Institute and Faculty of Actuaries

Pension freedoms inquiry

IFoA response to Work and Pensions Committee

23 October 2017

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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

Rt Hon Frank Field MP
Work and Pensions Committee
House of Commons
London
SW1A 0AA

23 October 2017

Dear Mr Field

IFoA response to Work and Pensions Select Committee's Pension freedoms inquiry

1. The Institute and Faculty of Actuaries (IFoA) strongly supports the Committee in opening this inquiry. The pension freedoms have placed a significant amount of responsibility on individuals in managing their income in retirement. If poor decisions are made the repercussions could be significant and wide reaching, leaving pensioners without sufficient income to meet their basic needs in the latest stages of their lives. Ensuring that consumer protections are in place and establishing mechanisms for pooling of risk within this new environment will be key to the success of these reforms.

2. Our members with expertise in both defined contribution (DC) and defined benefit (DB) pensions have contributed to this submission.

What are people doing with their pension pots and are those decisions consistent with their objectives? Is there adequate monitoring of the decisions being made?

3. There are many objectives that individuals might have in managing their pension income, ranging from meeting their basic needs, to enjoying their retirement and leaving a bequest. It is clear that the freedom and choice agenda allows individuals to meet a variety of needs.

4. However, we consider that a primary objective of the pensions framework should be to ensure people, as a minimum, are able to meet a minimum income standard for the duration of their retirement. To achieve this, individuals will need to grapple with two complex financial considerations – how much is a sustainable amount to withdraw and how long will they need their pension to last. Further, decisions are not made at a single point of retirement any more – in many cases, individuals will have continuing responsibility for deciding how to access their funds well into their retirement. We believe that without further reform the freedom and choice agenda does not support individuals to achieve this objective, or to make these complex financial decisions.

5. The FCA's Retirement Outcomes Review Interim Report published in July 2017 showed a number of potentially worrying trends:

- A high prevalence of early access (before age 65)
- A transition from annuities to drawdown
- Decisions being made without shopping around or seeking advice
- Limited product innovation[1]

6. This report found that in almost two-thirds (64%) of cases the pots being accessed were under £30,000 and that these consumers had other sources of income. However we are concerned that these trends may be exacerbated by the increasing number of DB to DC transfers (i.e. they may not have other sources of income in the future that will provide a lifetime income). The volume of DB to DC transfers in January 2017 was 10 times the average amount of transfers in the twelve months before the reforms were announced (May 2013 to April 2014). Perhaps of even greater concern is that the value of those transfers was 18 times that of the average value of DB to DC transfers in 2013 / 2014.[2]

7. The IFoA has undertaken two surveys to gain a better understanding of individuals' decision-making and preparations for retirement since the introduction of these reforms. Though we are aware that individuals behaviours may not match their responses we hope that they provide some insight into the people's attitudes and current level of understanding.
   a. Freedom and choice: Public attitudes one year on

      The first survey was conducted one year on from the implementation of the reforms.[3] It found that whilst there was a high level of confidence in making decisions, only one fifth of respondents felt their pension income would be enough for them to live on for the rest of their life. It also found that those aged 55 to 64 were most likely to be positive about the reforms, yet they were less likely than older age groups to feel confident making decisions regarding their pension.

      When considered in the context of the FCA's findings that 72% of pots accessed since the freedoms were by consumers under 65, it seems the pension freedoms may be being used by people who do not fully understand the implications of their actions. Poor decisions made in the run up to retirement could have significant consequences on an individual's income in retirement. For example, if individuals are starting to spend their pension savings 10 years sooner, it means that those savings need to last even longer – further exacerbating the impact of increasing life expectancies.

      Additionally, they will be losing out on tax-efficient investment growth during this period, unless it has been reinvested – the FCA's Review found that only a fifth of those accessing their pots were transferring the money to alternative investments. In some cases, individuals may end up paying more tax than they

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[1] Financial Conduct Authority (2017) *Retirement Outcomes Review Interim Report, July 2017* [Available online: https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf]
[2] Willis Towers Watson (2017) *DB member choice survey 2017: the rise of pension flexibility*
[3] IFoA (2016) *Freedom and choice: Public attitudes one year on, survey report* [Available online: https://www.actuaries.org.uk/documents/freedom-and-choice-public-attitudes-1-year-survey-report]

need to or are expecting to. Social status and gender were also influencing factors on awareness and confidence, suggesting a higher impact on more vulnerable groups.

b. Retirement Readiness: A Comparative Analysis of Australia, the United Kingdom and the United States

   The second survey was conducted in the UK, US and Australia to compare preparations for retirement between these three countries.[4] Whilst all three countries reveal limited readiness for retirement the UK shows the lowest levels of preparedness compared to the US or Australia. We found the UK respondents to be least well-informed, least likely to be saving sufficiently and least likely to have contingency plans in place to protect them should their circumstances change. Returning to our proposed primary objective for the pensions framework when we asked respondents what they would do if they ran out of money a fifth said they did not know, whilst a third said they would go back to work and just under half said they would reduce their spending. Returning to work may or may not be a realistic option depending on age and health at the time of the drop in value. Additionally a reduction in spending would have a negative impact on their quality of life.

8. These surveys point to be people not being clear about their objectives. Therefore, we suggest monitoring of behavioural trends is needed across all of the working age population and not just monitoring of the decisions being made by those currently accessing the freedoms. Otherwise, any policy responses may be too late. In the next stage of the inquiry, we encourage the Committee to look at both how decisions are being made and the working age population's priorities which are driving retirement income objectives.

9. Therefore in response to the inquiries question 'is there adequate monitoring of decisions being made', whilst the FCA's Review and industry monitoring of consumers' decisions are comprehensive, they do not go far enough. We need to monitor behavioural trends and the priorities of those approaching retirement to assess whether under the current policy framework consumers are likely to make decisions which help them to meet their objectives. If they are not, this will enable legislators and regulators to make changes to the policy framework before it is too late.

Are people taking proportionate advice and guidance and if not, why not? Are people adjusting behaviour in response to advice and guidance?

10. In our 2016 survey, we wanted to understand whether people understood the difference between guidance and advice, and therefore which may be appropriate and proportionate in their circumstances. We found that whilst there are clear regulatory distinctions between guidance and advice, it is evident that the

[4] IFoA (2017*) Retirement Readiness – A Comparative Analysis of Australia, the United Kingdom and the United States* [Available online: https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/ageing-population/retirement-readiness]

respondents are confused about the distinctions with 45% admitting that they do not understand or are not sure of the difference.

11. Because of this misunderstanding in the retirement readiness survey mentioned previously we wanted to better understand what information sources people are using. Worryingly, we found that a third of respondents in the 55+ age category had not sought any information. Of those who had made some effort to plan for their retirement, free sources of information were more popular than paid for financial advice. We surveyed respondents' use of three different sources of free information - the internet or other online sources, information provided by their employer and information from their pension provider. Approximately a quarter of respondents said that they had used each of these free sources, whereas just 6% of respondents had paid for financial advice. Further, paying for advice is likely to be a lower priority for the less well-off, who with fewer sources of income may be harder hit by an unfortunate decision.

12. Whilst it is understandable that many individuals may not want to pay for advice, it is less clear why the take up of the free guidance is so low. Especially where customer satisfaction with the government's free 30-minute guidance session is consistently high (94%). This includes satisfaction that their options were clearly set out to them and crucially that they were able to make an informed choice about their next steps. 93% of those who had taken the free session felt informed of their pension options compared to 56% of non-users. There is also evidence that this leads to positive behaviours with 72% of those who had taken their session going on to calculate the income they need in retirement, whereas only 29% of non-users reported doing this.

13. If a key barrier to taking the free guidance session can be identified then action could be taken to influence it as evidence suggests the guidance session is having a positive impact on customer understanding and behaviours. Otherwise, auto-enrolling individuals into the free guidance session, which must be taken before funds can be accessed, could be a relatively simple way of increasing take-up.

14. Another issue we would like to flag is the prevalence of 'insistent customers' who are taking decisions that go against their financial advice. The FCA's 2016 study of firms providing financial advice found that about half give retirement income advice to insistent clients and 29% would be prepared to transact against insistent customers.[5] This gives particular rise to concern when considered against the rising volume and size of DB to DC transfers taking place.

[5] Financial Conduct Authority (2016) *FCA survey of firms providing financial advice* [Available online: https://www.fca.org.uk/publication/research/financial-advice-firms-survey.pdf]

To what extent will pensions dashboards enable consumers to make more informed decisions about their retirement savings? What are the remaining obstacles to their creation and success and how should those obstacles be overcome?

15. The Pensions Dashboard will likely be a useful tool, but without infrastructure that helps individuals to firstly understand the information being presented and secondly to understand what this means for their retirement planning it is unlikely to have any significant impact (other than perhaps assisting with finding benefits from previous employers).

16. The infrastructure that sits around the dashboard technology will be hugely important to how successful the project can be in practice. Consumers need some way to make practical sense of the data the dashboard can display to them, and ways of understanding what the information means for their retirement. Providing personalised data which give individuals a real idea of the monetary amount in their pot is a first step towards achieving this. But the dashboard technology could also provide a wealth of opportunities to help people actively engage with their pensions by prompting them to consider what the numbers they see on the screen mean in practice, and to take steps to address any potential problems or maximise good outcomes. If the basic dashboard is accompanied by a range of interactive tools, linked to people's real-world circumstances, this would maximise its potential effectiveness.

17. It is possible we could see two models developing – a minimal version, perhaps distributed freely by providers, showing pension entitlements and perhaps projections under statutory assumptions; and an enhanced version more akin to robo-advice. However, we believe the latter is more likely to be run on a commercial basis – individuals may get what they pay for. It is also possible that scammers could use a third party dashboard both to tempt consumers by appearing legitimate, and to gain access to their data. However, some of the largest obstacles are likely to be cyber-security and data-protection as is the case with holding of data. If scams or a data breach happen this could have a significant reputational risk for the Government and the pensions industry.

Are there persistent gaps in the advice and guidance market and what might fill them? Is automated advice and guidance filling gaps as expected?

18. There is a persistent gap in that it is impossible to determine an individual's lifespan and therefore to manage longevity risk on an individual basis. The average life expectancy means that roughly half of people will die before this age and half will live longer. If individuals use this to work out how much they can withdraw from their pension half of people run the risk of running out of money in retirement. This risk is amplified by the possibility of needing to pay for unexpected long-term care.

19. Even with advice and guidance individuals will not be able to predict their lifespan and therefore advice and guidance should focus on the role of guarantees that can be bought from providers who pool this risk, and the security needed to meet e.g. housing costs.

Is there evidence of product market competition resulting in cheaper, clearer or a wider products for consumers? Are people switching from their pension provider in accessing their pots? Is an adequate annuity market being sustained?

20. The annuity market has shrunk owing to the decrease in demand since the introduction of the freedoms. The FCA's Review reveals there are only seven providers still offering annuities on the open market. Whilst the decrease in the number of providers could result in a lack of competition, we believe the larger problem facing competition is that the freedoms have done nothing to overcome the behavioural biases that stop people from shopping around. As was and remains the case with annuities, consumers are not shopping around for drawdown products either. Most consumers are accepting the drawdown option offered by their pension provider with the vast majority of drawdown sales being made to existing consumers. We would suggest therefore that the aim of encouraging shopping around has not been achieved by these reforms.

21. We hope that as a greater volume of consumers, with sizeable DC pots, are approaching retirement that the market will develop hybrid solutions, combining an element of annuitisation with the flexibility of drawdown offers. If this does not happen then we would suggest that an adequate annuity market has not been sustained, but it is too early to make that assertion. The IFoA will be publishing analysis in the coming months on potential pathways. For example, at what point does it seem most advantageous to introduce an element of guarantee, either through partial or full annuitisation, and what level of drawdown could be sustainable until this time? We would hope these findings will be useful both to those providing information to consumers, but also to those providers that are considering the development of hybrid-default solutions akin to NEST's blueprint. We would be delighted to share the findings of this analysis with the committee before publication.

22. We would also welcome the investigation of whether a proportionate framework for risk-sharing schemes, such as collective defined contribution, would enable providers to offer alternative means for individuals to obtain partial security in retirement through mutual pooling of risk.

Are the freedom and choice reforms part of a coherent retirement saving strategy? To what extent is it complementary to or undermined by other policies?

23. The freedoms can be part of a coherent retirement strategy. Both the US and Australia, who fared better in our international survey, have flexibility around pension income. However, there remains a real risk that the UK's freedom and choice reforms do indeed undermine retirement saving by making it easier for funds to be used for shorter-term financial needs that people may have. To ensure people, as a minimum, are able to meet their basic needs for the duration of their retirement the following are necessary:
    a. an adequate and sustainable State Pension that gives individuals long-term certainty about their basic level of income from the State;
    b. a review of Automatic Enrolment that considers changes to the minimum contribution levels from the outset, or a mode of auto-escalation which

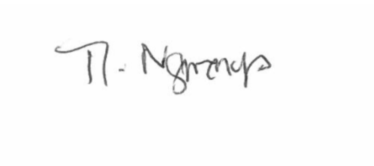
increases the minimum contribution level dependent on a trigger being reached (i.e. by age or increase in salary);

c. the development of appropriate defaults - that offer the flexibilities that have proven popular with the public with an element of guarantee - for the large proportion of individuals who are unlikely to ever engage with their pension, or for those who become unable to do so in future; and
d. a collective communication strategy led by Government, but with support from regulators, guidance providers and pension providers to raise the profile of longevity risk and the very real risk to individuals posed by running out of money in later life.

24. On this last point, we believe this communication strategy will need to segment the population and target information accordingly so that it resonates with consumers. In particular, we believe that those individuals with a middle income will benefit from a better understanding of longevity risk and the value of having an element of guarantee to mitigate this risk (those with low incomes will rely on the State Pension and those with high wealth will likely have comprehensive financial plans in place). Communications should aim to build financial capability over time as these individuals transition from inert auto-enrollers to decision-makers.

Should you wish to discuss our response any further please contact Rebecca Deegan, Policy Manager on rebecca.deegan@actuaries.org.uk.

Yours sincerely,



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