PENSIONS AND LIFETIME SAVINGS ASSOCIATION

**RETIREMENT OUTCOMES REVIEW: CONSULTATION RESPONSE BY THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION**

# "THE PENSIONS SECTOR NEEDS TO THINK CAREFULLY AND QUICKLY ABOUT THE FUTURE OF DECUMULATION"

15 September 2017

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

# INTRODUCTION

**We're the Pensions and Lifetime Savings Association; the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.**

**Our purpose is simple: to help everyone to achieve a better income in retirement. We work to get more money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.**

## INTRODUCTION

The interim report of the retirement outcomes review contained many findings to concern the reader and a few that were more alarming. Evidence of poor consumer decision making will not surprise anyone familiar with the "at retirement" market but that does not make your report easier reading. While the report showed little evidence of serious consumer detriment at the moment, we are less optimistic about the future.

Already, we have individuals retiring who may need to make the most of a small DC pot. While these people may benefit from not being very strongly incentivised to buy an annuity, they may not be well placed to navigate the pension freedoms.

But, in 10-15 years DC will be a much more important part of the overall retirement mix. As we showed in our report "Retirement Income Adequacy: generation by generation[1]", people retiring in 10-15 years will have lower levels of pension entitlement than the previous cohort. This generation will have largely missed out on DB and will not have received the full benefit of automatic enrolment. The challenge for them will be getting the best possible retirement income out of a combination of DC savings, whatever liquid savings they have amassed and housing equity. This challenge will be even greater for the significant group of individuals with no DB provision, housing wealth or any other savings to fall back on.

As such, the pensions sector needs to think carefully and quickly about the future of decumulation. In this response to your questions we run briefly through the challenges involved in the decumulation process. We then discuss how to combine a policy approach containing a default solution with a policy approach emphasising customer engagement. We see both approaches as necessary to the future of the decumulation market. One aspect of this challenge will be to design a default-style

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[1] PLSA (2016) Retirement Income Adequacy: generation by generation http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0605-Retirement-income-adequacy-Generation-by-Generation.pdf

solution that preserves individual choice while connecting people quickly to a means of accessing an income from their fund.

Why a default? Because a default choice will emerge in any complex system where choices are difficult and poorly understood. People will simply take the path of least resistance for want of better understanding. As your report shows, a default choice has already emerged with the pensions freedoms: it is to stay with the existing provider and take cash.

The choice, therefore, is not whether there should be a default option, but whether policy makers should try and shape what the default is. As with the accumulation phase, we believe that a default should be designed with the interests of the end customer in mind and not just left to emerge.

We think that Trustees should be able to choose a suitable retirement product for their membership. This product should be governed in the member interest, should provide an income and should allow flexibility for capital withdrawals. They should then “signpost” their members to the product in pre-retirement communications. We would envisage the signposting beginning at the same time as lifestyle or target date funds begin to de-risk c. age 55-60, as well as being a key component of the wakeup pack.

We believe that this would provide a path of least resistance for those who cannot or will not make a choice at retirement. But it would also provide freedom for those who want to engage with their savings and do something else.

Some argue, legitimately, that this is not a true default. We can see the merit in that line of thinking but an alternative term to replace “default” has yet to emerge. Hence we use default in the rest of this response.

Of course, a default approach is only one part of a possible solution. We see the price comparison and other measures proposed by the FCA as also being important to the future development of the market. We think that the industry will need to go even further over the next decade and develop engagement tools that meaningfully strengthen the buy side in order to make engagement work for those who genuinely want or need it.

While there are elements of the interim report that give cause for concern, we believe that concerted action beginning now may help prevent consumer detriment and may help make the pensions freedoms a success.

## THE ASSOCIATION'S VIEW OF DECUMULATION

As the interim report of the review shows, the pensions freedoms have had a dramatic impact on consumer decision making at retirement and, by extension, on the at retirement market. The at retirement decision has become much more complicated, with people expected to spread capital across different product types (drawdown and varying types of annuity) as well as having the option to take cash. The result here has been that many have taken small pots ahead of retirement as cash, sales of drawdown products have increased and the annuity market has contracted sharply.

There was and is, though, no obvious and direct path to a suitable income product for an average consumer at retirement. In our response to the FCA's consultation on CP15/30 in December 2015, we argued:

1) That the market was not likely to organically produce suitable decumulation products intended for those retiring only with DC.
2) That even if the market did produce suitable products, there is no guarantee that consumers would choose the products that best meet their needs. This is based more on an assessment of the complexity of retirement decisions, than an assessment of retirees' skills.

This led us to argue that:

1) Government will need to act to ensure the quality of products in the decumulation market – much as it did with the Better Workplace Pensions agenda in the accumulation phase.
2) Schemes should be able to "signpost" members to suitable decumulation products by highlighting a suitable product(s) as part of retirement communications – essentially a form of soft default. Signposting would insert a further step in "at retirement" communications to highlight trustees suggested decumulation option.

We think that the evolution of the market since December 2015, as shown in the interim report, does not contradict our initial judgement.

### HOW CAN WE MAKE THE MARKET EVOLVE IN THE INTERESTS OF CONSUMERS?

There are strong reasons to think that the market will not evolve organically in the interests of consumers. Specifically, we are concerned that it will not produce the sort of income products required to make the best use of DC funds in retirement.

First, there is an observable cycle in the evolution of financial products. In the past, markets have innovated, consumer detriment has occurred and then much money and effort has been expended on remedies. It is not hard to think of numerous examples of this across financial services, most notably personal pension mis-selling. The question for us is "do we see strong reasons why the decumulation market is an exception?"

Second, and linked strongly to the first point, we think the buy side is weak and this is probably a chronic problem. While the principal/agent issues present in the accumulation phase are absent at decumulation, there are few other reasons to think that the decumulation phase is different. The OFT's 2013 report into the workplace pension market argued that the buy side in that market was one of the weakest they had examined[2]. This was largely seen as being due to the high information asymmetries between purchaser and provider. We see similar evidence of buy side weakness in the decumulation market, in both published market research, in assessments of financial capability and in the interim report itself.[3] In the absence of meaningful consumer pressure, the impetus to innovate in the consumer interest is diminished.

Third, decumulation decisions are, to varying degrees, irreversible or hard to reverse. Some products are purchased for life, and, even where switching is possible, money drawn down cannot be unspent. The difficulty or impossibility of switching diminishes pressure on the provider and increases the importance of the initial purchasing decision. Difficulties in switching are one potential explanation for weak associations between consumer choice and service quality.

Fourth, consumer driven innovation in the accumulation market has been driven as much by regulatory and legislative action as it has been by competitive pressure. Policy action, including the charge cap and the introduction of NEST have, alongside competition, had a positive impact on charges. Policy action has also been critical in dealing with legacy charge issues.

On the basis of that, we think that without significant policy change, the market is unlikely to evolve in the interests of consumers. But that does not mean that a consumer driven market is an impossibility. Rather, it is worth considering what a vibrant consumer driven market would require in order for consumer decision making to really drive product quality.

First, a consumer driven market would require interested consumers. These consumers would not need to be experts but they would need to be aware of the need to make choices at retirement and be willing to invest time in the process. They would possess intent and a sense that the line of least resistance is not the right thing for them.

Second, there would need to be a means of engaging with consumers in an effective manner. This would mean appropriately structuring the choices consumers face. A minimum engagement process would mean:

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[2] OFT (2013) Defined Contribution Pensions Market Study, http://webarchive.nationalarchives.gov.uk/20131101172428/http://oft.gov.uk/shared_oft/market-studies/oft1505

[3] FCA (2017) Retirement Outcomes Review: interim report MS16/1.2 https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf

1. Helping consumers discover all their pots and, potentially, consolidate them.
2. Assisting consumers to divide capital between different product classes/taking cash
3. Structured choice tools that enable consumers to choose between different income products based on their personal needs

The first step may be addressed by the pension dashboard project. We see the dashboard as an essential component of any future engagement strategy and it has our full support.

The second and third steps can currently be addressed through financial advice and, to a limited extent, through Pension Wise. Willingness to take full financial advice is limited among today's retirees.[4] We should be mindful here that retirement will not be a cliff-edge event, if it ever really was, and that engagement might have to be an ongoing process. That has repercussions for the cost and nature of any engagement effort and also for the likely cost of any advised solution.

It is relatively easy to imagine sophisticated online structured choice tools becoming a standard part of decumulation decision making. These could also accommodate the signposted product that we discuss later in this response. The purpose of these tools would be to eliminate the information asymmetry between purchaser and provider and thus create informed clients. Dashboards, once operational, will provide a potential platform for people to think about decumulation and providers may be able to build tools that use the dashboard to help people make product choices.

Last, there would need to be attractive, suitable products.

Desirable as that future may be, it is plainly a vision of the future rather than a vision of the present. The PLSA broadly supports the measures outlined by the FCA in its paper to strengthen the buy side. But we think that further innovation and smarter technical solutions will be required if we want to develop a viable consumer driven market.

### WHAT'S THE RELATIONSHIP BETWEEN ENGAGEMENT AND DEFAULTS IN DECUMULATION?

We think that one of the main missing elements in pension policy is an understanding of the relationship between policy approaches based upon defaults and policy approaches based on engagement. There is not always clear agreement over what the balance should be between the two policy tools.

For example, some see accumulation phase defaults as a backstop – for example seeing default funds as something people need to be encouraged out of.[5] Others,

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[4] https://www.plsa.co.uk/portals/0/Documents/0564-Pension-Freedoms-no-more-normal-v4.pdf
[5] See for instance: http://www.dectech.co.uk/behavioural_science/briefs/dectech_damage_by_default.pdf

including the PLSA, see the default fund as the core of the automatic enrolment investment approach to which most provider effort should be devoted. This discussion is commonly replicated across other aspects of pension product design.

On the other hand, it is also clear that each policy option has significant downsides. A default may not suit some individuals well. Others may simply choose not to engage.

This leads us to suggest that we need to be explicit about the relationship between the two. In our view, the role of the default is to provide a minimum level – a least detriment option that will be suitable for most people most of the time. By its nature this will never be perfect a default solution can never accommodate all possible individual circumstances. But it should be able to both reduce the worst possible harm and also provide a high quality solution – potentially for the majority. These might include not saving for retirement, inappropriately investing only in low risk assets or decumulating a large fund into cash in one tax year.

By contrast, we see the role of engagement based policy options as to identify those for whom the default is not suitable and encourage them to make active choices. That might imply a different role for communications, in some instances communications might best be used to help people become more comfortable with a default option. It also potentially implies more effective segmentation of different populations of savers.

### THE PLSA'S WAY FORWARD

Over the last few pages we have laid out a view of the decumulation market and a view of the different policy options available to strengthen the market and help savers get into the income products that they need. We think we can boil this analysis down into four main conclusions:

1. The buy side in workplace pensions in both accumulation and decumulation is weak. This has serious implications for how we approach the decumulation market as a whole and the role of consumer choice within the decumulation market.
2. A default option is required in order to provide a "least detriment" income option for those who cannot or choose not to engage with complex financial choices.
3. A market powered by engaged consumers is a possibility but would require substantial innovation in order to eliminate or reduce purchaser/provider information asymmetries
4. The purpose of engagement should be to identify people for whom the default is not suitable and direct them to alternative product options.

This analysis leads us to suggest simultaneous pursuit of both a default product intended to protect those genuinely unable to engage with the decumulation market and further emphasis on engagement.

## A FRAMEWORK FOR A DEFAULT APPROACH TO DECUMULATION: TOWARDS A FIRM PROPOSAL

In light of the above, it is clear that the market for decumulation products requires significant reform. The PLSA's preferred solution rests on savers being supported in their efforts to make effective at-retirement decisions through the introduction of a regime that:

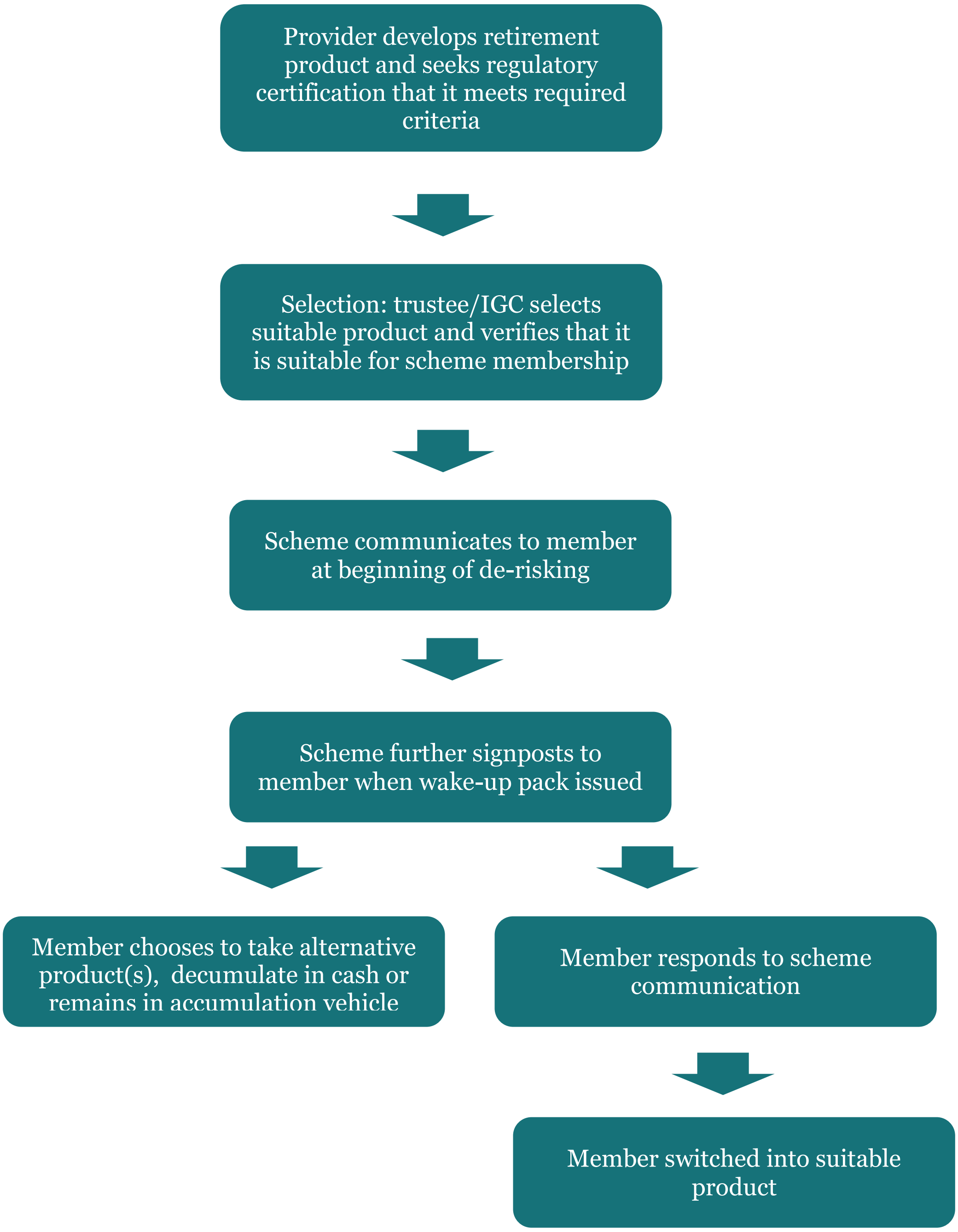
- Allows an independent body, like a trustee or IGC to select a suitable decumulation product. The product should be appropriate to the membership of the scheme as a whole.
- Requires trustees/IGCs to select products that conform to certain government mandated principles. A trustee/IGC selecting such a product would receive safe harbour, indemnifying them from future claims.
- Signposts savers to the suitable product ahead of and at retirement. This should take place at the beginning of de-risking and also when the wake-up pack is issued.

### PROCESS FOR JOINING: STEP BY STEP

The process for joining a suitable decumulation product will involve only a handful of stages. In the process outlined below, providers would apply to have products certified as potentially suitable by a regulatory authority. They would need to demonstrate that the product meets the criteria outlined in the next section of this response. Trustees and IGCs would then select from this pool of products and verify that the product is, indeed, suitable for their membership.

No member would be moved into the signposted decumulation product without their explicit consent. As now, communications to members would present all decumulation options to the member. Information about typical scheme member decumulation choices would also be provided as standard alongside information about where further guidance and advice can be obtained.

#### FIGURE 1: SIGNPOSTING – BASIC FLOWCHART




#### SUITABLE PRODUCTS

We feel that outlining the desirable characteristics of a suitable product and then encouraging the market to innovate is preferable to restricting the market by outlining what that product should look like. Our intention is that a suitable product should have particular characteristics:

- **Member Interest:** The product should be managed by a predominantly independent body which operates in the interests of members i.e. it should be a trust-based vehicle or governed by a suitably empowered IGC. This is intended to:

    - Ensure Value for Money
    - Provide a Default Investment Strategy that operates in the interest of members.
    - Set minimum / recommended maximum income levels to protect against someone outliving their capital or drawing down too slowly.
    - Protect against cognitive decline: limit the need for people to take complex un-advised decisions in later life.

- **Provides an income:** PLSA research demonstrates that 84% of savers want to achieve some sort of income stream in retirement from their accumulated savings.
- **Provides flexibility for capital withdrawals:** Savers appreciate the ability to access capital sums and prefer products that allow them to do so.

A trustee/IGC offering a product that meets these standards and which has properly assessed the product's suitability should receive safe harbour and be free from legal challenges for mis-selling.

This is very close to the CIPR framework proposed for the Australian superannuation system. Indeed, the original CIPR proposals, especially around the construction of the soft default had much in common with our proposals made in our response to CP15/30. We believe that it is likely that people will independently reach similar conclusions from the behavioural economics evidence base and the experience of DC more generally.

## CONSULTATION QUESTIONS

In general, we support the initiatives set out in section eight of the interim report. We feel that they are likely to have mild, positive impacts on a minority of retirees. They are therefore worth pursuing. We believe, though, as set out in the preceding sections that more radical thinking is required in order to prepare the ground for DC dependent savers retiring with much larger funds. This is true both in being more ambitious with signposting but also in being more ambitious over time with the engagement policy levers we have.

### Q1. DO YOU AGREE WITH OUR INTERIM FINDINGS AS SET OUT HERE AND THROUGHOUT THE REPORT? IF NOT, WHY NOT? CAN YOU PROVIDE ANY RELEVANT EVIDENCE TO SUPPORT YOUR VIEWS?

Yes. We think the interim report accurately describes the state of the market.

### Q2: DO YOU AGREE WITH OUR OVERALL APPROACH TO INTERVENING IN THIS MARKET? IN PARTICULAR, DO YOU HAVE VIEWS ON WHETHER OUR PROPOSED REMEDIES STRIKE THE APPROPRIATE BALANCE BETWEEN:

### INTERVENING EARLY BUT ALSO GIVING THE MARKET TIME TO ADJUST

### MEASURES AIMED AT PROTECTING CONSUMERS AND PROMOTING MORE EFFECTIVE COMPETITION

The suite of measures set out in paragraph 8.15 will all improve the degree of competition in the market and protect consumers. We do not feel, though, that they are going to deliver the step change that the market requires. These look like sensible, incremental improvements that will have mild positive effects.

### Q3: DO YOU CONSIDER WE SHOULD INTRODUCE FURTHER CONSUMER PROTECTIONS FOR CONSUMERS WHO BUY DRAWDOWN WITHOUT TAKING ADVICE TO ENSURE CONSUMERS ARE NOT AT RISK OF CHOOSING PARTICULARLY UNSUITABLE INVESTMENT STRATEGIES?

### SHOULD WE EXPLORE THE POSSIBILITY OF DEFAULT INVESTMENT PATHWAYS?

As set out in our introductory section we think that a default will emerge in any complex system. The question therefore is not whether a default is the right policy tool, the question is what the default should look like. We believe that exploration should go further than just the examination of investment options and should include default products.

It follows from that that we think that the FCA should also investigate the possibility of default investment pathways for non-advised drawdown. While we feel that more fundamental change is required, default pathways for non-advised drawdown would be an important step forward.

### SHOULD A CHARGE CAP ALSO BE CONSIDERED FOR DEFAULT INVESTMENT PATHWAYS?

We do not believe that price regulation is the right tool at this time. This is for two reasons. First, we think that aligning product level governance with the interests of members should achieve a similar outcome. Second, the products we think DC dependent retirees will need do not exist yet. It is therefore impossible to suggest a maximum acceptable price.

### SHOULD THE ROLE OF IGCS BE EXTENDED TO DECUMULATION PRODUCTS?

Yes. In order to qualify for the RQM standard, a decumulation product should have the supervision of a trustee or an IGC. We think this principle has more general application outside of RQM.

Over time the FCA should also evaluate whether the powers IGCs have to supervise both accumulation and decumulation products. We see the weakness of the buy side in both the accumulation and decumulation phase as an unalterable fact of life. We think this means that market based remedies intended to intensify competition by encouraging shopping around will produce benefits but these will be comparatively small. The FCA and predecessor organisations worked hard to encourage shopping around for annuities and achieved only limited success.

In a context where the weakness of the buy side is endemic and unalterable, the number of levers policy makers have is reduced. We think that tighter alignment between the interests of the customer and the provider through strong independent governance is preferable to tightening regulation. Although both may yet prove necessary.

### DO YOU AGREE WITH THE DECISION NOT TO PURSUE THE OPTION OF INTRODUCING AN APPROPRIATENESS TEST FOR NON-ADVISED DRAWDOWN AT THIS STAGE?

Yes

### Q4: DO YOU BELIEVE THE MARKET CAN DELIVER ‘DECOUPLING’ WITHOUT REGULATORY INTERVENTION?

We believe that the technical difficulties associated with decoupling outweigh potential customer benefits.

Decoupling would require schemes and providers to run different types of pot in the accumulation phase. Providers would need to hypothecate funds from which PCLS has already been taken from funds on which PCLS might accrue in future. While this is feasible, the merits of this approach would benefit only those who take benefits in this manner. The costs, meanwhile would be spread across all customers and scheme members. We need to consider, in a charge capped environment, the extent to which we can ask all scheme members to pay for options exercised by a minority.

**Q5: DO YOU CONSIDER IT PROPORTIONATE FOR US TO PURSUE REMEDIES TO MAKE IT EASIER FOR CONSUMERS TO SHOP AROUND FOR DRAWDOWN? IN PARTICULAR:**

**DO YOU CONSIDER THAT THE INTRODUCTION OF DRAWDOWN COMPARISON TOOLS SHOULD BE LEFT TO THE MARKET OR IS MORE PROACTIVE INTERVENTION NEEDED?**

**WHAT ARE YOUR VIEWS ON THE BENEFITS AND COSTS OF MANDATING THE USE OF A SUMMARY COST METRIC IN CUSTOMER'S COMMUNICATIONS?**

**DO YOU AGREE WITH THE DECISION NOT TO PURSUE THE ALTERNATIVE MEASURES AT THIS STAGE?**

We think that these measures make sense within the current operating model for the market. They are all sensible steps to increase competitive pressure on firms driven by more informed consumers. The implicit assumption sitting behind them is that increased information will strengthen the buy side and enable consumer choice.

We think that these measures will empower a minority of customers who are able to engage with the information provided and make informed choices as a result. We are sceptical about the impact of these type of interventions at the population level. As you will note from our introductory sections, we believe that further engagement tools will be required to level the purchaser/provider information asymmetries present.

**Q6: DO YOU AGREE WE SHOULD ACT TO MAKE EXISTING INFORMATION MORE IMPACTFUL AND EFFECTIVE RATHER THAN INTRODUCING NEW DISCLOSURE? IN PARTICULAR WHAT ARE YOUR VIEWS AND SUGGESTIONS ON OUR PROPOSALS TO:**

**IMPROVE THE EFFECTIVENESS OF COMMUNICATIONS SENT TO CONSUMERS BEFORE AND WHEN THEY ACCESS THEIR PENSION POTS?**

**EXPLORE THE FEASIBILITY OF INTRODUCING TOOLS THAT COMPARE DIFFERENT PRODUCTS AND OPTIONS?**

**RAISE CONSUMER AWARENESS OF POTENTIAL ELIGIBILITY TO PURCHASE AN ENHANCED ANNUITY EARLIER IN THE CONSUMER JOURNEY? IS THERE A BETTER WAY OF ENSURING CONSUMERS ARE MADE AWARE?**

Again, we feel that these are well conceived initiatives that will have mild positive effects on consumer decision making. We would support the pursuit of all three suggested options.

**Q7: DO YOU AGREE THAT WE SHOULD NOT BE INTERVENING IN THESEAREAS AT THIS STAGE? IF NOT:**

**WHY DO YOU CONSIDER WE SHOULD BE INTERVENING?**

**WHAT INTERVENTIONS SHOULD WE BE PURSUING?**

The approach we have set out in the introduction, a signposting towards a suitable product, explicitly requires market making on the part of the government and regulators. It would require definition of product standards in both legislation and rules. It would require legislation to permit or mandate a soft default/signposting.

We have a short window before a generation without substantial DB entitlement and with a greater degree of dependency on DC approaches retirement. We feel that we do not have the luxury of time and should be more ambitious about the future of decumulation.