Institute
and Faculty
of Actuaries

Independent Review of Retirement Income

20 February 2015

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20 February 2014

Dear Ms Parris-Bell

IFoA response to the Independent Review of Retirement Income

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to provide input to the Independent Review of Retirement Income. This response has been led by our DC Advisory Group whose members design and advise on defined contribution (DC) schemes.

2. The pension reforms announced in the 2014 Budget, and the consequent Pensions Schemes Bill, provide a clear opportunity to help individuals manage their retirement income in a way that reflects their specific circumstances. However, there is an increased risk that individuals may make decisions that mean their retirement funds may not last for the duration of their retirement. The IFoA welcomes this study by the Pensions Institute into how Government, regulators and industry can help individuals to mitigate this risk and promote good outcomes.

Question 1:

(a) What should be the primary aims of a 'good' DC scheme? Please explain.

3. Good DC schemes should promote adequacy of income in retirement. We would suggest adequacy is defined within the context of specific parameters, such as individual contribution rates. This approach would suggest that good DC schemes do not only enable individuals to save for retirement, but also offer options for decumulation.

4. If the aims of a 'good' DC scheme are extended to the decumulation phase, then good schemes should enable individuals to make decisions about their contribution level and therefore, their probable benefits. This approach would likely require the provision of member education within the framework of the scheme. Good outcomes will be reliant on members saving adequate funds and understanding what the most appropriate decumulation vehicle is dependent on their individual circumstances e.g. health status, current level of debt and amount of non-pension wealth such as housing equity.

(b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined?

5. The provision of a predictable income will require schemes to communicate to its members a clear expectation of their retirement income based on a number of assumptions. This should also cover an indication of the likelihood of meeting this expectation. The definition should

also capture the increase in the level of certainty around the expected level of pension income as the individual nears retirement. This should facilitate informed decision making.

(c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?

6. Members obtain maximum benefits within the schemes operating environment, for example, dependent on member savings, charges and investment returns. This should be determined assessing cost, resource use, timeliness and ultimately scheme member outcomes.

Question 2:

(a) Do you agree with the breakdown of risks listed in the Introduction?

7. The IFoA suggests individual contribution rates should also be listed as a risk, as there is a significant risk individuals will not save enough for their retirement.

(b) Are there any important risks we have not identified?

8. The IFoA would suggest that the cost of long term care is included. Whilst this would not impact the majority of the population, the financial implications could be catastrophic for those it does affect.[1]

(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)?

9. The IFoA would welcome further discussions on the merits of an independent Pension Commission.

Question 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?

10. The certainty in income that an annuity provides is fundamental in mitigating longevity risk. An annuity is unique in this regard. However, there is (currently) a trade-off in that the purchase of an annuity is a one-off, irreversible decision. The IFoA anticipates that these types of products will remain important, but that many individuals may choose to purchase these types of products later in their retirement, when longevity pooling becomes more important and the perceived value of insurance outweighs the perceived cost of tying up capital.

(b) How should those individuals who continue to buy lifetime annuities be assisted to obtain the best value products for their circumstances?

11. Individuals should be helped to find the right type of annuity, i.e. they should not be encouraged to buy a standard lifetime annuity should it be clear an enhanced annuity, for example, would be more appropriate. People should also be encouraged to consider the impact of inflation and whether their needs will increase in this standard way. In addition, as outlined in our response to 3(a), individuals should be encouraged to consider the most suitable time for purchasing an annuity. However, there are risks associated with cognitive

[1] IFoA (2014) *How pensions can help meet consumer needs under the new social care regime*

decline as people get older and it would be helpful to ensure that individuals are able to avoid having to make decisions when they are less capable of doing so.

12. The use of the Open Market Option (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 analysed. This will help Government and providers to understand how they can further encourage consumers to shop around.

(c) If individuals do not purchase lifetime annuities, how does an individual hedge their longevity risk in retirement?

13. Demand and economies of scale are crucial if new products are to emerge in the market which provide hedging at an affordable cost. It is not clear yet what new products will emerge.

Question 4:

(a) Where annuities are purchased later in retirement, what are the most effective and efficient products for providing income in the period between retirement and the age at which the longevity insurance comes into effect?

14. Two possible options are income drawdown and fixed term annuities. The following paragraphs provide further detail on the potential benefits and risks associated with these options. Other options might include non-pension investments and equity release.

i. Income drawdown
An income drawdown plan enables pensioners to avoid locking their pension fund into annuity rates when investment conditions may appear unfavourable. However, individuals are exposed to longevity risk and unfavourable financial conditions. Income drawdown plans may be particularly suitable where income needs are variable, or an individual need only take a restricted income for a period following retirement, perhaps because of the receipt of income from other sources.[2]

ii. Fixed term annuities
A fixed term annuity offers more flexibility than a traditional lifetime annuity by offering a guaranteed income for a fixed period of time and possibly a guaranteed maturity lump sum. Death benefits can also be built into these products. Where there is a guaranteed maturity lump sum, there would be no investment risk for the individual, who can reassess their income and financial needs at the end of the term, reinvesting their maturity lump sum accordingly. Where there is not a guaranteed maturity lump sum, the investment risk would remain similar to the income drawdown. However, the fixed period may end during unfavourable financial conditions. This would impact on the benefits available if the individual wishes to purchase another product with any maturity lump sum. In addition, income and benefits, in most cases, cannot be changed during the term of the plan (although index-linked, unit-linked, or fixed increments may be purchased at inception). If death benefits have not been selected, and the policyholder dies during the term, the potential loss of capital may be similar to current lifetime annuities.

(b) Should such products have a maximum recommended level of income withdrawal?

[2] IFoA (2011) *Briefing note: Income Drawdown*

15. The IFoA suggests a recommended maximum level of withdrawal could be a useful tool for individuals. However, to maintain the spirit of the freedom and choice agenda any maximum level should only be recommended, not compulsory.

(c) If so, how should that level of income be determined?

16. The IFoA does not have a response to this question.

Question 5: What are the advantages and disadvantages of scheme drawdown (i.e., where the scheme provides an income to the retired member prior to the purchase of an annuity)?

17. Should DC schemes begin to offer drawdown, it will significantly change the underlying nature of these schemes, and consequently, the role of the trustees of these schemes, and potentially, the employers of trust based schemes.

The advantages and disadvantages for scheme members include:

Advantages	Disadvantages
Members are not committed to a single irreversible decision.	The money could run out and leave members with nothing in later life, or a member could be overly cautious with spending and unnecessarily reduce their consumption, which could reduce their standard of living.
It allows variable income to best fit a retiree's changing needs.	The fund that remains invested is not guaranteed. This is particularly risky in volatile markets. This risk is the individual's full responsibility.
The fund can remain invested.	Withdrawals are potentially subject to tax.
Members can withdraw the whole fund at once to pay off debts.	Charges are higher and this can outweigh the value for smaller funds.
Any remaining funds can be passed on in the event of death.	There is no protection should the individual become unable to manage the risks associated with this option. This could leave them vulnerable to scams.
Access to the expertise of professional investment managers, as opposed to the individual navigating investments.	It will require greater time and effort to engage on the individual's part.

Question 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?

18. The IFoA encourages measures which promote good governance and believes members should experience the same standards of governance irrespective of the type of scheme they are a member of. This should remain true regardless of whether the fund is in the accumulation or decumulation phase.

(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.

19. The IFoA welcomes the introduction of independent governance committees (IGCs). However, IGCs will not come at zero cost – additional regulation can mean that less money is available for policyholder benefits if paid for from policyholders' funds. It is important that IGCs offer value for money in relation to improved consumer outcomes. If the IGC is to act in the interest of members, it must consider value for money for all members in the fund, especially given the possibility of varying charging structures for different sized employers. Consideration of all costs and charges are relevant to assessing value for money.

20. This is particularly important for default funds, which should be kept under review to account for; the changing needs of members over time, changing investment opportunities and future regulatory developments. As a final point we consider that measures to improve governance should apply consistently for all members, regardless of whether they are in a contract or trust-based scheme.

Question 7:

(a) What could be the typical total expense ratio (TER) for a default drawdown product provided by a large-scale master trust?

21. Others will be better placed to answer this question.

(b) How might this TER compare with individual drawdown products sold in the retail market?

22. The IFoA suggests the size of large-scale master trusts may create an opportunity for lower TERs compared with individual drawdown products. On the other hand, should these products only be offered by a small number of large-scale master trusts, the lack of competition may lead to higher TERs. It is important that TERs are transparent for both large-scale master trusts and individual retail drawdown products.

(c) Can you give any examples of TERs for retail drawdown products?

23. Others will be better placed to answer this question.

Question 8:

(a) Should scheme default drawdown products be subject to the charge cap?

24. The IFoA suggests that, if the charge cap for accumulation is not replicated for decumulation, it may cause confusion for scheme members. This could cause particular confusion where the member keeps their funds with the same provider, as they may be unaware they have transitioned from accumulation to decumulation.

(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?

25. Please see our response to question 8(a).

Question 9: Retail drawdown products will be sold via regulated advice and they will be purchased via non-advice (execution-only). Is there a case for:

(a) Higher quality controls and consumer protection in relation to risk and costs? Explain.

26. Typically, individuals have needed regulated advice to access drawdown products. This is because drawdown products are typically complex and ongoing advice may be needed. If it

is anticipated that people will purchase these products without regulated financial advice, it is not obvious how the need for ongoing advice will be mitigated. Therefore, it will be important that there are sufficient safeguards in place to ensure that the risks are communicated to, and, as far as possible, understood by the consumer. Safeguards could include a requirement for the provider to ask the customer their reason for not seeking advice, or ensuring they complete a standardised decision tree before purchase.

(b) Making retail products subject to a charge cap? Explain.

27. While we welcome the focus on charges, the main impact of any legislative change should be to obtain good outcomes for scheme members. This is particularly important for complex products such as retail drawdown, as there is a risk to the quality of information and / or advice provided to the customer. We suggest the market for these products will become more competitive under the new freedoms.

Question 10: What is the optimal investment strategy in scheme drawdown prior to the introduction of longevity insurance?

28. There is not a 'one size fits all'; the most appropriate investment strategy will depend on individual member's circumstances and risk appetite.

Question 11: What are the advantages and disadvantages of institutional annuitisation (i.e. where annuities are provided on a bulk basis either by the scheme (self annuitisation) or by an insurance company, rather on a retail basis as currently)?

29. The benefits of institutional annuitisation can be seen in the DB market, where scale has benefitted scheme members and providers by improving funding levels and risk profile. However, there could be risks that this approach challenges the definition of DC as it is a possible step towards Defined Ambition (DA). Institutional annuities place liabilities on employers and trustees that currently do not exist in DC schemes. A governance structure similar to a DB scheme would have to be put in place and this would fundamentally change the role of DC trustees.

30. Australia's experience suggests that group self-annuitisation enables members to pool mortality risks to deliver higher incomes in retirement than an account-based pension and provides significantly more protection against longevity risk. It allows members to share risk and does not require capital to back guarantees. Whilst income is not guaranteed, this method could generate a higher income through efficiency savings. However, members could have lower income in later life, should the majority of the pool live longer than expected. Members will also lose flexible access to capital and are unable to pass on funds at death.[3]

Question 12: Could institutional annuitisation deal with the individual underwriting of annuities and still encourage competition from providers in the open market to maximise consumer outcomes (e.g. in the case where a retired member has a medical condition which reduces their life expectancy)?

31. The IFoA does not have a position on this question.

Question 13:

(a) Would a market for advanced life deferred annuities be viable?

[3] Australian Government the Treasury (2014) *Interim report of the Financial System Inquiry.* Commonwealth of Australia 2014

32. In the US, advanced life deferred annuities are a vital part of the retirement income product market. We would therefore suggest, that there is a need for further research into the viability of such a market, given that it could potentially offer financial security in later retirement to those who opt not to buy an annuity at retirement.

(b) What is the likely demand for advanced life deferred annuities?

33. Others will be better placed to answer this question.

Question 14: Is there likely to be demand for inflation protection?

34. The IFoA does not have any information on the likely demand for inflation protection. However, we do note that this will be important for some individuals, as even low rates of inflation can seriously reduce the amount you can buy with each £1 of income over the full length of retirement. If inflation is 3% per annum, after 10 years someone with a fixed pension would only be able to afford 75% of the goods they could have purchased when they first retired.[4]

Question 15: What are your views on the proposals by HM Treasury to allow annuities to have more flexible payment terms by:

(a) allowing lifetime annuities to decrease

35. The IFoA would welcome any policy developments that allow new products to reflect the new freedoms in the retirement market, while also highlighting the risks that individual policyholders may face in the future. Clear communication to the customer when purchasing these annuities will be very important.

(b) allowing lump sums to be taken from lifetime annuities

36. Consumers need to understand the impact of withdrawing a lump sum on the remaining fund with which they will need to purchase a retirement income product.

37. The IFoA notes that there may be unintended consequences for those who choose to withdraw large amounts of pension savings. For example, it is not clear yet whether there will be discrepancies in the respective treatment of income and capital in local authority financial assessments for individuals with long-term care requirements.

38. The IFoA would encourage a fuller debate about the consequences for providers, from a prudential viewpoint, of allowing surrenders from existing contracts.

(c) removing the ten-year guarantee period for guaranteed annuities

39. While the IFoA does not have a specific position on this question, removing any restrictions may encourage further product innovation.

(d) allowing payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000?

40. The IFoA does not have a position on this question.

[4] IFoA *Post-retirement risks - inflation*

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

41. Presenting annuities in this way could be helpful for individuals to visualise the shape of their retirement income. However, we would suggest it is difficult for people to plan 10 or more years in advance, as illustrated by pre-retirement engagement levels. Therefore, in the spirit of the freedom and choice agenda, we would suggest that whilst illustratively useful, members should be aware of the consequences of purchasing products which 'lock them in' and do not allow for changes in circumstance.

42. The IFoA is encouraged that the Government is considering products that can adapt to potential monetary needs in later retirement, which could be particularly useful for those who need to pay for their long term care needs. At the same time we welcome the Government's 'deprivation rules' and hope these will prevent a situation in which the purchase of such products could enable people to run down their savings in a manner which means they would not need to pay for their care (as they would be eligible for state funding owing to the social care means-testing limit).

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

43. The IFoA does not have a position on this question.

Question 18: What other retirement products do you expect to become available? Please provide details if possible.

44. The IFoA does not have a position on this question. However, we suggest products will continue to evolve over time as the saving pattern of retirees' changes i.e. as more retirees have a greater proportion of their wealth in DC, rather than DB, schemes.

Question 19: Is there a case for designating certain retirement products as 'safe harbour' products? Explain.

45. The IFoA does not have a position on this question.

Question 20: Following the impact of the Budget 2014 tax changes on annuity providers, do you have any concerns about supply-side contraction or other developments in the annuity market that might make it less competitive?

46. The IFoA does not have a position on this question.

Question 21:

(a) What is the best way to deal with stranded pots? Explain.

47. The IFoA does not have a position on this question.

(b) Two approaches have been put forward to date: 'aggregator' and 'pot-follows-member'. Do you have preference for one over the other? Explain.

48. The IFoA does not have a position on this question.

(c) Would 'scheme-follows-member' be feasible? Explain

49. The IFoA does not have a position on this question.

Question 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?

50. There is a risk that increasing choice for retiring members may result in some of those members feeling overwhelmed, particularly if they are required to make complex decisions involving unfamiliar concepts. If individuals are overwhelmed in this way, there is a risk their engagement in decision making will reduce. Improving the way the information is currently presented may improve individuals' understanding of the range and uncertainty of potential outcomes.

51. 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.[5] 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.

Question 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?

52. Regulatory market segmentation has value for retail customers and could be of equal value for DC retirees.

(b) What nudges and choice architecture do people need to deal with these issues and overcome the behavioural barriers they face?

53. 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.

54. 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 and providers 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 members are aware of all potential outcomes throughout their decision-making.

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

55. 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 providers have on the distinction between guidance and advice, and perhaps the role of market segmentation within these confines, the more willing they are likely to be to provide guidance. Without this clarity providers may be conservative in the amount of information they provide to minimise the risk of misinterpretation by the customer that they had received advice.[6,7]

Question 24:

(a) What lessons from auto-enrolment in the accumulation phase can be brought to the decumulation phase?

56. Auto-enrolment has capitalised on the inertia that manifests in the face of complex financial decisions as a means of nudging people into saving for retirement. To capitalise on this inertia during the decumulation phase, it is important that individuals have access to suitable default vehicles. There is a risk that, for many scheme members, the least complicated route may be to take their pot as a lump sum. While this may be the best outcome for some (e.g. members with small pots), it may not be the best decision for others (e.g. those who would incur large tax charges). While developing a default strategy may not lead to the best outcome for all 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.

(b) Given the importance of income security for the elderly and the existence of longevity risk, is there a case for defaulting people into buying longevity insurance via auto-enrolment (i.e., drawdown with longevity insurance becomes the default retirement strategy)? Consider the advantages and disadvantages of such a strategy.

57. Such insurance would mitigate the longevity risk retirees face. While it offers a straightforward solution in principle, the cost of such products may be expensive or, potentially, could offer less value than an annuity.

(c) What would be the likely annualised cost of such products for individuals?

58. Others will be better placed to answer this question.

(d) How could the default principle, upon which the success of auto-enrolment is predicated, be best reconciled with the individual freedoms for DC decumulation introduced in the 2014 Budget?

59. Any default should allow an active choice at a later date to reconcile with the freedom and choice agenda. In the development of such an approach, whilst acknowledging this may not lead to the best outcome for all scheme members, it should seek to build on the improvement of outcomes resulting from inertia - nudging members towards a good outcome and reducing the risk of poor outcomes.

Question 25: What are the implications of the Chancellor's announcement in September 2014

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

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

effectively ending the 55% tax rate on inherited pension pots?

60. Our understanding is that an individual could be the beneficiary from several sources, accumulating up to the value of the Lifetime Allowance (LTA) in each case, and that such assets could be transferred on to subsequent generations without the LTA applying.

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

61. 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. A poorly chosen decumulation strategy can negate the potential rewards from diligent efforts in accumulation. It is therefore important members are given every opportunity to understand how they can maximise the likelihood that their pot will equate to an adequate income in retirement. This presents a number of challenges that HM Treasury, the FCA, delivery partners and pension providers will need to overcome if it is to be effective.

    i. Managing consumer expectations will be instrumental – it is imperative that consumers understand the scope, purpose and limitations of the guidance session.
    ii. We would recommend that, as a minimum requirement, this guidance would cover life expectancy, the danger of running out of money during retirement, tax implications of taking lump sums, consequences in the event of bankruptcy, possible long-term care needs (and related means-testing), funds available to be passed on at death and investment risk.
    iii. The proposals would require consumers to provide a significant level of detail. Many individuals will be unable to access this information easily and this could act as a significant barrier to the success of these reforms. It will be important that the combination of requiring people to collate significant amounts of information and asking them to use it to make complex decisions involving unfamiliar concepts, does not overwhelm individuals and reduce the effectiveness of the guidance offer.
    iv. The broad range of individual circumstances is likely to be difficult to capture in a single session. Further, a retiree's objectives and other factors, such as economic conditions, are likely to change over time and so a 'one-off' session may prove insufficient.
    v. Ideally, the pre-retirement investment strategy would reflect how the funds are to be used at retirement. The guidance offered by the Guidance Guarantee, at retirement, is too late to facilitate this.
    vi. Similarly, people drawing down their funds will need guidance at later stages in their retirement, suggesting that a 'continuing care' responsibility should sit either with the guidance provider, or with the decumulation provider.
    vii. The task of the providers of the Guidance Guarantee is made, perhaps unnecessarily, difficult by the complexity of some of the anti-avoidance rules around drawdown.

Question 27:

(a) Will other forms of guidance and advice be needed?

62. We would anticipate that, owing to the Government's initiative 'fuller working lives', increasingly retirement will not be a 'cliff-edge', but will be staged, with many people of retirement age continuing to work. They will require access to relevant information throughout their phased retirement. This could take the form of online resources which both provide information and, where appropriate, sign-post individuals to relevant services - whether that be free services such as Money Advice Service, or towards regulated advice.

(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)?

63. We consider good quality governance to be central to the successful management of a pension arrangement. Setting the quality standards in regulations is the best way to ensure compliance in practice. Good quality requires promptness, accuracy and clarity of information for members. There is a need to balance a variety of potential approaches to achieving quality with the need to ensure that members receive value for money.

64. In addition, it is important that all products comply with transparency requirements. Sufficient information should be provided to enable consumers to make informed decisions. Conversely, members should not be overwhelmed by a volume of information that could result in confusion rather than clarity.

Question 28:

(a) What specific risks should regulatory safeguards aim to address in relation to financial decisions made at retirement?

65. Underestimation of life expectancy may lead to some individuals drawing down their pension wealth too quickly. Even where people do understand life expectancy calculations, should they not opt for a product with a lifetime guarantee, 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.

66. Another significant challenge is long term care needs. Should policy decision-makers want to encourage individuals to contribute towards their care costs, it will be important they raise awareness around both the likelihood of need and the potential cost of care provision.

(b) At what point does individual choice cease to be a regulatory concern/responsibility?

67. The individual remains a regulatory concern until they have made a final decision that is irreversible. Regulators should also continue to actively monitor the processes around any final decision making.

Question 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?

68. 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 (e.g. tax efficiency, impact of small pots, other debts and other investments).

69. 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. For this to be viable, there is a need for clarity around their different roles to minimise the possibility of retrospective assessment of 'bad' advice, as trustees are not financial advisers; and without support, would not necessarily have access to information and resources to provide advice.

70. Schemes could provide support for their members leading up to, at the point of and after retirement. This should cover the options available under the new flexible regime, ensuring members are aware of 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. Care will be needed to ensure that the scheme is not providing advice and that this is understood by the scheme's members.

Question 30:

(a) What is the best way of ensuring that any DB-to-DC transferees only undertake such a transfer when it is in their best interests?

71. We would ask whether it is feasible to determine if a transfer is in a member's best interest, as an individual's circumstances will likely change overtime. However, should such a transfer take place, we would suggest that all members with a pot greater than £30,000 (the legislative threshold) should receive regulated advice about the risks and benefits of such transfers.

72. There are a number of risks that should be considered if DB members are allowed to benefit from the full DC flexibilities, including:

    i. Lower income and greater reliance on the State in later life through members spending their pension assets earlier.
    ii. Members underestimating their own life expectancy can lead to pension pots being depleted more quickly than if the variation in life expectancy were understood.
    iii. An increase in pension "liberation" fraud.

(b) What are your estimates of the number of DB-to-DC transferees (deferred and also active) and size of assets involved?

73. The IFoA does not have evidence in response to this question.

(c) Is the requirement for regulated independent advice for such transferees adequate?

74. There are a number of considerations:

    i. Firstly, this will depend on the definition of adequate in this context.
    ii. Secondly, requiring independent financial advice will only ensure that where members do transfer, they do so in full knowledge of the benefits they are giving up, if they do get the full advice. This will only be possible if the individual is able to give the advisor all of the relevant information. Regulated independent advice should mitigate the risk of members wanting to take advantage of increased flexibility, but failing to understand the benefits they are forfeiting. It is paramount that this does not become a tick-box exercise, otherwise there will be failure.
    iii. Finally, for smaller pots, the cost of obtaining this advice could be prohibitive.

(d) Can/will the guidance guarantee process cope with DB active/deferred members who seek help in considering their options?

75. We suggest this advice is outside of the scope of the guidance process.

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

76. We note that families' and pension savers' interests might not always be aligned. However, we would encourage a focus on improving financial literacy more broadly and creating a framework that assists people to make informed decisions.

Question 32: What evidence is there of individuals' ability to reliably estimate how long they are going to live?

77. There is a body of evidence to suggest that people tend to underestimate the amount they need to save to meet their income expectations in retirement. A recent industry poll suggested that people underestimate longevity by up to ten years and this exacerbates under-saving.[8]

Question 33: How easy is it for individuals to quantify longevity risk? What evidence is available on this question?

78. There is a considerable degree of uncertainty associated with attempting to estimate how long someone will live. While a best estimate life expectancy has its place, it is just one point on the curve and, at an individual level, reliance on it for retirement planning does not work. There is also a significant degree of variation in estimates once state of health is taken into consideration, which reinforces the value to consumers of underwriting longevity products.

79. Actuaries are conscious of the gap between the reality of mortality experience, consumer expectations and the inherent uncertainty around estimating future mortality experience. In preparing people to manage this uncertainty, it is critical that they are able to access appropriate financial information and, when relying on life expectancy estimates, the degree of variation and implications of this are clearly communicated. For some retirees, longevity protection provides a valuable means of protecting against the financial risk of outliving their resources.

Question 34: Is longevity risk a risk that individual savers are able – and should be expected – to manage themselves?

80. This will be difficult for individuals to manage themselves as estimated life expectancies based on a large and relatively stable population cannot be used to determine the actual future lifetime of an individual within that population. It is therefore important for individuals to understand both the concept, and the likelihood, of their lifespan being significantly different from their life expectancy. This level of uncertainty will make it difficult for individuals to plan their retirement income. There is a risk individuals will either, overspend and run down their retirement income, and a risk they will underspend - unnecessarily reducing their quality of life if they have to manage longevity risk themselves.

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

[8] http://newsroom.mgmadvantage.co.uk/long-life-not-according-to-the-wife/ MGM Advantage research among 2028 UK adults, 314 of which were aged 55-64, conducted by Research Plus Ltd, fieldwork 17-22 October 2013. Respondents were asked "Being as realistic as you can, approximately how old do you think you'll live until?"

81. It is important that the tax incentives given for pension saving should not be wasted at the point of retirement. However, this will need to be balanced with the freedom and choice agenda.

Question 36:

(a) Do you believe that the DC retirement income market could benefit from the introduction of a market in longevity bonds? Explain.

82. The IFoA does not have a position on this question.

(b) Do you believe that a market in longevity bonds is viable (in the sense of having sufficient demand to justify its introduction)? Explain.

83. The IFoA does not have a position on this question.

Question 37: Do you have a preferred design for a longevity bond?

84. The IFoA does not have a response to this question.

Question 38: Is there a case for the government to issue longevity bonds? Explain.

85. The IFoA does not have a position on this question.

Question 39: Are there alternatives to longevity bonds to hedge systematic longevity risk? Explain.

86. The IFoA does not have a position on this question.

Question 40: Are there other ways of helping savers to manage longevity risk?

87. Member communication and the availability of products that offer a lifetime guaranteed income, such as annuities, are important elements of helping savers to manage longevity risk.

Question 41: Should NEST provide retirement income products to its members?

88. There are benefits, in that NEST can provide scale, and as NEST's model is based on inertia, it could be the most efficient way to ensure individuals do not have poor outcomes.

Question 42:

(a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)?

89. 99 per cent of NEST members currently rely on default funds suggesting appropriate default pathways will continue to be important.[9]

(b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?

90. NEST should have to meet the same standards as other schemes. As the default fund for Auto-enrolment, it should be a leader in high-quality standards.

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

Question 43: Are there any other ways in which NEST can help savers to access good quality retirement products?

91. The scale of NEST could make it easier to offer external providers' products at improved rates. Its scale could also make it financially viable for NEST to offer an additional guidance session, perhaps in preparation for the Government's free guidance session, helping members to ensure they have all of the information that will enable them to make the most of the session.

Question 44: In an aggregator model for stranded pots:

(a) Would it be desirable for NEST to act as one of the aggregators?

92. The IFoA does not have a position on this question.

(b) Which other schemes could act as aggregators?

93. The IFoA does not have a position on this question.

Question 45: Could NEST do more in decumulation for the self-employed and workers excluded from auto-enrolment?

94. We welcome that NEST is open to those who are self-employed and excluded from Auto-enrolment, as it is important that all individuals who are able to, and wish to save for their retirement, are catered for within the pensions framework. Those who are self-employed may be more reliant on their pension scheme to provide them with information and relevant sign-posting leading up to and at the point of retirement regarding decumulation. The IFoA would welcome any measures NEST takes to help those who are self-employed in understanding their decumulation options.

Question 46:

(a) Could NEST become a collective pension scheme? Explain.

95. The IFoA does not have a position on this question.

(b) Should NEST become a collective pension scheme? Explain.

96. The IFoA does not have a position on this question.

Question 47: What should 'collective' mean in the UK context (e.g., collective in terms of scale and governance, and collective in terms of risk-sharing)?

97. The IFoA's Sleepwalking into Retirement Working Party has looked at what 'collective' might mean in the UK, starting from a DC position. The range of possibilities it suggests include:
    i. DC in a with-profits fund
    ii. Deferred annuities
    iii. Managed DC
    iv. DC with insured capital guarantees
    v. Split retirement into term annuity plus (mutualised) later life annuity

vi. Employer smoothing fund[10]

Question 48: What are the main benefits of CDC schemes over individual DC schemes?

98. We recognise that shared risk schemes can offer more certainty than traditional DC arrangements depending on how the risk is shared.

99. Other benefits of CDC schemes include:
    a. Employers still have their exposure linked to payment of a defined contribution, thereby capping their exposure and giving certainty of cost.
    b. The smoothing of returns has the advantage of greater predictability, and limits exposure to short term volatility. This is the most significant advantage to employees, as it offers greater certainty and confidence in pension income.
    c. Members no longer need to be involved in investment decisions.
    d. Use of a fiduciary body to determine investment decisions should also deliver greater economies of scale, than achievable through member choice.

Question 49: What are the main disadvantages of CDC schemes over individual DC schemes?

100. The management of a fund that offers intergenerational savings, and provides for cross subsidy between cohorts, requires substantial technical expertise, strong governance and fiduciary oversight. This will create additional costs and, therefore, likely affect members' level of future retirement income. If employers are not able and willing to meet these additional costs scheme members will have to bear them and this could deter members.

101. Other disadvantages of CDC schemes include:
    e. There is a possibility that existing benefits can be reduced and members may not expect this.
    f. There could be concern over whether members really understand the implications of soft guarantees which are inherent in such plans. There is the potential that these complex arrangements may deter members.
    g. The potential for future regulation treating these benefits as DB, linking entitlements to preservation, would be a real concern for employers. Whilst this may seem unlikely, an extended decline in investments and adverse publicity could lead to regulation and therefore exposure for plan sponsors.
    h. There is likely to be a need for employers to invest in employee communication. To ensure the additional complexity and risk of such schemes is consistently reaffirmed and understood will be an additional cost.
    i. Need for a stable membership and protections against people withdrawing savings when markets are low.

102. Two other points for consideration are:
    j. The impact of generational cross-subsidy, particularly in the early stages of these schemes, where fluctuation reserves would need to be established; and
    k. The lessons that can be learnt from with-profits funds.

The IFoA would welcome the opportunity to discuss this in greater detail.

Question 50: CDC schemes may be able to generate incomes that are higher than individual DC schemes as the latter are currently operated.

[10] IFoA's Sleepwalking into retirement Working Party (2013) *Why DC desperately needs actuaries* (http://www.actuaries.org.uk/research-and-resources/documents/d05-sleepwalking-retirement-%E2%80%93-why-dc-desperately-needs-actuaries)

(a) Are there reasons why an individual DC scheme could not follow the same investment or decumulation strategy as a CDC scheme?

103. Individual DC schemes can offer a broad range of investment options that could reflect a similar approach as a CDC scheme. As with the selection of any investment strategy, individual members should be aware of the consequences of those decisions.

(b) Would trustees of an individual DC scheme be willing to accommodate the greater investment risk, given the need to enable members to transfer out and to take their pension pot with them?

104. Trustees are likely to accept different levels of risk within their schemes. Risk appetite will determine a range of outcomes that will reflect the freedom within the overall legislative framework. Experience of with-profit funds should be considered when understanding the range of outcomes. It is worth noting that CDC schemes in the Netherlands do not take the degree of investment risk that some of the UK proponents of the design are recommending.

Question 51:

(a) Would a CDC scheme have any additional risk-sharing advantages over a large master trust DC scheme which followed the same investment and decumulation strategies where possible?

105. The IFoA suggests it could, but the model would rely on many assumptions, some of which are likely to be subjective.

(b) Can the benefits from any additional sources of risk sharing available to CDC schemes be quantified?

106. The IFoA does not have a position on this question.

Question 52:

(a) What is your preferred design for a CDC scheme, in terms of targeted benefits? (e.g., a CDC scheme that is intended to replace a DB scheme and hence would be earnings-related (specify accrual rate, earnings measure, pre-retirement indexation rule, post-retirement indexation rule); or a CDC scheme that is intended to replace an individual DC scheme and hence would be with-profit and a target return, unit-linked and a target return, etc).

107. The IFoA does not have a position on this question.

(b) Explain why

108. The IFoA does not have a position on this question.

Question 53:

(a) What is the best estimate contribution rate to achieve the target benefit?

109. The IFoA does not have a position on this question.

(b) How should the contribution rate be shared between employer and member?

110. The IFoA does not have a position on this question.

Question 54:

(a) Can a CDC scheme work with a planned contribution rate that is fixed independent of a member's age or is an age-dependent member contribution rate required?

111. The IFoA does not have a position on this question.

(b) If the latter, is a change to equality legislation required?

112. The IFoA does not have a position on this question.

Question 55: What investment strategy would be appropriate for CDC schemes: (a) in accumulation and (b) near retirement and (c) in decumulation?

113. The IFoA does not have a position on this question.

Question 56: What are the main benefits of a CDC scheme in terms of intra-generational risk pooling?

114. The IFoA does not have a position on this question.

Question 57: What are the main benefits of a CDC scheme in terms of inter-generational risk sharing?

115. Intergenerational risk sharing can smooth volatility over many generations as the indexation on pensions is much smoother than the market returns and also highly correlated. This is a desirable feature in a pension system, as it will provide time for individuals to smooth their consumption levels. However, this should be balanced against the level of risk for younger and future generations and appropriate safeguards to mitigate this could be beneficial.

Question 58:

(a) Over how many generations should risk be shared?

116. The IFoA does not have a position on this question.

(b) Explain why this is optimal

117. The IFoA does not have a position on this question.

Question 59: How should the risk-sharing rules in a CDC scheme be defined?

118. The IFoA does not have a position on this question.

Question 60: How much discretion should a CDC scheme's managers have when it comes to smoothing or adjusting benefits to target benefits, or should the rules be fully transparent?

119. The IFoA suggests the rules be fully transparent.

Questions 61:

(a) If the actual pension is above the target pension, when should adjustments be made?

120. The IFoA does not have a position on this question.

(b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?

121. The IFoA does not have a position on this question.

Question 62:

(a) If the actual pension is below the target pension, when should adjustments be made?

122. The IFoA does not have a position on this question.

(b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?

123. The IFoA does not have a position on this question.

Question 63: What mechanisms are needed to ensure that no CDC scheme becomes insolvent? For example, a CDC scheme might try to use a high target return to attract more customers.

124. Strict and transparent rules must apply, with clear actions outlined should the solvency of a scheme deteriorate due to poor investment performance, or increased longevity forecasts.

Question 64: Is it necessary for a CDC scheme to start with or build up a reserve fund to give it credibility?

125. Dependent on the model of CDC adopted, it is likely that a reserve fund will be required to ensure the scheme is sustainable.

Question 65: CDC schemes in other countries (e.g., Holland) have virtually no flexibility with respect to member choice (e.g. contribution rate, investment strategy, retirement date, form of decumulation (i.e., pension). Do the freedoms and flexibilities introduced by the 2014 Budget render CDC schemes unfeasible or more risky in the UK? Explain why not or, alternatively, how freedom and flexibility would need to be tailored in the context of CDC schemes?

126. The more freedom and choice that is allowed to members, the harder it will be to run the CDC scheme.

Question 66: One of the biggest growth areas prior to the 2014 Budget was the medical underwriting of annuities and the growth of enhanced annuities. But in a standard CDC scheme, everyone gets the same pension irrespective of health status.

(a) Would it be feasible in a CDC scheme to medically underwrite the pension in retirement?

127. The IFoA does not have a position on this question.

(b) Would it be desirable to do this?

128. The IFoA does not have a position on this question.

Question 67: How should a CDC scheme best be organised: (a) on a company-wide basis, (b) an industry-wide basis, or (c) a nation-wide basis?

129. The IFoA does not have a position on this question.

Question 68: What is the minimum number of members in a CDC scheme to make it viable? Explain this figure.

130. The IFoA does not have a position on this question.

Question 69: Effective regulation, governance and quality standards will be crucial, given the absence of member property rights (which apply in standard DC schemes) and also the absence of a sponsoring employer that guarantees benefits (which applies in DB).

(a) What regulation is required to protect members' benefits?

131. The IFoA does not have a position on this question.

(b) What governance mechanisms and quality standards are needed in CDC schemes, especially to ensure inter-generational equity?

132. Strong independent governance is needed to achieve the holistic view across all the facets of a pension scheme, without getting distracted by a short-term focus on inputs that may reflect immediate public opinion. Achieving members' retirement goals should be the focus of attention of the governance body.

Question 70: Could CDC schemes operate both on a trust basis and a contract basis? Explain.

133. The IFoA does not have a position on this question.

Question 71: Could a 'for profit' organisation run a CDC scheme? Explain.

134. The IFoA does not have a position on this question.

Question 72: What communication strategy would be appropriate for CDC schemes (a) in accumulation and (b) near retirement and (c) in decumulation?

135. Members also have an important role to play in keeping their own pension on track. This will require considerably more member engagement than we have seen to date, and a level of understanding much higher than auto-enrolment will bring.

136. Moving to an outcome focus will look to bring greater engagement and higher levels of personal responsibility. If employees know and understand their target outcome, then they are in a position to monitor it and take corrective action. Moreover, if those corrections are made soon enough then small but frequent alterations should be enough to keep the ship on course.[11]

Question 73: What measures should the government take to make CDC attractive to: (a) potential sponsors, and (b) potential members?

137. The IFoA does not have a position on this question.

[11] IFoA Defined Ambition Working Party (2014) *Outcomes and Defined Ambition*

Question 74: How should transfer values be treated in CDC schemes, both in and out?

138. The IFoA does not have a position on this question.

Question 75: Is it possible for a CDC scheme to work within a charge cap of 0.75%?

139. The IFoA does not have a position on this question.

Question 76: With the remit in mind, please tell us if there is anything else you think we should be considering that is not covered in the sections and questions above.

140. The IFoA has not provided comment on many of the questions relating to CDC schemes where it might be anticipated that actuaries' expertise can add value. The IFoA is maintaining a 'watching brief' over developments around CDC, and should it become clearer this will be a part of the UK pensions framework we would welcome the opportunity to obtain evidence and provide input.

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 / 07771814329).

Yours sincerely

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