how likely people are to spend their savings in the first few years of retirement indicates that 53 per cent of respondents would spend less than 25 per cent of their savings – less than the tax free lump sum. However, 5 per cent suggested they would spend more than 75 per cent of their savings.[4] This indicates that spending patterns are likely to be varied. As options for spending retirement savings broaden, it is important that scheme members are helped to make decisions that are appropriate and encourage good outcomes.

Question 6: What member behavioural risks do providers need to manage?

17. Please see our response to question 5.

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

Long term care

18. Research has shown that the fastest growing age group within the UK population is people aged over 85 years but, whilst life expectancy is increasing, healthy life expectancy is not increasing at the same pace.[5] The IFoA's Pensions and Long Term Care Products Research Group has explored how pension products could help people fund potential long term care needs within the new regime (taking account of both the Care Act (2014) and the Budget announcements). The paper suggests a number of pre-funded long term care products that an individual could purchase using their pension savings to mitigate catastrophic care costs and, importantly, the risk of having to make financial decisions when most vulnerable and in crisis.[6]

19. The products explored in the paper include:
    i. Protection insurance – these products are designed to cover an event that is uncertain and in some cases unlikely to occur, but where the financial consequences may be challenging without insurance. A product like this could be integrated into the pension framework; premium payments prior to retirement could form part of an employee's retirement benefits package, with post-retirement payments made from their pension, or paid as a single lump sum at retirement.
    ii. Income drawdown – the flexibility provided by these products lends itself to meeting care costs. This could be a popular option for those who still have a large proportion of their pension pot at the point of needing care, and for those who want to avoid selling their home to fund their care.
    iii. Pension Care Fund – this is not a product currently available in the market but could be used by retirees with DC pots. This fund is envisaged as a ring-fenced pot within an existing occupational or private pension and that accumulated assets could only be used for funding care costs for the individual, their partner or their children. For members to opt to ring-fence some of their funds, tax incentives would be required.

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[4] Hymans Robertson (2014) Reality Cheque [Available: http://www.hymans.co.uk/media/572559/dc_research_report.pdf]

[5] Jagger C, Collerton J, Davies K, Kingston A, Robinson L, et al. (2011) Capability and dependency in the Newcastle 85+ cohort study. Projections of future care needs. BMC Geriatric 11: 21.

[6] IFoA Pensions and Long Term Care, Products Research Group (2014) How pensions can meet consumer needs under the new social care regime

iv. Disability-linked annuities – this would provide standard lifetime annuity payments that would increase if and when the policyholder requires long term care. The trigger for the enhanced level of annuity could be based on the number of Activities of Daily Living which the individual is not able to perform. This product would be most suitable for those who have access to a large lump sum at the point of retirement that can be used to purchase this type of annuity.
v. Immediate and deferred needs annuity – an enhanced annuity like this is medically underwritten and calculated based on the life expectancy of the consumer at the point of purchase. This type of product is typically purchased at the point of needing care. A death benefit offering a partial return can also be offered.
vi. Variable annuity – this product can provide a minimum level of pension income within an income drawdown framework. This is already available in the UK pensions market, but currently does not have a link with needing care. However, charges are higher for these products than those that do not have guarantees.

Taxation

20. The flexibility introduced into the pensions regulatory environment has created a more complex taxation environment for many scheme members; therefore, it is important that scheme members understand the potential tax implications of their decisions.

21. In addition, the changes to taxation of death benefits means pensions may now be considered by some as a tax-efficient means of passing wealth to the next generation.

Automatic transfer

22. It is clear that the terms of any automatic transfer arrangement will not benefit members if they lead to a shift of retirement savings to funds with higher charges; or to inappropriate investment strategies, that do not reflect members' risk appetites.

Securing an adequate income for whole of retirement

23. Annuities are widely perceived as offering poor value for money. However, any product that provides a lifetime income guarantee protects an individual against the risks of higher than expected inflation, lower than expected investment returns and greater longevity. This transfer of risk, particularly over the long lifetime of these products, has a cost and therefore runs the risk of being viewed as unduly expensive. Removing this risk transfer if people choose not to annuitise could have significant repercussions for an individual's ability to turn their pension savings into an income at retirement that lasts their lifetime.

Question 8: What works in terms of communicating and getting DC savers to engage with decision making in the approach to retirement? How can we help members make good choices before and during retirement?

24. The introduction of greater freedom and choice into the accessibility of pension funds means that scheme members are likely to benefit most if they are able to access comprehensive information about their retirement savings that reflects their wider financial and personal circumstances.

25. Whilst the Government is seeking to implement the Guidance Guarantee, we suggest it could be helpful for all participants in the retirement income process (providers, advisors, trustees, etc.) to also take an active role in developing a comprehensive approach to retirement planning. Schemes could provide support for their members leading up to, at the point of and

after retirement. This should cover all the options available under the new flexible regime, ensuring that members are aware of all potential outcomes throughout their decision-making. Ideally, this would begin far earlier in the accumulation phase than in the immediate approach to retirement and provide an additional safety net in instances where the Guidance Session was not taken.

26. In our response to the FCA's guidance consultation on the boundaries of advice, we stated that financial services firms do have a part to play in increasing awareness and understanding by producing clear and helpful information on the products and services they offer. Evidence supports the premise that the greater the clarity that providers have on the distinction between guidance and advice, the more willing they are likely to be to provide information. Without this clarity, providers may be conservative in the amount of information that they provide so as to minimise the risk of misinterpretation by the customer that they had received advice.[7,8]

27. There is a risk of overwhelming individuals if they are required to collate significant amounts of information and then use this information to make complex decisions involving unfamiliar concepts. If individuals are overwhelmed in this way, there is a risk that their engagement in decision making will reduce. One way to achieve this is through the projection of the total fund and an annual income in retirement. This already exists but, by improving the way the information is currently presented, it may be possible to improve individuals' understanding of the range and uncertainty of potential outcomes.

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

28. As we noted in paragraph 21, it would be helpful to ensure that individuals are able to avoid having to make decisions when they are least capable of doing so.

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

29. Under the proposed framework, the least complicated route for many scheme members may be to take DC pots as lump sums at one particular date, which may not be the date of retirement. This provides members with an opportunity to avoid making a more complex decision. While this may be the best outcome for members with small funds, it might not be the best decision for those who would incur large tax charges and then keep their savings in a less tax efficient fund. While developing a default strategy may not lead to the best outcome for all scheme members, it may reduce the risk of poor outcomes for those members whose least complicated option would be to withdraw their funds as a single lump sum.

30. Default funds are likely to require a certain number of assumptions about what members may, or may not, do at retirement and, as a consequence, we would anticipate providers seeking assurance that they will not be subject to subsequent claims from members if the default does not provide the optimal result (provided they act within current regulatory and legislative requirements).

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[7] http://www.fca.org.uk/static/documents/guidance-consultations/gc14-03.pdf

[8] http://www.actuaries.org.uk/research-and-resources/documents/gc14-3-retail-investment-advice-clarifying-boundaries-and-exploring

31. As the new flexibilities will inevitably blur the distinction between accumulation and decumulation, any default, pre, at, or post-retirement, would need to meet a range of minimum standards, including capped charges and flexibility to allow an active choice at a later date. This may also require an option to annuitise at a later age, when longevity risk pooling becomes more important and outweighs the perceived reduction in value, due to the cost of providing a guaranteed income within regulatory requirements.

32. If fewer people purchase annuities during the traditional range of retirement ages, current investment strategies - particularly default strategies - may no longer be appropriate. While individuals draw capital and income from their accumulated funds, they must be aware of the risk and reward consequences of investment decisions about their pension assets. While the funds remain invested, individuals will be faced with a series of investment decisions. It has traditionally been challenging to engage members to plan for periods of around fifteen years, so the need to consider the longer term impact of retirement decisions will be even more challenging for many scheme members.

33. Historically, drawdown has been an advised product. If this is no longer the case, the IFoA would welcome feedback from NEST on whether it will have scope to supply a sufficiently robust, non-advised, product.

Question 11: Should we consider having more than one default strategy for different types of member, and which variables can be reasonably used to differentiate member needs in the event of no member engagement?

34. The IFoA would not take a position on whether NEST should consider having more than one default strategy.

Question 12: Based on the member evidence presented should the default target retirement age remain the same as state pension age? If not what are the alternatives?

35. The IFoA would encourage NEST to survey its members to find out their planned retirement ages, or at least to remind its members to consider their likely retirement ages and the effect this decision could have on their income in retirement.

Question 13: Based on the evidence presented, should purchasing annuity income be part of retirement planning for DC savers? If so - on average - what age should this purchase happen?

36. Annuitising at a later age, when longevity risk pooling becomes more important and outweighs the perceived reduction in value, may be a more appropriate time for individuals to protect themselves against longevity risk by purchasing a product with a lifetime guarantee. However, the age at which this becomes appropriate will likely differ between individuals. The factors an individual will need to consider when deciding the most appropriate time for them include their appetite for risk, the size of their pot and their health status.

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

37. All of these products could be advantageous for some members, however, we would caution against any of products being seen as a ‘one size fits all’ decumulation vehicle.

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

38. The IFoA would not take a position on whether NEST should consider having more than one default strategy.

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

39. As noted in paragraph 26, annuities are perceived to be poor value for money. Protection against risk comes at a cost and annuities have provided a mechanism for hedging longevity for a significant part of the population. While strategies exist to hedge longevity risk for larger populations, they may be too expensive for the vast majority of scheme members to purchase at an individual level.

Question 17: Does investing through retirement, as an alternative to immediate annuitisation, have a significant role to play in meeting the retirement needs of DC savers?

40. Again, this strategy could be advantageous for some members, but we would caution against any approach being adopted across all members without consideration of their needs. Continued investment in growth assets will play a role for those members with material retirement savings, although the majority of NEST's population will not fall into this category.

Question 18: If you were designing a default drawdown strategy for NEST members, how would you do it?
We believe such approaches will require innovation and are therefore interested in solutions that address the following issues:

- **governance – including setting pay-out rules**
- **asset allocation and risk management**
- **flexibility for members**
- **incorporation of insurance for market and longevity risk.**

41. The current demographic of NEST's members could suggest the appropriate strategy in the short-term will usually be either immediate cash or annuitisation. We would reiterate our earlier point that, should the average fund at retirement increase over time, it will be important any default strategy is non-binding.

Risk Management

42. Real income guarantees are likely to be expensive. A possible alternative might be a less certain promise, such as a narrowing funnel of doubt around final pension income. However, guarantees do become more affordable in scale. For affordable guarantees, it is likely that a substantial proportion of the market would need to move to a consistent approach for guarantee provision with a small number of providers.

43. A number of DC default fund investment strategies have already been developed that balance risk and return seeking, including lifestyling, multi-asset / absolute return strategies, volatility targeting and Liability Driven Investment (LDI). However, for the investor, these matching strategies have two disadvantages when compared to a guaranteed floor from an insurance company (or financial institution):
    - Compared to a guaranteed floor, the risk management is difficult to understand
    - The investor absorbs the loss if the hedges do not perform as expected (unlike guarantees, where the institution pays hedge losses if they would result in benefits less than the floor).

44. Operational risks of the investment strategy will be borne by the member unless there are additional employer guarantees. However, by narrowing the distribution of expected returns, these strategies ought to provide members with more certainty as to their pension benefits and therefore encourage contributions.[9]

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

45. The IFoA would not take a position on whether NEST was to offer some form of risk sharing solution, however, were it to consider some form of risk sharing we would suggest the following are considered:
    i. Managing a pension fund which operates sharing of risk between generations requires substantial technical expertise and strong governance. This is to help ensure that members are treated as equally as it is reasonable to expect.
    ii. The increased complexity and the inherent opaqueness of collective schemes will require strong governance and strong fiduciary oversight. This increased governance and the necessary expertise come with a price. It is important that any additional costs in governance provide scheme members with value for money. NEST may be one of the few schemes with sufficient scale and technical expertise to be able to cope with these demands.

46. There is a broad range of scheme designs that could be established within the proposed framework. The IFoA's Sleepwalking into Retirement Working Party considered starting points of either purely DB or DC structures and then sought to demonstrate how to adapt those starting points to provide shared risk schemes.[10] The options provided in that paper illustrate the type of designs that many providers could implement.

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

47. The IFoA would not take a position on whether NEST should combine a risk sharing approach and pure DC.

Should you wish to discuss any of the points raised please contact Philip Doggart, Technical Policy Manager in the first instance (philip.doggart@actuaries.org.uk / 0131 240 1319).

Yours faithfully,

Nick Salter
President, Institute and Faculty of Actuaries

[9] IFoA Defined Ambition Working Party (2014) Outcomes and Defined Ambition
[10] IFoA's Sleepwalking into retirement Working Party (2013) Why DC desperately needs actuaries