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Independent Яeview of Retirement Income

Report

We Need a National Narrative: Building a Consensus around Retirement Income

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Pensions Institute: pensions-institute.org

March 2016

Chapter 2: How to ensure that savers can get the best products in retirement

In the past, most members of DC pension schemes were required to buy a lifetime annuity at some point during their retirement. The Budget on 19 March 2014 has changed that requirement, as well as opened up the possibility that new types of retirement products will become available. Not all of these will be appropriate, especially if they can lead to people spending all their pension savings before they die. We will examine the new products to see which are most suitable, given the new pension flexibilities. We then consider the most effective way in which scheme members can access the best of these products. In particular, we will look at how 'longevity insurance' (e.g., in the form of an immediate or a deferred lifetime annuity) can be combined with 'scheme drawdown' to provide a cost-effective institutionally delivered retirement income solution that allows for flexibility in spending during retirement, while ensuring that savers do not run out of money before they die. We end by looking at the best way of helping people deal with stranded pots.

2. How to ensure that savers can get the best products in retirement

> *'I suppose I ought to eat or drink something or other; but the great question is, what?' The great question certainly was, what? Alice looked all round her at the flowers and the blades of grass, but she did not see anything that looked like the right thing to eat or drink under the circumstances.*
>
> Lewis Carroll (1865), *Alice's Adventures in Wonderland*

In the past, most members of DC pension schemes were required to buy a lifetime annuity at some point during their retirement. The Budget on 19 March 2014 has changed that requirement, as well as opened up the possibility that new types of retirement products will become available. Not all of these will be appropriate, especially if they can lead to people spending all their pension savings before they die. We will examine the new products to see which are most suitable, given the new pension flexibilities. We then consider the most effective way in which scheme members can access the best of these products. In particular, we will look at how 'longevity insurance' (e.g., in the form of an immediate or a deferred lifetime annuity) can be combined with 'scheme drawdown' to provide a cost-effective institutionally delivered retirement income solution that allows for flexibility in spending during retirement, while ensuring that savers do not run out of money before they die. We end by looking at the best way of helping people deal with stranded pots.

2.1 Introduction

Until recently, the *only* purpose of a pension scheme was to provide lifetime income security. Members of defined benefits (DB) schemes received a pension for life and members of defined contribution (DC) schemes had to buy a lifetime annuity and the annuity provider purchased low-risk bonds to back the annuity payments. The annuity, in effect, died when the member died and the annuity could not be bequested (unless a joint life annuity was purchased for a surviving partner).

However, a combination of falling bond yields and increasing life expectancy resulted in a substantial reduction in annuity rates, making annuities more expensive.[62] This was one of the factors that led to the introduction of income drawdown in DC schemes in 1995 as an alternative to an annuity. The pension scheme retained an investment in growth assets during the decumulation phase and this helped to generate an average return in excess of the return on bonds, although with the risk that the value of the assets in the pension pot could fall in times of financial market turbulence.[63]

[62] This does not necessarily make them poorer value.

[63] It would be interesting to know, given the degree of global stock market turbulence since 2000, how many of those using drawdown have actually enjoyed a higher standard of living than they would have done had they instead bought an annuity.

When income drawdown was first introduced, it was a recommended strategy only for pot sizes above £250,000 and there was still a requirement to annuitise the remaining pot by age 75. Compulsory annuitisation ended on 6 April 2011. From that date, retirees with a minimum income requirement (MIR) of at least £20,000 from all state and DB pensions could make use of 'flexible drawdown' and access any DC pension pot without any restrictions. Anyone failing to meet the MIR was required to use 'capped drawdown' which restricted the annual amount that could be withdrawn to some multiple of the GAD rate, which was the amount from a single life level annuity as specified by the Government Actuary's Department. The multiple, which is set and changed by the Government, has varied between 100% and 150% of the GAD rate. As a result of these changes, drawdown providers lowered the minimum pot size they would accept to £75,000 – £100,000 depending on the provider. However, the median pot size at retirement is currently around £17,000, the average pot size is £28,000 and only 10% of the 350,000-400,000 people who retire each year have pot sizes of £75,000 or more.[64]

The 2014 Budget introduced a new regime of 'freedom and choice' for all DC scheme members from age 55[65] (whether retired or not).[66] The most significant of these was that no one was required to annuitise at all.[67] However, only a small number of people currently have a sufficiently large pot size to take full advantage of the new regime without risking running out of money before they die. With the success of auto-enrolment, pot sizes will, on average, be larger in future. Although pension contributions and pension adequacy are not formally part of our remit, it is worth restating the obvious point that in order to get a decent-sized pension pot for retirement, it is necessary to make adequate pension contributions (something of the order of 15% of pensionable salary,[68] shared between the

[64] ABI annuity sales statistics.
[65] To rise to 57 in 2028.
[66] The enabling legislation for the Budget proposals was the Pension Schemes Act 2015, while the consequential changes to pension tax legislation were set out in the Taxation of Pensions Act 2014.
[67] The risks associated with ending annuitisation were discussed in:

- David Blake, Edmund Cannon, and Ian Tonks (2010) *Ending Compulsory annuitisation: What are the Consequences?*, Pensions Institute; www.pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences.pdf;
- David Blake, Edmund Cannon, and Ian Tonks (2010) *Ending Compulsory Annuitisation: Quantifying the Consequences,* Pensions Institute; www.pensions-institute.org/reports/EndingCompulsoryAnnuitisationConsequences2.pdf;
- David Blake (2014) *The Consequences of Not Having to Buy an Annuity*, Pensions Institute; www.pensions-institute.org/workingpapers/wp1409.pdf

[68] Lord John Hutton, former Work and Pensions Secretary, is the latest in a long line of people who have recommended that the UK adopts a national retirement savings target of 15% to avoid future pensioner poverty (reported in Ollie Smith (2015) Labour peer calls for 15% UK retirement savings target, New Model Adviser, 10 March). If people think that a 15% contribution rate is a lot, they should consider what happens in other countries. In Holland, for example, the contribution rate is around 20%. As the Dutch say, 'we work Fridays for our pension'. In Sweden and Singapore, the contribution rate is even higher.

employer and scheme member) into a pension scheme which are then invested over many years.

From 6 April 2015 (or Flexiday), individuals above the age of 55 will have to decide the retirement financial strategy for their DC pot. This comprises:

- The investment strategy – the strategy for investing the pension pot
- The withdrawal strategy – the strategy for withdrawing cash from the pension pot to finance expenditures
- The longevity insurance strategy – the strategy for determining when longevity insurance is purchased and when it comes into effect.[69]

There are three broad classes of product for delivering the retirement financial strategy: annuities, drawdown and hybrids (which combine drawdown and annuities). These products have different advantages and disadvantages in terms of withdrawal flexibility and investment risk and we discuss these at length in this Chapter.

There are five legal forms[70] for drawing funds from a DC pension scheme from 6 April 2015, as laid out in the Taxation of Pensions Act 2014 (all of which are subject to income tax at the highest marginal rate while the member is alive, although 25% of the pension fund can be taken as a tax free lump sum, known as a 'pension commencement lump sum'):[71]

- Lifetime annuities (LTAs). LTAs provide an income for however long the scheme member lives. Payments on LTAs can be guaranteed for a set period even if the member dies during that period. There are no death benefits with standard annuities unless they are joint life annuities or have a guarantee term. However, it is possible to buy a capital-protected LTA.
- Capped drawdown. This option is not available for new schemes after 6 April 2015, but can continue if it was already in place on 5 April 2015. The member takes an income from the fund, but the income is capped at 150% of the equivalent annuity rate set by the Government Actuary's Department, known as the GAD rate. The cap will be reviewed every three years prior to age 75 and annually thereafter. The member can take up to 25% of the fund as a tax-free benefit. Whatever tax-free lump sum is taken, three times that amount will be treated as 'crystallised' for tax

[69] A scheme without a longevity insurance strategy is NOT a pension scheme.
[70] There is technically a sixth product called 'money purchase scheme pension', but since it is currently not possible to move from a scheme pension to drawdown, it is likely that the popularity of this product will decline.
[71] For more information about these choices, see: Institute of Chartered Accountants in England & Wales (2015) *Freedom and Choice in Pensions: A Guide to the Pension Reforms*; Aon (2015) *Reward: In-depth Guide to Retirement and Pension Changes;* Staffcare and LCP (2015) *Your Essential Guide to Implementing Flexible Benefits*; Retirement Intelligence (2014) *The Retirement Advice Survival Guide* (www.mgmadviser.com/retirement-advice-survival-guide).

purposes on the death of the member, with the remainder of the fund being 'uncrystallised'.[72] If members only take the tax-free lump sum, they can continue to make contributions to a scheme under capped drawdown up to the £40,000 money purchase annual allowance (MPAA) with tax relief available on contributions up to age 75. If they draw down more than the lump sum, the MPAA reduces to £10,000.

- Flexible drawdown. There are no restrictions on what can be withdrawn from the fund. Prior to the Budget, flexible drawdown was only available to members who had a guaranteed income (known as the minimum income requirement (MIR)) of £20,000 from other sources, such as the state pension or a DB pension. Members choosing this option will have their pension fund transferred into a 'flexi-access drawdown (FAD) fund'.[73] The trigger event for a reduction in MPAA is the same as with capped drawdown.
- Uncrystallised fund pension lump sum (UFPLS).[74] The fund is drawn down in a series of payments when the member needs cash. The first 25% of each payment is tax free and the rest is taxed as income.[75] What is left in the fund is 'uncrystallised' on death. Members using this option have their MPAA for making additional contributions reduced to £10,000 and there will be no option to carry forward any unused annual allowance.
- Trivial commutation. Members with up to three pension pots each of £10,000 or less from three different providers can take them as a lump sum rather than transfer to a drawdown policy. This means that up to £30,000 can be taken as a lump sum (which is now the trivial commutation limit). The first 25% is tax free and the rest taxed as income. Any residual balance on death will not be taxed, but will instead will be included in the member's estate for inheritance tax purposes.[76]

The tax treatment of death benefits with capped drawdown, flexible drawdown and UFPLS is shown in Table 2.1, following the 2014 Taxation of Pensions Act. The Taxation of Pensions Act 2014 does not apply to DB schemes.

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[72] See below. Essentially this means that this segment of the pension fund has not been accessed by the member for inheritance tax purposes.

[73] Beneficiaries' FADs are separated into dependants' FADs, nominees' FADs and successors' FADs. Nominees are those who are not dependants on the first death, while successors comprise all beneficiaries on the second death. The successor is named not by the member, but by the nominee, unless the member nominates a trust on the first death with trustees who will reflect the member's wishes.

[74] Note this is not the same as the pension commencement lump sum which is tax free.

[75] This option is only available from uncrystallised funds. It is not available in drawdown. It can therefore be offered by schemes which do not offer flexi-access drawdown.

[76] 'Inheritance tax (IHT) rules on when a pension fund will be counted in the deceased's estate have not changed. Generally, where the scheme member can bind the trustees to pay to a specified beneficiary who is not a dependant, it will be treated as part of the deceased's estate for IHT. But where the trustees can exercise discretion, the funds will generally be outside IHT assessment. Most schemes operate on an expression of wish basis (sometimes called a 'nomination of beneficiary'), with the scheme administrator making the final decision' (Source: Institute of Chartered Accountants in England & Wales (2015, p.4) *Freedom and Choice in Pensions: A Guide to the Pension Reforms*).

Table 2.1: Tax treatment of death benefits with capped drawdown, flexible drawdown and UFPLS					
Age at death	Paid from benefits which are:	Benefit type	Relevant time	Tax	Subject to Life Time Allowance test?
< 75 years	Crystallised	Income	< 2 years	Tax Free	No
< 75 years	Crystallised	Income	> 2 years	Tax Free	No
< 75 years	Uncrystallised	Lump Sum	< 2 years	Tax Free	Yes
< 75 years	Uncrystallised	Lump Sum	> 2 years	45%	No
< 75 years	Uncrystallised	Income	< 2 years	Tax Free	Yes
< 75 years	Uncrystallised	Income	> 2 years	Marginal	No
< 75 years	Crystallised	Lump Sum	< 2 years	Tax Free	No
< 75 years	Crystallised	Lump Sum	> 2 years	Tax Free	No
≥75 years	Crystallised/Uncrystallised	Income	N/A	Marginal	No
≥75 years	Crystallised/Uncrystallised	Lump Sum	N/A	45%	No
Source: Institute of Chartered Accountants in England & Wales (2015, p.5) *Freedom and Choice in Pensions: A Guide to the Pension Reforms*					

The Pension Schemes Act 2015 allows scheme members to transfer all their DC benefits and leave their DB benefits in the scheme.[77] It seems unlikely that the trustees of a DB scheme will allow their members to exercise the new flexibilities within the scheme itself and instead will require members to transfer the value of their benefits to a DC arrangement.[78] This could be a transfer either to the sponsor's own DC scheme if it has one or to an external provider. In addition, the changes to the tax treatment of death benefits do not currently apply to DB schemes. A dependant's pension in a DB scheme is taxed at the dependant's

[77] Previously, all benefits had to be transferred.

[78] Reported in Natasha Browne (2015) Schemes likely to rebuff plans to extend freedoms directly to DB, Professional Pensions, 22 January. Simon Taylor, partner at Barnett Waddingham, said: 'From the schemes I've spoken to, there's not a lot of interest in administering these freedoms within their DB scheme. I think it falls into the 'too difficult' box. You have all sorts of admin and actuarial issues about how to calculate the benefit that's left behind. What do you do about advice and guidance?'.

marginal rate of tax irrespective of the age at which the member died. Further, death benefits can only be paid to a narrow group of dependants in DB schemes, whereas death benefits can be paid to any named beneficiary in a DC scheme.[79]

Of equal importance to the pension product itself is the delivery or distribution vehicle, the arrangement through which the scheme member receives the pension product. Traditionally, the distinction was between institutional and retail distribution arrangements, but a new hybrid institutional-retail distribution arrangement is being considered. Currently, most DC scheme members have to go to the retail market to buy a pension product, even if they have been a member of their employer's pension scheme during the accumulation stage.[80] But the retail retirement income market has a reputation for poor design and high charges.

Although, the 2014 Budget will revolutionise the retirement income market, this will only be of any benefit to customers if the new market is both effective and efficient in terms of both product design and delivery channels. It also needs to meet the customer's needs as well as recognise that retirement will no longer be a single point in time event in future, but instead will for many people be a process that takes place gradually over time.

A good product for delivering retirement income needs to offer at the very minimum:[81]

- Accessibility – the degree of flexibility to withdraw funds on an ad hoc basis
- Inflation protection either directly or via investment performance, with minimal involvement by individuals who do not want to manage the investment risk[82]
- Longevity insurance.

No single product meets all these requirements, but a combination of drawdown and a deferred (inflation-linked) annuity does, for example. So a well-designed retirement income plan will have to involve a combination of products. Mark Fawcett, chief investment officer of NEST, agrees with this. He argues that 'for many members, flexibility in the early stages of retirement is key, as they will simply not know what their income needs will be….[However], as retirees get older, they need less flexibility and longevity risk becomes the most important risk. The most appropriate solution is therefore a hybrid product that blends

79 Punter Southall (2015) *Flexiday Briefing Note Issue 10*, February.

80 This is unlike a defined benefit scheme in which the member receives a pension directly from the scheme. The exception would be members of group personal pension schemes.

81 This was suggested at a meeting with Ewan McCulloch and Stuart Patton Evans of Scottish Widows on 12 May 2015. Other criteria for a good pension scheme are listed in Table 1.1.

82 This is confirmed by surveys discussed in the next Chapter.

drawdown in the early years and longevity insurance, with opt out options, in the later years'.[83]

Taking all these issues into account implies that the appropriate arrangement for providing income in the period between retirement (or more strictly the age at which the pension is first drawn) and the age at which the longevity insurance comes into effect:

- Benefits from institutional design, governance, and pricing
- Is simple to understand, transparent and low-cost
- Requires minimal consumer engagement
- Benefits from a low-cost delivery system.

If any product satisfies these conditions as part of a hybrid solution in a good pension scheme (as specified in Table 1.1), it might be considered to be a 'safe harbour' product. The term comes from the US Pension Protection Act 2006 which introduced auto-enrolment in the US and created a demand for safe harbour Qualifying Default Investment Alternatives, such as target-date funds, for 401(k) savings plans. Any adviser in the US recommending such a product cannot subsequently be sued for poor advice. So far the Financial Conduct Authority (FCA) has refused to grant safe harbour status to any UK investments.

We now turn to an examination of the following issues:

- The products on offer for investing the accumulated pension pot and for providing an income in retirement
- Current and planned delivery systems for these products
- The withdrawal strategy
- The longevity insurance strategy
- Charges, charge disclosure and proposals to cap charges
- Product and provider regulation
- How to deal with stranded pots

2.2 The products on offer for investing the accumulated pension pot and for providing an income in retirement

We discuss the three main ways of providing an income in retirement: annuities, drawdown and hybrid products.

[83] Quoted in Amanda White (2015), Best practice de-cumulatisation - a hybrid approach, Top1000funds, 14 May.

2.2.1 Annuities[84]

2.2.1.1 Lifetime annuities (LTAs)

Lifetime annuities (LTAs) provide a guaranteed income for life for the scheme member (single life annuity) or for the scheme member and their partner (joint life annuity). There are two variations: level (the income is fixed for the whole period) and index-linked (the income increases with inflation). For the same premium, index-linked annuities pay a lower starting value than a level annuity: around 50% lower at age 55, 44% lower at age 65 and 26% lower at age 75.[85] The Financial Services Compensation Scheme (FSCS) covers 100% of the value of an annuity in the event that the insurance company providing the annuity defaults.

LTAs have two main advantages, as Tom McPhail, head of pensions policy at Hargreaves Lansdown, points out: 'they provide a guarantee of income for the rest of an investor's life, however long that may be; they also allow investors to benefit from the "mortality cross-subsidy",[86] by sharing out some of the value of the pensions of those who die young, they increase the payments to those who live longer. This is an extremely efficient system'.[87]

LTAs also have a number of disadvantages. First, there is no flexibility to change the payments. Second, there is no residual fund with a single life annuity on the death of the annuitant, so it is not possible to bequest the annuity when the annuitant dies.[88] Third, the investment return on LTAs is related to the return on bonds. This is because annuity providers, which must be established as life assurance companies, invest the proceeds from selling the annuity (i.e., the premium) in low-risk, low-return bonds and make the annuity payments from these.[89] Further, due to the nature of the guarantees involved in providing LTAs, the life companies selling annuities face stringent capital requirements, the cost of which is inevitably borne by the annuitants. Nevertheless, the return on a LTA does increase the longer the annuity purchase is delayed, on account of the mortality premium being higher at higher ages.[90] Finally, LTAs will become more expensive in the new pensions

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[84] For more details, see Billy Burrows (2015) *The Case for Annuities*, Retirement Intelligence. Prior to the 2014 Budget changes, 90% of annuities sold were level, 5% index-linked (or inflation-linked) and 5% investment-linked (ABI sales data 2014).

[85] Cazalet Consulting (2014, p. 69) *When I'm Sixty-Four*, September.

[86] The 'mortality cross-subsidy' – also called 'mortality premium', 'mortality drag', or 'mortality credit' – arises because LTAs are a longevity risk pooling mechanism, whereby those dying earlier than their life expectancy cross-subsidise those who live longer.

[87] Reported in Corporate Adviser, 29 September 2014.

[88] This is not a design fault. It is a deliberate feature of the longevity risk pooling aspects of an annuity which, unfortunately, is not well understood by consumers.

[89] The provision of annuities is not primarily an investment risk management business, rather it is a longevity risk management business.

[90] The greater the age at which the pool starts, the greater the percentage of the pool that will die every year, and hence the larger the mortality premium that goes to surviving annuitants.

environment. This is, in part, because fewer annuities will be sold in future and, as a result, scale economies and the effectiveness of risk pooling will be reduced. It will also be because of the impact of 'selection' effects: those buying LTAs in a voluntary market are likely to have higher life expectancies than those buying in a mandatory or compulsory purchase market and this will be reflected in their price.

It is also important to bear in mind the following point about adviser fees. The FCA's Retail Distribution Review (RDR) banned advisers from receiving commission from product providers and providing 'free' advice to customers in exchange. Instead, from 1 January 2013, clients must pay advisers a fee for advice. However, if annuities are sold directly to consumers via a comparison website or platform, the FCA does not stop providers paying commission (of between 1-3%) to the owners of the comparison website or platform.[91] So we have the anomaly that, on the one hand, customers using an adviser pay an advice fee but no commission, and, on the other hand, customers using a comparison website or platform indirectly pay commission but receive no advice, even though the commission might be equal to or higher than the fee might have been. Moreover, there is less consumer protection – via the FSCS – for customers who make the product choice, because, by so doing, they take responsibility for the decision.

The Market Study on annuities by the Financial Conduct Authority (2014), together with the Occasional Paper by Aquilina et al (2014), found that annuities generally provided good value for money relative to alternative withdrawal strategies if they were purchased on the open market by someone in good health for their age and an average-sized pension pot.[92] But the FCA found that the current annuity market did not serve well the following types of customer: captive (or internal or rollover) customers of an insurance company accumulation fund who did not shop around,[93] consumers in poor health who would have benefited from an enhanced annuity, and consumers with small pots. The failure of customers to shop around, despite being told about the open market option (OMO) – the right to buy an

[91] A platform is 'an online administration service, with a single point of contact to the investment market. It provides advisers and clients with a single view of the client's entire portfolio. A platform provides the technology for advisers to manage their client's investments more efficiently and more effectively' (Emma Ann Hughes (2012) What is a platform?, FT Adviser, 4 April). Platforms provide portfolio valuation statements and portfolio planning tools. They also need to safeguard clients' assets and disclose separate platform, adviser and fund manager fees. Platforms are typically provided by life insurance companies where they are also known as wrappers (e.g., Cofunds which was owned by Legal & General at the time of writing) and by fund supermarkets (e.g., Vantage is owned by Hargreaves Lansdown), although there are some independent platforms. See Chapter 3 for more details.

[92] Financial Conduct Authority (2014), *Retirement Income Market Study: Interim Report*, Market Study MS14/3.2, December (http://www.fca.org.uk/static/documents/market-studies/ms14-03-2.pdf); Matteo Aquilina, Robert Baker and Tommaso Majer (2014), *The Value for Money of Annuities and Other Retirement Income Strategies in the UK*, Financial Conduct Authority, Occasional Paper No. 5, December (http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-5.pdf)

[93] They were 'deterred from engaging with their options by the length and complexity of the "wake-up packs" sent out by providers' (p.6) in the period before they have to make their annuity decision.

annuity from a different insurer to the one which offered the pension savings scheme – is a serious problem. Figures from the Association of British Insurers (ABI) show that 60% of annuities sold in the first quarter of 2015 were bought from customers' existing insurers. In some cases, this will be because the annuities have valuable guarantees not available with other providers. But, in many cases, it will be because they are, according to Tom McPhail, 'disengaged from the whole shopping around process'.[94]

Even for annuities sold on the open market, annuity rates have fallen by 73% since 2000 as a result of falling interest rates and increasing longevity. A study by Moneyfacts found that, if a 65-year old man who paid £100 a month into a typical personal pension fund for 20 years and bought a level annuity in 2015, he would receive an annual income of £2,109, compared with £7,748 if he had bought it in 2000. Richard Egan, pensions editor at Moneyfacts, said: 'The days of 15 years ago have gone forever. The economic climate has worked massively against retirees. Dreams of a comfortable retirement could easily be shattered unless individuals can either make up the pension shortfall through greater contributions or accept that they may have to delay their retirement'.[95]

As a result of the high proportion of captive customers who did not get a competitive rate and negative press coverage, the value of annuities is now severely underappreciated. However, annuities are being given a makeover and we will consider some examples below. There are also attempts to rebrand them as a 'guaranteed income for life' product. In the process, their critical role in well-designed retirement income plans will need to be explained much better. Customers need to understand the difference between investment and insurance – only insurance (an annuity) can provide a perfect hedge against longevity risk.

LTAs sold on the open market (via the OMO) could be classified as safe harbour products.

2.2.1.2 Short- or fixed-term annuities (FTAs)

Short-term or fixed-term annuities are written under income drawdown rules and the product is classed as an investment within a drawdown plan, and, indeed, is sometimes referred to as 'guaranteed drawdown'. This means the FTA could be either a single arrangement whereby the whole of the DC pot is used to buy a FTA or part of a drawdown portfolio that also includes investment funds. Although classed as drawdown, the product can, and usually is sold on a non-advised basis. Typical commission is about 2% of the fund.

While products vary, the conventional FTA provides income payments for a set number of years, e.g., five. Traditionally, the annual income did not exceed the GAD maximum. The

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[94] Reported in Ruth Lythe (2015) Savers urged to shop around as two in three opting for an annuity take the first pension deal offered to them, Dail Mail, 1 July.

[95] Reported in Rosie Taylor and Louise Eccles (2015) 75% fall in annuity income in 15 years: Ageing population and rock bottom interest rates blamed for the fall on pension income, Daily Mail, 14 September.

premium might be invested in a short-term gilts fund, but some products link the income level to a fund or index performance. As with LTAs, most sales of FTAs are for a level single life, but the policy can be set up on a joint life basis and with a guaranteed income period or a value-protection option to provide death benefits.

At the end of the term, the insurer returns a percentage of the original premium as a maturity value, e.g., 80% after five years – the amount will depend on the number of years and the level of income chosen. The maturity value can be used to continue DC decumulation, for example, by purchasing another FTA, a LTA, or by using drawdown.

The advantages of the FTA, like income drawdown, include the deferment of the LTA purchase, while still receiving a regular income. A traditional use of the FTA was to provide a bridging pension for an individual who had a DC pot that matured at age 60 and a good DB pension that began at age 65. In this case, it made sense to take the maximum income permitted from the FTA. The 2014 Budget allowed all pension pots to be accessed from age 55 from April 2015.

The main attraction of a FTA as promoted by providers is that when the fixed term ends, annuity rates might have improved and/or the individual's health might have deteriorated, in which case he or she might qualify for a higher LTA rate than would have been the case previously. However, the opposite might also occur, so the individual needs to be aware of the risks associated with uncertain future annuity rates (interest rate risk) and the individual's future state of health (longevity risk). These are very significant risks which, from an individual's perspective, are not so much unknown as unknowable.

There is, therefore, a danger that this product confers a potentially misleading sense of psychological security. Although it keeps the capital secure for a short period, it is not 'safe' in terms of protecting future income sustainability, since it cannot guarantee the income that the maturity value will buy when it matures in, say, five years' time. This is a significant risk for low-income investors, especially if they are also conservative investors. Therefore, we would argue that fixed-term annuities might be more accurately described as short-term income drawdown. It will be important for the promotion of these products to avoid the use of the word 'guarantee', unless the precise nature of this 'guarantee' is explained clearly.

Moreover, the combination of income and return of fund can vary and we were told that some providers emphasise the higher income at the expense of maturity value. If the income taken at the outset is at the GAD maximum, the fund returned at the end of the term will be lower than if a lower income had been taken. If, at this time, interest rates are lower and less favourable mortality assumptions are being used to price new annuities, then the buyer of the FTA could end up with a lower income than if a LTA had been purchased from the start. We were informed that there needs to be a 10% increase in the prevailing annuity rate for the annuitant to break even, when compared with the purchase of a LTA from the outset. One adviser who ran a series of quotations for us showed that assuming no changes in health, the income that could be purchased after five years is likely to be significantly lower. Reinvestment risk is therefore the main concern with this product, as well as the additional charges which include the new fee for advice or the new commission where a replacement annuity is purchased via a non-advice service.

Legal & General has introduced two FTAs that it describes as 'flexible retirement income products' which people with a larger pension pot can combine with flexible drawdown to produce the best combination of retirement income solutions for their circumstances:

- A cash-out retirement plan, which offers a guaranteed level of income over an agreed time period and also allows for tax-efficient withdrawals to stop people exceeding their tax allowance
- The fixed-term retirement plan provides a guaranteed level of income over an agreed time period with a cash lump sum at maturity.

An example of a FTA provided by a fund manager rather than an insurer is the FTSE100 Retirement Deposit Plan 1 launched by Investec Structured Products in August 2015. The product offers guaranteed income payments plus a bonus payment at maturity which is dependent on the level of the FTSE100 index at the time. The product – available only via a self-invested personal pension (SIPP) – offers fixed annual payments of either 5.25% (Option 1) or 4% (Option 2) over its six-year term. Option 1 aims to return the full deposit amount provided the FTSE100 index is greater than 90% of its start level at maturity, while Option 2 requires the index to be greater than 75% of its start level at maturity, to return the full deposit. Gary Dale, head of intermediary sales at Investec Structured Products, said: 'In today's financial environment of low interest rates and low gilt yields, it is more and more important to be able to ensure that capital lasts longer and retains its power to provide long-term income throughout the period of retirement. This new [plan] will help clients maximise income from their retirement funds at a time when the need for more competitive retirement income is clearly a priority within the post-retirement market'.[96]

FTAs could NOT be classified as safe harbour products, since they do not hedge longevity risk.

[96] Reported in Professional Adviser (2015) Structured product for retirees launched, 19 August.

2.2.1.3 Annuities with more flexible payments and more flexible terms, including marketability

Annuities with more flexible payments

HM Treasury (2014, p 14-15)[97] announced that it was consulting on whether to allow annnuities to have more flexible payment terms that:

- Allow lifetime annuities to decrease, which will provide significantly more flexibility around the design of the product. This will allow providers to offer products which meet individuals' needs more closely, for example, by allowing annuity payments to reduce once an individual becomes eligible for the state pension
- Allow lump sums to be taken from lifetime annuities, on the condition that this is specified in the contract at the point of purchase. This will allow providers to structure much more flexible products that are capable of meeting specific circumstances, such as care needs
- Allow payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000. This will allow beneficiaries to receive pension payments as a lump sum if they wish, rather than having to spread these out over several years.

Another proposal is to have 'lifestyle annuities' which provide an income that depends on which stage of retirement – early, mid or late – the annuitant is in. Specific examples of these are U-shaped and J-shaped annuities.[98] A U-shaped annuity has payments that are initially high, then fall and later rise again. This is designed to match expenditure needs in the three periods of retirement: active retirement, inactive retirement and the final period of life when care costs start to impact. A J-shaped annuity is a U-shaped annuity which allows for the possibility that expenditure during the final phase of retirement might be higher than during the initial active phase.

Annuities with more flexible payments could be classified as safe harbour products.

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[97] HM Treasury (2014) *Freedom and Choice in Pensions: Government Response to the Consultation*, Cm 8901, July 2014; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332714/pensions_response_online.pdf

[98] Suggested by Dr Ros Altmann (2014) Pensions revolution: how a 'J-shaped annuity' could revolutionise your retirement, Daily Telegraph, 21 July; http://www.telegraph.co.uk/finance/personalfinance/pensions/10979903/Pensions-revolution-how-a-J-shaped-annuity-could-revolutionise-your-retirement.html

Annuities with more flexible terms

A number of suggestions have been put forward to allow annuities to have more flexible terms. These include a cooling-off period after purchase and the ability to change the type of annuity, to switch provider and to sell the annuity.

The former Pensions Minister, Steve Webb MP, had a pre-2014 Budget proposal to introduce a 12-month cooling-off period after the LTA purchase. The Government was aware of the intense pressure DC customers are under when they make their LTA purchase. The idea is that the cooling-off period would give retirees the chance to review and change what might have been a poorly informed decision. It would have the additional benefit of putting insurance companies and distributors on notice, since they would suffer if there were a mass exodus of customers in the first 12-months due to poor pricing and/or sales processes. Moreover, data on redemptions and repurchases would be very valuable for the industry and the regulators, as it would be possible to identify insurance companies that sell inappropriate products at uncompetitive rates and distributors that operate poor sales practices.

Nevertheless, there are cost implications. Insurance companies would have to hold the premium in low-interest liquid assets for a year in case annuitants asked for their money back at the end of the cooling off period. Further, the annuity would have to be re-priced at the end of the year to reflect prevailing interest rates and any revised mortality assumptions. If insurance companies were required to honour the quote made a year earlier, then this would have to be sufficiently low to account for the risks that the insurance companies are carrying in the intervening period.

Following the 2014 Budget reforms, this proposal should no longer be necessary at the point of retirement, particularly if scheme drawdown becomes the norm, since this would provide a breathing space pre- rather than post-LTA purchase. This would avoid the introduction of a potentially complex and costly process of LTA review, rebate and repurchase that the cooling-off period would entail, and the equally likely danger of a ‘churn’ mentality developing among insurers and distributors, since they now have an incentive to bid for these clients during the cooling off period.

Despite these concerns, the proposal still might be relevant for two reasons. First, the purchase of annuities for health/lifestyle reasons at the point of retirement might be inappropriate where the enhancements are small. It will be important to avoid annuitisation under the new regime, where the rationale is based on the availability of an enhancement without considering its merits relative to drawdown. Second, it will still be important when

DC retirees purchase a LTA in later life, since at this point it will be essential to achieve the best rate in the open market, based on the underwriting of health and lifestyle factors.[99]

Currently, people cannot switch between products, such as between a single-life and a joint-life annuity and vice versa if their circumstances change. In future, insurers could be allowed to offer policies that enabled members to switch from a joint-life to a single-life policy if their spouse or civil partner dies before them, or to make the opposite switch if they marry after purchasing a single-life annuity.

Steve Webb, also had a pre-Budget proposal that would enable members to switch annuity provider post purchase. The proposal was met with fierce criticism by insurance companies, which argued that the cost of this flexibility would reduce LTA rates by about 25%.

Insurance companies are buy-and-hold investors of the bonds used to make the LTA payments. They buy bonds with different maturities and make the annuity payments from the coupons and redemption payments on these bonds. The cash inflows from the bonds need to be received before the LTA payments are made in order to minimise the insurance companies' holdings of liquid reserves.

LTA payments typically are made monthly, but the coupon payments on the bonds are only received semi-annually. The required cash-flow matching exercise is complex and needs to be done in the most cost-effective way. Once the bonds are in place, they are held until they mature and then the redemption proceeds are used to buy new bonds at prevailing rates which might be higher or lower than the insurance company had initially predicted. This is known as reinvestment risk and insurance companies need to hold reserves to cover the possibility that interest rates are lower and therefore that the new bonds are more expensive than predicted.

Insurance companies already have to accommodate in their reserves the possibility of adverse mortality experience, i.e., that realised mortality rates turn out to be lower (annuitants live longer) than predicted. If, in addition to this, insurance companies have to allow for the possibility that annuitants can sell back their annuities at any time, then this would certainly increase costs. Insurance companies would have to hold sufficient liquid reserves to avoid the possibility of having to sell some of the bonds needed to make payments to the remaining annuitants. This proposal has, to a certain extent, been superseded by the next proposal, namely the introduction of a secondary annuities market.

Annuities with more flexible terms could be classified as safe harbour products.

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[99] This is where insurers ask applicants to fill in a medical questionnaire relating to their health and lifestyle. Insurers will be aware that individuals who voluntarily purchase annuities are likely to know from their own and their family's medical history that they will have above average life expectancy and insurers need to get as accurate a fix as possible on their true life expectancy.

Secondary (or marketable or second-hand) annuities

In the Budget on 18 March 2015, the Chancellor announced that annuitants could sell (or assign) their annuity for cash to the highest bidder (but not back to their annuity provider) from 6 April 2016.[100] The proceeds could be paid directly to the seller or paid into a drawdown account. In both cases, tax on withdrawal is payable at the individual's marginal income tax rate.[101] However, people who did this would not be allowed to claim means-tested benefits to compensate for the loss of income, and people already on means-tested benefits would not be eligible. Also the annual allowance would be reduced to £10,000 if the option were exercised. Further, the option will not be open to someone receiving a DB pension. The institution buying the annuity would receive a taxable income for as long at the annuity seller is alive. Steve Webb had raised the possibility of selling annuities in January 2015.[102] There are currently around 6 million people in the UK with annuities from their pension scheme.

In July 2015, MorganAsh, a company that provides medical information for assessing longevity for the financial services industry, announced plans to operate a 'central annuity bureau' in the second-hand annuity market, following discussions with the FCA and other interested parties. The company proposed using medical underwriting to help in the valuation of the annuities brought to market. It said four key points had emerged during its discussions on annuity resale:

- There is efficiency in undertaking the medical underwriting and other checks on the consumer just once and sharing among the various purchasers
- There is merit in having one or a few central annuity bureaux (CAB) or portals that would undertake the medical underwriting and additional checks
- There is merit in the CAB being independent from the purchaser and the seller to avoid bias
- There is benefit to having some structure and order to the medical underwriting and tendering process.

The company argues the CAB service could run as a commercial operation, rather than a government-sponsored organisation, on the grounds that:

- Commercial organisations can be flexible and quick to provide solutions
- The purchasers are likely to self-police the quality of the medical underwriting services, as they are likely to lose out if this service is poor or biased

[100] HM Treasury (2015) *Creating a Secondary Annuity Market*, March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413763/Creating_a_secondary_annuity_market__print_file_.pdf
[101] In addition, there would be no tax-free allowance.
[102] Tim Ross (2015) Sell your pension for cash under radical plan, Sunday Telegraph, 4 January.

- 90% of the systems and processes required already exist within commercial organisations.[103]

There was some support for the idea of a secondary annuity market. For example, Dr Ros Altmann suggested that the following would benefit:[104]

- 'People who purchased an annuity because they had no choice, but need the money now to repay debts or pay for health or care needs or other urgent spending'
- 'People who have other pensions and for whom the annuity is not an important source of their retirement income'
- 'People who purchased small annuities, for whom the small amount of ongoing income will make little difference to their standard of living in retirement. For example, someone with a £5,000 pension fund who bought an annuity at age 60 might have less than £5 a week for life, whereas having a few thousand pounds straight away could make a real difference to their lives'.

Similarly, Stephen Lowe, group external affairs and customer insight director at Just Retirement, gives qualified support for the idea:

> *As you would expect, we are passionate supporters of guaranteed income to provide simplicity and peace of mind through retirement. Yet we also support the power of innovation and choice to drive better value through individually tailored solutions. The secondary annuity market will free that small but significant minority of annuitants who could benefit by switching out of their current contract.*
>
> *So in what kind of scenarios might people benefit by trading their annuity in?*
>
> *• To reconfigure benefits – for example, to switch out of a single life annuity to provide income for a spouse, or to switch from regular income to more flexible arrangements*
>
> *• To preserve value for the next generation – trade the annuity and transfer the value into flex-access drawdown*
>
> *• To turn income into a lump sum – where people find they have sufficient income from other sources*
>
> *• To rationalise a small annuity income – to switch an annuity paying a trivial income into a worthwhile lump sum, and*
>
> *• To extract more value from pensions containing guaranteed annuity rates (GAR) for those people needing a lump sum – accept the GAR but*

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[103] Reported in Jenna Towler (2015) MorganAsh reveals secondary annuity market bureau plans, Professional Adviser, 1 July.
[104] Reported in Scott Sinclair (2015) Ministers 'to discuss' radical annuities-for-cash plan, Professional Adviser, 12 March.

then trade the annuity to generate a lump sum above the current value of the DC pension.

Our support for a secondary market depends on two major conditions. ..[T]here needs to be robust consumer protection in place to ensure people considering selling their annuity fully understand the consequences. There also needs to be a transparent and competitive marketplace.[105]

A secondary annuity market could also help DB plans hedge their longevity risk. According to Adam Michaels, partner at LCP, traded contracts could be bundled and sold to DB schemes to match pensions in payment, hedging changes in long-term interest rates and longevity improvements.[106]

However, most industry insiders were not particularly enthusiastic about the proposal. A *Pensions Buzz* poll in Professional Pensions of 135 trustees, scheme managers and industry figures found that only 30% thought it was a good idea.[107] A common view was that 'It is all too easy to imagine older pensioners being bullied by their families into selling their annuities for a lump sum for their own needs, leaving the pensioner more reliant on the state… I can't imagine it would be an option we would advise taking often'.[108] Sales would need to be carefully regulated to prevent high-paying annuities bought before the fall in interest rates as result of quantitative easing being sold to unscrupulous companies for a pittance. Another negative factor is the insurance company's gross profit margin. We were told this accounts for up to 20% of the original purchase price and for the sale to be equally profitable, the annuitant will receive a 'secondary screwing'.[109] Some commentators have suggested that sales costs could be between 20% and 40% of the value of the annuity.[110] The Institute for Fiscal Studies (IFS) pointed out the complexity of the decision, especially for older people: 'Evidence suggests that at least a significant minority of annuity holders – in particular, older annuity holders – may struggle with the complex decisions required in valuing their annuity compared to an alternative lump sum. This suggests that, at the very least, individuals will need to have access to good quality financial advice and guidance in order to navigate this new market – if, indeed, such a market does spring into existence'.[111]

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[105] Stephen Lowe (2015) Consumer protection – Words of warning on second-hand annuities, Professional Adviser, 29 June.

[106] Reported in Natasha Browne (2015) Second-hand annuities would help DB schemes hedge longevity risk, Professional Pensions, 24 June.

[107] Michael Klimes (2015) Second hand annuities: preying on the 'ignorant, desperate and feckless'?, Professional Pensions, 20 March.

[108] Jamie Smith-Thompson, managing director, Portal Financial, quoted in 'The verdict on letting pensioners cash in their annuities', Pensions Insight, 5 January 2015.

[109] According to Mark Polson, The freedom to sell your annuity (read: The freedom to get screwed), Professional Adviser, 6 January 2015.

[110] Reported in Tim Bateman and Katie Dawson (2015) Second-hand annuity market needs 'strong controls and close policing', Professional Adviser, 24 August.

[111] Quoted in Stephanie Baxter (2015) IFS warns annuity buy-backs could harm retirees, Professional Pensions, 1 April.

There would be a particular issue with joint life annuities in order to ensure that the interests of the second beneficiary were protected and that they were getting fair value for their foregone benefits.

It was also not clear that all providers would find the proposition that attractive: 'a lifetime annuity is priced on the life and medical conditions of that particular customer. So if it is sold on, the new risks and medical conditions would need to be priced in as part of the transaction'.[112] There is a clear moral hazard problem, since there is nothing to stop an annuitant who develops a life shortening illness from trying to sell the annuity without informing the provider of their new medical situation. There is also a clear adverse selection problem as the IFS recognises: 'Who is most likely to want to cash in their annuity? Someone who now knows they don't have long to live. How much will they get for their annuity? Not much'.[113]

There would also be an expensive monitoring process to ensure that the annuity payments stop when the annuitant dies if the policy were sold to a third party. The seller would have to agree to regular certification of being alive (such as a monthly phone call) with the original insurance company. Finally, there is the issue of contract law. It is hard to change existing contracts if one side does not want to. Nevertheless, Toby Strauss, then chief executive of Scottish Widows, while acknowledging the contractual problems, thought that some new providers might be interested in investing in these income streams.[114]

An obvious question is whether a second-hand annuity could be sold to a retail investor and the Government has ruled this out. A second-hand annuity would be similar to a traded life policy or life settlement. The FCA condemned these as 'high-risk, toxic products' and effectively banned them for sale to retail customers in 2014.[115] More suitable buyers might be pension funds which wanted such assets to match their pensions in payment,[116] but it is not clear how big a market this would be. A simpler solution would be to sell the annuity back to the original life company in exchange for a lump sum, subject to a medical examination, but how would a fair price be determined in this case? While it might be argued that the facility to surrender annuities would stimulate competition and prompt insurance companies to offer higher rates initially, the calculation of the 'surrender value' of

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[112] Kate Smith, regulatory strategy manager, Aegon UK, quoted in 'The verdict on letting pensioners cash in their annuities', Pensions Insight, 5 January 2015.

[113] Quoted in Mark Atherton (2015) Pension windfall figures dismissed, The Times, 20 March.

[114] Helen Morrissey (2015) Provider's 'interested' in Webb's annuity unwinding plan', Professional Adviser, 22 January.

[115] http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/traded-life-policy-investments

[116] If their members live longer than expected, pension schemes have to pay out pensions for longer than expected, but if they buy second-hand annuities from people with a similar mortality profile as their own members, then these annuities will also pay put longer than expected.

an annuity would prove complex and potentially allow the insurer to extract additional profit.[117]

A survey by Saga of 2,000 existing annuity holders found that 20% would be willing to sell, with those with the smallest pots and hence the lowest incomes 'most likely' to do so. The main reasons are as follows: 58% said their monthly income is too small to be able to do anything meaningful with it, 30% said they would use the cash to invest in an ISA or the stock market, and 12% said they would spend the money on luxuries such as cars and holidays.[118] A survey of 1,800 retirees by Tilney Bestinvest found that 17% would consider selling their annuity, 33% said they would not sell, while 50% stated they did not know what their plans were.[119]

Another survey, this time of 1,531 over-55s conducted by YouGov and sponsored by the Institute and Faculty of Actuaries (IFoA) found that 55% of annuitants would avoid cashing in their policies on a secondary market, despite only 48% believing their policy to be good value. Only 9% said they would be tempted because they had not wanted to buy it in the first place, and an additional 10% said they were in a position to cash in their annuity because they had another source of income. Around 40% agreed there was a high risk they would end up worse off if they cashed in their contract. Gareth Connolly, chairman of the IFoA pensions board, said: 'It remains to be seen how much demand there will be in practice for buying secondary annuities once the market has developed, and whether they will be good value for pensioners. As the YouGov survey demonstrates, annuities will continue to play an important role in the pensions market as people value the certainty they provide. Access to adequate financial advice will be vital for pensioners in understanding the pros and cons, and the inherent risks, relating to the new option they will have available. Many annuitants will likely be amongst the most vulnerable in society. It is therefore crucial that the implications of choices are fully understood and that consumer safeguards are in place to reduce the risk of mis-selling'.[120]

In July 2015, the Government announced that the introduction of a secondary annuity market would be delayed until April 2017, much to the relief of industry. Huw Evans, director general of the ABI, said: 'The new timetable announced today is a very welcome move and follows strong representations from the industry that the previous timetable was

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[117] The challenges of setting up a secondary annuity market are set out in the Government's own consultation document: HM Treasury and DWP (2015) Creating a secondary annuity market, Cm 9046 March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413764/Creating_a_secondary_annuity_market__web_file_.pdf

[118] Reported in Scott Sinclair (2015) Small pot annuitants 'most likely' to sell up, Professional Adviser, 27 March.

[119] Reported in Professional Adviser (2015) At least third of annuitants to stick with plan – poll, 21 April.

[120] Reported in Natasha Browne (2015) IFoA - Half of annuitants would resist urge to cash in contract, Professional Pensions, 23 June.

too quick. Providers want the reforms to the secondary annuity market to work for customers and it is right more time is allowed to get the right structures and regulation in place before going ahead'.[121] The same announcement also allowed the annuity to be sold back to the original annuity provider.

Marketable annuities could be classified as safe harbour products.

2.2.1.4 Annuities with guarantees

<u>Extended guarantee annuities</u>

HM Treasury (2014, p 14-15)[122] announced that it would remove the 10-year guarantee period limit for guaranteed annuities and allow payments to be made to beneficiaries from guaranteed annuities to continue beyond the current 10-year maximum. This will allow providers to create annuities that ensure more of an individual's fund is returned to their families in the event of their death.

However, such extended guarantee annuities are expensive to offer and it appears unlikely those over 75 would be permitted to buy them.

Annuities with extended guarantee periods could be classified as safe harbour products.

<u>Annuities with capital protection</u>

One way to overcome members fears of losing their capital when they die is the capital-protected (also known as the value-protected or money-back) annuity. This might be more attractive than an annuity with a 10-year guarantee period.[123]

These annuities work by gradually phasing into full annuitisation over a period of time. Only a small amount of the fund is annuitised in the first year after retirement, and then there is a gradual increase in the percentage of the fund annuitised, with full annuitisation occurring only by around age 80, after which age the entire remaining fund will be lost on death in exchange for the lifetime income guarantee.

The capital-protected annuity removes one of the single biggest consumer objections to annuities: 'If I die soon after I retire, the annuity provider will keep my fund'. The 'live or die' guarantee of the member getting their money back is very easy to explain and avoids uncertainty by allowing the member to lock into investment and longevity guarantees to provide guaranteed lifetime income.

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[121] Quoted in Michael Klimes (2015) Industry relieved by secondary annuities market delay, Professional Pensions, 8 July.

[122] *Freedom and Choice in Pensions: Government Response to the Consultation*, Cm 8901, July.

[123] The attraction of a capital protected annuity was further increased by the abolition of a 55% tax charge from 6 April 2015.

The cost of the capital protection is around 7% for a standard healthy life and 14% for an unhealthy life. In October 2014, the best annuity rate for a standard 65-year old male with a £100,000 pension pot was £6,024 pa, while it was 7% lower for a 100% capital-protected annuity at £5,596. For a 65-year old male who survived a heart attack, the rate was £7,130, while full capital protection lowered the rate to £6,119, which is 14% lower.[124]

In April 2015, MGM Advantage introduced a capital-protected annuity which offers retirees a selection of guarantee options with improved death benefits. This is achieved through either an extended income guarantee period of up to 30 years or returning the fund balance in a lump sum. Another option is for a capital protection benefit of up to 100% of the initial purchase price, giving a lump sum on death at any age. Andrew Tully, pensions technical director at MGM, said: 'The money-back guarantee is a cost-effective option that everyone should consider, and which can be designed to suit the needs of individual customers. This gives families peace of mind that the money invested in providing a secure income won't be lost and removes the understandable sense of financial injustice that can sometimes be felt when a holder dies early. [MGM's own research showed that consumers do still want a secure income for life, so] it's important that annuities are reinvigorated so they can remain central to retirement planning in the future'.[125]

Annuities with capital protection could be classified as safe harbour products.

Ruin-contingent life annuities

Another type of annuity with guarantees is the ruin-contingent life annuity (RCLA) which makes payments based on two contingencies related to longevity and weak investment performance. A RCLA is an annuity that pays out only if both the pensioner is still alive at a certain date and there has been weak investment performance prior to that date. The payments are inflation protected.

RCLAs are not currently available in the UK.

2.2.1.5 Investment-linked annuities (ILAs)

This type of annuity (also known as 'investment-backed'), which accounts for 5% of total annuities sold, invests the premium in one or more funds. There are two types: with-profits annuities (WPAs) and unit-linked annuities. As the name suggests, the former invests in a with-profits fund; the latter invests in the annuitant's choice of a range of unit-linked funds, which can be actively or passively (indexed) managed. The income, which is set at the outset with reference to the prevailing annuity rate and an assumed investment return, might fluctuate significantly, depending on the choice of fund. On average over the long run, a

[124] Katie Morley (2014) The annuities that don't die when you do, Daily Telegraph, 22 November.
[125] Quoted in Jenna Towler (2015) MGM unveils 'money back' annuity guarantee, Professional Adviser, 1 April.

higher income should be achieved by an ILA which invests in growth assets compared with a LTA which invests mainly in bonds, but this is not guaranteed.

ILAs offer a similar range of features to the LTA, such as single or joint life, a guaranteed period, and different payment frequencies. We understand that enhanced terms can also apply. Some providers set a guaranteed floor below which the income will not fall, which might be around 50-55% of the LTA rate at the time of purchase. As with a standard annuity, a mortality premium is built into the return, although this is likely to be smaller than with a LTA because, in general, it is only the wealthier and healthier annuitants who buy this product.

While favoured by some experts, due to the potential for income growth, there are important considerations that might make this product unsuitable for some people:

- Standardisation – There is little standardisation in product design, which makes it very difficult to compare like with like. Nevertheless, the purpose of the ILA is to combine the best features of drawdown – maintaining an investment in growth assets in the immediate period after retirement – with the best features of an annuity – providing longevity insurance. In principle, if it were well designed and offered good value for money, the ILA would be an attractive competitor to drawdown, particularly if it included capital protection features which are currently not common. It is also more attractive than a LTA for those who would not qualify for an enhanced LTA rate and who have no partner or dependants to consider. The ILA might also represent a suitable component part of a mixed portfolio of DC decumulation products.
- Cost – Annual costs are estimated at about 2% p.a., with a higher charge in the first year to include the cost of advice. However, we were shown many examples where the costs were not easy to calculate. Nevertheless, charges are typically lower than with drawdown
- Investment risk – Investment risk and income risk are closely connected, as we show in the more detailed consideration of the with-profits annuity below. The perceived attraction of the ILA is that it will deliver a higher income over time than is possible with the LTA, therefore the fund must generate a minimum level of growth, after charges, so that the actual maximum income that can be drawn is higher than that offered by the LTA rate that was available at the date of purchase.

Example: With-profits annuities

To explore the risks of the ILA, we focus on the with-profits version. It is significant to note that the with-profits market is generally in decline, as a result of reputational damage caused by Equitable Life and with-profit mortgage endowment policies. Nevertheless, several providers – including mutual insurers – continue to offer the fund as a general investment. The important point here is that the choice of provider and its financial strength (which indicates its ability to support future bonuses, among other factors) is crucial. Where a provider closes its with-profits book to new business, the investment strategy will become more cautious as the book matures.

With-profits funds invest in a range of asset classes, for example, bonds, equities and property. The declared annual bonus is set to provide a smoothed – generally growing – income from the fund, unlike the income from a unit-linked fund which is much more volatile since the value of the units directly reflects the value of the underlying fund. The smoothing mechanism requires the holding of a reserve, with the objective of delivering a fairly stable income even during periods where the markets are volatile and falling.

How the bonus is calculated is not at all transparent to customers. The initial income is set in accordance with basic LTA principles, but the future income in a particular year depends on the relationship between the declared bonus – which represents the actual 'return' on the fund to the annuitant in that year – and the anticipated bonus rate (ABR) – which is the projected growth rate of the fund. The annuitant – with the help of his or her adviser, where relevant – can increase the starting income by selecting a higher ABR.

The Retirement Academy describes the process as follows:

> *The ABR can currently be anywhere between 0% and 5% and effectively allows a policyholder to borrow against future income payments. At the end of the year, the anticipated bonus is subtracted from the annuity before adding the actual bonuses declared in that year. If the anticipated bonus is lower than the declared bonus, the annuity payments increase and vice versa.*
>
> *For example, if you select a 4% ABR, the starting income will be similar to a standard level annuity. This makes sense because standard annuities are priced in relation to yields on fixed interest bonds which in normal market conditions are around 4%. The ABR is effectively the yield on which the WPA is priced. Whereas the yield on the standard annuity is fixed for the term of the annuity, the annual bonuses on WPAs change every year.*
>
> *This means that, if in year two the declared WPA bonus is higher than the ABR, the WPA income will increase, whereas, if the bonus is lower the WPA, income will fall.*
>
> *Example*
>
> *Assume a WPA with an ABR of 4% pays a starting income of £ 1,000 p.a.*
>
> *If the year 2 declared bonus is 5%, the Year 2 income increases to*
>
> *£ 1,000 x [1.05 (Declared bonus) – 1.04 (ABR)] = £1,010*
>
> *However if the year 2 declared bonus is 3%, the Year 2 income decreases to*
>
> *£ 1,000 x [1.03 (Declared bonus) – 1.04 (ABR)] = £ 990*

A few insurance companies have tried to launch a product that invests part of the premium in a LTA and part in a with-profits annuity. However, we understand that these products have been withdrawn after a short period.

Despite the current poor reputation of with-profit products, there is great value to having a product which smooths out investment returns (using a smoothing fund) and provides an income for life.[126] There is therefore a strong case for 're-inventing' with-profit annuities with a new name. However, this will only be successful if there is much greater transparency over how the smoothing is done and also over costs.

If the issues surrounding standardisation, cost and investment risk can be resolved, then ILAs (with a minimum income underpin[127]) could be classified as safe harbour products.

2.2.1.6 Deferred annuities

With a deferred annuity, a premium is paid when the annuity is purchased, but the income received does not start for a number of years. In the case where the income does not begin until the purchaser has reached a high age such as 80 or 85, the annuity is known as an advanced life deferred annuity (ALDA). In the standard case, the premium is non-refundable if the purchaser dies before the payments begin.

A deferred annuity is potentially an ideal asset in a drawdown programme. It would, however, require investment managers to partner with insurance companies to provide ALDAs.

However, there are a number of important hurdles to cross. First and foremost is the fact that a deferred annuity market does not currently exist in the UK. There used to be a market for deferred level annuities for the self-employed, but a combination of high inflation in the 1970s and more onerous regulatory capital requirements under various EU solvency capital requirements led to its demise. Solvency II, introduced in January 2016, will not help. Second, deferred annuities would need to be medically underwriten and this will add to costs. Third, there is the reluctance of individuals to buy deferred annuities because they are concerned that they might die during the deferment period.

A key question is: 'will deferred annuities make a comeback?'. Adrian Boulding, Pension Quality Mark chairman, believes they could do. He points to the growing success of 'longevity insurance' in the US which is the US name for a deferred annuity. It works by using 10-15% of the pension pot at age 65 to buy longevity insurance. Mr Boulding believes that having to pay for longevity insurance upfront might put people off and prefers the idea of monthly instalments. Simon Chinnery, head of UK defined contribution at J.P. Morgan

[126] David Blake (2003) Take (Smoothed) Risks When You Are Young, Not When You Are Old: How To Get The Best From Your Pension Plan, *IMA Journal of Management Mathematics*, 14, 145-161.
[127] Such as 80% of the initial amount.

Asset Management, also believes deferred annuities will make a comeback: 'There will still a place for annuities as the primary retirement vehicle for those wanting certainty, but we're likely to see more investors incorporating partial or deferred annuities as one part of a wider investment mix'.[128]

Others doubt whether this will happen. Adrian Kennett, director at Dalriada Trustees, said: 'Who is going to voluntarily buy this product? If you are taking your DC benefit flexibly, you are doing that because you want the cash now. The only way that product will fly is if someone legislates to say you have got to buy it – and that is not going to happen because that goes against the pension freedoms'. David Harris, managing director of TOR, argues that communicating the benefits of deferred annuities would be a challenge: 'They are notoriously confusing and complicated to explain'.

Andy Cheseldine, partner at LCP, believes it is a matter or branding: 'If you asked people, "would you like to buy an annuity?", 90% of people would say "no, no, that's horrid". But, if you asked, "would you like an insured guaranteed income in retirement?", a lot of them would say "yes". It's the same thing, it's just annuities have had a bad press'. Mr Cheseldine accepts that deferred annuities could be expensive, but believes the strengths outweigh the weaknesses: 'It will look expensive no matter how you do it, but being expensive does not make it poor value. I think it would be popular if you get it right. There are some people who would not be able to afford it and just take cash. If you are going to take your income over the long term, then this is a really good safety net and does make sense. These products will then be popular because it means people are not running out of money in old age'.

Mark Stopard, head of product development at Partnership, believes that the way that deferred annuities are sold – through the retail market or packaged up as part of an integrated institutional solution – will also have an important impact: 'From the customer's point of view, it needs to be a packaged solution. As soon as you ask consumers to buy an add-on, it becomes a more complicated and difficult decision for consumers'.

Deferred annuities could be classified as safe harbour products. One fundamental problem, however, is that a deferred annuity market does not currently exist in the UK. Another is that level deferred annuities would be subject to inflation risk.

[128] Simon Chinnery (2015) Close collaboration - 'Retirement ready' clients need long-term advice, Professional Adviser, 5 May.

2.2.1.7 (US-style) Longevity Insurance Annuities

The 2014 Budget overhaul of the DC decumulation tax rules, and, in particular, the new regime after Flexiday, will – or certainly *should* – focus attention on the value of the LTA as an insurance product that provides a perfect longevity hedge for pensioners in later retirement, when insurance against living beyond their life expectancy becomes a more important consideration than investment returns. Such a focus would recognise that the real weakness in the new DC regime is the long tail of longevity risk that individuals must bear.[129]

In the US, one form of DC decumulation for those with 401(k) pension plans[130] is to split the fund, say, 85/15, between a drawdown product and a deferred annuity product. The former, known as a 'rollover' or income retirement account (IRA), operates in a similar way to income drawdown. The latter can come in one of two forms: a deferred income annuity (DIA) or, since 2014, a longevity insurance annuity (LIA). The distinction is that DIAs can start at any age, while LIAs start at advanced ages. LIAs are also known as an advanced life deferred annuities or simply as longevity insurance. They begin to pay out at a date in very late retirement, e.g., age 80 or 85, if the DC customer survives to that age, although they could start as early as age 70. Both types are purchased at the time of retirement.

When they are purchased through IRAs, LIAs are provided on a gender basis. LIAs are also available through employer-sponsored plans under ERISA,[131] but in this case must be provided on a unisex basis. Because annuities sold on a unisex basis disadvantage men and the extent of the disadvantage increases with age, men are reluctant to buy unisex LIAs. One of the respondents to our consultation told us: 'In my view, a market for longevity insurance annuities is not viable in the UK, because they would be offered only on a unisex basis. The difference in life expectancy by gender at older ages makes these annuities unfavourable to males, so, in principle, they would only be offered based on female mortality rates. To my knowledge, nowhere in the world is there a viable unisex longevity insurance market'.

The basic LIA is pure insurance: it only pays out if the insured individual lives until the specified age. It is possible to buy certain features, which reduce the rate, e.g.:

- Death benefit – if the annuitant dies *before* the start of payments, the insurance company returns the value of the fund and, in some cases, adds an amount for interest.

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[129] This is discussed in detail in Chapter 4.

[130] A 401(k) is an employer-sponsored pension scheme ('plan' in the US), similar in some ways to a group personal pension in the UK. It is named after the section of the tax code that governs the plans, introduced in the 1980s.

[131] Employee Retirement Income Security Act 1974.

- Cash refund – if the annuitant dies *after* payments commence, the balance of the fund is paid to his or her beneficiaries.
- Early payment – this can be arranged with some providers, for example, where the annuitant has to go into a nursing home. This element is also known as a life-care or immediate needs annuity (see Section 2.2.1.8).

Only a small number of US life companies offer LIAs, notably, New York Life Insurance Company, Symetra Life Insurance Company and Northwestern Mutual Life Insurance Company. New York Life is currently the largest seller, although only 4% of the purchasers of these annuities buy a pure LIA; the rest are LIAs with death benefits. Fidelity and Vanguard sell DIAs. LIAs are also sold in Chile, but not currently in the UK.

The combination of tail-end longevity insurance (via a LIA) and drawdown potentially sounds an attractive proposition, but there are some problems. The first is the regulations on unisex annuities, although this could possibly be circumvented by individual underwriting. Second, the standard LIA is a level annuity, so the impact of inflation is likely to be significant by the time the annuitant begins to draw the income. Third, from a regulatory perspective, LIAs are capital intensive for insurers to provide in the absence of a longevity hedge.[132]

Nevertheless, if these problems can be overcome, LIAs could be classified as safe harbour products.[133] *As with deferred annuities, it would be important to recognise that level LIAs would be subject to inflation risk.*

2.2.1.8 Annuities linked to health status

<u>Enhanced Annuities</u>

There are two types of enhanced annuity:

- Lifestyle annuity – provides higher annuity payments to an individual who has a lower life expectancy than a typical member of that individual's cohort as a result of the individual's lifestyle. An example is an individual who smokes or is obese. A smoker can get a 10-15% higher annuity payment than a non-smoker of the same age.[134]

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[132] The classic longevity hedge is a longevity bond, but such bonds do not currently exist. Longevity bonds are discussed in detail in Chapter 4. The same problem applies to deferred annuities, and indeed to annuities more generally.

[133] More information on LIAs can be found here: Michael Kitces' blog for 9 July 2014 entitled 'Why The New Qualifying Longevity Annuity Contract (QLAC) Regulations Don't Mean Much For Retirement Income… Yet?'; https://www.kitces.com/blog/why-the-new-qualifying-longevity-annuity-contract-qlac-rmd-regulations-for-dont-mean-much-for-retirement-income-yet/

[134] Cazalet Consulting (2014, p. 69) *When I'm Sixty-Four*, September.

- Impaired life annuity – provides higher annuity payments to an individual who has a medical impairment which lowers their life expectancy. Examples would be heart disease, high blood pressure, cancer, and Parkinson's disease. Someone with prostate cancer can get a little more than twice the amount paid to a normally healthy person of the same age.[135]

All enhanced annuities are medically underwritten: individuals applying for one need to fill in a health questionnaire and might also need to give permission to their doctor to show the insurer their medical records. If the health questionnaire contains an extensive set of questions and the insurer also makes a detailed examination of the applicant's medical records, a procedure known as full underwriting, the applicant might be offered a much higher annuity than the standard annuity, since the insurer will now have a better estimate of the applicant's reduced life expectancy. If, on the other hand, the health questionnaire is short and there is no examination of the applicant's medical records, a procedure known as light underwriting, the level of enhancement offered might be quite small compared with a standard annuity.[136]

Billy Burrows argues that enhanced annuities are hard to beat when compared to drawdown (in *The Case for Annuities*, April 2015). The annuity specialist Partnership estimates around 65% of people could qualify for an enhanced annuity.[137]

Immediate-Needs/Long-Term Care Annuities

The standard benefit from a long-term care (LTC) insurance policy is a particular type of LTA known as an immediate-needs or long-term care annuity. This will pay an income for the remainder of the policyholder's life and the income is used to fund long-term care for the policyholder.

It is important to bear in mind that, while an immediate-needs or LTC annuity is payable for life, there is no guarantee that the annuity will provide sufficient income to cover the full cost of the care required. This might be because the inflation rate in LTC provision is much higher than the general inflation rate. There are also tax benefits if the annuity is paid directly to the care or nursing home: the policyholder is not liable to income tax on the annuity payments.

It is also important to recognise the possibility that the policyholder might eventually experience dementia and that this should be prepared for by the policyholder assigning a power of attorney to a family member or solicitor who would, if necessary, take responsibility for spending the income under the annuity.

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[135] Billy Burrows (2015, p.9) *The Case for Annuities*, Retirement Intelligence.
[136] See Retirement Health and Lifestyle Forum; http://www.retirementhealthform.co.uk/
[137] Reported in Jenna Towler (2015) Enhanced annuities - Top ten medical conditions clients should disclose, Professional Adviser, 16 July.

Tom McPhail and Patrick Gale, Defaqto non-executive chairman, have proposed that the Government allow savers to access their pension pots tax free to pay for long-term care,[138] a move supported by Dr Ros Altmann, then the Government's business champion for older workers, in her report *A New Vision for Older Workers* released in March 2015.[139]

Both enhanced annuities and immediate-needs/long-term care annuities could be classified as safe harbour products.

2.2.1.9 State annuities

On 2 April 2014, the Government announced the details for its plan to allow pensioners and those who reach pension age before 6 April 2016 to top-up their state pension by up to £25 per week.[140] The offer, which will be available for 18 months starting in October 2015, will enable people to get a higher inflation-proofed state pension by making Class 3A Voluntary National Insurance Contributions. The cost is based on age and takes account of average life expectancy. For a 65-year-old, an extra £1 of weekly pension will cost £890; for a 75-year-old, £1 per week will cost £674. A calculator is available online.[141]

This is an interesting move on the Government's part, as, in effect, it represents a short-term entry into the retail annuity market. The Government's pricing compares very favourably with an index-lined annuity bought on the open market.

2.2.2 Drawdown products

2.2.2.1 Issues to consider with drawdown

Standard drawdown does not involve the purchase of an annuity at any stage after retirement. Instead, the buyer of a drawdown product can take the tax-free lump sum, leave the rest of the fund invested and make withdrawals as and when required. Withdrawals are taxed as income at the marginal income tax rate. People can invest in funds offered by life offices or investment managers, either directly or via a platform, or they can build their own investment portfolios. The investments can be actively or passively managed. If the withdrawals exceed the income generated by the investment fund, then the fund will be reduced. With an annuity, the product automatically provides a lifetime income in retirement. But, this is not the case with drawdown where the customer has to make an

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[138] Carmen Reichman (2014) Pensions experts call for policy intervention on care funding, Professional Adviser, 12 November; Carmen Reichman (2014) Care for a tax break? Funding LTC through pension savings, Professional Adviser, 28 November.
[139] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/411420/a-new-vision-for-older-workers.pdf
[140] https://www.gov.uk/government/news/state-pension-top-ups-pensions-can-be-increased-by-up-to-25-a-week
[141] www.gov.uk/state-pension-topup

active decision to withdraw cash and the fund can run out of money before the customer dies.

Drawdown has three components:

- the product in which the pension pot is invested according to an agreed investment strategy
- the arrangement for delivering the pension (e.g., a self-invested personal pension scheme or scheme drawdown), and
- the withdrawal strategy, the programme for withdrawing funds over time to finance expenditures.

Drawdown, by itself, does not have to have a longevity insurance strategy, and, because of this, it could not be classified as either a pension scheme or a safe harbour product.

As an investment product that is classified by the FCA as potentially high-risk, the regulator used to require a fully advised process for drawdown. This is distinct from guided- or non-advice (execution-only) which is the most common method of purchasing annuities, particularly for funds worth less than £100,000. However, providers and advisers now make drawdown available for DC customers with as little as £30,000 to invest. Since, Flexiday, drawdown customers are not required to take regulated advice.[142]

The suitability of drawdown in relation to the risk-return trade-off will depend partly on the individual's risk tolerance, but also on a professional assessment of the 'Type A Critical Yield'. This is the return needed to provide and maintain an income equal to that obtainable under an equivalent immediate annuity. The calculation assumes that an income will be taken at the level of the available annuity until a specified age (usually 75) and, at that age, there will be sufficient money in the drawdown fund to purchase an annuity equal to what could be bought at the point when drawdown started. The higher the annuity rate available (for example, enhancements might apply), the higher the critical yield required.

Unfortunately, it appears that the regulations on calculating the critical yield, which were introduced in 1998, are out of date and contain dangerous loopholes. Where these loopholes are exploited, this could lead to cases of mis-selling on the basis of an understated investment risk. In particular, the rules do not specify the basis of the calculation. A revision to the rules should include the requirement to use the best OMO rates, including the best enhanced rates.

Annuity Direct gave us the following explanation:

> *This creates an issue in that the basis for the annuity is not properly defined and when Regulatory Update 55 was drafted in August 1998, the*

[142] This is discussed in more detail in Chapter 3.

enhanced market was not as advanced as it is today. This means that providers generally use their own annuity rate to calculate the critical yield. The result will be that, where the annuity rate is not competitive, the critical yield will be lower, resulting in the risks of drawdown being understated.

The problem is exacerbated when a client is eligible for an enhanced annuity, because the higher the annuity rate available, the higher the yield required. Our practice, therefore, is to broke the annuity in the open market – including medical information where appropriate – and then to use the highest annuity rate to calculate the Type A Critical Yield. The following example may help:

A client has £61,000, which he wants to use for drawdown.

The quote from the [provider's name deleted] internal rates produced an annuity of £3,010 and this was used to calculate a Type A Critical Yield of 6.6% p.a.

We were able to obtain an enhanced annuity for the client amounting to £3,488. When we ran this rate through the critical yield quote system, the required yield increased to 7.65% p.a.

A final issue to consider is the implication of the ageing process, as Fiona Heald, head of court of protection at Moore Blatch, points out. Drawdown, unlike an annuity, requires the person to be able to manage their financial affairs until they die. However, as individuals age, they are more likely to experience a physical or mental disability that could reduce their ability to manage their own affairs. The appropriate way to prepare for such an eventuality is through a lasting power of attorney (LPA). This is a legal document allowing the 'donor' to appoint someone (known as an 'attorney') to make decisions on their behalf, should they have become incapacitated. There are two types of LPA, one for managing a person's health and welfare, and one for managing a person's property and financial affairs.[143]

2.2.2.2 Examples of drawdown products

All drawdown products need to balance income security, growth and cost. But modern drawdown products also need to be able to deal with much smaller pot sizes than before. With a current average pot size of £28,000, many retirees will prefer to take that as cash. But a percentage of retirees will want to experiment with drawdown.

We begin with the investment funds that have been proposed for use with drawdown. The most common are multi-asset funds – in particular, diversified growth funds (DGFs) – multi-asset target return funds, and multi-asset income funds. There are also examples of multi-manager funds. In addition to the charges (for administration and fund management)

[143] Reported in Jenna Towler (2015) Why all drawdown clients need lasting power of attorney, Retirement Planner, 20 August.

reported below, there would be a platform charge of 0.25-0.5% p.a. and a potential advisory charge of 0.5-0.75% p.a.[144]

We came across the following examples of diversified growth funds:

- Prudential has launched a range of diversified growth funds. The five Dynamic Growth Funds were designed to reflect different member risk appetites, with the lowest risk option having a 30% weighting in equities and the highest risk option having 100% exposure. The asset allocation of the different funds is built using sub-funds, such as Blackrock's passive equity funds and M&G's active fixed interest funds. Charges fall within the 0.75% charge cap imposed on default investment funds in the accumulation stage[145]
- HSBC Global Asset Management has introduced three risk-rated multi-asset retirement funds: cautious, balanced, and dynamic. Head of UK institutional, Stuart White, said the DC investment world needed to move from a 'collectivised approach' to 'mass customisation' where savers' individual needs can be met.[146] Each portfolio will have an annual management charge of 0.25% and the ongoing charges figure (OCF) will vary between 0.46% and 0.53% depending on the underlying asset mix.
- Blackrock has introduced a dynamic diversified growth fund with a charge of 0.65%.

Similarly, some examples of target return funds:

- Pimco's multi-asset fixed income fund has a target return that is based on the average of three objectives – tracking annuity prices, outperforming cash and producing a stable income – thereby providing a compromise between the requirements of those who want an annuity and those who prefer to remain in drawdown
- Legal & General Investment Management's (LGIM) Retirement Income Multi-Asset (RIMA) Fund. This has a target return of 3.5% above the Bank of England base rate over a complete 5-7 year market cycle. Income is paid by redeeming units and LGIM

[144] The reader will notice that different companies give different names to the charges that they impose, e.g., annual management charge AMC), annual fund management charge, ongoing charges figure (OCF) and total expense ratio (TER). Further, some of the charge measures (e.g., AMC) are defined by different companies in different ways. This is potentially confusing to customers who should also note that the headline charge is not always the total charge imposed. For example: 'The ongoing charges figure (OCF) shows the drag on performance caused by operational expenses associated with a fund. Expenses which are represented by this figure include payments to the manager [annual fund management charge], the trustee, the custodian and their representatives. The figure also includes registration, regulatory, audit and legal fees, and the costs of distribution. Performance fees, transaction costs, interest on borrowing, costs associated with derivatives, entry and exit fees and soft commissions are not included in the OCF calculation, and should be factored in separately by the investor' (Source: Trustnet).

[145] Reported in Stephanie Baxter (2015) Prudential launches multi-asset funds in response to Budget freedoms, Professional Pensions, 24 April.

[146] Quoted in Professional Adviser, 4 March 2015.

believes that a drawdown rate of 6.5% is sustainable. The fund's principal investments are bonds and equities, but the fund also invests in property and alternatives, such as global real estate investment trusts, infrastructure, private equity and high yield bonds.[147] This involves a much greater diversification into long-term growth assets than traditional drawdown products, a key benefit of institutional design. But LGIM is also concerned that savers are not forced to sell assets in distressed markets and so the fund is designed to generate sufficient regular cash flows from coupons, bond redemptions, and dividends. The annual fund management charge is 0.35% p.a.[148]

- Schroder's Flexible Retirement Fund is a multi-asset fund – invested in risk-seeking assets, such as equities, and property, but also investment grade bonds – has the target of generating returns in line with the Consumer Price Index plus 2% for members over a three to five-year business cycle, with losses limited to 8% over any time frame. John McLaughlin, head of portfolio solutions, said: 'When volatility goes above 6%, we take a break. If something spooks the market, we would immediately put a quarter of the portfolio into cash – so if, for instance, stress is at 8%, they would sell out and take volatility down to 6%'.[149] The fund has sufficient liquidity to meet withdrawals. The annual fund management charge is 0.3% p.a.[150]

Multi-asset income funds aim to generate a stable income (higher than on a deposit account) with capital preservation.[151] There are three types of income funds: (a) equity income funds which invest in the equities of mature companies and utilities generating a dividend yield in excess of 3.5% per annum, (b) fixed-interest income funds which invest in corporate bonds but offer no capital growth, and (c) covered call funds which use call options to boost the 'natural' income[152] produced by the underlying assets, paid for by giving up some capital growth.

Some examples of multi-asset income funds involving equities or bonds are: Premier Multi Asset Monthly Income (estimated yield 5%), Fidelity MoneyBuilder Balanced (4%), Woodford Equity Income (4%), Artemis Global Income (3.2%), Henderson UK Property (3.4%) and Jupiter Strategic Bond (3.2%). Typical multi-asset income funds have annual fund

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[147] David Blackman (2014) Welcome to the world of drawdown, Pensions Insight, November/December.

[148] http://www.trustnet.com/Factsheets/Factsheet.aspx?fundCode=M5FUH&univ=P

[149] Reported in Louise Farrand (2015) Five new investment innovations ahead of April 6th, Pensions Insight, 6 March.

[150] http://www.schroders.com/globalassets/staticfiles/schroders/sites/ukinstitutional/pdf/schroders-flexible-retirement-fast-facts-january-2015.pdf

[151] Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.

[152] This concept is explained in Section 2.4.

management charges of around 0.9% a year.[153] The M&G Episode Income fund has a 1% fund management charge. It aims for a 4% yield, is managed dynamically and holds between 20% to 50% in equity, 40% to 80% in fixed income (including cash), and up to 20% in other assets.

Examples of covered call funds are: Insight Equity Income Booster (estimated yield 8%), Schroder Income Maximiser (7%), Schroder Asian Income Maximiser (7%) and Fidelity Enhanced Income (6.2%).[154]

Danny Cox, head of communications at Hargreaves Lansdown, argues that income funds should be a serious consideration for customers considering income drawdown.[155] Nevertheless, Tom Becket, chief investment officer at Psigma Investment Management, has warned that, as a result of quantitative easing, it has much more difficult for income funds to generate returns without taking on more risk. He said: 'Years of monetary stimulus had turned low-risk, higher-yielding assets into high-risk, lower-yielding assets….It has never been more difficult to be a cautious investor. In fact, the term 'cautious' is now basically prehistoric as the ravaging and distorting effects of central bankers have eliminated the return potential of most traditionally cautious investment choices….Our analysis shows that some cautious funds [which traditionally invested mainly in gilts and investment grade bonds] now have around 50% of their assets in equities, mostly in income strategies'.[156]

It is also the case that UK equity income fund managers are struggling to find suitable investment opportunities in the UK and are beginning to look overseas. They are able to hold up to 20% of their assets in overseas equity markets. Some of the largest funds are nearing the 20% limit (e.g., Newton UK Income), although the average for 2015 is 13%, up from 10% in 2013. Simon Molica, senior investment consultant at Morningstar which compiles the data, said: 'If your manager is buying overseas stocks, you need to understand how the currency could add to the volatility within the fund performance, and whether the fund hedges currency exposure'.[157]

Multi-manager funds outsource investment decisions to other fund managers. These can have higher annual fund management charges up to 2%, although some are lower.[158] For example, Schroder's Multi Manager Diversity Funds have OCFs in the range 1.26 – 1.97%.[159]

[153] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.
[154] Kyle Caldwell (2015) Five ways to invest a £300,000 pension pot, Daily Telegraph, 17 April.
[155] Quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.
[156] Laura Dew (2015) Psigma's Becket - 'Cautious' is now a prehistoric term, Investment Week, 15 April.
[157] Reported in Anna Fedorova (2015) Yield squeeze forces UK income fund managers to look overseas, Investment Week, 16 June.
[158] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.

Hargreaves Lansdown has a multi-manager range of six funds for non-advised retail investors called Portfolio Plus. The six funds, which are rebalanced back to their original weightings every six months, are: Adventurous Income (estimated yield 3.03%), Balanced Income (estimated yield 3.03%), Conservative Income (estimated yield 2.38%), Adventurous Growth, Balanced Growth and Conservative Growth. There are no set-up charges, but the annual management charge varies between 1.34% and 1.46% and there is an additional platform (Vantage) charge of 0.45%. The portfolios are constructed from Hargreaves Lansdown's five multi-manager funds, including its Equity & Bond and Special Situations funds.[160]

The main advantages of drawdown can be summarised as follows:

- Control over the investment strategy
- Flexibility to change the income drawn on an annual basis (subject to the maximum in the case of capped drawdown)
- Potential for higher returns over the longer term, but only if the fund is invested in riskier assets than those used to provide an annuity (mainly bonds)
- Death benefits: on death in drawdown, the investor's partner or other nominated beneficiary can continue to draw an income or take it as a lump sum
- Deferment of the annuity purchase – in theory indefinitely, although experts agree that in most cases the guarantees provided by the LTA will become attractive at some point.

The main disadvantages of drawdown can be summarised as follows:

- Ill-informed decisions – this is the risk that the guidance and advice market[161] will not provide the level of individual support required to ensure all consumers make well-informed decisions, for example, in relation to taxation and the income level drawn
- Cost – drawdown can be an expensive product and not all of the costs involved will be visible
- Longevity risk if longevity insurance has not been purchased – the risk that the individual will run out of money before death
- Investment risk – the risk that the investment returns will not exceed those on a comparable annuity after the additional costs have been taken into account. In addition, there is the potential inability of drawdown products to generate stable

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[159] http://www.trustnet.com/Factsheets/Factsheet.aspx?citiCode=KR23&typeCode=FIJB2&univ=O

[160] Reported in Professional Adviser (2015) Hargreaves Lansdown unveils 'ready-made' portfolios for non-advised investors, 2 June.

[161] This is discussed in depth in Chapter 3.

returns over time.[162] There is increasing evidence that investment returns since 2000 have been on average lower and more volatile than in the 50 years before 2000. The implication is that retirees will have to draw down their capital to maintain their living standards, which increases the likelihood that they will run out of money before they die. Furthermore, investment risk increases as life expectancy reduces, since there is less time left to recover from a big fall in the stock marketAnnuity-conversion risk – a range of factors, including the level of interest rates, the mortality assumptions and the individual's health status, will all affect the LTA rate in the future, assuming the individual buys longevity insurance at some point

- Capacity to take risk – related to the previous three points, any longevity insurance needs to be in place before its price exceeds the funds available to purchase it and the capacity to continue taking risk disappears.

David Trenner, technical director at Intelligent Pensions, argues that the new style multi-asset funds will fail to deliver in precisely the same way that the old style multi-asset funds failed to deliver:

> *[I]f the objective of drawdown is to provide income for life, the one keyword that seems to be absent from all of these changes [following pension freedom] is sustainability.*
>
> *Quite simply people want to ensure that their income does not expire before they do.*
>
> *Back in 1995, a number of the early drawdown plans offered by insurance companies offered with-profits investment.*
>
> *With reversionary bonus rates as high as 9% per annum, it looked simple to take the bonuses as a sensible level of income, leaving the capital intact.*
>
> *Some companies did not offer with-profits funds for drawdown, however.*
>
> *They argued that bonus rates might fall – how right they were! They also drew attention to the need for market value reductions when the underlying value of assets was below the face value of the with-profits units.*
>
> *So these companies introduced drawdown invested in managed funds.*
>
> *These invested in cash, bonds, property and equities to provide the prospects for growth, but with downside protection. But they did not solve the problem of taking income when markets were down: while the fund included cash it was still necessary to take income from all of the fund thereby capitalising any losses. …*

[162] A particularly lethal risk which drawdown customers face is 'sequence-of-returns' risk which is discussed later in the Chapter.

Since Mr Osborne announced the pension freedoms there have been few new products, but there has been a plethora of new fund launches. And the fund of choice seems to be the 'multi-asset fund'.

These funds include income producing assets with income targeted at around 3% of the fund. But which client wants only 3%?

From where I sit, multi-asset funds are just managed funds coming back with a new name, and if I am right, they will fail drawdown investors for the same reason that managed funds did.[163]

Standard flexible drawdown products could NOT by themselves be classified as safe harbour products, since they do not hedge longevity risk.

2.2.3 Hybrid products

Hybrid products combine drawdown with longevity insurance to provide a lifelong income. They are therefore part drawdown and part annuity to differing degrees, although this will not be apparent to the consumer for whom an 'annuity' is a bad product. Those that are more annuity-like are provided by insurance companies, those which are more drawdown-like with income guarantees tend to be offered by investment management houses and investment banks, as well as some insurers. We focus on two key examples: variable annuities and guaranteed drawdown.

2.2.3.1 Variable annuities

The classic example of a hybrid product lying between lifetime annuities and drawdown is a 'variable annuity' (VA) which was invented in the US in the 1950s and was introduced in the UK around 10 years ago.[164] However, unlike a lifetime annuity or drawdown, VAs have an accumulation stage and a decumulation stage, although people are free to use only a decumulation stage VA. As such, they offer both living benefits and death benefits.

Living benefits are those which can be exercised by policyholders while they are still alive. These include:

- Guaranteed minimum accumulation benefits (GMABs)[165]
- Guaranteed minimum income benefits (GMIBs)
- Guaranteed minimum withdrawal benefits (GMWBs)[166]

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[163] David Trenner (2015) Why multi-asset funds will fail drawdown investors, Retirement Planner, 28 May.
[164] VAs were first introduced in the US in 1952 by TIAA-CREF (Teachers Insurance and Annuity Association - College Retirement Equities Fund).
[165] GMABs include capital guarantees (e.g., a fixed maturity amount at age 75) and a guaranteed minimum return, while still permitting investments in equities, although this is really a stop-loss rather than a return guarantee.
[166] A GMWB can be interpreted as a RCLA on top of drawdown plan, implying that a RCLA is similar to a variable-annuity-style guarantee.

- Free partial withdrawals (FPWs). Under specified conditions, the policyholder can exercise the right to withdraw a proportion of the fund value without incurring a surrender charge. An example might be the option to withdraw up to a specified limit (e.g., 30%) of the expected value of the residual payments based on a mortality table at the time of purchase on a one-time only basis on a key date (e.g., the 5th, 10th or 15th anniversary) upon a 'significant non-medical loss'
- Guaranteed minimum surrender benefits (GMSBs).

Death benefits (in the form of guaranteed minimum death benefits, GMDBs) are those which accrue to contingent beneficiaries once the policyholder has died. The most common is the (partial) return of premium. When the VA policyholder dies, a specified beneficiary will receive the larger of the account balance and the value of the initial investment less total withdrawals.

The lifetime income and investment guarantees, whereby the policyholder receives a minimum income irrespective of longevity and investment returns, are funded via an annual management charge and a restriction on maximum withdrawals in any year. The continued access to capital and higher death benefits comes at the expense of a lower income than available under a conventional lifetime annuity. The living benefits options incur higher charges as well as having the effect of reducing the death benefit paid to individuals who die at older ages, but also enable the provider to build up reserves from all policyholders up to the point of their death to help it honour the lifetime income guarantee to those who live a long time. This is the way in which the longevity bonus works with a VA.

The new flexible payment terms for standard annuities (see Section 2.2.1.3) also apply to variable annuities. Previously, while the income paid can increase if the underlying investment fund performs well, it was not possible to cut the income if the investments are performing poorly. In future, providers of variable annuities will be allowed to raise and lower the income paid depending on investment performance.

Subject to there being complete transparency over design and the absence of excessive charges, variable annuities (with a minimum income underpin) could be classified as safe harbour products.

2.2.3.2 Guaranteed drawdown

An example of a 'guaranteed drawdown product' is the Secure Income Option offered by MetLife, a US life insurance company with a presence in the UK since 2007.[167] The product offers flexible drawdown (in the form of immediate income and deferred income) with guarantees. Customers can consolidate existing DC pension pots into a pre-drawdown product and lock in a drawdown rate pre-retirement. There is a formula for uplifting the

[167] The following is based on discussions with MetLife.

drawdown rate if income is deferred. If the client chooses a secure income, this is guaranteed by MetLife. The drawdown rate is lower than an annuity by up to 30% (e.g., 4% at age 65 when the annuity rate is 5.5%), but allows more flexibility of access, a guaranteed income and death benefits. MetLife does not offer standard LTAs, but there is no maturity date with the guaranteed drawdown product which therefore potentially provides a guaranteed nominal income for life.[168]

Once purchased, the customer locks in guaranteed future income rates. If they elect not to take benefits on their initial chosen age, they have flexibility to change dates and use the guaranteed rate for new higher age, for example 4% at age 65 increasing to 4.10% at age 66. For each year the guaranteed income in delayed, MetLife will increase the guarantee base by 5%. So for a £100,000 investment, a delay in taking income by a year will increase the guarantee to £105,000. If after 12 months, the fund value is higher, e.g., increased to £107,000, then the higher fund value of £107,000 will be locked in and become the new guarantee base. In addition, if the fund has performed better than 5%, the higher value will be locked in annually.

Lump sum withdrawals above the guaranteed level of income will proportionately reduce the guaranteed income. For example, a £100,000 investment could pay a guaranteed income of £4,000 p.a. at 65. If the policyholder decides to withdraw a lump sum of £10% of the fund, the guarantee base would reduce by 10% to £90,000. Subsequently, the guaranteed income would reduce by 10% to £3,600.

The death benefit paid is the higher of:

- the initial guaranteed base minus guaranteed income taken, and
- the fund value.

So for example, suppose a policy has an initial guarantee base of £100,000. Suppose also £10,000 of guaranteed income is paid and the fund value has fallen to £85,000. The amount payable is £90,000. The policyholder’s beneficiaries can take the death benefit as a lump sum or as income.

Longevity risk modelling and analysis is an important component of the design of the product and MetLife:

- Uses a standard actuarial table for mortality (not the general population table)
- Assumes a mix of males and females
- Makes adjustments to these tables to reflect MetLife’s client demographics
- Allows for mortality improvements over time.

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[168] There is no guaranteed income that is linked to an inflation index such as RPI/CPI. However, the product has the potential to provide increases in income in payment through good investment performance.

The product invests in unit-linked funds and involves unit-linked guarantees. The objectives of the funds chosen by policyholders are to manage volatility to a target and to seek a total return. This creates liabilities for MetLife. MetLife uses a dynamic hedging programme called constant proportion portfolio insurance (CPPI)[169] to hedge the risk to its balance sheet from offering these guarantees.[170] CPPI involves daily switching between unit-linked funds and risk-free assets (such as Treasury bills) as the value of the unit-linked funds changes. If the fund values fall, units are sold and T-bills purchased; if the fund values rises, the opposite set of transactions occurs. The goal of the hedging programme is to construct a synthetic put option to protect the portfolio from falls in the market values of the underlying assets. The effectiveness of the hedge depends on holding assets which can be readily bought and sold. This broadly means that the funds it offers will comprise equity and fixed interest assets which are listed on large stock markets. MetLife uses BlackRock (for equities) and Fidelity Worldwide Investment (for fixed income). Only small amounts of property or hedge funds are included in the portfolio as they are inherently unhedgeable asset classes.

Since no hedge is perfect, it is possible for mismatches between assets and liabilities to occur. In this case, the liability is MetLife’s, so any shortfall would be met from MetLife’s reserves/capital. If the hedging programme were to fail, then the shareholder capital would be used to cover any unmet policyholder liabilities. The only point at which the guarantee could fail would be if MetLife Europe Limited were to fail. In this circumstance, the customer’s investment and their guarantee could be lost. However the products are covered by the FSCS.

Charges are as follows:

- Annual management charge (i.e., the charge for administration) – 0.70% for funds up to £149,999, 0.6% for funds from £150,000 to £249,999, 0.5% for funds from £250,000 to £499,999, and 0.4% for funds above £500,000
- Investment management charge (for the operation of the funds) – 0.55%
- Guarantee charge (for providing the income guarantee) – 0.60%
- Additionally, there may be an adviser charge.

[169] See, for example, André F. Perold and William Sharpe (1988) Dynamic Strategies for Asset Allocation, *Financial Analysts Journal*, January/February, 16–27; Fischer Black and André F. Perold (1992) Theory of Constant Proportion Portfolio Insurance, *Journal of Economic Dynamics and Control*, 16, 403-426; David Blake, Andrew Cairns and Kevin Dowd (2001, p.195) Pensionmetrics: Stochastic Pension Plan Design and Value-at-Risk During the Accumulation Phase, *Insurance: Mathematics & Economics*, 29, 187–215.

[170] Prior to September 2015, MetLife used over-the-counter options with a number of counter-parties to hedge this risk.

This means that the charge for a £50,000 investment by a 65-year-old would be 1.85%, excluding any adviser charge.[171]

The preferred customer is someone with a £1.5m pension pot who uses £0.5m to provide minimum core income for essential spending and puts £1m into a diversified portfolio. Next are clients with other assets who want to guarantee a legacy for their descendants with long-term capital guarantees. Next are mass affluent clients with £100,000-150,000. MetLife has now brought down the minimum to £30,000, in line with the new level of trivial commutation.

Clients come via advisers (i.e., the product is an advised solution) who help explain longevity risk and the risk of underestimating how much people need to live on using cash flow modelling software (e.g., Voyant) which inputs data on typical spending patterns of the client. According to MetLife, 'advised sales provide greater comfort as benefits and risks of our products are explained to our customers and the adviser checks for understanding. For example, MetLife believes it is important how customers understand sequence-of-returns risk and how safe drawdown overcomes this'.[172]

Another example is Aegon which has launched a drawdown product with combined access to unit-linked guarantees on its Retirement Choices platform in July 2015. David Macmillan, Aegon managing director, said: 'The ability to combine true lifelong income guarantees with drawdown on platform will provide customers and their advisers with the certainty of income they tell us they want, but also with a huge amount of flexibility, both in terms of income and in terms of their ability to switch between products'.

Zurich is also launching a guaranteed drawdown product in 2016 that combines drawdown and a protection element that converts the plan into an income for life at a certain pre-determined age. The charge is not yet known. The product was designed in response to a survey Zurich conducted which revealed that 18% of respondents were interested in drawdown, but were fearful of running out of money. The survey results were as follows:

- 10% of over-55s in DC pension schemes have dipped into their retirement savings under the new freedoms
- 69% of over-55s have not explored their options under the new freedoms (37% were 'not ready', 26% had already bought an annuity).

The main reasons for not accessing pensions after exploring options were:

- 54% were not ready to make a decision

[171] Jenna Towler (2015) MetLife unveils flexible guaranteed drawdown offering, Retirement Planner, 14 September.

[172] http://www.metlife.co.uk/uk/Sales_Aids/2015/0471_Hour_of_Maximum_Danger.pdf. 'Sequence of return' risk will be discussed shortly.

- 34% were keeping their pension funds invested and tapping into other assets first
- 18% claimed the fear of running out of money by taking a lump sum or going into drawdown was holding them back
- 7% said their pension provider did not offer the option they wanted.[173]

Subject to there being complete transparency over design (in particular how the guarantee is underwritten) and the absence of excessive charges, guaranteed drawdown products (with a minimum income underpin) could be classified as safe harbour products.

2.2.4 Other products

2.2.4.1 'Mix and match'

Just Retirement has launched a range of 'mix and match' retirement income products targeted at 'Middle Britain'. Alongside LTAs, it offers UFPLS, guaranteed income products with flexible extended guarantee periods and 'drawdown-lite' which invest in a selection of moderate to low-risk passive funds. Stephen Lowe, director, said: 'The consensus of consumer research shows that people with sufficient pension savings would like the best of both worlds – a guaranteed income for life to ensure regular bills may be paid and a flexible fund that may be accessed when required for irregular expenditure and to provide a 'just in case' fund'.[174]

2.2.4.2 DIY

Some commentators have proposed a do-it-yourself approach which involves investing in assets and dipping in to them to withdraw investment returns or capital as required. Simple examples of assets suggested for this purpose are investment trusts and exchange-traded funds that focus on income generation. Typical yields lie between 3.4 and 3.8%.[175] More sophisticated approaches would involve constructing a DIY fund, in other words, a personalised multi-asset fund consisting of UK and global income funds, possibly with some diversification into property.[176]

DIY products could NOT be classified as safe harbour products, since they do not hedge longevity risk.

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[173] Reported in Carmen Reichman (2015) Zurich to launch protected drawdown product, Professional Adviser, 9 September.

[174] Quoted in Jenna Towler (2015) Just Retirement unveils post-pensions freedom 'mix and match' products, Professional Pensions, 25 February.

[175] Richard Evans (2015) Need income from your pension? Here are six alternatives to an annuity, Daily Telegraph, 12 May.

[176] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.

2.2.4.3 Pension bank account

This is where the pension scheme is used as a cash machine (i.e., taking withdrawals via UFPLSs, where 25% of what is withdrawn is tax free) and has traditionally been available only for retail customers via a SIPP. So-called 'pension bank accounts' have very high charges. The initial fee could be as high as 3% and there will be additional administration and fund management charges of 1% p.a. For example, someone setting up a SIPP with Alliance Trust with a pension pot of £20,000 will pay an arrangement fee of £300, annual administration charge of £311 plus an annual fund management charge. Ad hoc cash withdrawals could cost anywhere between £30 and £400 per withdrawal depending on the SIPP provider.

In March 2015, the FCA said it would 'look at the different types of charging structures put in place, and look at whether they are sufficiently transparent [and whether] people are aware of what charges they will face'.[177]

The charges are a lot lower in providers' schemes that allow UFPLS.[178] For example, Aviva, Scottish Widows, Standard Life and Aegon will allow such withdrawals and will not charge extra for doing so or limit the number of withdrawals, while Legal & General and LV= will not, and Prudential and Friends Life were undecided as of February 2015.[179] However, most existing workplace DC pension schemes cannot currently be used as bank accounts, since they are not set up to offer this facility.[180]

In June 2015, the Daily Telegraph reported that Friends Life was refusing to allow clients to use their pension schemes as 'bank accounts', while other companies, including NEST, were refusing to allow clients to 'dip into their funds as often as they need'. Customers faced the following restrictions depending on the provider: a minimum withdrawal of £5,000, a maximum of 3 or 4 withdrawals per year, and no flexible access if the pension pot is less than £30,000. Fidelity charged no fee for up to three withdrawals per year, while NFU

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[177] Katie Morley (2014) Pension 'bank accounts': You will have to pay for cash withdrawals, Your Money, Daily Telegraph, 8 November; Professional Adviser (2015) FCA to investigate 'rip off' pensions freedom charges – reports, 30 March.

[178] This option is not available with flexi-access drawdown.

[179] Katie Morley (2015) Will your pension provider give you freedom?, Daily Telegraph, Your Money, 14 February.

[180] Michelle Cracknell, chief executive of The Pensions Advisory Service (TPAS), said: 'The majority [of our calls now] are about how to cash in pension pots and what the tax positions is, and there is a lot of misunderstanding. People are saying to us "how do I [get the money] quickly" and I think the shock will be…that they have to access another product to take out their money.' Quoted in Michelle McGagh (2015) Want pension cash from your employer? Prepare to be disappointed, City Wire, 13 February.

Mutual charged £240 per withdrawal. However, under pressure from the Daily Telegraph and other national newspapers, Friends Life reversed its decision shortly after. [181]

In July 2015, Which? published a report on drawdown charges, included those on UFPLS.[182] This again confirmed the variety of charges from different providers ranging from Charles Stanley Direct which charges £270 for the first withdrawal each year, through James Hay (£100), Barclays Stockbrokers, Halifax Sharedealing and TD Direct (all £90) to Fidelity and Hargreaves Lansdown which have no charge at all.

There is a risk that people will take their pension as a cash lump sum and leave it in a bank account. The Financial Services Compensation Scheme provides 100% protection for annuities and up to 90% of the value of other insurance products without limit. For deposits, however, it only protects up to £75,000 per person per bank or building society. FCA Consumer Panel chair Sue Lewis says: 'We are concerned that consumers with pension pots exceeding the FSCS's £75,000 limit may inadvertently lose out on protection for their money if they choose to withdraw their pot rather than buying an annuity or leaving their money invested'.[183]

Pension bank accounts could NOT be classified as safe harbour products, since they do not hedge longevity risk.

2.2.4.4 Buy-to-let pensions[184]

With a buy-to-let pension, part of the pension pot is used to make a deposit on a buy-to-let property. The pensioner then takes out a mortgage and uses the rest of the pension pot to cover the mortgage repayments. The rental income provides the pension which is taxable.

The attraction of buy-to-let was that the mortgage repayments attracted tax relief. However, this relief was removed in the Budget on 8 July 2015, in large measure due to the increase in pension wealth moving into buy-to-let and the distortions to the housing market this was causing, following the introduction of the pension reforms in April 2015. Instead a tax credit worth 20% of the mortgage interest will be applied. The changes will be phased in between 2017 and 2020. The Daily Telegraph provided the following before and after example to illustrate the consequences, assuming a landlord paying 40% tax:

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[181] Dan Hyde (2015) Pension companies 'failing to move with times', says minister, Daily Telegraph, 4 June; Dan Hyde (2015) Osborne's promises rejected by most pension providers, Daily Telegraph, 6 June.

[182] http://www.which.co.uk/news/2015/07/the-true-cost-of-pension-freedom-409249/

[183] Reported in Tessa Norman (2014) Consumer bodies warn over FSCS protection and Budget reform, Money Marketing, 3 October. The compensation level was reduced from £85,000 at the beginning of 2016 and the quote from Sue Lewis has been amended to reflect this.

[184] Michelle McGagh (2015) Annuity alternatives: 5 income solutions on the cards, Citywire, 7 January.

NOW

Your buy-to-let earns £20,000 a year and the interest-only mortgage costs £13,000 a year. Tax is due on the difference or profit. So you pay tax on £7,000, meaning £2,800 for HMRC and £4,200 for you.

2020

Tax is now due on your full rental income of £20,000, less a tax credit equivalent to basic-rate tax on the interest. So you pay 40% tax on £20,000 (i.e., £8,000), less the 20% credit (20% of £13,000 = £2,600), meaning £5,400 for HMRC and £1,600 for you. Your tax bill has therefore gone up by 93%.

Now, say Bank Rate – and in turn your mortgage rate – rises by a small fraction, lifting your mortgage cost to £15,000, while your rent remains at £20,000.

You will have to pay £5,000 tax in this scenario, so you make no profit at all.[185]

In November 2015, the Government announced that purchasers of buy-to-let properties will have to pay an extra 3% in stamp duty from April 2016. There are other potential pitfalls. The mortgage lender is likely to require a deposit of 40% or more. If the pensioner draws down the pension pot to pay a mortgage of this size, this could put the pensioner into a higher income tax bracket which could make the strategy uneconomic. The net rental income after taking into account mortgage repayments, the letting agent's fee, insurance, service charges and maintenance costs might not be very large. Further any void periods, where the property is unlet, will reduce rental income. If a large number of people start to use buy-to-let, this will have the effect of lowering average rents. Also the buy-to-let property is included in the pensioner's estate for inheritance tax purposes. If the property is sold before death, capital gains tax is payable.

A survey of 1,000 over-55 year olds by Prudential in September 2015 indicated that 14% of them were planning to buy property to let as a result of the pension freedoms, while 37% said they were planning to buy property to live in themselves. The most common reason (43%) for planning a purchase was to downsize to a smaller home.[186]

It is an open question whether a buy-to-let pension could be classified as a safe harbour product. While it potentially hedges longevity risk (assuming a sufficiently long lease) and could provide an inflation-linked income, the changes to the market announced by the

[185] Richard Dyson (2015) The death of buy-to-let, Your Money, Daily Telegraph, 22 August. The Daily Telegraph has launched an 'Axe the buy-to-let tax grab' campaign.
[186] Reported in Marion Dakers (2015) Savers have shunned buy-to-let despite pension freedoms, Daily Telegraph, 3 September.

Government on and after 8 July 2015 have substantially reduced the return on and increased the risk of this product.

2.2.4.5 Extreme-inflation protection

At present, due to the approximate 40% reduction in initial income, only about 5% of people who buy a LTA purchase inflation-proofing (i.e., buy an index-linked annuity). We were told that it would be possible to design a cheaper form of inflation-proofing which aims to match RPI more closely and which would provide a hedge against extreme inflation shocks (a feature described as an 'inflation-kicker').

The concept, which has yet to come to market, is based on the assumption that most retirees can tolerate a limited amount of inflation risk. Therefore, if inflation were below 3%, the annuity income might fall slightly. If it were exactly 3%, there would be no change. Above this figure, the income would increase. [187]

This is an interesting idea and quite different from the two existing methods of capping the cost of inflation protection. The first is to buy a fixed rate of escalation, e.g. 3% per annum. The problem with this is that the annuitant receives the increase irrespective of actual inflation rates, so it could be more or less than is needed to keep pace. Due to the current low-inflation environment, 3% indexation is not significantly cheaper than full RPI. The main problem with a fixed rate of escalation is that it offers no protection in the event of soaring inflation, such as that experienced in the 1970s. With quantitative easing about to unwind, it would be impossible to rule out an inflation spike over the next 20 or 30 years.

The second method is limited price indexation (LPI). This matches RPI, but only up to a limit of 2.5 or 5%. So, like fixed escalation at 3%, it does not protect against a future inflation spike.

2.2.4.6 Home equity release plans

Home equity release plans (also known as reverse mortgages or lifetime mortgages) can take the form of a LTA, although this is not the most popular form. Equity release allows home owners to borrow from the equity in their homes while still living in them. This might be particularly attractive to the elderly who might have low pensions, but substantial net housing wealth.[188] According to a study by LV=, 32% of retirees live on less than the

[187] This is similar to the smoothing principle of a with-profits annuity.

[188] See Les Mayhew and David Smith (2014) *The UK Equity Bank: Towards Income Security in Old Age*, ILC-UK, June for a proposal 'to establish a state agency which helps people release income from their homes in the form of a lifelong annuity in return for selling a portion of the equity in their homes to the state in which the value of the annuity is recovered on the death of the recipient'.

minimum wage, are going without adequate food and heating, yet the majority of these have untapped housing assets.[189]

Home equity release plans started in US in the 1980s, where they are available from age 62. The most common type is the home equity conversion mortgage, which allows borrowers to take a reverse mortgage in the form of: a lump sum, a lifetime income or drawdown (in effect a line of credit). The amount that can be borrowed is negatively related to the interest rate. Interest (typically 1.50% above government bond rates) is accrued and paid on moving or death, so there is no credit risk. However, the total interest payable is capped at the sale price of the property and lenders are protected against total interest costs rising above this limit (as a result of the home owner living a very long time) by a mortgage insurance policy that the borrower is required to take out (at a cost of 2% of the amount borrowed plus 0.5% p.a.).

In the UK, home equity release plans are provided by members of SHIP (Safe Home Income Plans). SHIP members offer a range of guarantees, including the right to live in the property for life, the flexibility to move home without penalties, and never owing more than the value of the property.

The following types of plan are offered:

- Home reversion plans – The home (in whole or part) is sold in exchange for a lump sum or monthly income (or some combination). The home owner therefore becomes a tenant and when the property is eventually sold (typically following the plan member's death), the reversion company receives the value of the loan plus interest (up to the value of the property sold)
- Home income plans – The plan member takes out a mortgage against the value of the property and uses the money to buy a purchased life annuity (PLA). Interest on the mortgage is deducted from the annuity, while the capital sum borrowed to buy the annuity is generally repaid when the property is sold after the plan member's death
- Lifetime mortgages – The plan member receives a lump sum or annuity (or some combination) with the interest being rolled up into the loan. The original loan plus interest is repaid when the property is eventually sold.

The maximum initial loan increases with the plan member's age, but is generally capped at 50% of the value of the property.

Equity release has not always had a good image in the UK. There was a mis-selling scandal in the 1980s. Since then, standards have improved with the establishment of the Equity

[189] Reported in Sarah O'Grady (2015) 5m pensioners go without food and heat in cash, Daily Express, 10 September 2015.

Release Council (ERC). Membership of the ERC ensures that only qualified independent financial advisers can sell equity release products, that the value of the loan cannot exceed the value of the home, and that a homeowner cannot lose their home, since interest can be rolled up and paid on their death. However, the protection against losing the home has been put at risk by the European Mortgage Directive (EMD) which allows new 'equity release-lite' products called 'lifetime mortgages' to be sold. They can be sold without advice and require interest to be paid rather than rolled up. The requirement to pay interest means the product no longer comes under the equity release rules, but instead comes under the residential mortgage rules, which means borrowers can lose their homes if the interest is not paid.[190]

In September 2015, the ERC announced that there was £710m of equity release in the first half of 2015, the largest half-year amount on record. Homeowners over 55 were withdrawing more than £4m of housing wealth every day. The main reasons given for this are rising house prices, tougher borrowing conditions and inadequate pension provision. Table 2.2 provides details of the equity release market and shows, for example, that 65% of new plans were drawdown and 35% were lump sum.[191]

Table 2.2: The equity release market in 2015

	Drawdown	Lump sum
Average house price	£304,340	£242,476
Average initial withdrawal	£46,958 (15.4%)*	£77,494
Average drawdown reserves	£32,348 (10.6%)*	NA
Average loan-to-value (LTV)	26%	32.0%
Average age at purchase	71.5	67.7

Source: ERC
Note: * % of average house price

Alex Edmans, head of retirement at Saga, said: 'The [FCA's] Mortgage Market Review has stopped many older people from accessing a traditional mortgage, this and the fact that many people are now coming to the end of their interest-only mortgage term without a full repayment plan, has meant that more are turning to equity release as a viable solution to borrowing in retirement. Indeed, Saga has seen an increase in the use of equity release to clear a mortgage. Now is a good time to consider equity release, as interest rates are at

[190] Michelle McGagh (2014) Mortgage directive revives equity release fears, Citywire, 24 November 2014.
[191] Reported in Professional Adviser (2015) Older homeowners flock to equity release, ERC data shows, 23 September.

their lowest ever levels, property prices are increasing and loan-to-values have recently increased, meaning people are able to access more of the wealth tied up in their property'.[192]

In September 2015, the FCA announced that it was considering how regulation can help foster 'more of a market' in equity release. Christopher Woolard, director of strategy and competition said: 'The average pension pot is £30,000, yet a significant number own property assets of around seven times that number or more. The ability to access some of that asset, as a restricted lump sum or as a gradual income, could make a significant difference to people's lives. Yet, in the not too distant past, equity release became a dirty word. Whilst we have seen a combination of regulation and industry-led initiatives to help clean up the market, some will argue that the costs of equity release, both up front and compounded over time, are relatively high for the individual, and that the previous image has stuck. We believe there is a debate to be had about what products and markets could exist, and whether more entrants and innovation here might benefit consumers with greater choice and improved products'.[193]

Some argue that equity release could also be used to fund long-term care. For example, Adrian Walker, retirement planning manager at Old Mutual Wealth, raised the issue when he discussed the findings from a survey his company had conducted for its *Redefining Retirement* report. The YouGov survey of 1,600 people aged 50 to 75 showed that 'while equity release was predicted to play a greater in people's retirement and long-term care planning, long-term care is still one of the great unknowns of growing old. We Brits famously don't like to talk about death and, similarly, it would seem that we also don't like to think about how and where we might spend our later days'. The survey asked people aged 50 to 75 about their provision for long-term care: 30% of respondents have some savings set aside for their long-term care, but only 1% had a care plan in place, and 2% have, or plan to have, long-term care insurance; 46% had not thought about their long-term care needs and 8% had no intention of doing so.

Mr Walker argues that 'advisers and clients must address the potential need to meet long-term care costs and come up with a plan accordingly. As property is very often the biggest asset that people hold, it makes some sense to look at how that, as an asset, could be used to help pay for a person's care costs. Housing assets are taken into account in the current system. If you have more than £23,250 in assets[194] you will be responsible for your own care costs. However, if you receive care in your own home, property assets are not considered in the calculation. As soon as you move into a care home, then your home is included and can

[192] Reported in Professional Adviser (2015) 'Perfect storm' sparks record equity release sales, 28 July.

[193] Reported in Carmen Reichman (2015) FCA to examine equity release market amid reputation concerns, Professional Adviser, 7 September.

[194] Figures differ slightly in Scotland and Wales.

be used to cover costs. In the same survey, we asked whether people would be interested in releasing value from their home and, of those who would, 34% said they would do so in order to pay for their long-term care'.

Mr Walker accepts that: '[Equity release] is already increasing in its use as a source of delivering income in retirement of which care costs would be part. It seems a logical step that people should start to consider how they access the value of their property when they are able, in order to put something aside and form a plan for later in life when they may have a requirement for care outside their home and when they may not have the luxury of time to plan'.

However, many people do not like the idea of someone else having an interest in their home, so another solution is downsizing, allowing the released equity capital to be invested to fund future long-term care, although this too has 'emotional issues attached to it'.[195] It also has cost implications, with typical moving costs in the region of £20,000.[196]

2.2.4.7 ISA pensions and care ISAs

ISA pensions have been proposed by Michael Johnson of the Centre for Policy Studies.[197] He argues that 'Many eschew pension saving, thereby missing out on tax relief, but engagement with ISAs is high. Ready access and flexibility is valued above tax relief'.

His proposals involve replacing occupational pensions with ISA-style pensions. This, in turn, would involve replacing the existing EET (exempt-exempt-taxed) pension tax system with the TEE (taxed-exempt-exempt) tax system of ISAs.[198] With EET, contributions and investment income are exempt from tax and only the pension is taxed. With TEE, contributions are taxable (i.e., paid from post-tax income), but investment income and withdrawals are exempt. Mr Johnson believes this switch would bring forward significant tax payments and reduce the deficit by 'perhaps up to £10bn'.

Early research from PwC suggests that employees would welcome switching to a system that treats pensions like ISAs, since they believe that the current tax treatment of pensions is too complex. PwC surveyed 1,197 employees and found two-thirds did not understand the current system. Around 40% said they would rather contribute out of taxed income, and enjoy tax-free money in retirement, while only 27% wanted to keep the current tax regime, and just 14% said the tax relief on offer was an incentive to save. Further, 60% said that the

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[195] Reported in Jenna Towler (2015) Can equity release help solve the long-term care funding crisis?, Retirement Planner, 18 August.
[196] Reported in Nicole Blackmore (2015) 'Downsize? It's more costly than staying put'. Your Mpney, Daily Telegraph, 3 October.
[197] Michael Johnson (2015) , The Workplace ISA And The ISA Pension, Briefing Note, Centre for Policy Studies, 3 July; http://www.cps.org.uk/files/reports/original/150703115927-TheWorkplaceISAandtheISAPension.pdf
[198] The pension tax system is discussed in more detail in Chapter 7.

constant tinkering with the pension system had put them off saving. Philip Smith, head of defined contribution pensions at PwC, said: ‘People want a once in a lifetime overhaul of how pensions are taxed to create a simple and stable system which they can understand and trust. Moving towards an ISA-style tax system would create consistency across people’s savings pots and help them plan for their future with more certainty’.

Nevertheless, Raj Mody, head of pensions consulting at PwC, said the Government would still need to incentivise people to put money into retirement saving vehicles, if upfront relief was removed: ‘The reality is that when it comes to tying up money for the long term, people need an incentive. Otherwise, why would you bother saving for your retirement when faced with more immediate pressures on your finances?’. A similar warning came from Jonathan Howe, UK insurance leader at PwC: ‘Pensions savings are a hugely important part of the UK retirement bank. Any reform must not reduce incentives for individuals to save for the long-term and increase the risk of a future pensions hole. Upfront reliefs can be a very important element and they also help make it clear that pensions are intended to be different – for long-term saving’.[199]

Phil Loney, chief executive of Royal London, also warned that saving levels could fall significantly under the TEE framework. He also believes that many people will not trust a system which requires people to accept that a future government will not tax pension withdrawals. He said: ‘This so called “ISA-style” tax treatment of pension contributions is a fundamental and far-reaching change to the principles of pension savings, which could pose considerable risk to the Government's aim of creating a savings culture in the UK. There is no evidence that the promise of tax-free income, 25-30 years into the future, would be believed by the public given the volume of changes to the pensions system over the last 25 years. Consequently, there is a real risk of a significant fall in savings, which are already too low in the UK. It would also create a parallel system which is wholly incompatible with people's existing pension arrangements, would take years to develop and would increase the overall cost of pensions. We believe that it is vital to reform the current tax relief system to make long term saving fiscally neutral for all. The incentives need to focus on those with lower incomes, to create a more realistic and lower risk way forward. This could also enable the abolition of the lifetime allowance’.[200]

In a similar vein, Dr Ros Altmann, before becoming Pensions Minister, proposed ‘Care ISAs’, as a vehicle for funding later life care.[201] In August 2015, the insurer LV= disclosed that, over the previous five years, more than 19,000 pensioners had to remortgage their homes with

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[199] Reported in Jack Jones (2015) Savers want ISA-style pensions, PwC research claims, Retirement Planner, 11 August.

[200] Reported in Carmen Reichman (2015) Royal London chief warns of 'real risk' to saving under ISA-style pensions, Professional Adviser, 18 August. These issues are raised again in Chapter 7.

[201] Reported in Jim Pickard and Josephine Cumbo (2015) ‘Workplace ISA’ to shake up UK retirement saving, Financial Times, 3 July.

local authorities because they were unable to afford the cost of residential care. Many people face care bills well in excess of their pension pots because of a dramatic increase in the average time spent in a care home in recent years.[202]

ISA pensions would NOT be classified as safe harbour products, since they do not hedge longevity risk.

2.2.4.8 Peer-to-peer loans

Peer-to-peer (P2P) lender Zopa has launched a campaign to allow members of SIPPs to include P2P loans in their pension pots. This followed a successful campaign for P2P loans to be allowed in a new style of innovative finance ISA (IFISA) from April 2016. According to the Daily Telegraph: 'Currently, P2P loans are classed as non-standard investments, meaning that the pension provider must set aside more capital against the possibility of the loan defaulting. The result is that any SIPP provider who does allow P2P investment will charge the pensioner extra fees to cover the capital cost.

'Peer-to-peer loan firms market themselves as an alternative to banks, where savers put their money into a platform that lends it on to pre-vetted individuals or companies. However, in return for the extra interest savers must also accept a greater risk that the borrower will not repay the loan and so it is possible to lose money…[and] 57% of lending on Zopa is funded by savers aged 55 or above'.[203]

In February 2016, the FCA announced it would bring P2P loans under its investment advice rules. This would allow advisers with appropriate permissions to advise on the products and introduce a ban on commission from the products. Other types of advisers would not be expected to give advice on specific P2P loans.[204]

Also in February 2016, Lord Adair Turner, former chair of the FSA, was concerned that automated processes and a lack of good credit underwriting will mean people are bound to lose money from their investment. He said that: 'You cannot lend money to small and medium enterprises, in particular, without somebody going and doing good credit underwriting. This idea that you can just automate that on to a platform, I think it has a role to play, but I think it will end up producing big losses….The losses which will emerge from peer-to-peer lending over the next five to ten years will make the worst bankers look like absolute lending geniuses'.

[202] Reported in The Times (2015) Pensioners in 'pay when you die' deals, 14 August.
[203] Reported in Tim Wallace (2015) Zopa lobbies for peer-to-peer loans to go in pension pots, Daily Telegraph, 18 August.
[204] Reported in Carmen Reichman (2016) FCA excludes P2P products from independent advice rules, Professional Adviser, 3 February.

Kevin Caley, chief executive of crowdfunding platform ThinCats, confirmed that neither it nor its 'sponsors' – a network of former bank managers who write a report on what the business does, its cashflow projections, and its ability to repay the loan – give recommendations to investors. He said is was the responsibility of the financial adviser recommending a client make a P2P loan to do their own due diligence on the borrower.[205]

Peer-to-peer loans would NOT be classified as safe harbour products.

2.3 Current and planned delivery systems for retirement income products

Until Flexiday, the most common vehicles for delivering retirement income from DC schemes were personal pensions, SIPPs, and group personal pensions (GPPSs), all of which are essentially retail products. Following the new pension flexibilities, three forms of retirement income delivery vehicle have been developed: institutional, retail, and a hybrid combination of institutional and retail.

2.3.1 Institutional distribution vehicles

2.3.1.1 Institutional annuitisation

With institutional annuitisation, the DC scheme arranges for the pension to be paid until the scheme member dies. This is what happens in DB schemes. There are two cases.

In the first case, the scheme self annuitises and is responsible for making good any deficit arising because, say, member life expectancy has been underestimated. The benefit from group self-annuitisation is that the scheme retains the mortality premium that arises from those members of the scheme who die earlier than their life expectancy. It is equal to the ratio of the proportion of the annuitants aged x who die during a particular year (having survived to the beginning of that year, denoted q_x) to the proportion of the annuitants aged x who survive the particular year (denoted $(1 – q_x)$).[206] It can be used to enhance the annuity paid to those who live longer than their life expectancy. This can be seen from Figure 2.1 which shows that the amount paid on an annuity has three components: the return of capital or initial premium,[207] the investment return on the capital (less charges), and the mortality premium.[208] Initially the weight of the mortality premium in the total payment is

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[205] Reported in Carmen Reichman (2016) Ex-FSA chairman attacks P2P in wake of industry's biggest failure, Professional Adviser, 10 February.

[206] That is, the mortality premium at age x is equal to $q_x/(1 – q_x)$, which, in turn, is equal to the odds of dying at age x. It arises because those annuitants who die below life expectancy no longer need to be paid and the payments that would otherwise be paid to them are redistributed to surviving annuitants. No other type of investment has this additional source of return and it increases significantly with age as both Figure 2.1 and Figure 2.3 show.

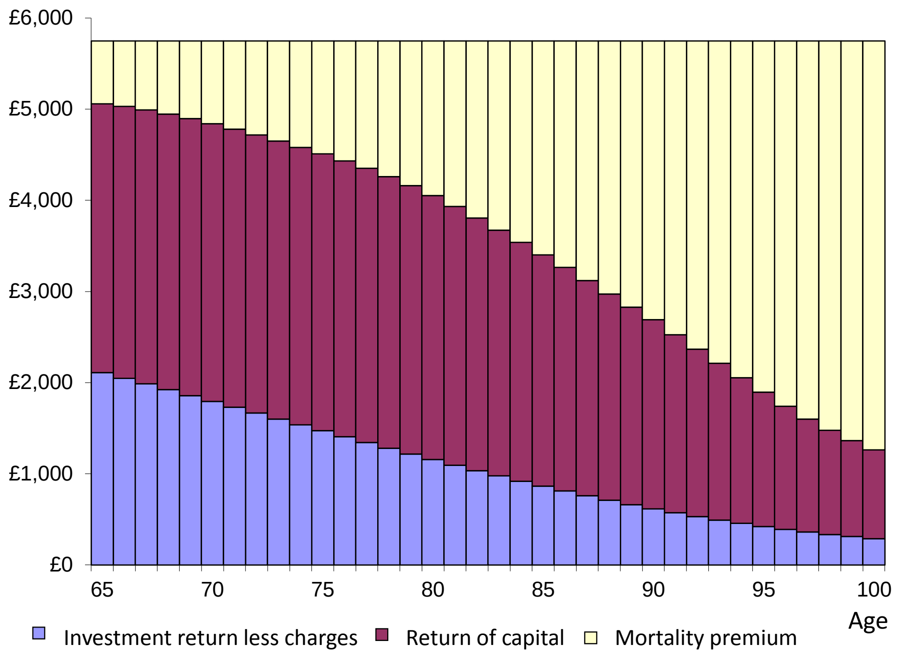
[207] The annuitant's initial investment (the premium or capital) is gradually 'returned' (or paid back) to the annuitant as part of each annuity payment.

[208] We are grateful to Tom Boardman for preparing this Figure.

quite low, since only a small proportion of the retirees die soon after retirement. By contrast, the proportions of the total payment represented by the return of capital and the investment return (net of charges) are initially quite large. Over time, these proportions decrease in size as capital is returned to the annuitant and the relative significance of the mortality premium increases.

Group annuities are the *only* financial asset ever invented to benefit from this additional source of return. Drawdown products do not benefit from the mortality premium (since they do not pool mortality risk). Unfortunately, very few people understand this.[209]

Figure 2.1: Decomposition of annuity payments



An international example of group self-annuitisation is the Swedish Premier Pension System (PPM).[210] Here each cohort of retirees completely 'self-annuitises' using tontine annuities.[211]

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[209] For a useful explanation of the mortality premium, see Michael Kitces (2015) Understanding the Role of Mortality Credits – Why Immediate Annuities Beat Bond Ladders for Retirement Income, 1 April; https://www.kitces.com/blog/understanding-the-role-of-mortality-credits-why-immediate-annuities-beat-bond-ladders-for-retirement-income/#more-5955

[210] Edward Palmer (2000) The Swedish Pension Reform: Framework and Issues, *World Bank Pension Primer*, Washington D.C.

[211] A tontine annuity – named after a Neapolitan banker called Lorenzo Tonti (1635-1690) – is generally classified as a pooled or mutual annuity where the investment and longevity risks are borne by the members of the pool and there are no cross-subsidies with other cohorts of members. In other words, there is complete self-annuitisation within the pool. A number of subscribers contribute capital to a common investment fund and then take an annuity from the fund which depends on the fund's performance and the number of

The starting annuity rate is set on the basis of current mortality projections and interest rates. However, the annuity is rebased annually in the light of revised mortality projections and investment returns. This means that the annuity can rise and fall over time. The intention is to avoid intergenerational cross-subsidies.

In the second case, the scheme buys in annuities for its retired members from an insurance company via bulk purchase annuities (BPAs). BPAs have become common in DB schemes since 2007 and the economies of scale involved can benefit scheme members as well as the DB scheme itself (i.e., through an improvement to its funding level and its risk profile relative to liabilities). The idea is for the insurance company to underwrite the longevity risks, relative to a guaranteed lifetime income, presented by a cohort of retirees. There would be a requirement for the individual underwriting of each annuity sold by means of a medical questionnaire, but it is possible that this could be simplified if there were common characteristics in the cohort, for example, in relation to the industry in which they worked (e.g., a common occupational health risk) and/or in the area in which they lived ('postcode' or socio-economic underwriting, also known as geodemographic profiling).

If this model could be fully developed for the DC auto-enrolment market, it could deliver better value for money for retirees, and it might be implemented via a national clearing house, for example, to ensure universal access and competitive pricing. It might also be offered directly by the large-scale DC schemes, once they have achieved the necessary critical mass. However, it is also possible that some – indeed many – schemes might be reluctant to assume the additional liabilities associated with group self-annuitisation.

2.3.1.2 Scheme drawdown

How scheme drawdown works

Scheme drawdown is where a pension scheme is used to provide a withdrawal facility together with an institutional investment management solution to meet the decumulation needs of DC members in early retirement, i.e., until longevity insurance kicks in. In many respects, scheme drawdown is a natural extension of the default fund used by modern multi-trust, multi-employer schemes for the auto-enrolment accumulation stage. It is also a natural extension of the trustees' governance role and fiduciary duties, which, prior to 6 April 2015, ended very abruptly when members were steered towards the purchase of LTAs at the point of retirement. Under scheme drawdown, the trustees would be responsible for

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surviving subscribers. As each subscriber dies, his or her share is divided among the survivors in proportion to their initial subscription. Depending on the mortality experience of the pool and the investment performance of the fund, the survivors will receive either an increasing or falling annuity over time. The last surviving subscriber gets the entire residual fund.

governance, which would include the selection of the investment manager(s) and administration of payments into retired members' individual accounts. This governance structure would avoid the need to rely on individual employers.

The specific details about scheme drawdown offerings available are sketchy. However, Towers Watson's Fit for Retirement Survey 2015 suggested that 31% of schemes are planning to offer some form of scheme drawdown in 2016 and a further 13% are considering its introduction in 2017.[212] We were told that the maximum recommended income that a member can drawdown might still be linked to GAD rates, as was the case for retail drawdown prior to Flexiday, although it would be reviewed annually (rather than every three years) because members might wish at any point to purchase a LTA. The cap on maximum income might be set at a slightly lower level than the GAD maximum – e.g., 5-10% lower – in order to provide a 'buffer' or reserve. This would enable the fund to smooth the income payments when markets are volatile and also to return funds to members who decide the time is right to make an annuity purchase.

The income would be generated partly from the investment yield and partly from a drawdown of capital (i.e., the accumulated pension pot). For example, if the aim were to deliver a maximum income of 6%, this might comprise 3.5% from the yield and 2.5% from capital. Funds are likely to be low-risk and largely bond-based, but might also include a modest allocation to growth assets in order to help preserve the annuity-purchasing power of the funds.

We were told that there would be no need for individual advice with this type of arrangement – as there is with retail income drawdown – because it is an income-paying fund with an administration facility offered by the scheme trustees. Even if this is the case, it will be necessary for trustees to provide clear member communications and much would depend on whether scheme drawdown is the default or an option. Where drawdown is the default, then for the early years of retirement, there would need to be some form of screening process to ensure members for whom the strategy is not suitable are offered alternative arrangements. For example, a single person with no dependants who is in poor health would probably be better off with an enhanced annuity or a cash lump sum. Where it is not the default, a professional decumulation service appointed and monitored by the trustees could steer members towards the most appropriate decision for their circumstances, in which case, the scheme drawdown fund would be one of the available options. The regulator would also have to settle the issue of whether any such steer constituted guidance or advice.[213]

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[212] Jonathan Gardner (2015) Withdrawal Strategies for DC Retirees, Towers Watson Corporate and Trustee Briefing, 5 October.
[213] This is discussed in detail in Chapter 3.

The attraction of scheme drawdown is that it has the potential to be much cheaper and deliver more consistent results than conventional drawdown, due to economies of scale, trustee oversight, and the use of a well-designed institutionally managed fund. Scheme drawdown would also be more flexible than a FTA because members would be able to purchase an LTA at any time or at designated regular intervals, depending on the scheme rules.

Scheme drawdown could therefore be used as a relatively short-term decumulation solution. This would provide members with a breathing space before purchasing the LTA. It might also be used for a longer period during the early stage of retirement. The scheme might have a default age to switch to an LTA, such as 75.

We did not have access to the pricing of products that are being launched, but we estimate that the member charge might be in the region of 0.6% to 1%. The breakdown for a member charge of 0.6% might be 0.40% for fund management and 0.20% for administration of payments to individual accounts.

Investment strategies with scheme drawdown

The investment strategies with scheme drawdown will have to reflect the realities of the new world of 'freedom and choice'. In particular, scheme designers will have to reconsider the asset allocation of the glide path during the de-risking phase pre-retirement. Previously, most de-risking glide paths ended up with a fund that was 25% in cash, to hedge the tax-free cash element, and 75% in bonds, to hedge annuity rates. This would no longer be suitable for members who go into drawdown: it would be appropriate to have a much larger weight in growth assets at the beginning of the decumulation phase. However, for scheme members who want to take cash as soon as they can under the new flexibilities, a glidepath that ends with 100% in cash is more appropriate in this case.

Scheme providers will therefore have to ask their members what their likely choice will be – cash, drawdown and annuitisation – at the beginning of the scheme's de-risking glidepath, which might be 5 or 10 years before the nominated retirement age. If the choice is drawdown, then the next question that scheme providers will need to ask members is what income level they wish to achieve in retirement. This will allow members to reconsider their funding strategy and, if necessary, increase their contribution rate. They might also use the opportunity to consider the investment strategy they will employ post retirement (although, of course, that can be reviewed again much closer to the date).

A key aim of scheme drawdown is to deliver a low-cost and flexible drawdown facility. The most common investment vehicle for doing this is a target date fund (TDF) which spans the later years of accumulation and the early years of decumulation.[214] The TDF is an investment strategy designed for DC default funds, whereby the scheme establishes a range of TDFs, each with its own de-risking glide path. This might involve a TDF for each possible retirement date, or there might be a single TDF for members who plan (or are expected) to retire within a given five-year window. The more traditional method of de-risking in the UK is to use lifestyle strategies. The similarities and differences between the TDFs and lifestyle strategies are presented in Table 2.3.

Table 2.3: Target date funds versus life style strategies
Similarities
• Both place funds in higher-risk assets when individuals are younger and move these in to less risky assets as they approach retirement • Both types are managed with a retirement date or retirement window in mind • Both types have assumed, at least until recently, that individuals will with draw a 25% tax-free lump sum and purchase a level annuity
Differences
• Target date funds are overseen by professional fund managers who can make changes to both the strategic and tactical asset allocation in the event of changes to the markets or regulatory framework. In contrast, lifestyle strategy funds are generally pre-programmed to place funds in lower-risk assets as individuals approach retirement, and only change this approach at the discretion of trustees and pension providers • Target date funds operate to a broad retirement window (e.g., 2032-34 fund) in contrast to lifestyle strategies that target a specific day, often linked to a birthday • Target date funds can continue to pro-actively manage members' assets beyond their retirement date in contrast to lifestyle strategy funds that tend to 'set and forget' after reaching the assumed retirement date
Source: Pensions Policy Institute (2014) *DC savers' Needs under the New Pension Flexibilities*, PPI Briefing Note Number 72, October

[214] TDFs that target a specific age or age range are known as 'to' funds, while those that maintain a significant investment in growth assets into retirement are known as 'through' funds.

TDFs have their supporters. For example, in August 2015, Mark Fawcett, chief investment officer at NEST, gave his views on why he supports the use of TDFs which he regards as inherently flexible when compared to 'mechanistic lifestyling':

> *With fewer and fewer workers knowing the exact date they'll retire, what's the point of target date funds? If savers are now going to continue investing through retirement, why de-risk as they approach state pension age? Retirement rarely happens on one day at the end of a working life anymore. It's more of a journey than an event. But this doesn't undermine the case for target date approaches to investment management, in our view.*
>
> *Rather we'd argue that target date funds represent an agile way to respond to savers' shifting needs in a world of changing retirement patterns and greater pension freedoms. People may continue investing for longer, but there'll come a point when they're no longer building up their pots and start to rely on them for income instead. Their risk capacity will change significantly in their final working years and beyond. The amount of investment risk in their pots will need to be gradually reduced, although not necessarily completely into bonds and cash, as in the days of compulsory annuitisation. They'll also need a different type of asset mix, focusing on generating an income and avoiding the risk of sharp declines in value.*
>
> *Unlike with mechanistic lifestyling, the target date fund structure is inherently flexible. This allows for sophisticated and dynamic risk management that can be implemented and adapted, efficiently and cost effectively. In traditional 'lifestyling', the re-balancing of assets happens automatically at the same rate, each year, irrespective of market conditions and the valuation of the different asset classes. By contrast, target date fund managers, like NEST, are able to analyse economic and market conditions at the time and then act accordingly to best keep members on track.*
>
> *But this isn't all. NEST's 'default fund', where members are invested if they don't make an active choice, is actually made up of around 50 single year target date funds. This unique structure means we've been able to adapt to the new landscape by implementing two significant changes to the de-risking phase of these funds.*
>
> *The first was to the shape of the glidepath into retirement following the 'freedom and choice' reforms. Many pension providers including NEST have tended to de-risk into annuity-tracking portfolios, which no longer seems appropriate. Savers are now less likely to be buying annuities straight away as many will have had to do in the past. In response, we've changed the primary objective of the consolidation phase for funds maturing after 2020. These funds will now aim to outperform CPI after all charges while progressively dampening volatility. In the run up to 2020, we believe our members' pots will still be relatively small and it's most likely*

they'll be taken as cash. We've therefore changed the consolidation phase objective for NEST Retirement Date funds maturing up to 2020 to manage the risks associated with converting a member's pot into a cash lump sum rather than an annuity. We've used the flexibility of target date funds to set different groups of members on different glidepaths, according to their likely needs in the run up to retirement.

The second change was to add into the consolidation phase asset mix single-year dated gilts that mature in line with their fund's target date. For example the 2017 NEST Retirement Date Fund now invests, in part, in a 2017 gilt, the 2018 NEST Retirement Date Fund invests in a 2018 gilt, and so on. This measure is designed to get better returns than the cash we've been holding in the portfolios, without needing to worry too much about the market value of the bonds in the interim…

Both these changes have borrowed from concepts of 'liability-driven investment' that are more common in the defined benefit world. The aim is to align the investment horizon of a member's portfolio with their saving journey. In other words, workers should have a seamless investment experience as they move from saving up to withdrawing their pension. So far this type of 'liability aware' approach, which is possible within a target date fund structure, has not been widely applied in more traditional defined contribution strategies.[215]

Others, however, are critical of both TDFs and lifestyle as de-risking strategies. A poll carried out by the Association of Investment Management Sales Executives (AIMSE) of its members found that 55% of respondents believed that, following 'freedom and choice', traditional life-styling would need to be radically overhauled, while 30% said it would only work if life-style de-risking also followed through to the decumulation stage. Despite the greater flexibility claimed for TDFs by their supporters, only 12% of AIMSE members – whose job is to sell TDFs – thought they would work well in the new pensions environment.[216]

Another critique is Robert C. Merton, the 1997 Nobel laureate in economics. He believes that both TDFs and lifestying focus on the wrong target: 'If the goal is income for life after age 65, the relevant risk is retirement income uncertainty, not portfolio value…The seeds of an investment crisis have been sown. The only way to avoid a catastrophe is for plan participants, professionals and regulators to shift the mindset and metrics from asset value to income'.[217] This, of course, is the opposite of what the 2014 Budget changes do.

Furthermore, de-risking glidepaths will not be effective in a world where individuals make ad hoc withdrawals from their pension pot, while leaving much of the remaining pension

[215] Mark Fawcett (2015) Coming into land: NEST's fresh approach to the retirement 'glidepath', Professional Adviser, 11 August.
[216] Reported by Stephanie Baxter in Professional Pensions, 20 February 2015.
[217] Robert C. Merton (2014) The Crisis in Retirement Planning, *Harvard Business Review*, July–August; https://hbr.org/2014/07/the-crisis-in-retirement-planning

pot invested for the long-term (i.e., where individuals use their pension pot as a bank account). According to information compiled by Hargreaves Lansdown, lifestyle funds lost an average of 9% of their value between February and June 2015. Some such as Aviva, Blackrock, Friends Life and Scottish Equitable lost more than 10%. The explanation is that the funds switched from equities into long-dated bonds at a time when long-term interest rates are anticipated to rise which led to a loss in value for these bonds. According to Alan Miller, founder of fund manager SCM Private: 'It is scandalous that losses on this scale have occurred with supposedly "safe" funds…Lifestyle funds are no longer fit for purpose'. The solution, according to Steve Patterson, managing director of Intelligent Pensions, is for people between the ages of 55 and 65 to take on more risk, via a higher equity exposure on the grounds that equities give people a better chance of inflation-beating returns which will ultimately provide more income in retirement.[218]

A report by JLT Employee Benefits published in September 2015 indicates that 56% of companies have not changed their investment strategies in the light of the new pensions freedoms, despite the fact that just 11% of employers thought members would purchase annuities. Maria Nazarova-Doyle, deputy head of defined contribution investment consulting at JLT, said: 'A fund that continues to employ a seemingly safe strategy of investing into long-dated gilts and corporate bonds to track the price of annuities more closely becomes quite risky if members do not plan to buy this type of longevity insurance...For instance, pension savers looking to withdraw cash lump sums [using] income drawdown could be left open to the adverse effects of interest rate fluctuations [which change the returns offered by bonds] without much of an upside….In addition to the actual investment risk consideration, there is now a requirement for default strategies to be relevant for the majority of pension scheme members. So, if the majority of members no longer intend to purchase an annuity, keeping the old strategy unchanged cannot be justified'.

Another study, by Towers Watson's master trust LifeSight of around 100 employers, found that two-thirds were still targeting annuity purchase in their default investment strategy. Only 43% of the employers surveyed said they planned to offer drawdown options. When asked why not, 70% said the management and implementation was too difficult, 60% cited governance problems, 53% had no desire, and 45% mentioned costs and other barriers. Fiona Matthews, managing director of LifeSight, said many employers and trustees had been slow to respond because they had been careful to balance giving people what they wanted with mitigating risk.[219]

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[218] Reported in Katie Morley (2015) Pension Freedoms – Your investments aren't safe, either, Your Money, Daily Telegraph, 20 June.

[219] Reported in Miles Costello (2015) Employee pensions fail to keep up with pace of retirement reforms, The Times, 1 September, and Stephanie Baxter (2015) Employers are failing to adapt DC default strategies to April freedoms, Professional Pensions, 1 September.

Whatever new de-risking solutions now develop in response to the new pensions flexibilities, it seems likely that they will be more expensive than previously. In part, this will be due to the increased uncertainty about when funds will be withdrawn. In part, it will be because the new flexibilities will discourage investment in long-term illiquid growth assets, such as infrastructure, thereby lowering the potential returns on pension savings. Although pension savers welcome increased flexibility, unfortunately this comes at a price.

Examples of scheme drawdown

There are scheme drawdown offerings from investment managers, life offices and consultants. We provide some examples.

AllianceBernstein has launched a scheme drawdown product that integrates both the accumulation and decumulation stages and is suitable for the mass market.[220] The product combines AllianceBernstein's range of TDFs – which were set up for the new auto-enrolment market – with an income drawdown product called Retirement Bridge. Its first client was the BlueSky Pensions master trust. The product is aimed at scheme members up to age 75 and employs an age-related diversified investment approach with a risk-managed investment growth target, while allowing member full accessibility to their funds. The Retirement Bridge fund will be available to members from age 55. At this age, the member is invested 40% in equities. AllianceBernstein's Dynamic Asset Allocation strategy is used to gradually de-risk the investment portfolio, so that by age 75, the equity investment is reduced to 20%. AllianceBernstein also uses volatility management to make short-term adjustments to the portfolio to protect against downside risks in turbulent market conditions. The aim is to produce an income that is 20% more than that from an annuity between 55 and 75.

AllianceBernstein believes that their product would make a suitable default from age 55. According to Tim Banks, managing director of sales and client relations: 'Our extensive market research shows that 74% of 55 to 64 year olds have not decided what to do with their pension pot. We believe that providing a default solution that keeps them invested during this important time in their life, while offering full flexibility to change their mind, best meets the modern working environment'. At 75, members are expected to annuitise remaining assets. The reason for this is given by Mr Banks: 'If someone is in drawdown, even if it professionally managed, you don't really want people in products that require engagement in their late 70's', given the fall-off in cognitive abilities by that stage.[221]

BlackRock has launched the Retirement Income Account for workplace pension schemes. Paul Bucksey, head of UK defined contribution, said: 'We believe this innovation provides

[220] 'AllianceBernstein launches first work-thru-retirement default', Corporate Adviser, 15 September 2014.
[221] Quoted from David Blackman (2014) Welcome to the world of drawdown, Pensions Insight, November/December.

our members with a simple, flexible and cost-effective way of moving from the accumulation phase of workplace pension saving to decumulation'. The account allows members to choose either regular or ad-hoc income payments which are made by selling units in the funds held in the account and drawing down capital over time.

The core fund in BlackRock's suite is LifePath Flexi. This is a TDF which extends into the decumulation phase with a typical asset allocation illustrated in Figure 2.2.[222]

The de-risking glidepath used reflects the new reality following the introduction of pension flexibilities, namely 'an initial focus on growth – equities and other risky assets – and a gradual move to a more balanced asset mix where growth and volatility management are twin objectives. That move may start 20 years or so from a stated retirement date, and accelerate as the date becomes closer. It's important to remember that the expected retirement date is rarely precise – the chosen date is just a best guess for most members'.[223]

The member can also choose from another 100 investment funds from BlackRock and other fund managers. By remaining invested into retirement, members can retain the potential for future capital growth, but also alter income as required. The AMC for the LifePath Flexi fund is 0.41% which covers account administration and fund charges. There are no set up, transaction, or exit fees. There is also no charge for moving from an existing workplace scheme to the BlackRock Retirement Income Account. The minimum fund size is £50,000.[224]

Prudential's offering focuses on four lifestyle solutions: a default solution for those who have not specified a retirement preference, a solution for those planning to take their fund in cash, a solution for those planning to use drawdown, and a solution for those planning to buy an annuity. John Warburton, distribution director, said: 'The launch of the Dynamic Growth Funds, priced to sit between active and passive investments, gives our corporate customers a modern, cost-effective, default investment solution which offers diversification, flexibility and choice around the new pension freedom. The addition of further default lifestyle strategies demonstrates our commitment to offering enhanced levels of flexibility to our customers. These enhancements are part of our continuing corporate pensions proposition development to meet evolving customer needs'.[225]

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[222] Reported in Sebastian Cheek (2015) Designing a secure retirement income: meeting the evolving needs of DC schemes, portfolio institutional, April.
[223] Alistair Byrne, senior DC consultant at State Street Global Advisers, quoted in 'Is my DC plan's default lifestyle strategy fit for purpose?', Pensions Insight, May/June 2015.
[224] Reported in Stephanie Baxter (2015) BlackRock steps into in-retirement market with drawdown launch, Professional Pensions, 27 April.
[225] Reported in Stephanie Baxter (2015) Prudential launches multi-asset funds in response to Budget freedoms, Professional Pensions, 24 April.

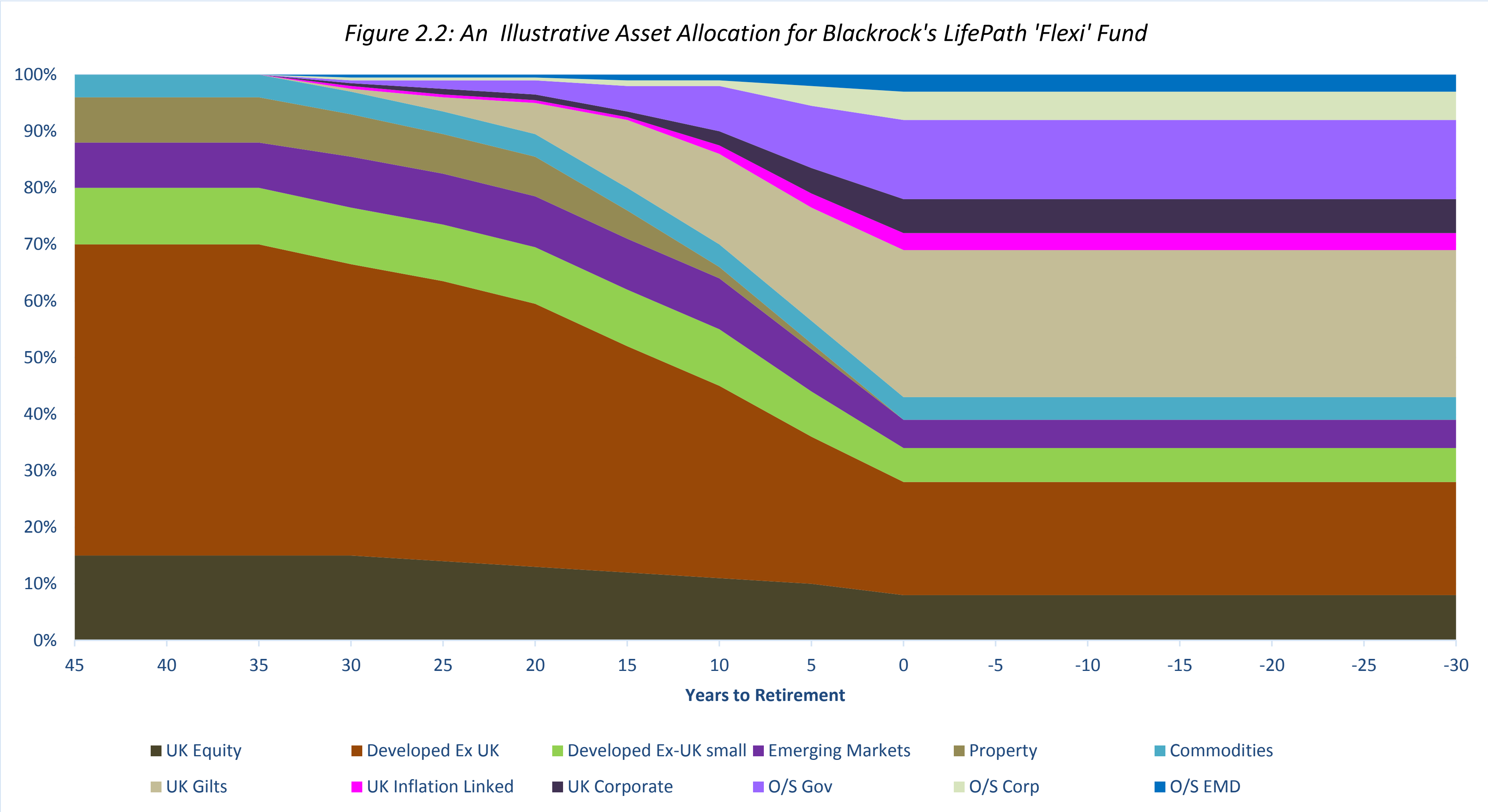

Figure 2.2: An Illustrative Asset Allocation for Blackrock's LifePath 'Flexi' Fund
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
45
40
35
30
25
20
15
10
5
0
-5
-10
-15
-20
-25
-30
Years to Retirement
UK Equity
Developed Ex UK
Developed Ex-UK small
Emerging Markets
Property
Commodities
UK Gilts
UK Inflation Linked
UK Corporate
O/S Gov
O/S Corp
O/S EMD

Consultants, such as Aon Hewitt, Buck Consultants and Mercer, have designed a scheme drawdown product for their existing employer accumulation clients. Xafinity is planning to launch a mass-market scheme with full flexibility.

Despite all these offerings and plans, there have been very few public announcements by companies that have adopted any of them in the days and months following Flexiday. This raises the question about how willing companies are to offer scheme drawdown to their members in practice. There are mixed views about this according to interviews with trustees and pension managers conducted by Spence and Johnson in March 2015 on behalf of the Defined Contribution Investment Forum (DCIF). Respondents in favour of scheme drawdown said this would be best delivered as all-in-one packaged solutions. Schemes that were less supportive said they were concerned about the administration difficulties and fiduciary implications. Some said scheme drawdown was more likely to be offered through master trusts than by single-employer schemes.[226]

The reluctance of many trust-based DC schemes to offer drawdown was confirmed by Adrian Boulding, then pensions strategy director at Legal & General: 'A lot of employers are reluctant to continue to be involved in a scheme providing drawdown, because it is not a "once and done" or "set and forget" solution. It requires ongoing management and monitoring, and the difficulties come between 15 and 20 years down the track when the money starts to run low. That's a step too far for a lot of them'.[227] Similarly, Nigel Aston, head of European DC at State Street Global Advisors, expects little appetite from trustees and plan sponsors to shoulder the burden of looking after members once they retire and expects them to look to master trusts and platforms instead: 'You can imagine a situation where some of the large master trusts – either the not-for-profit ones or the truly commercial ones – will say: "We'll aggregate all those individuals at retirement"'. At 65, Mr Aston believes members will leave the scheme used for accumulation and go across to NEST, NOW: Pensions, The People's Pension, or the Pensions Trust. Alternatively, they will move to 'a platform with Standard Life, Fidelity, Zurich, whoever;…. it'll be relatively seamless for the individual, but they're sort of on their own, but you still have a plan that is well governed'.[228] An additional concern of trustees is that partnering with a drawdown provider might be seen by members as giving advice.[229]

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[226] Stephanie Baxter (2015) Reported by DC schemes want more tools for 'biggest challenge' of member engagement, Professional Pensions, 1 May.
[227] Quoted in Peter Davy (2015) Complexity and Cost will limit pensions freedom, Financial News, 16-22 March
[228] Reported in Louise Farrand (2015) Five new investment innovations ahead of April 6th, Pensions Insight, 6 March.
[229] Lydia Rowson (2015) Emerging reality on pension freedom - What can sponsors and trustees expect in the new pensions world?, Towers Watson Trustee Briefing, 8 June. The issue of advice is discussed in the Chapter 3.

2.3.2 Retail distribution

With retail distribution, the scheme member chooses a drawdown provider either directly or via a platform and transfers their pension pot to them and sets up a SIPP with flexible access. We consider some examples.

Hargreaves Lansdown's SIPP is hosted on HL's Vantage platform which has an annual charge of 0.45% for pension savings up to £250,000. HL have no set up charge, but they have an exit charge of £295 + VAT if all the assets are withdrawn within 12 months. There will also be the annual fund management charge on the funds that the member chooses to invest in. This could average 1.5% pa.

LV= has launched a simplified drawdown product which charges 0.25% for funds up to £1m. It has a set up charge of £295 if the pot size is below £37,500 and £175 if the pot size is above. It also has a SIPP drawdown product with a maximum charge of 0.55% and no extra transactions costs.[230]

Intelligent Pensions has launched a fixed low-cost drawdown plan which allows DC scheme members to transfer to a SIPP and use flexi-access drawdown with ongoing advice. The SIPP is operated by James Hay. The drawdown plan has an annual charge of 0.75%, which matches the new charge cap on default funds in auto-enrolment pension schemes. The charge covers both the SIPP administration costs and the annual management charges on a wide range of investment funds. There is a set-up fee of 1% on funds above £100,000. The company believes that the minimum suitable for pension drawdown is £100,000. It also believes that flexi-access drawdown is only appropriate for people who are willing to take a 'fair degree' of ongoing risk in retirement and are also prepared to take ongoing advice. Managing director Steve Patterson said: 'Ongoing risk management is second only to initial suitability and anyone who thinks of drawdown as a DIY process is highly likely to come unstuck with potentially disastrous effects. "One size fits all" solutions are no longer appropriate – everybody's retirement will be different. To achieve the best possible retirement outcomes a far more personalised approach is needed'.[231]

Charges for retail drawdown products can be very high. Which? investigated the drawdown market and found that one product was charging 2.76% p.a.[232] Natanje Holt, managing

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[230] Reported in Carmen Reichman (2015) Providers will revisit drawdown charges after 'race to the bottom', says LV=, Professional Pensions, 10 March.

[231] Jenna Towler (2015) Intelligent Pensions launches low-cost drawdown plan, Professional Adviser, 13 March.

[232] *Better Pensions*, http://www.staticwhich.co.uk/documents/pdf/better-pensions-report---march-2015-397468.pdf ; Carmen Reichman (2015) Providers will revisit drawdown charges after 'race to the bottom', says LV=, Source: Professional Pensions, 10 March.

director at Dunstan Thomas, has identified the following types of retail drawdown charges:[233]

- Transfer out charge – for moving from one contract to another
- Transfer out charge to UK-based schemes
- Transfers out charge to overseas schemes
- Annuity purchase charge
- Tax-free cash charge (in drawdown a member might be charged several of these as they drawdown tax-free cash by stages)
- Income charge (essentially an annual usage fee)
- Crystallisation charge (as monies are drawdown)
- Pot depreciation charge (taken just before the pot balance goes to zero)
- Review charge (for those in capped drawdown where pre-April 2015 drawdown scheme members opting to be capped will remain if they do not exceed their stipulated maximum income allowance)
- Death benefit charge
- Additional designated charges, associated with phased drawdown.

In addition, the Dunstan Thomas analysis found little uniformity in terms of amounts charged. For example, based on a sample of 54 SIPP providers, the average transfer out charge was £161.70, but it varied between nothing and more than £500.

2.3.3 Hybrid institutional-retail distribution

With hybrid institutional-retail distribution, the occupational pension scheme only offers the accumulation stage and then sends its members to a provider of retirement income solutions, such as those considered in the previous section, but as retail customers.

This reflects the reluctance, noted in Section 2.3.1 above, of trust-based DC schemes to offer drawdown themselves. Members will have to transfer to a SIPP if they want to use drawdown. Some trust-based DC schemes used to allow up to two lump sum withdrawals per year, but no more. A key reason is cost. Jon Dean, a consultant at Altus, said: 'Even something as apparently simple as removal of drawdown limits can necessitate changing multiple interconnected IT systems, redesigning the business processes and controls they support, and communicating the changes to distribution partners'. [234]

Some contract-based schemes, while showing more flexibility on UFPLS, will also require people who want drawdown to move to a SIPP or a stakeholder pension scheme. For

[233] Natanje Holt (2015) It'll cost you: Can providers justify income drawdown charges?, Retirement Planner, 2 December.
[234] Quoted in Peter Davy (2015) Complexity and Cost will limit pensions freedom, Financial News, 16-22 March.

example, Scottish Widows will allow unlimited UFPLS withdrawals, but customers will have to move to another Scottish Widows scheme to use drawdown.

The costs of transferring between schemes can be high. Exiting an existing pension scheme to get a lump sum or transferring a pension scheme to another provider with a drawdown facility could involve punitive exit charges imposed by the transferring scheme and the loss of valuable benefits such as guaranteed annuity rates. This would be especially true for pension policies sold by insurance companies during the 1980s and 1990s by advisers who were paid large commissions. These commissions are spread over the life of the policy, but need to be paid whether or not the policy holder continues to pay the premiums. Exit penalties are the way in which the remaining premiums are captured. It is hard to get reliable information on the size of the exit penalties. Insurers claim they are too complex and too tailored to individual policies. However, they can range between 2-20%.[235] One example is Abbey Life which has an annual charge of 5.25% and an exit penalty of 11%.[236,237]

2.4 The withdrawal strategy

Determining the withdrawal strategy for a DC pension scheme is a critical issue. If too much is withdrawn too soon, then there is the risk that the scheme member will run out of money while they are still alive. If too little money is withdrawn, then there is the risk that the scheme member dies with a large chunk of the pension pot unspent and hence could have enjoyed a much higher living standard in retirement.

2.4.1 Factors influencing the withdrawal strategy

A number of factors need to be taken into account.

The first factor is the level of income that should be drawn in relation to income tax (i.e., the avoidance of moving into a higher marginal rate band than is necessary) and to longevity risk (i.e., the avoidance of drawing a high level of income in the early years that would result in running out of money in later retirement should the individual live longer than expected).

The level of income drawn will also be influenced by the new rules on inheritance. For those with sufficient alternative sources of savings, such as ISAs, it will be optimal to draw from those sources before drawing from the pension scheme. This is because income from ISAs is tax free, whereas pension income is taxed. Further, ISAs are subject to inheritance tax (IHT), whereas the pension fund can be passed tax free to a named beneficiary if the member dies

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[235] Ruth Lythe (2014) Are the wheels coming off the pensions revolution? Savers who cash in their funds face charges of up to 20%, Money Mail, 27 August.
[236] Reported in Ruth Lythe (2014) Are the wheels coming off the pensions revolution? Savers who cash in their funds face charges of up to 20%, Money Mail, 27 August.
[237] The high exit charges for transferring to a scheme offering full drawdown flexibility became the subject of intense media and Government criticism in the months following the introduction of 'freedom and choice' and we consider this issue further in Chapter 3.

before age 75. If the member dies after age 75, the pension fund can go to any named beneficiary who pays income tax at their marginal rate.

The second factor is the state pension. For those with sufficient private pension savings and in good health, it pays to delay taking the state pension. Alan Higham, then head of retirement insight at Fidelity, has shown that those who reach state pension age before April 2016 would receive a 10.4% higher state pension for each year that they delayed drawing it. To illustrate, suppose someone is about to retire with a state pension of £6,000 and delays taking the pension for three years when inflation is 3%. The uplifted pension in four years' time will be £8,602 compared with £6,556 if there was no deferral, which is 31.4% higher. The three years of missing state pension payments amount to £18,922 and this has to be withdrawn from the DC pension pot. As an alternative to taking the extra state pension as an annuity, it is possible to take it as a lump sum. This would amount to £19,241. The retiree has to live 11 years for the strategy to break even, so the strategy is not suitable for those in poor health. If someone lived until 90, the total benefit would be £54,000. After April 2016, the increase in the state pension for each year of deferral falls to 5.8% which is still much better than most investments offer.[238]

The third factor is the investment strategy. The withdrawal strategy cannot be made independently of the investment strategy. If the scheme member chooses to invest entirely in a LTA, then the income from the pension pot will be predictable and lifelong, but also inflexible. If, however, the scheme member chooses to invest in a diversified growth fund, it is possible to withdraw a higher average, but potentially more volatile income. But investing in a DGF will not hedge longevity risk, so at some stage longevity insurance needs to be purchased to avoid running out of money before the scheme member dies.

A number of academic studies have shown that the optimal strategy for someone who is not extremely risk adverse is to begin retirement with a significant investment in growth assets and then to switch to an annuity in later life.[239] For example, according to Raimond Maurer and Barabara Samova's (2009) report *Rethinking Retirement Income Strategies – How Can*

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[238] Katie Morley (2015) How to increase your state pension by £54,000, Daily Telegraph, 22 February.

[239] Moshe Milevsky (2001) Optimal Annuitization Policies: Analysis of the Options, *North American Actuarial Journal*, 5(1), 57-69; Moshe Milevsky and Virginia Young (2002) *Optimal Asset Allocation and The Real Option to Delay Annuitization: It's Not Now-or-Never*, Discussion Paper, Schulich School of Business, York University, Toronto; David Blake, Andrew Cairns, and Kevin Dowd (2003) Pensionmetrics II: Stochastic Pension Plan Design during the Distribution Phase, *Insurance: Mathematics and Economics*, 33(1), 29-47; Andrew Cairns, David Blake, and Kevin Dowd (2006) Stochastic Lifestyling: Optimal Dynamic Asset Allocation for Defined-Contribution Pension Plans, *Journal of Economic Dynamics and Control*, 30, 843-877; Robert C. Merton (2007) The Future of Retirement Planning, in Z. Bodie. D. McLeavey and L.B. Siegel (eds) *The Future of Life-Cycle Saving & Investing*, Research Foundation of the CFA Institute; David Blake, Douglas Wright, Yumeng Zhang (2014) Age-dependent Investing: Optimal Funding and Investment Strategies in Defined Contribution Pension Plans when Members are Rational Life Cycle Financial Planners, *Journal of Economic Dynamics and Control*, 38, 105-124.

We Secure Better Outcomes for Future Retirees?, commissioned by the European Fund and Asset Management Association:[240]

> *[T]he modelling presented in this report [suggests that] the best investment strategy for payout solutions is to hold a significant proportion of pension assets in well-diversified equity portfolios early in retirement, and to switch to annuities and bond holdings progressively over time, taking into account individuals' specific circumstances. This strategy results in significantly higher consumption possibilities, at a relatively low risk compared to immediate full annuitisation at retirement.*
>
> *The risk of being worse off in terms of retirement income in [the] case of adverse stock [market] developments is limited for individuals adjusting their pension asset portfolio. ….The simulations of consumption levels under different financial markets conditions show that the majority of individuals (70%) can expect to enjoy up to a third of higher lifetime consumption level if they hold equity at the beginning of retirement and gradually switch to annuities over time, instead of annuitising all their wealth at the age of 65. Moreover, the consumption level of individuals ending up in the worst financial market scenarios would be less than 10% lower than under full annuitisation.*
>
> *As a consequence, compulsory full annuitisation of retirement wealth at the age of 65 results in significant costs in terms of foregone consumption. Taking into account the desire of individuals to leave money to their surviving relatives and/or build a financial buffer to cope with large and sudden expenses, the disadvantage from enforced annuitisation becomes substantially aggravated.*
>
> *The report also demonstrates that retirees can enjoy a smooth consumption pattern during retirement if they keep their retirement wealth invested in pension products featuring a switching mechanism to increase the proportion of annuities and bonds as time goes by. This result reflects the fact that short-term fluctuations in equity markets become less important over long investment horizons when the gradual reduction in equity expense limits the exposure of pension assets to market volatility.*

2.4.2 Is there a safe withdrawal rate?

As Abraham Okusanya argues: 'For clients in retirement, developing a sensible and sustainable withdrawal strategy is at least as important as developing a sensible investment strategy. Unless a client annuitises all or most of their retirement pot, they need to have a

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[240] Raimond Maurer and Barabara Samova (2009) *Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?*, European Fund and Asset Management Association, February; http://www.efama.org/Publications/Public/Long-Term_Savings_and_Pension_Steering_Committee/Maurer_Rapport.pdf.

robust framework in place to guide their withdrawal decisions or risk running out of money'.[241]

2.4.2.1 The 4% rule

The US financial planning community has developed the concept of a 'safe (sensible or sustainable) withdrawal rate' (SWR) which is based on the work of a financial planner called William Bengen. In 1994, he devised the '4% rule'. The rule stated that an individual could withdraw 4% of the fund in the first year and the same amount adjusted for inflation in subsequent years. Based on all the rolling historical periods in his dataset, Bengen showed that the fund would last for at least 30 years.[242] Bengen later introduced the term 'safemax' to describe the highest withdrawal rate that would allow at least 30 years' of inflation-adjusted withdrawals and showed that the safemax rate was 4.5% if the income is tax-free and 4.1% if it is taxable.[243]

The 4% rule was 'confirmed' by the so-called Trinity study in 1998. Philip L Cooley, Carl M. Hubbard, and Daniel T. Walz used Monte Carlo simulation techniques on US financial data between 1926 and 1995[244] to show that a 4% withdrawal rate from a fund invested 50% in US equities and 50% in US bonds would have a 95% chance of lasting at least 30 years (i.e., a 5% failure rate).[245]

More recently, Wade Pfau, a professor of retirement income at the American College of Financial Services, investigated the 4% rule for the UK and 16 other developed market economies.[246] He employed 109 years of financial market data (between 1900 and 2008) for each of the 17 countries. Using the same historical simulations approach as Bengen, he examined the outcomes for individuals retiring in each year of the 80 years between 1900 and 1979, allowing for a retirement period of 30 years.

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[241] Abraham Okusanya (2015) Probability and the 4% rule: How to ensure your clients retire 'safely', Professional Adviser, 18 February.

[242] William P. Bengen (1994) Determining Withdrawal Rates Using Historical Data, *Journal of Financial Planning*, October, 14–24.

[243] William P. Bengen (2006) *Conserving Client Portfolios During Retirement*, ISBN 978-0-97534483-5.

[244] Taken from *Stocks, Bonds, Bills, and Inflation, 1996 Yearbook*, Ibbotson Associates. Over the 1926 and 1995 period, the average returns on the key asset classes were 3.7% (Treasury bills), 5.7% (long-term corporate bonds) and 10.5% (large company common stocks). The real return on a 50/50 portfolio over this period was approximately 5%.

[245] Philip L Cooley, Carl M. Hubbard, and Daniel T. Walz (1998), Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable, *AAII Journal*, 20(2), 16–21.

[246] Wade D. Pfau (2010), An International Perspective on Safe Withdrawal Rates: The Demise of the 4 Percent Rule?, *Journal of Financial Planning*, 23(12), 52–61.

Table 2.4: Safe withdrawal rates for UK retirees				
	'Safemax'	10th percentile	% failures (4% rate)	% failures (5% rate)
'Perfect' foresight assumption	3.77	4.17	3.8	27.5
UK 50/50 portfolio	3.43	4.01	9.3	55.6
Global 50/50 portfolio	3.26	3.55	17.9	31.0
Source: Wade D. Pfau (2010) An International Perspective on Safe Withdrawal Rates: The Demise of the 4 Percent Rule?, *Journal of Financial Planning*, 23(12), 52–61.				

The outcomes for the UK are shown in Table 2.4. Even with perfect foresight of future asset returns and the most favourable asset mix in the light of this perfect foresight, Pfau showed that the 'safemax' rate for the UK is only 3.77%. If the individual is prepared to accept a 10% probability of failure (i.e., a 10% chance of running out of money before 30 years), the SWR increases to 4.17%. A 5% withdrawal rate results in a failure probability of 27.5%. Returning to Bengen's original case of a 50/50 portfolio, the 'safemax' rate is just 3.43%. With a 10% failure probability, the SWR is 4.01%, while a withdrawal rate of 5% leads to a failure rate of 55.6%. The outcome is actually worse if the individual invests in a global 50/50 portfolio (i.e., 50% in global equities and 50% in global bonds). Now the 'safemax' rate is 3.26%, the SWR rate with a 10% failure probability is 3.55%, and the failure rate with a 5% withdrawal rate is 31%.

While a fixed SWR is simple to understand, it has a number of weaknesses.

First and most importantly, it ignores longevity risk. Office for National Statistics data shows that a 65-year old couple has a 25% chance of one of them reaching 97 and a 17% chance of one of them reaching 100. A rule designed so that funds last 30 years is clearly inadequate. Moshe A. Milevsky and Huaxiong Huang (2011, Table 3) show that, for individuals who are concerned about running out of money before they die (i.e., have longevity risk aversion), it is optimal for them to use a proportion of their pension pot to buy index-linked LTAs. These authors show that lifetime consumption in retirement (as well as lifetime utility or welfare) is maximised if all pension wealth is annuitised at the time of retirement.[247] Some have argued that individuals who do not want to formally purchase an annuity because they

[247] Moshe A. Milevsky and Huaxiong Huang (2011) Spending Retirement on Planet Vulcan: The Impact of Longevity Risk Aversion on Optimal Withdrawal Rates, *Financial Analysts Journal*, March/April, 45-59.

value the flexibility of drawdown, should not actually choose a SWR above that of an annuity (i.e., 2.5% - 3%).[248]

Second, it ignores the individual's attitude to risk, both in terms of the underlying investment portfolio and the failure probability. Individuals with a low degree of investment risk tolerance and a low tolerance to running out of funds before dying would want to invest in a much more conservative fund and, consequently, have a much lower SWR.

Third, the rule involves taking out a fixed (albeit index-linked) amount whatever market conditions. This leaves open the possibility that individuals could spend all their pension pot before dying. It also leaves open the possibility that individuals underspend their pension pot before dying and hence could have enjoyed a higher standard of living in retirement.

Fourth, it is not 'safe' in a low-yield world. Michael Finke, Wade D. Pfau, and David M. Blanchett show that if the Trinity study was repeated with real bond rates as of January 2013 (4% below the historical long-run average), then the failure rate with the 4% rule increases from 5% to 57%. If bond rates return to their historical average after 5 (10) years, the failure rate is still high at 18% (32%).[249]

Fifth, it ignores fund management charges. Maria A. Bruno, Colleen M. Jaconetti, and Yan Zilbering show that the SWR with a 50/50 US equity/bond portfolio, an 85% success rate and a 30-year spending horizon drops from 3.9% with a 0% charge, to 3.8% with a 0.25% charge, and to 3.3% with a 1.25% charge.[250]

Sixth, it ignores the dynamic nature of market and portfolio returns. Many advisers use cashflow models to help clients understand their income and expenditure needs after retirement. Included in income is the withdrawal amount from the fund, e.g., 4%. This withdrawal rate will be based on an assumed rate of return on the invested fund. The problem is that the cashflow models are deterministic and assume that the rate of return is fixed and hence ignore real world randomness. In particular, they ignore 'sequence-of-returns' risk.[251] This is the risk that there is a sequence of negative returns on the invested portfolio in the early years after retirement. If a fixed (in real terms) amount of money is still withdrawn from the fund each year, many retirees will run out of money, not only well before they die, but also well before they have completed 30 years of retirement.

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[248] Jonathan Gardner (2015) Withdrawal Strategies for DC Retirees, Towers Watson Corporate and Trustee Briefing, 5 October: 'Running out of money is a possibility with the 4% rule, as it does not allow for adjustments based on poor investment performance or life expectancy'.

[249] Michael Finke, Wade D. Pfau, and David M. Blanchett (2013) The 4 Percent Rule Is Not Safe in a Low-Yield World, *Journal of Financial Planning*, 26(6), 46–55.

[250] Maria A. Bruno, Colleen M. Jaconetti, and Yan Zilbering (2012, Figure 5) Revisiting the 4% spending rule, Vanguard Research.

[251] Also known as 'pound cost ravaging': see, e.g., Simon Chinnery (2015) Navigating the dangers of pound cost ravaging, Professional Adviser, 5 June.

Table 2.5: *Sequence-of-returns risk*					
Year	Portfolio A	Portfolio B	Client age	Portfolio A	Portfolio B
1	-5.9	5.73	60	89,100	100,730
2	-13.3	5.73	61	72,250	101,502
3	-22.7	5.73	62	58,849	102,318
4	20.9	5.73	63	56,476	103,181
5	12.8	5.73	64	58,705	104,093
6	22.0	5.73	65	66,621	105,057
7	16.8	5.73	66	72,813	106,077
8	5.3	5.73	67	71,672	107,155
9	-29.9	5.73	68	45,242	108,296
10	30.1	5.73	69	53,860	109,501
11	14.5	5.73	70	56,670	110,775
12	-3.5	5.73	71	49,686	112,123
13	12.3	5.73	72	50,798	113,547
14	20.8	5.73	73	56,363	115,054
15	-5.9	5.73	74	48,038	116,646
16	-13.3	5.73	75	36,649	118,330
17	-22.7	5.73	76	23,330	120,110
18	20.9	5.73	77	23,206	121,993
19	12.8	5.73	78	21,176	123,983
20	22	5.73	79	20,835	126,087
21	16.8	5.73	80	19,335	128,312
22	5.3	5.73	81	15,360	130,664
23	-29.9	5.73	82	5,767	133,151
24	30.1	5.73	83	2,503	135,781
25	14.5	5.73	84		138,561
26	-3.5	5.73	85		141,500
27	12.3	5.73	86		144,608
28	20.8	5.73	87		147,894
29	5.73	5.73	Average		

Source: FinalytiQ

This can be shown using the following example.[252] Table 2.5 shows the returns from two portfolios. The second column (Portfolio A) represents a sequence of realistic annual returns, while the third (Portfolio B) represents what advisers might use in their deterministic cashflow model by assuming the average annualised return from column 2 holds for each of the 29 years in the Table. The key point is that both portfolios have the same average return, but the sequence of returns is very different.

A client withdrawing £5,000 a year from age 60 will run out of money with Portfolio A by age 83, while Portfolio B allows the customer to withdraw the same level of income indefinitely and bequest more than the initial pension pot to their descendants. The explanation for what happens to portfolio A is 'reverse pound cost averaging' or ‘pound cost ravaging’: the customer has to sell units at low prices to pay the required income and the portfolio can never recover from the early poor performance by later good performance, however good that subsequent performance is.[253] As Abraham Okusanya argues: ‘Deterministic modelling tools hide the danger of negative sequence-of-returns, especially in the early years of retirement’.[254] Some advisers are even less complementary about cash flow models. Richard Bishop, director and principal at Premier Practice, says: ‘I'm going to come out and say it: cashflow modelling is utter nonsense and is only used to justify extortionate adviser fees’.[255]

Finally, the SWR ignores the fact that the future might not be like the past: in particular, future returns might by lower and more volatile than the historical returns upon which the 4% rule was based. As mentioned by Jonathan Gardner of Towers Watson, the 4% rule was built on the particularly favourable post-World War II investment experience, and this might well not be repeated going forward.[256] A similar point has been made by Duncan Robertson, marketing director at Aegon Ireland: ‘Yes, the past has a useful story to tell, and through our experiences of the past we can build models of what might happen in the future. But it would be misguided to use it blindly. Models on sustainability need to be calibrated to today's world, using today's expectations on rates of return and volatility of assets and today's expectations on an individual's longevity….. Withdrawal rates of 5%+ may be perfectly sustainable when risk-free yields are at historical higher levels, and planning to

[252] Taken from ‘Pound Cost Ravaging: Understanding Volatility Drag, Sequencing Risk & Safe Withdrawal Rates in Retirement Portfolios’, http://www.finalytiq.co.uk/pound-cost-ravaging-whitepaper/; see also Abraham Okusanya (2014) Understanding that silent portfolio killer – Sequence of return risk, Professional Adviser, 9 October; and Carmen Reichman (2015) Sequence of return risk threatens non-advised drawdown retirees – Standard Life, Professional Adviser, 1 April.

[253] See, e.g., David Blackman (2014) Welcome to the world of drawdown, Pensions Insight, November/December.

[254] Abraham Okusanya (2015) Understanding that silent portfolio killer - Sequence of return risk, Professional Adviser, 9 October.

[255] Quoted in Scott Sinclair (2014) Is advisers’ love affair with cashflow modelling masking its shortcomings?, Professional Adviser, 5 June.

[256] Jonathan Gardner (2015), Withdrawal Strategies for DC Retirees, Towers Watson Corporate and Trustee Briefing, 5 October.

exhaust funds 30 years after retiring may also be okay when people weren't living so long. However, this isn't the current world'.[257]

It is, of course, possible to reduce the failure rate by adjusting withdrawals down in bad years and up in good years. The main ways of doing this are through the use of variable spending strategies:

- Giving up the inflation uprating in years when there are poor investment returns
- Cutting spending when the portfolio withdrawal rate exceeds 20% of their initial level because the portfolio is declining[258]
- Increasing spending when portfolio withdrawal rate falls by more than 20% of their initial level because the portfolio is growing
- Withdrawing a constant percentage from the fund, rather than a constant amount.

All these options involve, albeit to differing degrees, volatile income and hence expenditure from one year to the next, although with the last option, the retirees will never run out of money before they die.

Luke Delorme (2014, p.33) examined three common withdrawal strategies in terms of their 'utility scores'.[259,260] These were the original 4% rule (an inflation-adjusted percentage starting at 4% of the initial pot), a constant monetary amount (equal to 4% of the initial pot) and a constant percentage (4% of whatever the pot size is at the time of withdrawal). Based on bootstrapped simulations which draw returns randomly from the period 1928 to 2013, the author shows that the withdrawal strategy with the highest utility score in the worst-case scenario is the original 4% rule (utility score = 4.93). The strategy with the lowest score is the constant monetary amount (utility score = 2.92), while the constant percentage strategy lies in between (utility score = 4.11).

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[257] Duncan Robertson (2015), Past performance: Sustainable withdrawal rates face trouble ahead, Professional Pensions, 2 December.

[258] This and the next strategy are associated with Jonathan T. Guyton (2004), Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?, *Journal of Financial Planning*, 17, 54–62; and Jonathan T. Guyton and William J Klinger (2006), Decision Rules and Maximum Initial Withdrawal Rates, *Journal of Financial Planning*, 19, 49–57.

[259] Luke Delorme (2014) *From Savings to Income: Retirement Drawdown Strategies*, American Institute for Economic Research.

[260] A utility score adjusts a monetary amount for the utility or welfare that an individual expects to experience from consuming goods and services equal in value to the monetary amount. It is particularly useful when comparing changes in monetary amounts. This is because most people experience diminishing marginal utility. This implies that doubling the monetary amount increases the utility score by less than two: eating a second ice cream is not usually as enjoyable as the first ice cream. Conversely, halving the monetary amount leads to more than a 50% reduction in the utility score.

2.4.2.2 Alternatives to the 4% rule

Some alternative withdrawal strategies to the 4% rule have been proposed which dynamically adjust withdrawals to market and portfolio conditions and we consider the most common of these.[261]

This first is based on withdrawing the annuitised value of the fund, i.e., withdrawing the amount F_x/a_x at age x, where F_x is the value of the fund at age x, and a_x is the annuity factor at age x.[262] This is known as the 'equivalent annuity' strategy. A variation on this is the '$1/E_x$' rule, where E_x is the individual's life expectancy at age x, and the withdrawal amount at age x is given by F_x/E_x. With these strategies, retirees will never run out of money before they die.

Ed Denbee (2008, Figures 4 and 8) examined the equivalent annuity and $1/E_x$ strategies.[263] Both strategies give similar results.[264] The pattern in the case of the median simulation for someone retiring at 65 is that the withdrawal amount is initially higher than for an equivalent index-linked annuity.[265] It increases year on year until the early 70s and then falls back, dropping below the annuity payment in the early 80s. Someone surviving to 100 would have around one quarter of the payment they would have received on the index-linked annuity.

The second is to draw only the 'natural' income from the fund. Mark Rimmer, product director for Premier's multi-asset team, defines this as the 'pay-out of dividends [coupons, rent etc] from income-generating investments'.[266] This, of course, is what equity income funds do. Since there is no cashing-in of units to pay an income, the annual income received will fluctuate from one year to the next and 'there is no tidy way of getting around this'.

The third is auto-rebalancing.[267] This involves making withdrawals from the asset classes that experienced the highest growth during the year. An extreme form would be to

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[261] A number of the strategies below are examined in more detail in Wade Pfau and Jeremy Cooper (2014) *The Yin and Yang of Retirement Income Philosophies*, Challenger.

[262] The annuity factor is the present value of £1 per year for the remaining life of the annuitant, taking into account that at each age x, there is a probability of q_x that the annuitant will die at age x and a probability of $(1 - q_x)$ that the annuitant will survive to age (x + 1). The discount rate used to calculate the present value is typically related to the yield on long-term government bonds.

[263] Ed Denbee (2008) *Modelling Income Drawdown Strategies*, Investment Management Association, http://www.theinvestmentassociation.org/assets/files/press/20080311-01.pdf; see also Investment Management Association (2008) *Enabling Choice for Retirement*, Investment Management Association, http://www.theinvestmentassociation.org/assets/files/press/2008/20080311-02.pdf.

[264] And are identical when the discount rate for the annuity factor is zero (since $a_x = E_x$ under these circumstances).

[265] Except in the first year for the equivalent annuity strategy when the amounts withdrawn are the same.

[266] Mark Rimmer (2015) Is 'natural' income the answer to the sequence of return problem?, Professional Adviser, 23 March.

[267] Cazalet Consulting (2014, p. 117-9) *When I'm Sixty-Four*, September.

rebalance the portfolio annually to a constant asset mix, by selling relative winners and buying relative losers.

The fourth is to use a cashflow reserve (or bond) ladder or bucket (also called time segmentation).[268] This involves holding enough in deposits or short-maturing bonds to meet the next two years of expenditure. This means that equities do not have to be sold in a falling market to fund expenditure. The next rung of the ladder includes medium-term bonds intended to cover the next 5 to 10 years of expenditure, but which could be sold in a prolonged market downturn without too big a capital loss. At the top of the ladder are equities. With luck, by the time the client needs to sell equites to meet expenses, the market has recovered. A feature of this approach is that the portfolio becomes riskier over time, since there is no rebalancing of the portfolio as the safest and most liquid assets are sold to pay for consumption.

The fifth is the rising equity glide path proposed by Wade Pfau and the US financial planner Michael Kitces.[269] This starts with a low equity allocation which increases gradually during the first decade of retirement. This strategy reduces portfolio return volatility at the time the portfolio is most susceptible to sequence-of-returns risk. Also if there has been a sequence of negative returns during the early years of retirement, the rising glide path results in the clients buying low. The approach is the exact opposite of conventional wisdom which suggests that the equity weighting in the portfolio should decrease with age (as in the common rule of thumb used by advisers that the equity weighting should equal 100 minus age).

The sixth is the floor-leverage rule.[270] This involves establishing a safe and secure spending floor with 85% of the assets in the portfolio. The remaining 15% of the portfolio is invested in a 3 times leveraged equity fund. If the equity portion of the portfolio exceeds 15% of the total portfolio, equities are sold to reduce the allocation to 15% and the proceeds are used to increase spending. Otherwise, do nothing.

The final one is a 'least cost' or 'collared' spending strategy.[271] The designers of this strategy argue that the 4% rule leads to situations where surpluses are accumulated (and unspent) when markets outperform and where there are spending shortfalls when markets underperform. They estimate that these surpluses amount to 10%-20% of the retiree's

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[268] See Finalytiq (2014) *Pound Cost Ravaging: Understanding Volatility Drag, Sequencing Risk & Safe Withdrawal Rates in Retirement Portfolios*, http://www.finalytiq.co.uk/pound-cost-ravaging-whitepaper; Abraham Okusanya (2014), *Chaos Theory: How to Manage Sequencing Risk in a Retirement Portfolio*, Professional Adviser, 13 November; Cazalet Consulting (2014, p. 114-5), *When I'm Sixty-Four*, September.

[269] Wade D Pfau and Michael E. Kitces (2014) Reducing Retirement Risk with a Rising Equity Glide Path, *Journal of Financial Planning*, 27(1), 38–45.

[270] Jason S Scott and John G Watson (2013) The Floor-Leverage Rule for Retirement, *Financial Analysts Journal*, 69(5), 45–60.

[271] Jason S. Scott, William F. Sharpe, and John G. Watson (2009) The 4% Rule—At What Price?, *Journal of Investment Management*, 7(3), 31–48.

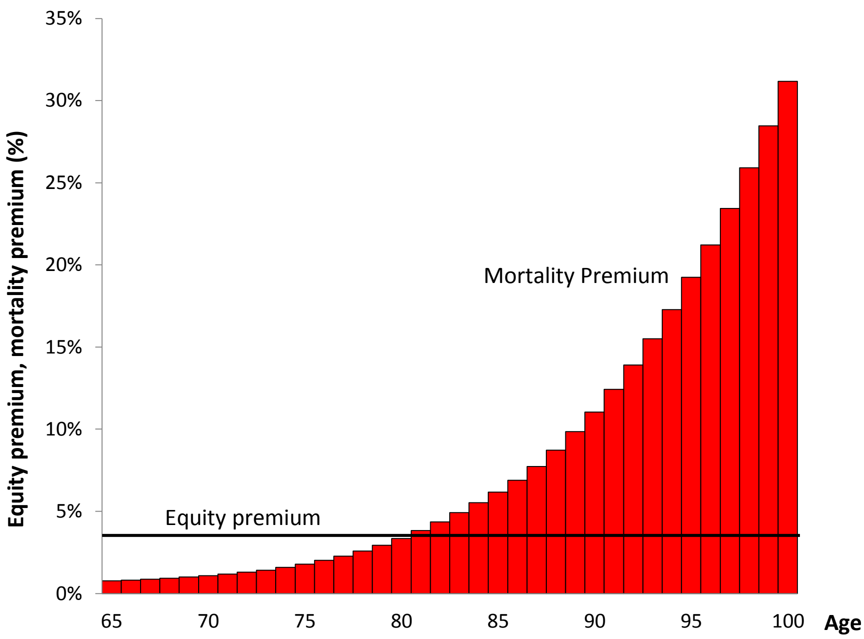
initial wealth, while the spending shortfalls are equivalent to an additional 2%-4% of initial wealth. They propose an alternative 'least cost' spending plan which eliminates the inefficiencies – amounting to 12%-24% of initial wealth – in the 4% spending plan. This involves using options to put a cap on spending when the market is underperforming and a floor on spending when the market is performing well and hence puts a 'collar' on spending that eliminates the surpluses and deficits.

It is important to note that none of these strategies, apart from the first one, hedge longevity risk, unless longevity insurance in the form of a deferred annuity is purchased at retirement which comes into effect at, say, 85.

2.5 The longevity insurance strategy

The longevity insurance strategy determines when longevity insurance is purchased and when it comes into effect. The strategy is essential for ensuring that a pension scheme serves its primary purpose of providing an income for however long the scheme member lives. But when should longevity insurance be purchased and when should it come into effect? This essentially boils down to the choice between buying an immediate annuity when it is needed and buying a deferred annuity at the point of retirement with the deferred annuity beginning to make payments when it is needed.

Figure 2.3: The Milevsky switching rule



The optimal combined investment and longevity insurance strategy in retirement is complex and impossible to implement properly without sophisticated stochastic dynamic programming software. However, Milevsky (1998) proposed a simple rule of thumb for deciding when to switch from risky equity-linked assets to an annuity: this is when the mortality premium exceeds the equity premium as shown in Figure 2.3.[272] The mortality premium for a particular age (*x*) can be thought of as the excess return on a level annuity over a risk-free investment; it is shown by the upward sloping curved line in the Figure. The equity premium is the excess return on equities over a similar risk-free investment: in Figure 2.3, the equity premium is assumed to be fixed at 3% p.a.

In the early years after retirement, the equity premium exceeds the mortality premium and, all other things being as expected, the retiree receives a higher average return from investing in an equity-linked portfolio than investing in a level annuity, which is equivalent to a bond-based investment. However, the level of the mortality premium increases each year and eventually exceeds the equity premium. Figure 2.3 shows that the switchover age is around 80 if the equity premium is 3%. This rule of thumb is a reasonable approximation to the optimal switching rule if the scheme member is risk-neutral, but it overestimates the switching age if the member is risk averse: for example, if they are extremely risk-averse they should annuitise at retirement and not delay.[273]

Figure 2.3 shows the 'average' investment outcome with a 3% equity premium. But, presenting information on the basis of averages is deceptive: investment returns are not guaranteed and Figure 2.3 ignores important realities, such as sequence-of-returns risk. To show what could happen in the real world, we use the PensionMetrics stochastic simulation model.[274]

We make the following assumptions:

- Male retires age 65 with a pension pot of £100,000 (F_{65})
- Investment strategy: 25% equites, 75% bonds
- Expected interest rate = 4%
- Volatility of interest rate = 4%
- Expected inflation rate = 2%
- Volatility of inflation rate = 4%
- Equity premium = 3%
- Volatility of equity returns = 20%

[272] Moshe Milevsky (1998) Optimal Asset Allocation Towards the End of the Life Cycle: To Annuitize or Not to Annuitize?, *Journal of Risk and Insurance*, 65, 401-26.
[273] This is demonstrated in David Blake, Andrew Cairns,and Kevin Dowd (2003) Pensionmetrics II: Stochastic Pension Plan Design during the Distribution Phase, *Insurance: Mathematics and Economics*, 33 (1), 29-47.
[274] We are grateful to Professor Kevin Dowd of Durham University Business School and a Fellow of the Pensions Institute for preparing these illustrations; http://www.pensionmetrics.net/

- Total expense ratio = 1%
- Annuity rate at age 65 (a_{65}) = 5.5%
- Age at which deferred annuity starts if purchased at age 65 = 85
- Number of simulation trials = 2,500.

Figure 2.4: Distribution of real income with 100% drawdown and no deferred annuity

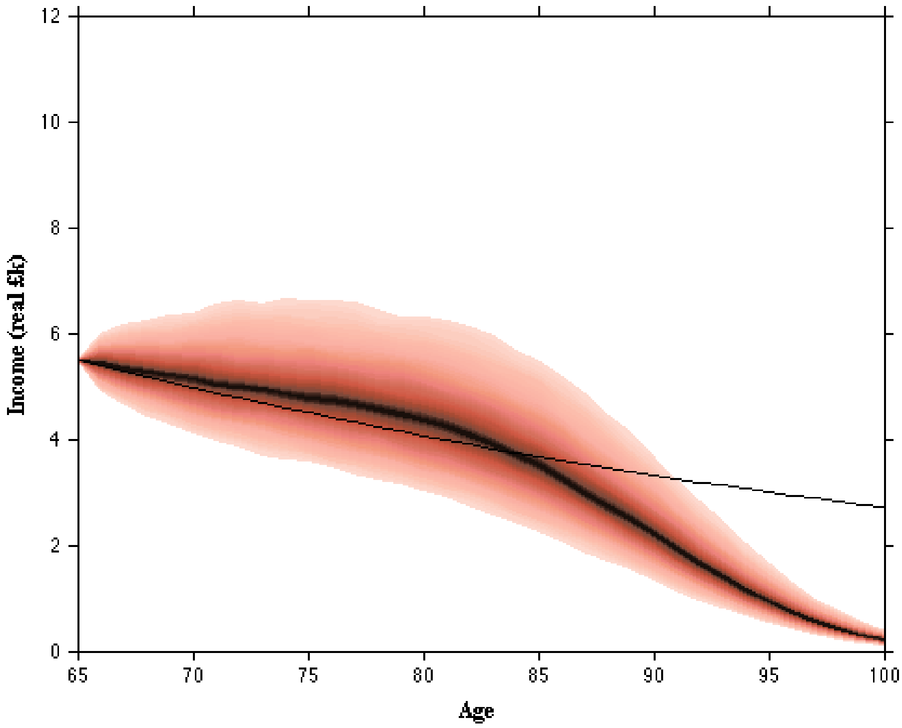


Figure 2.4 shows the distribution of real income with 100% drawdown and no deferred annuity. What is depicted is a fanchart showing the 90% prediction interval for the distribution of income from the 2,500 different scenarios. Each year, the member is assumed to withdraw the annuity equivalent of their remaining pension pot. At age 65, the member withdraws 5.5% of £100,000 (= a_{65} x F_{65} = £5,500), which is the same amount that could be taken from a level lifetime annuity at age 65. This means that £94,500 (=£100,000 - £5,500) is available for investment in the first year of retirement. Suppose the investment portfolio loses 5%, so the pension pot is valued at £89,775 (F_{66} = £89,775) at the end of the year, and the annuity rate is 5.8% at age 66 (a_{66} = 5.8%): then the income that could be withdrawn at age 66 would be £5,270 (= a_{66} x F_{66} = 5.8% of £89,775). Suppose instead that the investment portfolio gains 5%, so the pension pot would now be valued at £99,225 (F_{66} = £99,225), and the income that could be withdrawn at age 66 would be £5,775 (= a_{66} x F_{66} = 5.8% of £99,225). These are two of the possible 2,500 scenarios for what might happen at age 66. The most likely outcome for what could happen between ages 65 and 100 (assuming the member survives that long) is given by the dark central band in the fanchart. We can also be 90% confident that the actual outcome will lie somewhere in the fanchart.

Also depicted in Figure 2.4 is a thin slightly curved downward sloping line. This shows the real value of the payments on a level annuity purchased at age 65, with the payments declining in real terms at the rate of 2% p.a. due to inflation. The average real value of the income that can be drawn from the drawdown programme falls each year, since more is taken out of the fund every year than the average value of the investment return (and there is also the effect of inflation). But it initially falls by less than the fall in the real value of the annuity, due to the equity premium earned by the drawdown fund. However, after around age 80, the mortality premium exceeds the equity premium. Also a higher mortality rate implies a higher annuity rate.

Since the amount taken out of the fund in a given year depends on the fund size, the annuity rate for that year and the equity premium, once the mortality premium exceeds the equity premium, the income that can be drawn from the fund falls very rapidly. This is because, while the annuity rate increases, the fund size falls at a bigger rate. But note that the pension pot never runs out, because the member never draws down more than the annuity equivalent of the remaining pension pot. Also note that the prediction interval is very wide, particularly for people in their 80s. For example, at age 80, someone could be lucky and be drawing £6,500, or they could be unlucky and only be drawing £3,000.

Figure 2.4 shows that the user of drawdown will on average receive a higher income in the earlier years of retirement than the annuitant, but a lower income in the later years if they live that long. Of course, when the retiree dies, the residual fund with drawdown goes to their estate, whereas the family of an annuitant gets nothing.

Figures 2.5 and 2.6 show what happens if 120% and 150%, respectively, of the annuity equivalent is withdrawn each year. Individuals will enjoy a much higher standard of living in early retirement than a lifetime annuity, but they will pay for it in later retirement if they live that long.

Figure 2.7 shows what happens if only 80% of the annuity equivalent is withdrawn each year. In the first year, £4,400 is withdrawn. The larger sum that is retained in the pension pot to begin with means that, on average, increasing amounts can be taken out in subsequent years until the early 80s. Thereafter, the amount that can be withdrawn declines gradually and falls below that of an annuity by the late 80s.

Figure 2.8 shows what happens if a fixed amount is withdrawn each year – equal to 150% of the initial annuity amount of £5,500 (i.e., £8,250) – irrespective of the subsequent investment performance of the investment portfolio. It is clear that this is a very high-risk strategy that risks the pot being depleted completely by around age 80. Even taking only £5,500 per year is not much less risky as Figure 2.9 shows.

Figure 2.5: Distribution of real income with 120% drawdown and no deferred annuity

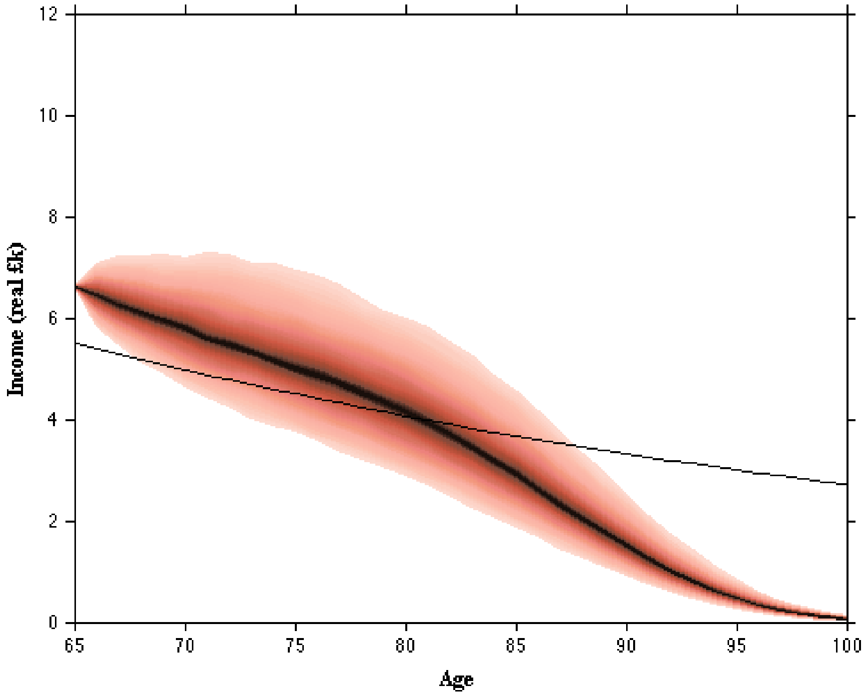


Figure 2.6: Distribution of real income with 150% drawdown and no deferred annuity

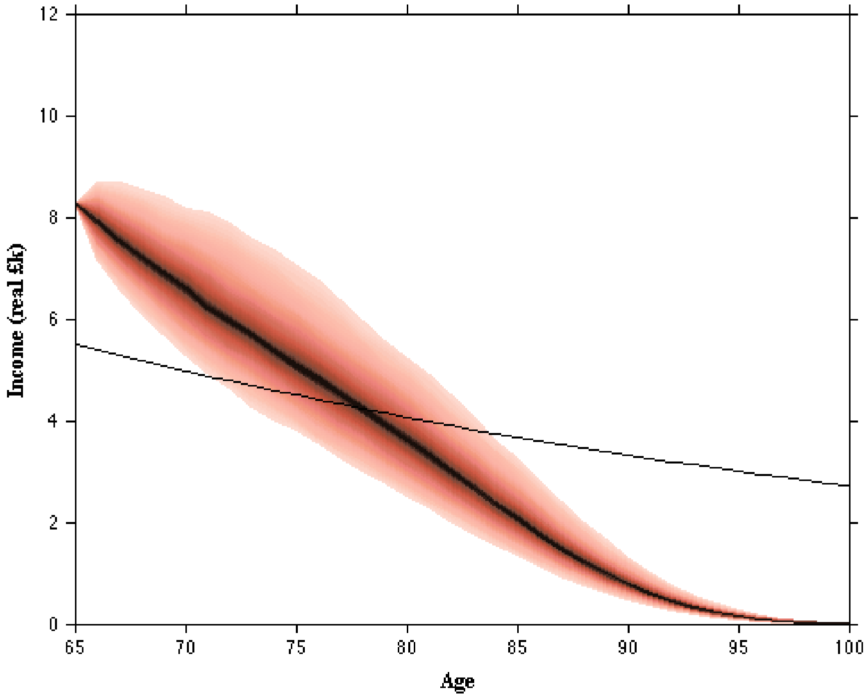


Figure 2.7: Distribution of real income with 80% drawdown and no deferred annuity

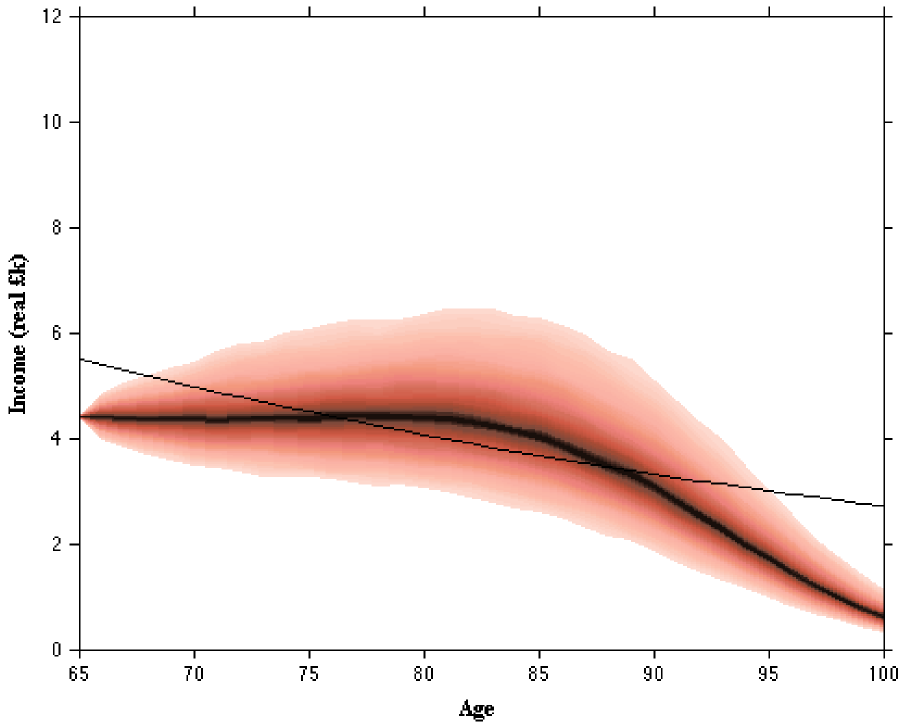


Figure 2.8: Distribution of real income with a fixed amount withdrawn each year equal to 150% of the initial annuity amount

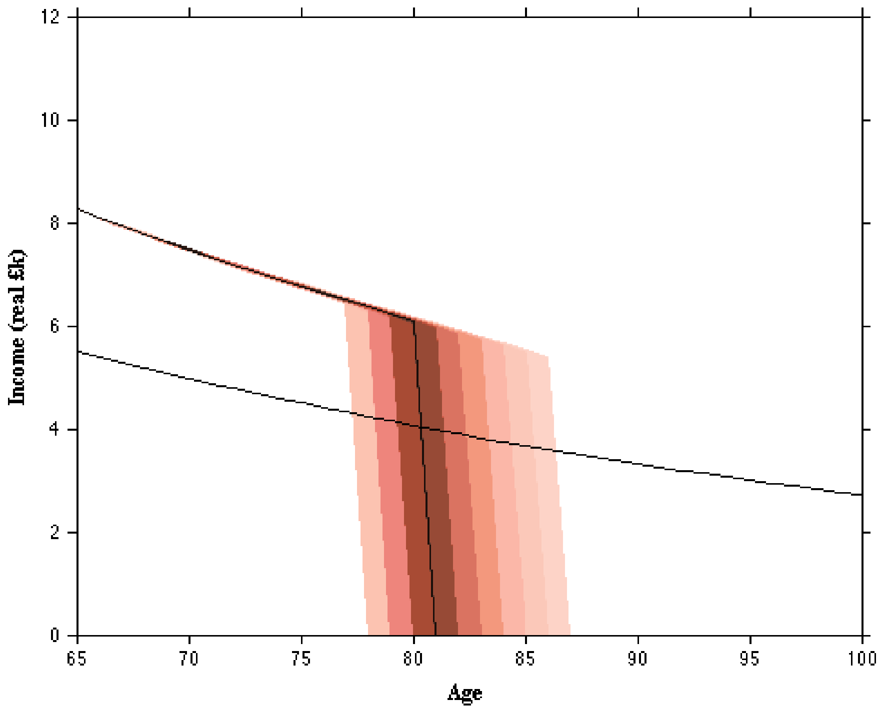
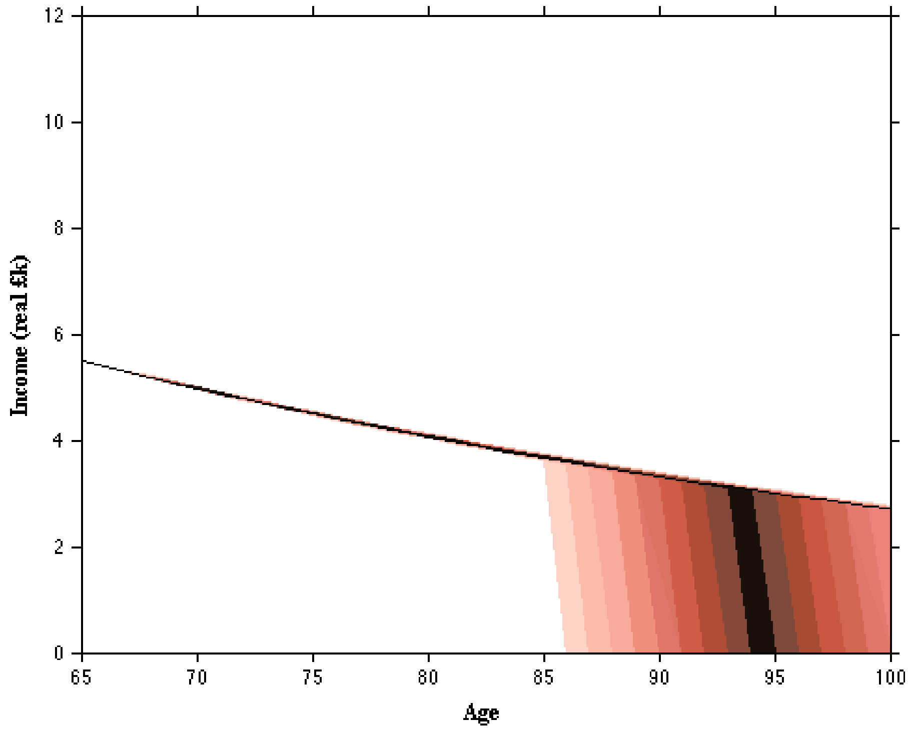


Figure 2.9: Distribution of real income with a fixed amount withdrawn each year equal to 100% of the initial annuity amount



The next set of Figures show what happens if part of the pension fund is used to buy a deferred annuity at age 65 which starts to pay out at age 85 if the member survives that long – the premium for the deferred annuity is lost if the member dies before 85. Figure 2.10 shows what happens in the case where 10% of the fund is used at age 65 to purchase a deferred annuity, and there is 100% drawdown on the remaining fund. Although lower on average than the income from an annuity at most ages, the income from this combination of drawdown and deferred annuity matches the annuity income quite closely – except at high ages – and certainly much better than the pure drawdown strategy shown in Figure 2.4. And drawdown has much more flexibility. If concerned about the fall off in income at high ages, the member could consider using 15% of the fund to buy a deferred annuity as shown in Figure 2.11. Figure 2.12 shows what happens in the case of 150% drawdown with 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85. The benefits from purchasing a deferred annuity at high ages are clear.

What these Figures strikingly demonstrate is the two key unavoidable tradeoffs people need to make in retirement: (a) a higher income earlier in retirement or a higher income later (and vice versa), and (b) the higher overall lifetime income from an annuity against the extra flexibility and death benefits available with drawdown. Ultimately, the optimal decision comes down to choosing what risk of a reduction in future lifetime income retirees are prepared to accept for retaining control over their assets.

Figure 2.10: Distribution of real income with 100% drawdown and 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85

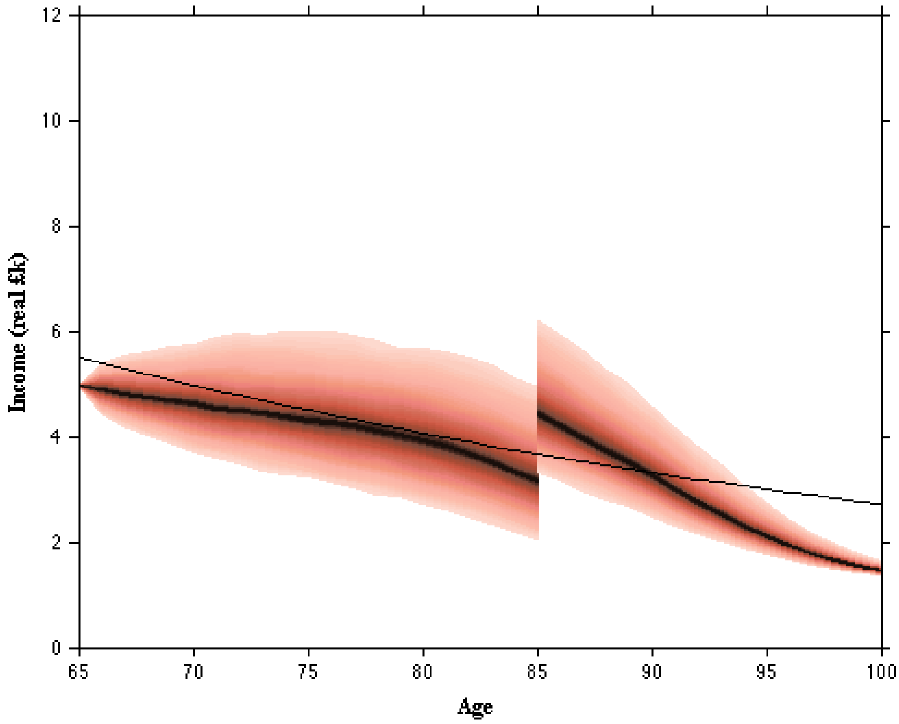


Figure 2.11: Distribution of real income with 100% drawdown and 15% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85

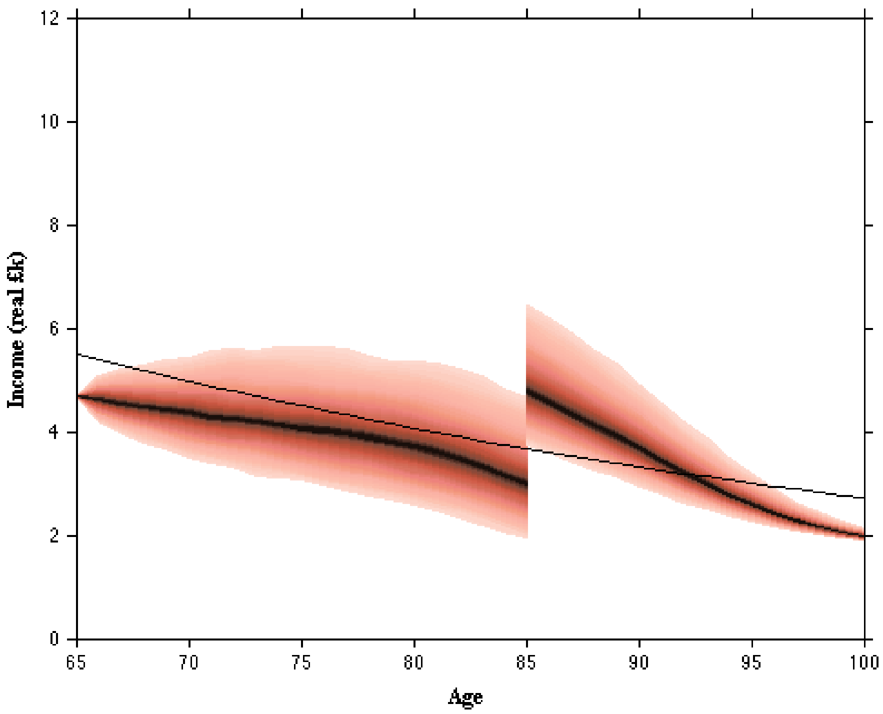
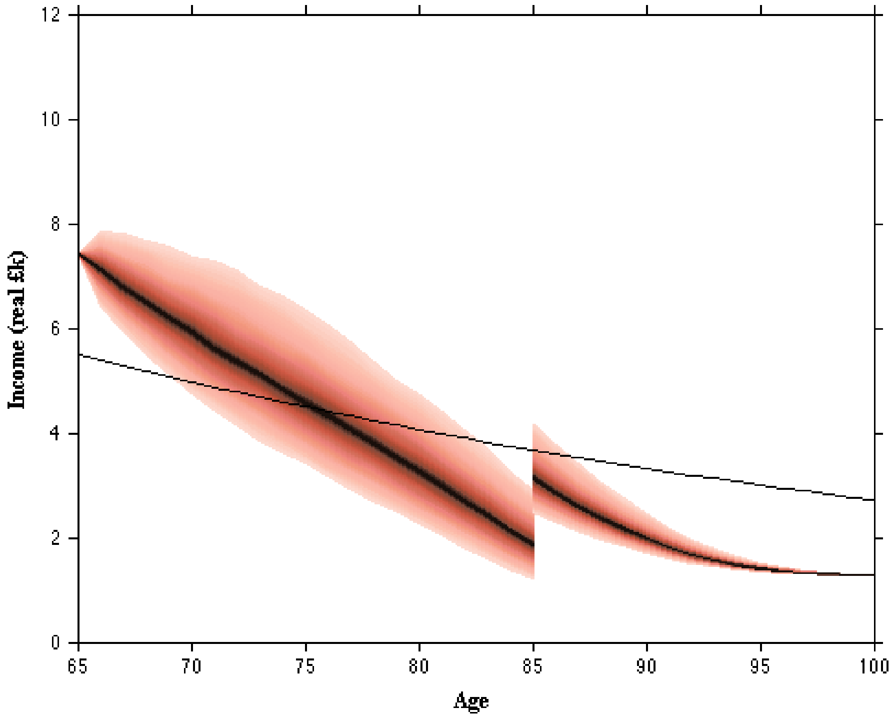


Figure 2.12: Distribution of real income with 150% drawdown and 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85



2.6 Charges, charge disclosure and proposals to cap charges

2.6.1 Charges

Charges for drawdown vary considerably and have up to four components: the charge imposed by the scheme provider to cover operational costs (such as administration), the fund management charge, the platform charge, and the charge for advice.

Even for a simple fund structure from a low-cost provider, the annual charge might be 1% plus an administration fee of £250 per annum, which would cover the cost of income payments and income amount reviews, for example. A more common total cost is about 2% p.a. which is similar to that for an investment-backed annuity. Guaranteed drawdown products could cost up to 2.5% p.a. (or even more), although for large funds, the charge drops to around 1.55% p.a. We came across cases where the charges for a SIPP package and advice were 4%-4.5% p.a. Platform costs can be between 0.25-0.50% p.a. and advice can be between 0.50-0.75% p.a. There are also hidden costs, including bid-offer spreads, the cost of sub-funds within the main fund, etc. Where an actively managed fund is selected, there is a risk that high turnover (churning) would add significantly to the total cost due to the transaction costs involved. Which? found 'one provider charging 0.5% more than another for investing in the exact same fund, and one provider's charges ranging from 0.44% to

1.24% for very similar funds, which can make a significant difference over the course of someone's retirement'. The worst case was a fund charging 2.76% p.a.[275]

We pool together some of the charges noted above:

- Annuities – It is hard to identify the 'charge' the annuity provider imposes for selling an annuity to a customer. The annuity provider simply sells the annuity for a price. It is possible to work out the annuity rate (which is the annuity payment divided by the purchase price), but that does not reveal anything about the charge. We do know that agents selling annuities on a non-advised basis get a one-off commission of 1-3% of the purchase price
- Short- or fixed-term annuities (FTAs) – Typical one-off commission for sales on a non-advised basis is about 2% of the fund
- Investment-linked annuities (ILAs) – Annual charges are estimated at about 2%
- Diversified growth funds – Annual charges are in the range 0.65% - 0.75%
- Multi-asset income funds – Annual charges of around 0.9%
- Multi-manager funds – Annual charges up to 2%.[276]

With current charges, drawdown products are more profitable to platforms than annuities, according to Ian Gorham, chief executive of Hargreaves Lansdown: 'we make a one-off commission if clients take out an annuity, but in the longer term we make more money on drawdown; as long as a client has a drawdown account for more than four years, it is more remunerative'.[277]

In July 2015, Which? published a comprehensive report on drawdown charges, entitled *The True Cost of Pension Freedom*.[278] For the case of a £50,000 pension pot with a 4% withdrawal rate, the difference in charges over 10 years between the most expensive provider (The Share Centre, which charged £8,100) and the cheapest (Fidelity, which charged £4,991) was around £3,000.

For someone with a £250,000 pot, withdrawing 6% a year, the cost differences over 10 years between the dearest and cheapest providers was £10,000, with Scottish Widows charging £26,490 and LV= charging £16,325. Table 2.6 shows the full set of results across the 18 companies that took part in the Which? survey.

The different companies had a variety of ways of charging: six charge to set up a drawdown plan, seven charge an annual fee for using drawdown, eight charge an annual fee if the

[275] Which? calls for additional pension reforms , 6 March 2015; http://www.which.co.uk/news/2015/03/which-calls-for-additional-pension-reforms-397246/
[276] Kyle Caldwell (2015) Under the microscope - the new funds launched for pension freedoms, Daily Telegraph, 14 May.
[277] Reported in Anna Fedorova (2015) Hargreaves shares slide 4pc as FSCS levy bites, Investment Week, 20 May.
[278] http://www.which.co.uk/news/2015/07/the-true-cost-of-pension-freedom-409249/

customer uses a SIPP, and seven charge a simpler single annual 'platform fee' but with additional charges for certain types of investments.

Richard Lloyd, chief executive of Which? said: 'The old annuity market failed pensioners miserably and the Government must ensure the same thing doesn't happen again with drawdown. With such big differences in cost, and confusing charges that make it difficult to compare, it's clear more needs to be done to help consumers make the most of the [pension] freedoms'.[279]

Table 2.6: Drawdown costs

Company	Cost over one year	Cost over a decade
LV=	£1,786	£16,325
Alliance Trust Savings	£1,966	£18,155
AJ Bell YouInvest	£2,035	£18,815
Halifax Sharedealing	£2,049	£18,957
Interactive Investor	£2,069	£19,156
The Share Centre	£2,467	£20,597
James Hay	£2,410	£21,152
AXA Wealth	£2,444	£22,081
Fidelity	£2,468	£22,284
Old Mutual/Skandia	£2,491	£22,487
Charles Stanley Direct	£2,636	£22,536
Hargreaves Lansdown	£2,620	£23,600
Barclays Stockbrokers	£2,699	£23,708
TD Direct Investing	£2,724	£24,031
Bestinvest	£2,880	£25,006
Aviva	£2,820	£25,310
Prudential	£2,820	£25,310
Scottish Widows	£2,959	£26,490

Note: The table calculates the costs based on a pot of £250,000, withdrawing 6% of the fund a year and pension growing by 5% per year. It also includes fund management charges. Which? used the Henderson Cautious Managed fund as the investment vehicle.

2.6.2 Charge disclosure

In September 2015, The People's Pension published the results of a survey of 1,256 working adults aged below 65 by YouGov which showed that 89% of scheme members did not know what charges they pay to their pension provider, while 51% said there were not aware that

[279] Reported in Michelle McGagh (2015) The £10,000 cost of getting drawdown wrong, Citywire, 21 July.

they were paying charges. Most (94%) respondents said providers should have to tell people how much they were charging them to manage their savings. Darren Philp, director of policy and market engagement at The People's Pension said: ‘Our research reveals a worrying lack of awareness about pension scheme charges. At the present time, schemes can charge in very different ways which makes comparison difficult and means consumers could be being ripped off. This survey reveals a strength of public opinion that the Government, regulators and wider pensions industry cannot afford to ignore. The public have made it clear that they want to see charges explained in a way that they understand, and which allows them to easily compare products’.[280]

In response to media criticism of their charges, some providers have reduced their charges. For example, Standard Life has removed its set up charge of £208 and one-off early depletion charge of £312 in its flexible drawdown product. David Tiller, head of adviser platform propositions at Standard Life, said: ‘From the feedback we've received, we know that it's the fundamentals that matter, such as: the reliability of income payments, the speed at which we can pay withdrawals on the day the client chooses and the quality of reporting to advisers and clients. It's not just about providing access, it's about providing a great service that can be relied on. The impact of the pension freedoms goes well beyond provider and adviser operational readiness. This legislation will transform the UK long-term savings market. Instead of being seen as inaccessible and opaque, pensions are about to become consumers' long-term savings vehicle of choice. Our role is to make it easy for advisers to access the flexibility, which is why we've decided to drop these additional drawdown charges. We know advisory businesses understand the opportunity arising from the new pension freedoms, but, at the same time, are concerned about increasing their capacity to deliver retirement advice while managing the obvious risks for clients living off their portfolios on a day-to-day basis. Platform technology has a clear role to play in providing an efficient and consistent way to facilitate the level of advice these clients need’.[281]

A requirement for full disclosure of all costs is currently being discussed by the industry, the regulators and the Government. MiFID II will also require product providers to disclose to clients full details of the costs and charges related to their investment, including cost aggregations, the timing of disclosure (ex-ante and ex-post) and information on the cumulative effect of costs on the investment return.

In July 2015, Martin Davis, chief executive of Kames Capital, called on the UK investment management industry to agree a common simple, transparent and understandable way to disclose fund management fees to investors. Although in 2014, he criticised the Financial Services Consumer Panel for recommending a single charge as being ‘over-simplistic’.

[280] Reported in Michael Klimes (2015) Vast majority of scheme members in the dark over fees, Professional Pensions, 15 September.
[281] Jenna Towler (2015) Standard Life removes drawdown charges, Professional Adviser, 5 March.

The Investment Association (IA), the trade body of the investment management industry, recommends the ongoing charges figure (OCF). However, some investment managers, such as Invesco Perpetual and Legal & General Investment Management, use the term fund management fee (FMF), which is similar to OCF. Others still use the less comprehensive annual management charge (AMC). But even OCF does not include all costs such as transaction charges.

Mr Davis said: 'There is no point in certain parts of the industry getting all cleaned up and not others. It has got to be meaningful and the customer has got to understand it. I would like to see the top ten in the UK, managing the vast majority of funds, come to some sort of agreement around the best way to articulate our charges in a way that is simple and understandable. Then the Investment Association could turn that into something the rest of the industry could sign up to'.[282]

2.6.3 Proposals to cap charges

The Pension Schemes Act 2015 allows the Government to impose a charge cap on drawdown products in future. No figure is mentioned, but it would be probably be higher than the 0.75% charge cap on DC default investment funds in the accumulation stage from April 2015.[283]

A number of organisations have put forward proposals to cap costs in the decumulation stage, just as they have been capped on default funds in the accumulation stage. For example, in December 2014, Age UK proposed a charge cap for income drawdown products on the grounds that 'understanding and comparing the total charges for an income drawdown pension is very complicated. It will be very difficult for consumers to compare the cost of different schemes, shop around and switch to better value arrangements. The extension of the charge cap to income drawdown will help prevent consumers from paying excessive charges'.[284] Similarly, in March 2015, Which? launched a Better Pensions campaign[285] in which it calls for the introduction of a charge cap for default drawdown products.[286]

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[282] Reported in Natalie Kenway (2015) Kames CEO calls on top UK fund houses to unite over charging, Investment Week, 27 July.

[283] Note the charge cap does not apply to investment funds offering any guarantees, say, concerning investment returns.

[284] Dominic Lindley (2014) Dashboards and Jam-Jars: Helping Consumers with Small Defined Contribution Pension Pots Make Decisions about Retirement Income, Age UK, December;
http://www.ageuk.org.uk/Documents/EN-GB/For-professionals/Policy/money-matters/dashboards_and_jamjars_helping_modest_savers_December_2014.pdf?dtrk=true

[285] Which? calls for additional pension reforms, 6 March 2015;
http://www.which.co.uk/news/2015/03/which-calls-for-additional-pension-reforms-397246/

[286] Along with other reforms, such as the safeguarding savings in schemes that go bust.

Futher, in the lead up to the May 2015 General Election, the Labour Party called for a cap on 'rip-off' drawdown charges on the grounds that 'people who draw money out of their hard-earned pension pot should have similar protections to when the put money in'.[287]

The Labour Party's proposals were not popular with industry practitioners. They said: 'it could be very damaging to how this market develops for customers if we saw an arbitrary cap imposed before we see how customers use their freedom or how providers innovate to meet their needs'. Further, introducing a charge cap on drawdown facilities is 'unnecessary because market forces will impose an effective cap'. A particular concern was a charge cap on drawdown products with built-in guarantees which the industry believes will be popular with customers. Steven Cameron, regulatory strategy director at Aegon, said: 'These valuable options come at a cost which may not fit within an arbitrary charge cap. This new market could be stunted before it even takes off.' Alan Higham said: 'A charge cap would be complex to implement across the range of retirement products and could stifle innovation at an early stage of development'.[288]

Speaking in the House of Lords in June 2015, Lord David Freud, Minister of State for Welfare Reform, said: 'We are going to see how the market develops. It has only been going for two months and, if it looks appropriate, we will introduce charge caps. We are meeting the industry and working with them to make sure they do produce the right level of charging and we are able to monitor that'. Lord Keith Bradley, then Labour's shadow Pensions Minister, reminded Lord Freud of Baroness Altmann's views before becoming Pensions Minister when she said that a cap on drawdown charges was important 'so that customers are not ripped off' and that 'a 2% a year charge just to keep your pension invested and to have access to it would take away much of the investment return and be a terrible deal for customers'. Lib Dem Lord Mike German asked the minister: 'My Lords, at all stages between the pension saver's pocket, the investment and back again, there are hidden charges and fees. Does my noble Lord agree that there should be transparency for pension savers and they should know what the hidden fees and charges are?' Lord Freud responded by saying: 'We already have the power to limit or ban decumulation charges and if we see that providers are charging excessive fees, we will not hesitate to act'.[289]

The Which? report published in July 2015 renewed the consumer organisation's support for a charge cap. It said it wanted the Government and FCA to work with the industry to simplify charges and to introduce a charge cap for default drawdown products.

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[287] Reported in William Robins and Gavin Lumsden (2015) Labour joins call for cap on pension 'drawdown' fees, City Wire, 6 March.
[288] Reported in Carmen Reichman (2015) Asset managers dismiss Labour's 'unnecessary' drawdown charge cap plan, Professional Pensions, 10 March.
[289] Reported in Michael Klimes and Jenna Towler (2015) Govt to 'closely monitor' drawdown charges as market expands, Professional Adviser, 10 June; Damian Fantato (2015) Government says drawdown charge cap possible, FTAdviser, 10 June.

Again there was industry resistence to this proposal. Tom McPhail disagreed with a cost cap, saying that it would lead to savers becoming disengaged with their money. He said: ‘The only sustainable answer is that we have a transparently competitive retirement market where informed investors shop around for the solutions which will suit them best. Drawdown isn't just about the price, it is also about putting investors in control of their money and giving them access to online tools and calculators to help them manage their money effectively. The risk with a price-capped “default drawdown” is that investors won't be sufficiently aware of the risks they face of investment losses or of drawing their money out too quickly. A “default” drawdown risks investors sleepwalking into unexpected investment losses. We would like to see the barriers to pension freedoms removed so that investors who have shopped around can move their money quickly and cheaply, without having to pay unreasonable exit penalties’.[290]

The Retirement Planner Inquiry for August 2015 asked advisers whether the Financial Conduct Authority (FCA) should intervene and cap charges as recently proposed by Which?. The vast majority (68%) said no regulatory intervention was needed, 20% were unsure and 12% thought it was warranted. A typical comment from an adviser supporting a cap was: ‘Even at modest charges, if the client wants 5% income, this suggests a return of nearly 8% will be needed to maintain capital values. Charges in excess will just decimate the fund’.

Typical views from cap opponents were:

- ‘Drawdown advice requirements are extremely varied and individual and therefore charges would vary accordingly. It always makes sense to try and look for a simple and cost-effective wrapper charge with no add-ons – the more expensive solutions will have to become cheaper over time or will disappear, anyway’.
- ‘Drawdown has never been a cheap product. It is inherently risky and requires a lot more work from the provider and adviser than an annuity. In a heavily regulated environment, people need to understand that they will have to pay for this. The products that provide the best value will dominate the market in the end. Or is Which? saying they don’t believe in free market economics?’.
- I don’t feel regulatory action is required, but I do agree that some of the drawdown charges are excessive’.
- ‘I object to any one person or group defining what is right for others. If a particularly wealthy individual with a particularly large fund is happy to pay particularly high charges, why shouldn’t he? He may buy an £800 suit as opposed to one from M&S.

[290] Quoted in Jenna Towler (2015) Which? calls for FCA crackdown on ‘confusing’ drawdown charges, Professional Adviser, 21 July.

He may buy a BMW as opposed to a Ford. Individual choice and freedom is required'.[291]

2.7 Product and provider regulation

In general terms, product and provider regulation comes under the FCA's conduct risk regime which, in turn, relates to the FCA principle of treating customers fairly.[292] The risk regime covers three main areas:

- The way the product is being developed (research, knowing target market, customer understanding, risks)
- The way the product is distributed to customers (training, do advisers understand the product that they are selling, are sales materials misleading?), and
- The way the products are subsequently serviced/administered and monitored (service levels, claim rates, are products performing as customers have been led to expect).

The FCA has seen fit to criticise the markets for annuities and structured products on all these grounds in recent years.

In March 2015, the FCA published the Final Report of its Retirement Income Market Study.[293] This followed a Thematic Review of annuities in February 2014 which found that the annuities market was not working well for most consumers.[294] The Final Report confirmed the FCA's provisional findings that the annuities market was still not working well for consumers. In particular:

- Many consumers are missing out by not shopping around for an annuity and switching providers, and some do not purchase the best annuity for their circumstances: for example, those with certain medical conditions or lifestyle factors had missed out by not purchasing an enhanced annuity
- Consumers are deterred from engaging with their options by the length and complexity of wake-up packs,[295] or because they do not believe the sums involved make shopping around worthwhile

[291] Reported in Jenna Towler (2015) RP Inquiry: Advisers on the post-April drawdown boom, Retirement Planner, 27 August.

[292] https://small-firms.fca.org.uk/fair-treatment-customers

[293] Financial Conduct Authority (2015) *Retirement Income Market Study: Final Report – Confirmed Findings and Remedies*, Market Study MS14/3.3, March; http://www.fca.org.uk/static/documents/market-studies/ms14-03-3.pdf

[294] Financial Conduct Authority (2014) *Thematic Review of Annuities*, Thematic Review TR14/2, February; https://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02

[295] The information that consumers receive from their providers in the run up to their retirement.

- Consumers' tendency to buy products from their existing provider weakens competitive discipline on incumbent firms and makes it harder for challenger firms to attract a critical mass of customers
- Consumers are highly sensitive to how options are presented to them. Savers reaching retirement will face a landscape that is more complex and will need support in making the right choices.

The FCA's solutions are:

- To require firms to provide an annuity quotation ranking so that consumers can easily identify if they could be getting a better deal by shopping around
- To require firms to redesign their wake-up packs and to consider including signposting letters and standardised pensions statements, before trialing them on consumers
- In the longer term, the creation of a pensions dashboard which will allow consumers to see all their pension pots in one place.[296]

Although the FCA said that its recommendations had received 'considerable support' from industry, some in the industry were disappointed. For example, Malcolm McLean, senior consultant at Barnett Waddingham, said: 'Most disappointing of all is the pace at which change in a market, so clearly in need of change, is drifting along. The FCA plans to consider all this further and to run another customer survey as part of a wider review of its rules in the pension and retirement area later in the summer. It will probably be another year at least before the remedies kick in, making it eight years since the regulatory probe of the market began. Both the FCA and its predecessors have shown a distinct lack of appetite for decisive action in relation to annuities. And as far as I can see from this latest lengthy report, no sanctions appear to be being proposed against those providers whom the FCA had investigated and found evidence of poor practice, particularly where providers actively discouraged people from taking up enhanced annuity products, if not widespread misselling'.[297]

In March 2015, the FCA published its Thematic Review of Structured Products.[298] Structured products are 'securities whose cash flow characteristics depend upon one or more indices or that have embedded forwards or options or securities where an investor's investment return and the issuer's payment obligations are contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows'.[299] Many

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[296] This is discussed in detail in Chapter 3.

[297] Reported in Natasha Browne (2015) FCA - Annuity providers must tell customers when they are getting a bad deal, Professional Pensions, 26 March.

[298] Financial Conduct Authority (2015) *Structured Products: Thematic Review of Product Development and Governance*, Thematic Review TR15/2;http://www.fca.org.uk/static/documents/thematic-reviews/tr15-02.pdf

[299] U.S. Securities and Exchange Commission (SEC) Rule 434.

structured products involve guarantees. Examples are: capital-protected accounts which are used as a savings alternative to deposit accounts; and capital-at-risk products which are used as investment alternatives to shares or bonds. The FCA had serious concerns about the complexity and value of these products.

The FCA found that retail customers generally struggle to understand the complex features common to many structured products and they find it difficult to compare alternatives. As a result, they frequently over-estimate the products' potential returns – by almost 10% of the assumed investment amount over five years. The FCA has concluded that, not for the first time, the structured product market is not working for investors: some firms are falling below the standards the FCA expects in their approach to the design, manufacture, packaging and distribution of structured products.

The FCA argues that providers need to define at the product design stage a clear target market of end customers and identify what needs these products would serve. Structured products should have a reasonable prospect of delivering economic value to customers in the target market, which firms must be able to prove via robust stress testing – through to the end of their life cycle – as part of the product approval process. Providers also need to strengthen the monitoring of their products, including by ensuring distributors – such as financial advisers – have enough information about the product to sell it appropriately and that each product is being distributed to its identified target market. Firms need to provide customers with clear and balanced information on each product and any risks. Products that fail this process should not be manufactured nor distributed.

At the EU level, the European Securities and Markets Authority (ESMA) is in the process of finalising its rules on the implementation of MiFID II which will take effect from January 2017. Most products which are not plain vanilla shares, bonds or UCITS funds[300] will be classified as 'complex' products, since they have a 'structure which makes it difficult for clients to understand the risks involved'. This means that many of the products that have been designed for the UK retirement income market in the new pensions environment will be classified as 'complex', since they have been structured as non-UCITS retail schemes (NURS). This, in turn, will mean that non-advised clients must take an 'appropriateness test' each time they purchase a NURS product.[301] The extent of the appropriateness test will depend on the complexity of the product's underlying investments, but, in all cases, product providers would be responsible for assessing the knowledge and experience of individual retail customers before they are able to invest in the product. Product designers have used the non-UCITS route (a) to enable greater diversification than can be achieved by using

[300] UCITS (Undertakings for Collective Investment in Transferable Securities) funds are mutual funds based in the European Union which can be sold to any investor within the EU.
[301] This is discussed in more detail in Chapter 3.

UCITs and (b) because certain asset classes, such as property, cannot be invested in via UCITS.[302]

Some feel that the drawdown market could soon attract the attention of the FCA in the same way that the markets for annuities and structured products have. For example, Holly Mackay, founder of The Platforum and Boring Money, believes that providers need to simplify drawdown charges or the regulator will intervene. She said she found it impossible to compare the cost of drawdown of different providers because of the variety of charging structures and types of fees. Further, her recent consumer research confirmed levels of engagement and understanding of retirement products were still low and fuelling the problem was the opaqueness of pricing of retirement products. She said if providers fail to act to streamline their charges soon the FCA will step in and force them to do so, leaving no further 'wiggle room': 'There is a real challenge here for drawdown providers: if they don't make [charges] clear, what we will see is what happened in the platform pricing arena where the regulator came and [intervened]'.[303]

2.8 How to deal with stranded pots

There is a final issue that will be covered briefly in the Chapter and that is what happens when people move jobs. Should the pension pot stay in the leaving scheme, or should it follow the member to the member's new scheme, or should it move to an aggregator scheme? Or should there be another type of solution altogether?

In Australia, scheme members tend to stay with the same scheme when they move jobs. In other words, the scheme follows the member: the member has one pot which they take with them when they change jobs. The same would hold for SAFE retirement plans in the US.[304] By contrast, the UK second pillar pension system is a workplace-based system, with schemes typically set up by individual employers, although in a small number of cases, they are established on an industry-wide basis, such as the Universities Superannuation Scheme. This means that in most cases, people have to decide what happens to their accumulated pension pot when they change employers. The default is to do nothing and leave the pot where it is (if the scheme agrees to this). The pot then becomes known as a stranded pot. If people move jobs many times over their career – and the average is 10 or 11 times – then they could end up with a large number of stranded pots. This is not only administratively inconvenient, there is the real risk that people could lose track of all their pots and, equally

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[302] Hannah Smith (2014) ESMA unveils final guidance on MiFID II rules, Investment Week, 19 December;
Laura Dew (2015) Multi-asset providers consider fund conversions on MiFID II fears, Investment Week, 13 April; Financial Conduct Authority (2015) *Developing Our Approach to Implementing Mifid II Conduct of Business and Organisational Requirements*, Discussion Paper DP15/3, March; https://www.fca.org.uk/static/documents/discussion-papers/dp15-03.pdf

[303] Reported in Carmen Reichman (2015) Providers must address 'opaque' drawdown charges or risk FCA intervention, Professional Adviser, 24 September.

[304] Examined in Chapter 6.

possible, schemes could lose track of their deferred members, which is likely to happen if people do not inform their previous schemes when they change address.

A number of solutions have been proposed for dealing with this problem.

The first is pot-follows-member. In this case, the pot, if it is below a certain size (£10,000), automatically moves to the member's new scheme when he or she changes job. If it is above this size, the member has to specifically ask for the pot to be moved, unless the leaving scheme insists that the member takes their entire pot with them. The size threshold is intended to deal with liquidity issues in the scheme. When someone moves, assets have to be sold and the cash value of the pot is transferred – it is rare for in specie transfers to take place. Schemes do not want to be in the position of having to sell illiquid assets to meet these transfers. They would prefer to do so with liquid assets which typically have lower returns than illiquid assets. So two of the key problems with pot-follows-member are switching costs and lower overall investment returns. If someone changes jobs many times, these two factors can materially reduce the value of the pension pot at retirement.

The second solution is the aggregator model. In this case, when someone changes jobs, their pot is automatically transferred to an aggregator fund which collects all the stranded pots into a single fund. A small number of funds would be authorised to offer this service. This has the benefit of introducing significant scale economies by consolidating assets in a small number of large funds, gradually moving assets away from the long tail of 200,000 mostly very small schemes. The aggregator funds would also benefit from good governance and institutional investment management if they were set up along the same lines as the National Employment Savings Trust (NEST).[305] Further, the switching costs would be lower than under pot-follows-member, since only the assets accrued in the ceding scheme need to be transferred when the member changes jobs, not the total assets accrued since the member started employment, as happens with pot-follows-member. There would be a default fund for those who make no active investment choice. A criticism of this model is that the member is unlikely to feel particularly engaged with this type of arrangement. However, the same criticism applies to the entire auto-enrolment process.

The third solution is the Australian solution of scheme-follows-the-member or what is also known as one-member, one-scheme. The employer pays contributions into the employee's chosen scheme which follows the member when they change jobs. This approach deals with the problems of switching costs and potentially lower returns. But it has the administrative inconvenience of requiring the employer to set up a direct debit for every employee's scheme. With a scheme run by the employer, the employer only needs to make a single payment covering all employees. The solution to this is to have a central clearing house into

[305] NEST is discussed in Chapter 5.

which the employer makes a single payment which is then allocated to each employee's scheme.

The one-member, one-scheme approach has been promoted by a number of industry practitioners, in particular Tom McPhail and John Lawson, head of pensions policy at Aviva. Mr McPhail argues: 'With the one-member, one-scheme approach, whenever you change jobs, you can pick up the pension and take it with you and the new employer can pay into that scheme. This would bring a sense of continuity for the member and the default position should not be to keep moving money around'.

In August 2013, the then Pensions Minister Steve Webb invited McPhail and Lawson to contact the Confederation of British Industry (CBI) to canvas support for the proposal. The CBI, while not fully endorsing the concept, accepted that that it was better for each saver to have a single well-managed pot.[306]

The technology available to execute transfers has improved significantly in recent years as a result of the introduction of Origo, an open source, e-commerce service established on a not-for-profit basis by 12 life and pension companies at the instigation of the ABI. Origo built 'Options' which does pensions transfers and reduced the transfer time from 4 months to 9 days. Version 1 does pensions-to-annuities transfers (via the OMO). Version 2 does pension transfers in accumulation (e.g., from Aviva's to Prudential's platform).

Nevertheless, this system has been criticised because the life companies involved still make it hard for consumers to switch to a new provider, according to Ben Cocks of Altus Business Systems. This is because the new provider has to get the approval of the life offices to participate in the service and pay the fees they demand. In response to this, the Tax Incentivised Savings Association and the UK Funds Market Practice Group (which sets the ISO-based open technical standards for UK financial services) have established an open transfer framework that deals with all the technical and legal aspects of transfers. Different technology companies can then offer compatible transfer services and all participating companies can have an equal say in how the service operates. This approach has been used in the ISA transfer market and has increased the level of competition between ISA providers considerably. However, Origo and the life offices have so far refused to allow open transfers for pensions, despite the Department for Work and Pensions allowing the use of open standards for automatic pension transfers.[307]

In October 2015, the Pensions Minister, Ros Altmann, announced that legislation dealing with stranded pots would be delayed in order to allow schemes to deal with other pressing

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[306] Reported in Retirement Planner (2015) Pot follows member won't engage savers, warns Tom McPhail, 30 June.

[307] Reported in Ben Cocks (2015) 'Tortuously complicated'- Pension transfer system needs shaking up, Retirement Planner, 11 August.

issues, such as the completion of auto-enrolment and the introduction of both ‘freedom and choice’ in April 2015 and the new single-tier state pension in April 2016.

2.9 Feedback from our interviews and responses to the consultation paper

2.9.1 Feedback from our interviews

2.9.1.1 Employers and consultants

In our meetings with employers and their consultants, we discussed a broad range of issues concerning the products and services relevant for scheme members which we summarise under the following headings.

What products/services might good employers be offering?

Good employers will be looking for something that protects against the longevity risk of their former employees.

This does not necessarily have to be a separate annuity – it could be a drawdown product that has a trigger point or crash barrier so that if the fund falls below a certain level this triggers automatic annuitisation. The idea would be to default DC members in: they do not have to actively join and could opt out at any stage. If the fund was falling due to market conditions, members might be offered the choice of annuitising or stopping/reducing withdrawals for a period.

Employers are likely to be influenced by what their AE provider offers, so, as in the US, the market will be provider-led. Employers considering making drawdown available will want a fire wall between the employer and the provider, ensuring liability is transferred and there is no come-back for employers if things do not work out as well as members hoped.

Employers have not yet come to a firm conclusion about whether their drawdown offering should be a retail solution or some sort of straight-through accumulation-to-decumulation process, involving scheme drawdown. The BT scheme, for example, is moving members into SIPPs for drawdown. This is a retail product, although the employer has negotiated the terms. So, employers can use their clout to negotiate better terms with one or more providers, which is what they do with other products made available through the workplace, e.g., insurance.

Despite the lack of major launches, many respondents agreed on the merits of scheme drawdown. One said: ‘Scheme pensions are more efficient in payment. Scheme drawdown is a scheme pension without pooling. It provides better governance and economies of scale but doesn’t give individuals the chance to engage to the same degree’. Another said: ‘The governance of scheme drawdown is crucial and must mirror that of accumulation. If the Grand old Duke of York marched his men to the top of the hill, he should march them down again’. And a third added: ‘Scheme drawdown’s big advantage is that it’s done within a pension fund, so it's not affected by regulatory capital requirements, which can add 1.5% to the cost, nor does it get into the grey area round advice – which is the case if a provider offers its retail drawdown product – usually a SIPP – to a member of a DC trust-based scheme. The chances are that this would – or certainly could – constitute regulated advice under FCA rules'.

The potential for scheme drawdown to offer lower charges than retail products was considered crucial:

- 'If drawdown costs more than 1%, it won't work. End of'.
- 'Scheme decumulation is likely to be the cost for accumulation plus up to 0.25% for added functionality, such as withdrawals. Retail decumulation total costs can be anything from 2% to 4%'.
- 'Retail advice adds 1% to the price. That might be OK for a one-off transaction, but what if it's a drawdown strategy with an additional 1% for advice each year?'

Another lesson from the US is that charges are regulated when members of 401k schemes roll-over into their provider's IRA.

<u>What are the risks with drawdown?</u>

We received the following comments:

- 'Drawdown is the most complicated of the choices that the employer/trustee might offer – there is a need to consider where to invest and how fast to draw down. The main risk with drawdown is that the income might have to be reduced. It is important for schemes to *suggest* a 'safe' level of withdrawal'.
- 'However, it is not the trustees' responsibility to *set* the withdrawal rate – this would be too risky'.
- 'Whatever the withdrawal rate suggested, it must be reviewed regularly – this cannot be set and forget – remember what happened with endowment mortgages'.
- 'It is crucial to manage the rate because, left to their own devices, individuals will panic if there is a market crash and cash out at the bottom of the market' (called composure risk by one participant).
- 'Drawdown investment strategies also need to match the annuity rate plus an additional percentage to account for the absence of the mortality cross-subsidy'.
- 'Without regulated advice, people will find it difficult to manage multiple pots'.
- 'One of the biggest risks is the interaction with means-tested benefits – this is an area that needs a massive amount of attention'.

<u>What are the risks with annuities?</u>

Longevity risk is the biggest concern for consultants. Deferred annuities are currently non-existent. Sales of immediate annuities have collapsed – historically most people annuitised by age 75. Pricing an annuity for someone who is still healthy at age 85 will look like poor value to the annuitant – insurers would expect them to live an additional 12 years on average. While it is easier to price a deferred annuity at age 65, consultants are not expecting many people will want to buy one – even if the product existed – because they would fear that they would 'lose' the purchase price if they died earlier.

Insurers really do not like selling to people in their 80s because of cognitive decline.

What will providers do?

In general, all providers are very keen to offer drawdown because this is when the DC pot is at its largest, so will provide a good fee income. Providers in the AE market will be keen to retain these assets.

Providers are likely to favour the sale of retail drawdown to retiring members – but if a major competitor offers scheme drawdown and this is seen to be better value for money, then they will do this too.

Some providers are developing a 10-year investment/drawdown period with an annuity built in, although some consultants think 80-85 is too late to annuitise, preferring age 75 (NEST is suggesting 85).[308]

What are consultants doing?

Most consultants are focusing only on advising on drawdown. Annuitisation is too far into the future to second-guess what the market for later life annuities will look like: 'There's no point in designing a product today that tries to second-guess what a 65-year-old will need at age 75+. There will be a massive differential where medical underwriting is used at older ages – far more significant than at the point of retirement'.

Some consultants that we talked to are advising employers with single-trust schemes. Previously, they would have put in place a third-party annuity bureau service. Now they are looking at other alternatives, but they do not want to retain the responsibility/liability and do not want to run any alternative themselves.

One consultant is working on a design for drawdown to last 30 years, i.e., a 'notional income for life' product. They will use a master trust and manage the transition from accumulation to decumulation, so the investment strategy is straight-through. This is important for the stability of the strategy, but also very important because it avoids out-of-market risk. Where a DC member buys a retail drawdown plan, it would be necessary to cash out of the accumulation scheme and reinvest in the new product. The plan is to match the investment strategy of the drawdown scheme with the tail end of the default accumulation fund.

[308] Discussed in Chapter 5.

The same consultant believes that, of the drawdown funds offered by providers, very few are suitable. Income needs to be reasonably stable, but not guaranteed – i.e., needs to reflect the actual experience of the fund – so, say, a 4% of original pot size set-and-forget model is flawed. If people want a guaranteed stable income, they need an annuity.

This consultant also said that adequacy is an important issue. If people cannot afford to retire, they need to consider working longer and possibly contributing longer. The problem is that members will not know 5 years out when exactly they will retire, so planning is very tricky for both the employee and the employer.

Scheme defaults

Many employers are uncomfortable with the idea of scheme defaults. While they are concerned about the risks facing members, they appear to be equally concerned about their own risk/liability. In particular, they are concerned that *anything* they do would be perceived as advice by members. So not only are employers concerned about scheme drawdown, they would even be reluctant to support annuitisation. They realise that if things go wrong, ex-employees will be knocking on their door first.

2.9.1.2 Providers and investment managers

Our discussions with providers and investment managers is summarised here under the following headings.

What about the quality assurance of products offered via, say, a decision tree?

There was support for having the products listed in the decision tree classified as safe arbour products. This means that any adviser recommending these products cannot subsequently be sued for poor advice, after having determined their suitability for the client. So far the FCA has been reluctant to grant safe harbour status to UK investments, unlike the US. We were told: 'It is important that we try and get the FCA to approve both the decision tree and the default options at the end of the decision tree even if they are only the least worst options'.

But where do we set the bar for the products listed in the decision tree? Should the products that are listed be the 'best' or should they be just 'very good' or 'adequate'? A view offered to us is that 'they should be reasonable options, not detrimental, but not necessarily optimal, but not a bad decision. They should be "good enough"'.

However, any safe harbour products need to be carefully regulated. There needs to be a mechanism to ensure these products are indeed 'good enough', since there could be no Financial Ombudsman Service referrals with safe harbour products (if their suitability for clients had been assessed).

Advisers, on the other hand, tend to suggest that everyone needs a perfect tailor-made solution. However, we were told that this would be an example of the case where 'the best is the enemy of the good' – and, in any event, would be too expensive for most people.

It was also pointed out that, while competition can be good, it can lead to a proliferation of essentially identical products which are marketed as being different. This leads to customer confusion.

What investment strategies are appropriate in the new pensions regime?

This turned out to be a difficult question to answer because it was not clear at the time of the interviews how consumers would behave following the introduction of 'freedom and choice'.

Many of the people we interviewed believed that 'lifestyle strategies and even TDFs are now out of date, but new investment strategies still need to deliver returns, although with reduced volatility. However, we will need to observe customer experience in decumulation before redesigning de-risking glide paths'.

It remains the case that diversification is the only low-cost way to reduce volatility. Other solutions to reduce volatility involve options and other derivatives, but these cost more than 0.75%. It was pointed out that a charge cap would reduce the scope to diversify risk and put products using derivatives to guarantee returns out of reach. It was also pointed out that the process of paying income to members is expensive, much more than the cost of collecting contributions.

In terms of new product design, investment managers and consultants are designing drawdown products with long-term (30-year) investment horizons. These would invest in fully liquid funds, so annuitisation could occur at any time, but these managers questioned whether there was any need to annuitise given the investment horizon. They pointed out that annuities were originally designed to last for 10-15 years, not 30. The success of this strategy is predicated on the assumption that an investment-based product can be as effective as insurance in terms of hedging longevity risk.

An example was JP Morgan which was designing a drawdown product with a cap on the maximum percentage of the fund that can be withdrawn, adjusted in line with fund performance, and a charge of 0.35% plus a cost per withdrawal. It would probably need to be held within a SIPP which would add an additional layer of costs. It would be offered on both an advised and non-advised basis.

What is the future of annuities?

Insurers tended to argue that the value of annuities are now underappreciated due to negative norming. It was agreed that the money's worth of annuities was high – and this was confirmed by the FCA's own research in December 2014. Annuities are the only product that can hedge individual longevity risk. It was agreed that there was a need to reinforce the value of annuities. This could be helped by rebranding them as a 'guaranteed income for life' product.

Some felt it was hard to see how annuities could be sold without advice, due to the complexity of the decisions that need to be made: level vs inflation-linked, single life vs joint life, standard vs enhanced; the latter needs individual underwriting, but this can now be processed quickly and cheaply using the common quotation form (available since 2008).

However, this view contrasts with those who believe that these issues could be addressed using a well-designed decision tree. It was also pointed out that, before the introduction of 'freedom and choice', NEST was going to operate an annuity clearing house using a filtered form (married v single, level v indexed) and an algorithm would recommend a particular provider, say, Prudential, from a panel of providers.

Retail v scheme drawdown

The standard drawdown product is retail. One of the biggest drawdown providers described how their company operates. Their main market is in advised drawdown. They also operate in the non-advised market (below £100,000) where they offer only 'safe' funds plus lots of guidance. They explain that if people need a guaranteed income, they should buy an annuity. Previously, this was the capped drawdown market, where the cap was a good safety net. They find there is difficulty in explaining volatility to customers and the consequential risk of overdrawing relative to the performance of the fund. They need to explain that the withdrawal rate cannot realistically be more than, say, 4-5%. But, they are conscious that another firm can always come along and say it can deliver 6%.

Charging is problematic: any fixed charge significantly outweighs a percentage charge in the £30,000-£100,000 market. Also administration is more intensive for drawdown customers – customers usually contact the provider 2-3 times p.a. – far more than under accumulation.

The same provider was also looking at scheme drawdown, but said it was hard to tell at this stage what DC scheme members will do. They said that it was virtually impossible to design a default, since there were too many 'substantial' minorities wanting different things:

- Annuity
- All cash
- Drawdown
- Drawdown plus annuity.

Some providers told us that there was a false distinction between scheme (institutional) and retail drawdown in terms of value for money. This is because it is possible to get low-cost non-advised drawdown in the retail market at all-in cost of 0.43% (e.g., Fidelity 'direct to customer') or 0.45% (e.g., Aviva). One provider said: 'We need to rethink what economies of scale means in a drawdown market. This isn't about scheme vs. retail; it's about scale in terms of the institution managing the money'. Similarly, an investment manager told us: 'Drawdown means an individual account, so it's not necessarily cheaper to distribute via a scheme because of the need for payment into bank account'. However, we wondered how different this was from how DB administration operates in the payout stage – DB schemes exploit economies of scale and lower costs using a third-party administrator (TPA), for example.

If the client wants advice, this can raise the cost to around 2.5%. For example, MetLife's guaranteed drawdown product costs up to 1.85% to cover the cost of the guarantees and the annual management charge, and another 0.5-0.75% for advice. Further, the drawdown rate is around 70% of an equivalent single-life annuity.

We were told that there remain substantial barriers to getting employers to offer scheme drawdown:

- Employers do not want the liability
- Trustees (in single trust schemes) do not want the liability
- There is also lack of clarity about regulation and uncertainty over liability for providers.

2.9.1.3 Trade unions

A panel of trade unionists and TUC officials (together with two representatives from consumer organisations) met with us on 12 January 2015 to address the following questions.

<u>Will longevity insurance remain an essential component of decumulation and if so why?</u>

This question elicited the following responses:

- 'People are generally positive about longevity insurance, but there is a limit to what they will pay for it'
- 'What people really want from a pension is a secure and predictable income. I have never come across any trade union members complaining they do not have sufficient flexibility from a DB pension. Unless there is some kind of longevity protection, it is no longer a pension'
- 'Annuity products are really good. But the market has ruined them. It is the way they sold them and the way they gamed them. The public have got this perception that they are terrible'
- 'If you ask people if they want an annuity they say no. If you don't call it an annuity, but instead call it "income for life", then this is attractive'
- 'There is still going to be a role for longevity insurance, but much latter. The aim should be to start an annuity at 75, 80, or 85 at the latest. The risk of income

drawdown is that people will leave the money invested. There is the issue of investment risk in the first five years or so after retirement'

- 'We are expecting individuals to make rational decisions about different annuities, but it would be much better if schemes could do it. People want someone on their side making regular payments until they die. It makes sense for schemes to do it'
- 'There remains the problem of people's reticence to committing large amounts of money to something they may not benefit from. My grandmother resisted buying a new settee at 75 because she felt she wouldn't get use out of it. I would worry that way of thinking would be amplified with committing large sums to buying an annuity that they think they won't benefit from for very long. Perhaps it would be better if there was a way of gradually buying a longevity product over time'
- 'Denmark with ATP has just one provider. Politically that is very hard to replicate in the UK'.

What are your views on defaults?

We asked: 'Can you have a single default option?'. Participants accepted that there had to be a 'default process' which would work along the following lines: 'from what we know about you, this is what we are going to do as a default. If you want to do something different, you need to opt out'. One participant said it would have to be pot-size related. Another said: 'It would also need to be age-related. At the moment for many people with DC pots, these represent a small proportion of their pension saving. That will change over time. A solution that works for those approaching retirement now is not a solution that works in 20 or 30 years' time. We need to be mindful that 90% of people will do nothing and take the default route. Yet £20,000 saved by a low earner can be a higher proportion of their pension savings than £100,000 is for high earners. Defaults have to be mindful of that'.

Another participant took a different view on the default: 'I am listening to this – is it not the case that an actual default, in the world we regrettably find ourselves in, is that the money remains invested? I do not think there can be a default to providing income. If the member does not make a decision, it remains invested until a member makes a decision. The reason people buy level annuities is that people do not want to buy annuities at all. They didn't think they provided value'.

Another participant (from a consumer organisation) commented: 'If you default them into a product (such as drawdown), you are right squarely in the area of regulated financial advice. I think scheme trustees will be very frightened of doing that. They can do that and get regulated. I just think they will not want to be. The key problem is people who take the money and run because they do not know what else to do'. The previous speaker responded: 'If you default into an annuity, you almost guarantee that people will opt out and just take the money'. The first speaker replied: 'You should only default into an annuity once they get the benefits of longevity pooling (at age 75, 80, or 85 whatever). Until then you should stay invested so the pot has the chance to grow'.

2.9.2 Responses to the consultation paper

We summarise the responses to Questions 3-21 in the consultation paper.

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?*

All respondents agreed that some form of longevity insurance would be needed at some point in retirement. However, there was a diversity of opinion about how this should be achieved. The two most commonly suggested options were to purchase an annuity later in retirement or to purchase a deferred annuity, possibly via the payment of regular premiums. Product innovation would be needed to deliver such products in practice.

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

A quarter of respondents suggested explicitly that it would be necessary to have a combination of approaches to ensure that individuals who choose to buy annuities get value for money and purchase appropriate products. The range of suggestions from other respondents also suggested that no single option would be adequate. So to help individuals get best value from annuities, they would need a mixture of nudges, better education, better market provision and better advice/guidance.

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

Most respondents suggested that new products, typically some form of deferred annuity, would be necessary to help individuals hedge longevity risk if those individuals chose not to buy a conventional annuity at retirement. Without some form of annuity product, the main alternatives suggested were additional saving (and hence under-consumption) and/or reliance on family support.

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? (b) Should such products have a maximum recommended level of income withdrawal? (c) If so, how should that level of income be determined?*

There was considerable agreement that drawdown was appropriate in the early period of retirement, with two-thirds saying this explicitly and the remainder suggesting approaches very similar to drawdown. Several suggested that drawdown products should or could have guarantees. There was also strong support for recommendations or guidance on the maximum that should be drawn down each year. Very few responses provided suggestions for how to calculate this maximum. There was little support for a compulsory maximum level of income drawdown.

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)?*

There were a variety of responses to this question and very few respondents were certain whether the advantages outweighed the disadvanges. Respondents were clear that scheme drawdown might have the advantages of lowering costs through economies of scale and providing better governance. However, economies of scale might be absent for small schemes which would find it difficult to cater for the diverse needs of different members. While improved governance would be an advantage for members, some schemes might struggle to take on the additional responsibility of looking after funds in the drawdown phase, and so this was potentially a disadvantage for the trustees, especially since the regulatory framework for this is not sufficiently clear.

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

Eighty-two per cent of responses accepted the principle of a default decumulation product, while 76% thought that the decumulation phase should be governed by the same governance standards in master trusts that apply to the accumulation default fund and should be overseen by IGCs in contract-based schemes. But a significant minority were unhappy with defaults, despite the fact that people were free to opt out of a default, and thought that IGCs were not appropriate, preferring instead to rely on existing FCA rules.

7. *(a) What could be the typical total expense ratio (TER) for a default drawdown product provided by a large-scale master trust? (b) How might this TER compare with individual drawdown products sold in the retail market? (c) Can you give any examples of TERs for retail drawdown products?*

Very few respondents were prepared to say what a typical total expense ratio should be for a default drawdown product. However, one respondent suggested that the TER should be no more than than 0.5 per cent, while another suggested it should be equal to accumulation TER plus 0.25 per cent. The small number of responses to this question noted that it is difficult to answer while new products are still being developed. Default products should be cheaper than retail products, but retail products, it was noted, can be expensive.

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

Sixty-three per cent of responses were against a charge cap on scheme default drawdown products, at least in the short run.

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

Overwhelmingly, there was support for higher quality controls on sales of retail drawdown products, with 65 per cent of responses favouring this. However, there was virtually no support for a charge cap on retail drawdown products, on the grounds that it would stifle innovation, with two-thirds being explicitly against a cap.

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

The strongest theme from responses to this question was that the investment strategy in scheme drawdown prior to the purchase of longevity insurance should be fairly cautious, namely to provide growth of the fund while reducing risk, with 43 per cent explicitly naming this as the appropriate strategy. However, 29 per cent of respondents noted that individuals have different needs and so there was no single strategy that would be appropriate for all individuals.

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)?*

Institutional annuitisation has the obvious advantage of scale and potentially the disadvantage of not being suitable for the individual, if not individually underwritten. Another disadvantage was that the scheme would be creating DB-like liabilities and the question was raised about who would ultimately underwrite these liabilities (employer, PPF or state) if the scheme underestimated the longevity and investment risks. Some respondents were uncertain whether the advantages outweighed the disadvantages and overall there was no clear majority one way or the other.

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)?*

The overwhelming majority of responses thought that institutional annuitisation could deal with individual underwriting and still encourage competition from providers.

13. *(a) Would a market for advanced life deferred annuities be viable? (b) What is the likely demand for advanced life deferred annuities?*

Sixty per cent of respondents thought that there could be a market for advanced life deferred annuities, but it is clear that there would be significant problems to be overcome to achieve this. To make the product more attractive, some respondents suggested it could be paid for in instalments.

14. *Is there likely to be demand for inflation protection?*

There was virtually unanimous support for the idea of inflation protection, but respondents doubted whether individuals would pay the high price needed to buy it.

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, (b) allowing lump sums to be taken from lifetime annuities, (c) removing the ten-year guarantee period for guaranteed annuities, (d) allowing payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000?*

There was a clear majority in favour of some or all of these options to increase the flexibility of annuities' payment terms, with 68 per cent of responses supporting at least one of the options. But many respondents also raised significant concerns that such products would increase complexity and potentially confuse customers: in addition to this, many of the suggested products would only be suitable for a small component of the market. So, at best, one would say that there was qualified support.

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

There were mixed views on the provision of U- or J-shaped annuities, with responses fairly evenly divided between those for and those against. A particular issued raised was where the minimum of the U should be. It was also suggested that these more complicated income streams could be achieved by more straightforward mixtures of drawdown and annuitisation.

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

Respondents disagreed on whether retirement products should be linked to the state pension. While many thought that it was a good idea in principle, there were issues about complexity of pensions in practice, which might make linking the two infeasible.

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

A range of products were suggested, including new (flexible) annuity products and new (guaranteed) drawdown products. Products which combined more basic products were also suggested, such as those combining drawdown and annuities. Several responses suggested products involving long-term care assurance.

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

There was a small majority of respondents in favour of designating retirement products as safe harbour products, but there were strong views both for and against.

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?*

Respondents were unanimous that the market would probably get smaller and less competitive as a result of the 2014 Budget changes.

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

The majority of responses were in favour of pot-follows-member to deal with stranded pots, although 25 per cent favoured aggregation (with a limited number of aggregators). An alternative was a central clearing house or virtual or notional aggregation via a central database. There was little support for scheme-follows-member: a number of respondents said the issue of costs to employers was believed to be so great that it was considered infeasible, while another said that given the recent changes it is too late to be considering this.

2.10 Analysis and Recommendations

2.10.1 Analysis

As we stated at the beginning of this Chapter, an effective and efficient retirement income plan in the new world of 'freedom and choice' will be one that implements a retirement financial strategy – comprising an investment strategy, a withdrawal strategy, and a longevity insurance strategy – using products that offer:

- Accessibility – the degree of flexibility to withdraw funds on an ad hoc basis
- Inflation protection either directly or via investment performance, with minimal involvement by individuals who do not want to manage the investment risk
- Longevity insurance

which are combined together in an arrangement that:

- Benefits from institutional design, governance, and pricing
- Is simple to understand, transparent and low-cost
- Requires minimal consumer engagement
- Benefits from a low-cost delivery system.

Longevity insurance needs to be a key component of any good retirement income solution. Indeed, we believe that any retirement income plan that does not involve longevity insurance is seriously flawed, since it fails to achieve a pension scheme's primary goal of providing retirement income security for as long as the scheme member lives.

2.10.1.1 The problems with existing products and their providers

Since no single product offers accessibility, inflation protection and longevity insurance, a well-designed retirement income plan needs to involve an appropriate combination of annuity and drawdown products.

Annuities and drawdown have different advantages and disadvantages which can be summarised as follows:

- Standard annuities give higher more stable (life-long) income than drawdown, but no flexibility or death benefits. However, Wadsworth et al. (2001) argue that investment-linked annuities fully hedge longevity risk, while also benefiting from both the mortality premium and higher average returns than fixed annuities. Tom Boardman (2006) shows how death benefits can be built into annuities.[309]
- Drawdown gives more volatile incomes, greater flexibility and death benefits, but no longevity insurance. While people might well like the flexibility of drawdown, this flexibility comes at a cost, either in terms of higher charges or lower average incomes compared with an annuity. Yet it appears to be a cost that people are prepared to pay. According to Rowena Griffiths, director at Female Financial Management: 'If the product suits their needs, they tend to be happy to pay the charge'.[310] In addition, people also like the idea of guarantees on capital or income or both. They also appear to be prepared to pay heavily for these. Yet products with guarantees could be up to twice as expensive as products without guarantees.[311]

The 2014 Budget changed the balance away from annuities in favour of drawdown products. This change in balance was reinforced by the announcement on 29 September 2014 ending the 55% tax charge[312] on the residual pension fund when the member dies after 6 April 2015. This made pensions wealth inheritable if held in a drawdown product, but

[309] Mike Wadsworth, Alex Findlater, and Tom Boardman (2001) *Reinventing Annuities*, Staple Inn Actuarial Society, London; Tom Boardman (2006) Annuitization Lessons from the UK: Money-Back Annuities and Other Developments, *Journal of Risk and Insurance*, 73, 633-46.

[310] Quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.

[311] Quoted in Nicola Brittain (2015) Income funds - Will they solve the pensions freedom conundrum?, Professional Adviser, 29 January.

[312] The 55% rate was set to recover the tax relief that a 40% tax payer received on contributions and investment returns during the accumulation phase of a pension scheme, taking account of the 25% tax free lump sum. This rate therefore made a pension scheme tax neutral over an individual's life cycle. Its abolition involves a significant transfer of wealth from the general tax payer to already well off families.

not in an annuity. Sales of annuities have more than halved since the Budget announcement. The inheritability of pension wealth is being emphasised at the expense of the longevity insurance that a pension is intended to provide.

This is potentially damaging for the sustainability of income at higher ages, since if people rely only on drawdown, more of them are likely to run out of money before they die than leave assets to inherit – recall the average pension pot is £28,000 and can be accessed from the age of 55. It also reduces the effectiveness of the annuity product as a longevity risk sharing device since it (a) reduces the overall size of the annuity pool and (b) shifts the pool towards the select group of voluntary and more healthy annuitants, thereby making them more expensive.[313]

Further, annuities are either being publicly trashed or treated as just another, not especially good value product along with a number of others that might be considered for inclusion in a retirement financial strategy, without mentioning, or if mentioned underplaying, their unique ability to hedge longevity risk.

Typical are the following media comments:

- 'Annuities stink. That is the general message from consumer groups, regulators and the UK Government, which last year legislated to remove the de facto obligation on retirees to use their pension savings to buy one'.[314]
- 'One of the great benefits of the new pension freedoms is that they make it easier for savers to take an income from their retirement fund without buying an annuity. While an annuity pays a guaranteed income for life, it does so at the cost of surrendering your savings at the outset; when you die, there is nothing to pass on to your family. The alternative offered by the new freedoms is to retain ownership of your pension savings but draw an income from them, either by taking income from investments, such as dividends, or withdrawing some of the capital. Either way, there should be money left to pass on to your family'.[315]

While, in the second of these comments, the longevity risk feature of annuities is mentioned in passing, it is downplayed in favour of the inheritability of the pension pot. It's rather like a commercial aircraft designer who pays little attention to landing the plane safely at the end of the journey on the grounds that such a small proportion of the total journey time is devoted to landing that it can be ignored. It's right at the end any way and the inflight experience is much more important.

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[313] Annuities will become even more expensive as a result of the introduction of Solvency II in January 2016, by around 10%, according to some estimates.

[314] Lex Column (2015) UK annuities: hope in the gloom, Financial Times, 26 May.

[315] Richard Evans (2015) Need income from your pension? Here are six alternatives to an annuity, Daily Telegraph, 12 May.

Even more significantly, the same sort of dismissive comments about annuities are being made by senior people in the investment management industry, which, for the first time in history, is able to compete unrestrictedly with the insurance industry to manage retirement assets. Typical are these comments by Martin Gilbert, chief executive and co-founder of Aberdeen Asset Management writing in the Financial Times (emphasis added): 'For the first time, individual investors have full and free access to their pension pots rather than being *compelled* to use the bulk of those funds to buy an annuity'.[316]

Any close observer of the pensions industry will be aware of the long-standing running battle between the investment management industry and the life assurance industry to manage pension scheme members' assets. The situation used to be clearcut: the former (which included the investment management divisions of life insurers) ran the money during accumulation, while the latter managed the money in decumulation, mainly via life annuities, since only authorised and appropriately capitalised insurers are allowed to sell annuities in the UK.

Fund managers have long complained about the lack of a level playing field. Their various trade bodies have spent years promoting the merits of drawdown products, claiming that this would encourage innovation. Here, for example, is an extract from the report commissioned by the European Fund and Asset Management Association in 2009 which clearly fails to acknowledge the unique role that annuities play in providing a life-long income in retirement:[317]

> *The regulatory framework in Europe should find a reasonable balance between satisfying the concerns of policymakers and addressing the needs of retirees. Enforcing compulsory conversion of pension savings into annuities does not give individuals the level of flexibility needed to choose the best approach to suit their circumstances and risk tolerance. This is particularly the case given the very different range of retirement income likely to be available, ranging from a very strong support from state and/or salary-related pension schemes through to greater reliance on a defined-contributions savings pot.*
>
> *Ideally, regulatory frameworks across Europe should support, on equal terms, both annuities and other payout solutions. Restrictions on non-annuity products should be relaxed and pooled, non-pooled and hybrid solutions should enjoy equal tax treatment.*

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[316] Martin Gilbert (2015) Aberdeen - We are the fund managers of the (pensions) revolution, Financial Times, 17 May.

[317] Raimond Maurer and Barabara Samova (2009, p. XIII-XIV) *Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?*, European Fund and Asset Management Association, February;
http://www.efama.org/Publications/Public/Long-Term_Savings_and_Pension_Steering_Committee/Maurer_Rapport.pdf.

A more balanced regulatory framework for the payout phase of funded pension schemes would spark innovation in the European financial market and stimulate the creation of payout products tailored to meet individuals' retirement needs. Competition between providers of payout products would also increase, thereby lowering the cost of products. The evidence from countries where drawdown plans and other non-pooled solutions are not hindered by legislative or tax rules, highlights the benefits of innovation and competition.

Less restrictive rules and regulation towards non-pooled solutions would also create incentives for the financial services industry to create a variety of standardised pooled, non-pooled and integrated payout products, designed especially for retirement. As such pre-packaged solutions are likely to include a range of choices with respect to risk attitude and preferences regarding the structure of periodic payments, improved information requirements, advice and financial education should assist individuals in deciding how to invest their accumulated pension savings. In addition, appropriate default options should be in place to help individuals who cannot or do not want to choose between the available payout products.

If nonetheless compulsion is still favoured, then the upper age limit for compulsory annuitisation should be pushed towards 85 in order to achieve a right balance between the objectives of securing a sufficient level of retirement income and protecting retirees from longevity risk at very old ages. This can be achieved by using some part of the accumulated assets to buy a deferred annuity starting payments at age 85 or requiring a switching of assets into annuities at that age.

One possible compromise between compulsion and a more liberalised market would be only to make pooled solutions mandatory if a basic standard of living is not available from other annuity-like sources, such as state pension, defined benefit schemes etc. Above that minimum level, individuals should be allowed to make a free decision for themselves given both that individual circumstances will vary considerable and that it is difficult to set regulatory restrictions that do not end up becoming burdensome for individuals.

The 2014 Budget has opened up the management of UK retirement assets to all comers. The investment management industry claims that consumers will benefit from new products which provide higher expected returns and greater flexibility than annuities, Martin Gilbert, in the same article in the Financial Times, confirms that: 'The fund management industry is working to develop transparent and attractive investment vehicles to win this important new business'. A survey of investment advisers by State Street found that 70% predicted an increase in product development involving capital and income guarantees. There was expected to be, by contrast, very little innovation in annuities, except for U- and J-shaped annuities.[318]

However, some commentators question whether much innovation has actually taken place. Tom McPhail argues: 'Since the Budget, we have seen development work on hybrid retirement income products which use complex investment guarantees and hedging strategies. So far we have not seen anything which appears to deliver a better mix of guarantees and potential investment returns than simply splitting a retirement fund between an annuity for certainty and a drawdown for flexibility'.[319]

Another important issue is cost. This is recognised by Martin Gilbert in his FT article: 'We are stewards of other people's money, with an accountability and responsibility to those individual savers to deliver a valuable service at a fair price. Our interests must be aligned with the interests of our clients, and transparently so….This aim for transparency is more easily stated than delivered. In addition to the fees charged by the fund manager for investing the money, the individual's pension plan provider, financial adviser or investment platform will usually charge fees that may be as large or larger than the underlying fund charge. And there are transactional costs that are…rarely well understood, including broker commission…[W]e must be open and transparent, not least about the fees and all other costs that are borne by the client…[F]ee structures on funds should align the fund management business's interests with those of the clients'.

Yet, there is, very little evidence that this improved transparency over charges is taking place,[320] despite attempts by Daniel Godfrey, chief executive of the investment manager's trade body, the Investment Association, to move the investment management industry very slowly in that direction, as, for example, with the publication of a position paper *Meaningful Disclosure of Costs and Charges* in February 2015.[321] Such was the hostility to such moves from member firms of the Investment Association that Mr Godfrey was forced to resign in October 2015. A senior investment manager told the Financial Times: 'He launched initiatives on transparency of fees and fund performance and remuneration, which are all important, but there are other bigger issues out there that matter to our institutional clients, such as the pensions time bomb'. According to the FT, 'concerns about the direction

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[318] Reported in Jack Jones (2014) Investment advisers fear rash of 'inappropriate products', post-Budget, Professional Adviser, 18 August.

[319] McPhail attacks 'irresponsible' Treasury reform agenda - Corporate Adviser, 29 September 2014.

[320] David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Pensions Institute Working Paper, May (http://www.pensions-institute.org/workingpapers/wp1407.pdf);

Department for Work and Pensions and Financial Conduct Authority (2015) *Transaction Costs Disclosure: Improving Transparency in Workplace Pensions*, Discussion Paper DP 15/2, March (http://www.fca.org.uk/static/documents/discussion-papers/dp15-02.pdf).

[321] Investment Association (2015) *Meaningful Disclosure of Costs and Charges*, Position Paper; http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

of the trade body' were raised by Aberdeen Asset Management, Fidelity, Henderson Global Investors, Invesco Perpetual, Investec Asset Management, Legal & General Investment Management, M&G and Schroders.[322]

The investment management industry is saying very clearly that 'fees and fund performance' are really second-order issues. Yet, David Ferguson, chief executive of 'wrap' specialist Nucleus, has branded retail fund management 'out of control' and called for it to catch up with good practices in the institutional sector. There was over reliance on 'risk-rated' funds, accompanied by poor performance and high charges. He said: 'Where the institutional market is tight and responsive, the retail market is slack and sluggish. Institutional clients wouldn't tolerate the pricing, the accountability or the performance of the retail sector, so why should your customers?'.[323]

When it comes to insurers, it is evident that the insurance industry has no intention of letting 'asset managers eat their dinner'.[324] They are taking full advantage of the natural inertia of their customers to stay with their existing provider when they move from the accumulation to the decumulation stages of their pension scheme. To switch the scheme to an investment manager, the member would have to 'take financial advice and move to a retail-based platform', according to Paul Bucksey, head of UK defined contribution at investment manager BlackRock. However, a reluctance to pay for financial advice 'may leave slim pickings for asset managers that do not have a large UK life insurance company as a parent or are unable to forge a relationship with one'. Further, people who have been auto-enrolled in a default investment fund are unlikely to suddenly want to become heavily involved in investment decisions after retirement and are therefore likely to stay with their current provider, according to Robert Holford, principal at Spence Johnson. Mr Holford believes that investment managers without a platform will only be able to gain some market share if they partner with pensions companies that do not have a particular investment expertise in-house or with the master trusts, such as NEST or The People's Pension. Spence Johnson predicts that there will be £125 billion under management in master trusts by 2025. The level of fund management fees charged is also likely to have an impact on the market share achieved by investment managers. According to Lorna Blyth, investment strategy manager for Royal London's pensions business, there is a 0.75% higher fee charged by external managers on Royal London's pension platform than that for internally managed funds, which explains why the in-house funds were gaining a greater market share.[325]

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[322] Reported in David Oakley (2015) Investment Association jettisons chief Daniel Godfrey, Financial Times, 6 October.

[323] Reported in William Robins (2015) Platform chief brands funds industry 'out of control'; High charges and poor performance still dog the retail fund sector, according to the head of investor services company Nucleus, Citywire, 6 March.

[324] According to Charlotte Moore (2015) A slow route to retirement riches, Financial News, 9 October.

[325] Reported in Charlotte Moore (2015) A slow route to retirement riches, Financial News, 9 October.

So at the very start of the 'freedom and choice' initiative, we have the following. Annuities are being trashed in the media and the investment management industry is reluctant to acknowledge that there is any role for annuities in retirement income plans. At the same time, there are serious question marks over the effectiveness and cost of the alternative retirement income solutions being offered by the investment management industry. The insurance industry and the investment management industry are at loggerheads with each other. The insurance industry is relying on customer inertia rather than good valued decumulation products to capture market share. At the same time, it is bifurcating between pure insurance companies and those insurers which have investment management divisions, such as Legal & General and Aegon, which see the greatest growth prospects in investment management rather than in insurance. This explains why Legal & General and Aegon have both decided to resign from their trade body, the ABI.[326]

This is not good news for consumers. Both annuities and drawdown products are necessary to provide a good outcome for pensioners under 'freedom and choice'. And this means that both life insurers and investment managers are needed to offer effective and good value annuities and drawdown products. This, in turn, means that the insurance and investment management industries need to cooperate as well as compete in order to improve customer outcomes. To illustrate, a deferred annuity is potentially an ideal asset in a drawdown programme. It would require investment managers to partner with insurance companies to provide deferred annuities. The investment management industry is unable to sell products that provide longevity insurance, since these can only be provided by authorised life offices. This cooperation is simply not happening, although NEST has announced that it will look for such a partnership.[327] In addition, annuities need to be rebranded as 'guaranteed income for life products',[328] and deferred annuities need to be rebranded as 'longevity insurance'.

Even if it can be agreed that both annuities and drawdown products are necessary to provide an effective retirement income solution and that there is evidence of a partnership developing between insurers and investment managers, there are a whole range of other issues that need to be resolved before we can be confident that consumers have a good choice of retirement income solutions. These relate to the withdrawal strategy, the investment strategy, and the longevity insurance strategy. Our interviewees indicated that the following factors were important to take into account:

- If drawdown is offered by schemes, consultants believe it is important for the scheme to *suggest*, but not *set* a safe withdrawal rate. Further, the suggested rate

[326] Reported in Peter Walker (2015) Aegon to leave the ABI, FT Adviser, 15 September.
[327] This will be discussed in Chapter 5.
[328] A number of people have proposed this, including Nigel Waterson, the former shadow Pensions Minister in an article offering advice to Ross Altmann, the Pensions Minister appointed by the new Conservative Government in May 2015: 'The new incumbent should see a role in restoring the reputation of a guaranteed income for life (aka annuities); because for many people this will still be the best solution' (Nigel Waterson (2015) A time for consolidation – why Altmann must avoid 'initiative-itis', Professional Pensions, 27 May).

must be reviewed regularly. Consultants are also concerned that if scheme members have complicated arrangements, such as multiple pots, and do not take advice, these members could soon find themselves in trouble in terms of increased tax liability and loss of means-tested benefits etc[329]

- The appropriate investment strategy should balance the demands for both flexibility and a secure income for life that covers at least essential life-long expenditure
- When it comes to annuitisation to deal with the longevity risk, the later that this is deferred, the more challenging it becomes due to issues of pricing and cognitive impairment
- The most common age suggested by the consultants we interviewed for triggering annuitisation was 75 and this could be paid for in a number of ways: (a) set aside 10% of the fund at retirement (to buy an annuity at 75) and keep it in a reserve fund, (b) pay a monthly premium during drawdown, (c) buy a deferred annuity at retirement, or (d) buy a series of annuities over, say, 5 years.

2.10.1.2 Issues with the arrangements for delivering retirement income

The first point to clarify is about nomenclature. Only arrangements for delivering retirement income schemes which involve longevity insurance (in the form of current or deferred annuities) should be allowed to call themselves 'pension schemes'. Arrangements which do not involve longevity insurance should not be allowed to call themselves 'pension schemes', but should be required to use another name, such as 'drawdown management schemes'.[330] In other words, the term 'pension scheme' should be a protected name. Furthermore, arrangements which do not involve longevity insurance should be classified as complex and high risk from a regulatory standpoint.

Turning to delivery systems, efficiency requires economies of scale. This is one of the most effective ways of keeping costs low. So products delivered by institutional delivery systems can be offered at lower cost than retail delivery systems. One overarching goal of innovation should therefore be to change the retail model for DC decumulation into an institutional model, in terms of product design, delivery and cost. This was a key lesson from auto-enrolment.

On the other hand, some providers told us that there was a false distinction between scheme (institutional) and retail drawdown in terms of value for money because drawdown involves individual accounts and it is possible to get low-cost non-advised drawdown in the retail market.

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[329] The question of advice is addressed in depth in Chapter 3.
[330] Even though they will still be in a pensions tax wrapper.

So there is a difference in view amongst industry practitioners about which type of arrangements would be more effective for delivering retirement income. We therefore need a clearer picture of the economics of scheme vs retail drawdown.

The disagreement might well be moot, however, since there has been little evidence since the 2014 Budget of new institutional delivery systems being offered. Two probable reasons are that the industry has been given so little time to implement the changes and that there has been so much uncertainty about how consumers would respond to the Budget changes. In short, no one has had the time or incentive to invest in new delivery systems.

2.10.1.3 The criteria for safe harbour status

There was support amongst those we interviewed for certain products to be classified as safe harbour products. Such products need to be 'good enough', since there could be no Financial Ombudsman Service referrals with safe harbour products, i.e., advisers, having confirmed their suitability, could not be sued for recommending them to clients. Bearing in mind that 'the best is often the enemy of the good', we would argue that, for most customers, the 'best products' are those that will be 'good enough' to be classed as safe harbour products for use in safe harbour retirement income plans.[331]

This, in turn, would require products to be rated according to a set of agreed criteria. These would relate to how effective and efficient the products were in delivering the outcomes claimed for them.

We suggest the following criteria:

- Design and construction – There needs to be a much clearer picture of how products are designed and constructed, especially if they involve guarantees. For example, if the guarantees are hedged with options, there needs to be clarity over whether the options are exchange traded or over-the-counter and, if the latter, the nature of the counterparties. It also is critically important that the charges, particularly for guarantees, are not excessive
- Investment strategy – It needs to be made clear how the investment strategy meets the aims claimed for the product. The circumstances under which the investment strategy fails to meet these aims also needs to be specified
- Projected real returns – Providers of drawdown products should present stochastic projections of the range of likely real outcomes (i.e., incomes adjusted for inflation and total charges and costs) that their products could deliver based on the product's underlying investment strategy

[331] Safe harbour retirement income plans combine safe harbour products with financial help or guidance (which includes confirming the suitability of the product for the client). This will be discussed in more detail in Chapter 3.

- Accessibility – The degree of flexibility to withdraw funds on an ad hoc basis
- Longevity protection – The degree of longevity protection afforded by the product, illustrated by the probability of running out of money at different ages for a range of possible withdrawal strategies. Also included here will be the impact of the amount, if any, paid on death
- Value for money – The benefits and costs of the product need to be clearly stated and the balance between them assessed.[332]

We should establish minimum standards for each of these criteria. Any product satisfying these minimum standards could be classified as a safe harbour product. Defaqto recently launched a provider rating service.[333] What should be considered is a product rating service along similar lines.

2.10.1.4 A metric for measuring value for money

There needs to be an agreed metric for measuring value for money, but first we need to recognise how challenging the concept is. Despite constant references to 'value for money', policy-makers and regulators have yet to define clearly and fully what this means in relation to DC retirement income products.

Nevertheless, two broad definitions from government agencies, used in non-pensions policy areas, provide a good starting point:

- The National Audit Office: 'Good value for money is the optimal use of resources to achieve the intended outcomes. "Optimal" means "the most desirable possible given expressed or implied restrictions or constraints". Value for money is not about achieving the lowest initial price'. [334]
- HM Treasury: 'Value for money is not about achieving the lowest initial price: it is defined as the optimum combination of whole life costs and quality'. [335]

While these definitions are clear and simple, they are nevertheless challenging in the context of DC retirement products.

What is required is a policy and regulatory definition of value for money that cannot be gamed, as argued in the Murray Report.[336] Murray said the measurement of value for money must be based on 'credibility and transparency: make relevant information public;

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[332] Value for money is discussed further in the next Section.
[333] Professional Adviser (2015) Defaqto launches pension ratings service, 1 May.
[334] The definition is in relation to public sector commissioning; http://www.nao.org.uk/successful-commissioning/general-principles/value-for-money/
[335] http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/Reg_Prop_and_VfM-November04.pdf
[336] This is discussed in Chapter 3.

avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate' (p.114). [337]

A 2014 Pensions Institute Report, *VfM: Assessing Value for Money in Defined Contribution Default Funds*, [338] argued that value reflects a range of features, including the appropriateness of the product structure for the target market, the price, a dynamic investment strategy (as opposed to 'set and forget'), effective communication, efficient administration, and good institutional-quality governance. While we agreed that cost is not the only consideration, we continue to believe that it is hugely important, especially when comparing products with similar objectives, such as SIPPs and drawdown funds.

Given its multi-dimensional nature, it is clearly impossible to find a single measure that captures all the different aspects of value for money. However, we believe that there is a measure that provides a good starting point and that is the 'money's worth' (MW) of a product. This is the ratio of the expected present value of payouts on the product to the price; in other words, it is the ratio of what you get back over time to what you put in. MW will always be less than 100% to allow for the provider's administrative costs and profit, but if the MW is high, then this implies that the value for money of the product is high.

MW can be used to compare different retirement income products, but we need a benchmark for comparison. We believe that the most obvious benchmark is provided by a life time annuity. This is because it provides a life-long income (hence satisfying the primary purpose of a pension scheme) and it is easy to understand how it is constructed. Moreover, the MW concept was invented for annuities. [339]

For annuities, the empirical evidence shows that the MW of annuities is fairly high,[340] but we would add the following caveats: the annuity type must be appropriate for the individual, medical underwriting is applied where appropriate, and the open market option

[337] The 2014 Final Report of the Financial System Inquiry in Australia, known as the Murray Report after its Chair, David Murray;
http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

[338] Debbie Harrison, David Blake, and Kevin Dowd (2014) *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute, January; www.pensions-institute.org/reports/ValueForMoney.pdf

[339] Edmund Cannon and Ian Tonks (2002) *Annuity Prices, Money's Worth and Replacement Ratios: UK experience 1972 – 2002*, Centre for Market and Public Organisation Working Paper No. 02/051, University of Bristol, September; http://www.bristol.ac.uk/media-library/sites/cmpo/migrated/documents/wp51.pdf

[340] Edmund Cannon and Ian Tonks (2009) *Money's Worth of Pension Annuities*, Department for Work and Pensions, Research Report 563; Matteo Aquilina, Robert Baker and Tommaso Majer (2014) *The Value for Money of Annuities and Other Retirement Income Strategies in the UK*, Occasional Paper No.5, Financial Conduct Authority, December (https://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-5.pdf)

is used to secure a competitive rate.[341] Nevertheless, many people regard the product as unattractive. This is due to a combination of the irreversible nature of the purchase,[342] lack of trust in the industry, and historically low rates, which, in turn, are due to external factors such as increasing longevity and low interest rates as a result of quantitative easing.

For drawdown products, assessing value for money is still a 'work in progress', not least because the charges for drawdown are reported in different ways – e.g., annual management charge, annual fund management charge, total expense ratio, ongoing charges figure, reduction in yield – none of which is as informative as MW.

The standard MW formula would have to be modified in the case of drawdown to reflect both the flexibility of being able to withdraw funds on an ad hoc basis and the death benefits. In a financial engineering sense, this flexibility can be expressed in the form of options. Each period while alive, the drawdown customer draws down a regular pre-agreed income (say, based on GAD rates), but also has the option to withdraw up to the entire remaining pot. These options are valuable and, if exercised, add to the MW of drawdown, but reduce the present value of all the remaining regular income payments. The options could be valued using standard option pricing methods. The MW formula should also incorporate penalties for withdrawal strategies that lead to the pension pot being depleted before the member dies (e.g., in the form of a penal negative cash flow for these periods). Death benefits can be valued using the same framework.

While, the MW formula provides a measure of expected value, it does not take risk into account. Since drawdown products need to generate a sufficient additional return over the risk-free rate to beat the benchmark return on an annuity which benefits from the mortality premium, the risk of drawdown products could be expressed in terms of the likelihood of a potential shortfall relative to an annuity.[343]

The need for better benchmarking to be able to assess value for money was discussed on a panel at the 2015 NAPF annual conference. Under the new DC governance rules, trustees are required to prepare a report on value for money and compare their offering with what other schemes provide. But the panel said it was very challenging and expensive to get hands on the data to do this. Lynne Rawcliffe, BASF pension manager, believes the data could be provided by the regulator, especially for trustees of small schemes that do not want to pay additional costs. Tim Banks, pension strategies group managing director at

[341] The FCA now requires insurers to provide an annuity ranking table with a quotation, so individuals can see how the roll-over rate compares. The aim is to encourage more shopping around, but it is too soon to tell if this will prove effective in what has historically been a stubbornly passive purchase market.
[342] Although this will change once the secondary annuity market starts in 2017.
[343] A simple measure of this would be the size of the area under the downward sloping annuity line in Figure 3.4 relative to the total area of the fanchart.

AllianceBernstein, said: 'We need more transparency and have better benchmarking that is then down to each scheme to decide what their setting value is'.[344]

2.10.1.5 Measuring and reporting charges, and a charge cap

There needs to be a commonly agreed method for measuring and reporting the charges for all retirement income products. Currently, charges are either not reported at all or, if they are reported, they are reported in a range of different ways – sometimes the same term is used, but what is included is different – so that a comparison between products is difficult if not impossible. Further, if charges are reported, they are generally not reported in full.

For example, there is no explicit charge reported for life-time annuities. An annuity buyer pays a premium and receives an income stream and is never told what the 'charge' is. Yet depending on how the annuity is sold, a sales agent might receive a 1-3% commission. This would be the case with a non-advised sale. MW was invented in part to deal with this issue, but the MW measure for an annuity takes into account much more than any commission or other charge. Administration costs and provider profit are included in the MW figure, for instance. As mentioned in the previous section, drawdown, by contrast, has a number of different ways of reporting charges, but they all give different answers and none can be regarded as giving a complete measure of the total costs borne by the customer.

In our view, the charge measure should cover all the costs borne by the customer either directly or indirectly. The costs chould be reported in the form of both a 'rate of cost' – which could then be deducted from the gross rate of return to give a net rate of return – and as a monetary amount – which can then be compared with the monetary value of the customer's fund.

For example, the cost of withdrawing funds, the platform charge and any adviser's fee should be included in the cost measure. Also the following investment costs should be included:[345]

- Visible cash costs (Level 1 costs)
  - Commissions
  - Taxes
  - Fees
  - Custodial charges
  - Acquisition costs
- Hidden cash costs (Level 2 costs)
  - Transactions costs of turnover, such as bid-ask spread

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[344] Reported in Stephanie Baxter (2015) NAPF 2015: Schemes need better benchmarking to judge value, Professional Pensions, 15 October.

[345] See David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Pensions Institute Discussion Paper PI-1407, May; http://www.pensions-institute.org/workingpapers/wp1407.pdf

    - Transactions costs in underlying funds
    - Undisclosed revenue
- Hidden non-cash costs (Level 3 costs)
    - Market impact
    - Information leakage
    - Market exposure
    - Missed trade opportunity or market timing costs
    - Delay costs.

In terms of charge capping, we note that there is now a charge cap of 0.75% on auto-enrolment scheme accumulation default funds. This does not currently include transaction costs, although the FCA and DWP plan to revisit this issue. If transactions costs are included, will the cap remain at 0.75%?

What would be included in a charge cap on a decumulation default strategy if it were to be introduced? We believe that at, a minimum, the following should be included in scheme drawdown:

- The total expense ratio or ongoing charges figure on the default investment strategy (including the costs of any guarantees)
- Transactions costs (what is covered to be agreed)
- Cost per ad hoc withdrawal subject to a maximum number of withdrawals.

The following additional costs would apply with retail drawdown:

- Platform charge
- Adviser fee.

It was clear from our discussions with industry practitioners that there was a very strong view that any charge cap on drawdown products – including even on a default decumulation product – would reduce the scope to diversify risk, put guaranteed drawdown products out of reach, and stifle innovation.

There was equally strong support for a charge cap from consumer champions. They pointed out that the same sort of objections were made to the idea of a charge cap in default funds, yet we know that high charges are the surest form of consumer detriment and they compound dramatically over time. One told us: ‘all we have at the moment is a proliferation of expensive retail drawdown products which are being sold to individuals in place of annuities. There is also no real innovation, just a repackaging of existing multi-asset funds. A charge cap would in fact be a spur to innovation and would be one of the mechanisms that would help encourage institutional as opposed to retail solutions. The consequence of not having a charge cap will be a proliferation of thousands of non-innovative retail products which it will be prohibitively disruptive to then attempt to aggregate. An eventual cap will then be introduced, as in accumulation, which, in order to avoid damage to the multitude of providers, will just shave off the extreme excesses. That is why we have ended up with a UK charge cap for accumulation at 0.75%, while in Sweden charges are at 0.2% (and heading below) for a country where the scale is, in principle, much lower than the UK'.

We therefore believe that it would be reasonable to have a charge cap in due course on a simple default decumulation product. Such a charge cap would be relatively straightforward to justify if it can already be justified in the accumulation stage. If charges are linked to asset values, the charge is maximised at the point of retirement when the pension pot is at its highest, implying that the revenue received by decumulation product providers is front loaded. This contrasts with the providers of accumulation products whose revenues are back loaded, but can still run a profitable business. It would also be useful for product providers to be aware that a charge cap was going to be imposed, so that they are not surprised as in the case of the cap on the default investment strategy in auto-enrolment.

2.10.1.6 Product and provider regulation

Annuities are amongst the oldest financial products in the world and structured products are amongst the newest. Both have a critical role to play in the new pensions environment. Yet in the months leading up to the introduction of the new regime, the FCA found serious flaws in their design and delivery. This suggests that there is an important role for product regulation, given how poor most customers are at assessing the efficiency and effectiveness of financial products. We are not proposing regulation for its own sake, only in the case where consumers are particularly vulnerable. Even where consumers are generally good at assessing value themselves, such as in the case of food, they are still vulnerable to fraud, as in the case of the 2013 horsemeat scandal[346] and need the protection of the Food Standards Agency.[347]

There could also be a role for provider regulation. Mick McAteer, director of the Financial Inclusion Centre, argues: 'asset managers [if they get involved in retirement income provision] will need to be subject to prudential regulation as annuity providers are'. He believes that investment managers would find it challenging to design products that had higher returns than annuities over the long term. He continued: 'We needed reform, but I think we are replacing something that is suboptimal with something that is catastrophic. We risk undermining the progress made with auto-enrolment and I feel that uncertainty and lack of confidence reverses trust'.[348]

[346] https://en.wikipedia.org/wiki/2013_meat_adulteration_scandal
[347] http://www.food.gov.uk/
[348] Reported in Helen Morrissey (2015), Asset managers should be subject to retirement income regulation, Professional Pensions, 11 February.

2.10.1.7 Modelling outcomes

An important part of determining whether a product meets the safe harbour criteria is modelling outcomes and this requires making projections of future returns on the product's investment strategy.

Traditionally, the modelling of outcomes of retail financial products in the UK has been very poor, since it involved the deterministic projections of returns. As Andrew Storey, technical sales director at eValue, says: 'Wouldn't it be great if markets performed in exactly the way they had done in the past? If, every year, equities managed to generate the 5% real return they have averaged since 1899, then advising on income drawdown would be a piece of cake? But as we all know, markets don't work in straight lines, even though a surprising number of projection tools, offered by big-name organisations, behave as though they do….Sequencing risk is one of the biggest challenges facing drawdown investors. It is not just a question of what returns an investor gets over their retirement, but the sequence in which these returns happen. As any adviser knows, suffer a couple of bad years in the early stage of drawdown and a client will never get their financial plan back on track. Yet many modelling tools being used by advisers today do not make any allowance for the fact that markets are complex, irregular and ever changing. It goes without saying that projections based on Excel spreadsheets – amazingly still used by a surprising number of advisers – are destined to be inaccurate from the outset. Base your projections on historical averages and they are guaranteed to set the client off with inaccurate information'. Mr Storey concludes that 'Advisers are putting themselves and their clients at very serious risk if they do not understand the considerable difference in the accuracy of the best and the worst financial modelling tools on the market'.[349]

In October 2015, the FCA released a Consultation Paper in which it stated it was concerned that product providers' projections of what retirees can expect to receive if they buy certain products are too high, and it wants to standardise the process.[350] In particular, it was concerned that firms using higher projections may be able to gain an unfair competitive advantage over their competitors. Since April 2014, the FCA requires firms to make projections using three deterministic rates 2%, 5% and 8%, denoted the lower, maximum intermediate and upper projection rates. Firms are required to produce projections of future benefits for pension products that reflect the investment potential of the product, subject to the maximum rates. However, the FCA has discovered that there are two different ways of calculating the maximum intermediate rate.

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[349] Andrew Storey (2015) Why advisers have to get under the skin of modelling tools, Professional Adviser, 27 July.

[350] Financial Conduct Authority (2015) *Pension Reforms – Proposed Changes to Our Rules and Guidance*, Consultation Paper CP15/30, October 2015; http://www.fca.org.uk/static/documents/consultation-papers/cp15-30.pdf

For example, suppose two firms assume gilt returns of 3% p.a., and equity returns of 7% p.a. A customer buys a product that is invested 30% in gilts and 70% in equities. Firm 1 caps the equity return at 5% and uses a projection rate for the product averaging 4.4% (i.e., 30% of 3% plus 70% of 5%). Firm 2 calculates the average projection rate for the product as 5.8% (i.e., 30% of 3% plus 70% of 7%), but then caps this at 5%. Over a 20-year investment horizon, the retirement income would be 12% higher under Firm 2's projection compared with Firm 1. We also pointed out earlier the problems with 'Type A Critical Yield' analysis which is again a feature of using deterministic projections.

These examples illustrate the ludicrousness of deterministic projections. Projections must be stochastic and the uncertainty around the projections must be illustrated – we favour fancharts – as we showed in Section 2.5 above.

In September 2013, the Pensions Institute set out a methodology to model the quantifiable uncertainty associated with DC pension products and illustrated it with projections from the PensionMetrics model.[351] The methodology established 16 good practice principles in modelling DC pension products as shown in Table 2.7. These principles could be adapted for modelling the outcomes with annuity and drawdown products.

Table 2.7: Good practice principles in modelling DC pension products
1. The underlying assumptions in the model should be plausible, transparent and internally consistent. 2. The model's calibrations should be appropriately audited or challenged, and the model's projections should be subject to backtesting. 3. The model must be stochastic and be capable of dealing with quantifiable uncertainty. 4. A suitable risk metric should be specified for each output variable of interest, especially one dealing with downside risk. Examples would be the 5% value-at-risk and the 90% prediction interval. These risk metrics should be illustrated graphically using appropriate charts. 5. The quantitative consequences of different sets of member choices and actions should be clearly spelled out to help the member make an informed set of decisions. 6. The model should take account of key member characteristics, such as occupation, gender, and existing assets and liabilities. 7. The model should illustrate the consequences of the member's attitude to risk for

[351] Kevin Dowd and David Blake (2013) *Good Practice Principles in Modelling Defined Contribution Pension Plans*, Pensions Institute Discussion Paper PI-1302, September; http://www.pensions-institute.org/workingpapers/wp1302.pdf

Table 2.7: Good practice principles in modelling DC pension products
the plan's asset allocation decision. It should also show the consequences of changing the asset allocation, contribution rate and planned retirement date, thereby enabling the member to iterate towards the preferred combination of these key decision variables. 8. The model should take into account the full set of plan charges. 9. The model should take account of longevity risk and projected increases in life expectancy over the member's lifetime. 10. The model should project both at-retirement pension outcomes and post-retirement outcomes. The risks associated with the following strategies should be clearly illustrated: a) the risk of taking a level rather than an index-linked annuity in terms of a reduced standard of living at high ages; b) the risks associated with drawdown strategies in terms of taking out more from the fund initially than is justified by subsequent investment performance. 11. The model should consider the pre- and post-retirement periods in an integrated way. This is necessary to avoid undesirable outcomes at a later date – such as a big fall in the standard of living in retirement. It will also help to determine what adjustment in member choices – in terms of higher contribution rate, an increased equity weighting and later retirement – are needed to avoid this. 12. The model should consider other sources of retirement income outside the member's own pension plan. These include the state pension and home equity release. A well-designed DC model will also help with lifetime financial planning. 13. The model should reflect reality as much as possible and allow for such extraneous factors as unemployment risk, activity rates, taxes and welfare entitlements. 14. Scenario analysis and stress testing are important. For any given scenario, one should also: a) Make key assumptions explicit; b) Evaluate key assumptions for plausibility; and c) Stress test assumptions to determine which really matter and which do not. This allows the modeller to determine the important assumptions and focus on getting them (as much as possible) 'right'. 15. The model will need to be updated periodically and the assumptions changed. Such modifications should be carefully documented and explained in order to make sure the model retains its credibility with users. 16. The model should be fit for purpose.
Kevin Dowd and David Blake (2013) *Good Practice Principles in Modelling Defined Contribution Pension Plans*, Pensions Institute Discussion Paper PI-1302, September; http://www.pensions-institute.org/workingpapers/wp1302.pdf

2.10.1.8 Stranded pots

The current system whereby job movers leave behind stranded pots which can all too easily be forgotten about is simply too inefficient to be acceptable. However, each of the three solutions that have been proposed for dealing with this problem have weaknesses.

The pot-follows-member model has the disadvantage of requiring assets to be sold and rebought when someone changes jobs. The switching costs involved and the high weight in low-yielding liquid assets that schemes need to hold in anticipation of these switches will have a material effect in reducing the value of the pension pot at retirement. The aggregator model involves lower switching costs than pot-follows-member, but does have the advantage of economies of scale.

A third solution, scheme-follows-the-member or one-member, one-scheme, deals with the problems of switching costs and potentially lower returns, but requires a central clearing house to operate effectively. Further, this solution would not be able to exploit economies of scale if there remains a large number of company-based schemes, many of which might be quite small. However, this solution becomes considerably more attractive if there are a small number of very large schemes. Now this might be the natural outcome of the auto-enrolment process as the Pensions Institute predicted in its 2014 report *VfM: Assessing Value for Money in Defined Contribution Default Funds*: 'We expect five or six trust-based multi-employer schemes to dominate the market by 2020….Single employer schemes are likely to transfer to multi-employer arrangements once employers have removed their defined benefit liabilities from the balance sheet, at which point they will be able to dismantle their DB trustee infrastructure'.[352] This outcome would considerably lower the cost of the clearing house and make greater use of other scale economies. However, the model does involve a movement away from work-based pension schemes which have been the foundation stone of supplementary pension provision in the UK for the last 150 years.

2.10.2 Recommendations

Our discussion in this Chapter leads us to make the following 10 recommendations.

Recommendation 2.1: Implementing the retirement financial strategy

We recommend that providers offering retirement income solutions make clear to customers how their solutions for implementing the customer's retirement financial

[352] Debbie Harrison, David Blake, and Kevin Dowd (2014) *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute, January; www.pensions-institute.org/reports/ValueForMoney.pdf. This prediction was reinforced by a subsequent report: Debbie Harrison and David Blake (2015) *The Meaning of Life: An Uncertain Future for the Traditional Life Company Business Model in the UK's Private Sector Pensions Market*, Pensions Institute, November; http://www.pensions-institute.org/reports/MeaningOfLife.pdf

strategy – comprising an investment strategy, a withdrawal strategy, and a longevity insurance strategy – make use of products that offer:

- **Accessibility – the degree of flexibility to withdraw funds on an ad hoc basis**
- **Inflation protection, either directly or via investment performance, with minimal involvement by individuals who do not want to manage the investment risk**
- **Longevity insurance.**

We recognise that there may be important differences in implementation strategy and disclosure requirements, depending on the distribution channel, i.e., these will be different where a customer pays a fee for a personal recommendation – selected from the retail product market and based on an adviser's understanding of the customer's complete financial position/objectives – and where a trustee (or governance) committee offers a decumulation product to auto-enrolled members (which might also be via a default or default pathway). It is also important to bear in mind that many customers in the mass market may not have a clear retirement financial strategy.[353]

Recommendation 2.2: Terminology

We recommend that the pensions industry reviews the terminology it uses in order to both modernise the language and bring greater clarity to customers. In particular:

- **Arrangements which do not involve longevity insurance should not be allowed to call themselves 'pension schemes', but should be required to use another name, such as 'drawdown management schemes'. The term 'pension scheme' should be a protected name**
- **Annuities should be rebranded as 'guaranteed income for life products', and deferred annuities need to be rebranded as 'longevity insurance'**
- **Arrangements which do not involve longevity insurance should be classified as complex and high risk from a regulatory standpoint.**

Recommendation 2.3: Criteria for granting safe harbour status to key retirement income products

We recommend that regulators agree a set of criteria for granting safe harbour status to key retirement income products. Providers and advisers could not subsequently be sued for offering or recommending a safe harbour product, having first determined its suitability for a client as part of a safe harbour retirement income solution.

[353] These issues are considered in more detail in Chapter 3.

We recommend the following criteria are used to do this:

- **Design and construction – There needs to be a much clearer picture of how products are designed and constructed, especially if they involve guarantees. For example, if the guarantees are hedged with options, there needs to be clarity over whether the options are exchange traded or over-the-counter and, if the latter, the nature of the counter-parties involved. It is also critically important that the charges, particularly for guarantees, are not excessive**
- **Investment strategy – It needs to be made clear how the investment strategy meets the aims claimed for the product. The circumstances under which the investment strategy might fail to meet these aims also needs to be specified**
- **Projected real returns – Providers of drawdown products should present stochastic projections of the range of likely real outcomes (i.e., income adjusted for inflation and total charges and costs) that their products could deliver based on the product's underlying investment strategy**
- **Accessibility – The degree of flexibility to withdraw funds on an ad hoc basis**
- **Longevity protection – The degree of longevity protection afforded by the product, illustrated by the probability of running out of money at different ages for a range of possible withdrawal strategies. Also included here will be the impact of the amount, if any, paid on death**
- **Value for money – The benefits and costs of the product need to be clearly stated and the balance between them assessed.**

The regulator should establish minimum standards for each of these criteria. Any product satisfying these minimum standards could be classified as a safe harbour product. As part of the process of product regulation, a product rating service should be established to assess whether products satisfy the minimum standards.

If the regulator fails to do this, the industry itself could establish a quality mark for in-retirement products – the Retirement Quality Mark (RQM) – as recommended in December 2015 by the Board of the Pension Quality Mark (PQM), building on the experience of the PQM and PQM READY quality mark.[354] The RQM would:

- Provide strong governance to in-retirement products so they operate in the customers' best interests not just at the point of sale, but on an on-going basis
- Ensure there are high quality, clear and actionable member alerts
- Ensure that default investment options are well governed and appropriately designed, and
- Provide value for money to savers.

[354] Board of the Pension Quality Mark (2015) *Developing a Retirement Quality Mark*, Consultation Paper, December.

Recommendation 2.4: Modelling outcomes for different retirement income products

As indicated in Recommendation 2.3, an important aspect of product design and construction is modelling outcomes. We recommend that:

- **The use of deterministic projections of the returns on products should be banned**
- **They should be replaced with stochastic projections that take into account important real world issues, such as sequence-of-returns risk, inflation, and transactions costs in dynamic investment strategies**
- **There should be a commonly agreed parameterisation for the stochastic projection model used, i.e., a 'standard model' should be developed**[355]
- **There should be a commonly agreed set of good practice principles for modelling the outcomes from retirement income products, as outlined in Table 2.7.**

Recommendation 2.5: Establishing a metric for measuring product value for money

We recommend that the regulator establishes a metric for measuring product value for money that would:

- **Reflect the benefits and costs of the product and the balance between them**
- **Reflect key risks**
- **Have credibility and transparency**
- **Be clear, simple, difficult to dispute and difficult to manipulate (i.e., avoid room for gaming the process).**

An example of such a metric would be the money's worth (MW) of a product, which is the ratio of the expected present value of payouts on the product to the price, with due allowance made for the greater flexibilities of some products in terms of accessibility and death benefits. The MW of a product could be measured relative to the benchmark provided by a lifetime annuity. Similarly, the risk of a product could be expressed in terms of the likelihood of a potential shortfall relative to a lifetime annuity.

Recommendation 2.6: Measuring and reporting charges and other costs

We recommend that:

- **A standardised method for measuring the charges (and other costs) for all retirement income products is introduced. The measure should cover all the costs**

[355] As in the case of Solvency II, product designers would be free to use an 'internal model', so long as they explained the differences between this and the standard model.

borne by the customer either directly or indirectly, including operational (administration) costs, fund management (including transaction and guarantee) costs, and delivery (platform) costs

- **A standardised method for reporting the charges (and other costs) for all retirement income products is introduced.**

Charges are a key aspect of a product's money's worth. They could be reported in the form of both a 'rate of charge' – which could then be deducted from the gross rate of return to give a net rate of return – and as a monetary amount – which can then be compared with the monetary value of the customer's fund.

Recommendation 2.7: Candidate products for safe harbour status

Subject to meeting Recommendations 2.3 – 2.6 and to meeting suitability requirements, we recommend that the regulator grants safe harbour status to the following products used to provide retirement income:

- **In the annuities class:**
  - **Lifetime annuities (with/without capital protection) – fixed and inflation-linked**
  - **Investment-linked annuities (with a minimum income underpin and with/without capital protection)**
  - **Enhanced annuities**
- **In the drawdown class:**
  - **Capped drawdown (with a minimum income underpin)**
- **In the hybrid class:**
  - **Variable annuities (with a minimum income underpin)**
  - **Guaranteed drawdown (with a minimum income underpin).**

It is important that there is full transparency over the product design and over charges for each of the above products – and that the charges are demonstrably not excessive.

Recommendation 2.8: Provider regulation and the economics of both institutional solutions and retail retirement income solutions

We recommend that the regulator:

- **Aligns provider regulation with Recommendations 2.1 – 2.7**
- **Reviews the economics of both institutional solutions and retail retirement income solutions, and**

- **Encourages the use of institutional solutions over retail solutions where it can be demonstrated that these provide better value.**

Recommendation 2.9: Capping charges

We recommend that, in due course, a charge cap should be imposed on a simple default decumulation product. The regulator should undertake preliminary work on what a reasonable level for the charge cap would be.

At a minimum, the following should be included in any cap:

- The total expense ratio or ongoing charges figure on the default investment strategy (including the costs of any guarantees)
- Transactions costs (what is covered to be agreed)
- Cost per ad hoc withdrawal subject to a maximum number of withdrawals.

The following additional costs would apply to any cap for retail drawdown:

- Platform charge
- Adviser fee if any.

We do not have a view on the size of the charge cap or when it should be introduced. However, if there is little further evidence of innovation, there would be little point in delaying its introduction. Of course, products outside the decumulation default would not be subject to a charge cap.

Recommendation 2.10: Stranded pots

We recommend that the Government investigates the feasibility of introducing one the following two models for dealing with the issue of stranded pots: a) the aggregator model and b) the scheme-follows-member or the one-member, one-scheme model.

While both have disadvantages (principally switching costs and the requirement for a central clearing house, respectively), they are both consistent with a transition of the UK pension system towards a small number of large trust-based schemes – which might be the natural outcome of the auto-enrolment process, an outcome that the Government should encourage.

The pause on dealing with this issue, announced by the Government in October 2015, gives the Government an opportunity to completely rethink the problem of stranded pots.