thinking forward

Avoid sleepwalking into retirement

DC Decumulation policy white paper

Standard Life
Part of Phoenix Group

Introduction

People are living longer. And the nature of retirement is changing. It's therefore more important than ever that people receive support and guidance before they retire as well as through their retirement.

As with most things, there is no single way to achieve this. But various solutions will help different parts of the UK's diverse population to live a good life in retirement.

We want to be able to:

- Make it easier for us to help our customers get the best outcomes in retirement
- Provide default retirement solutions that are available through guidance
- Innovate so that solutions better suit people's wants and needs

Claire Altman
MD Individual Retirement

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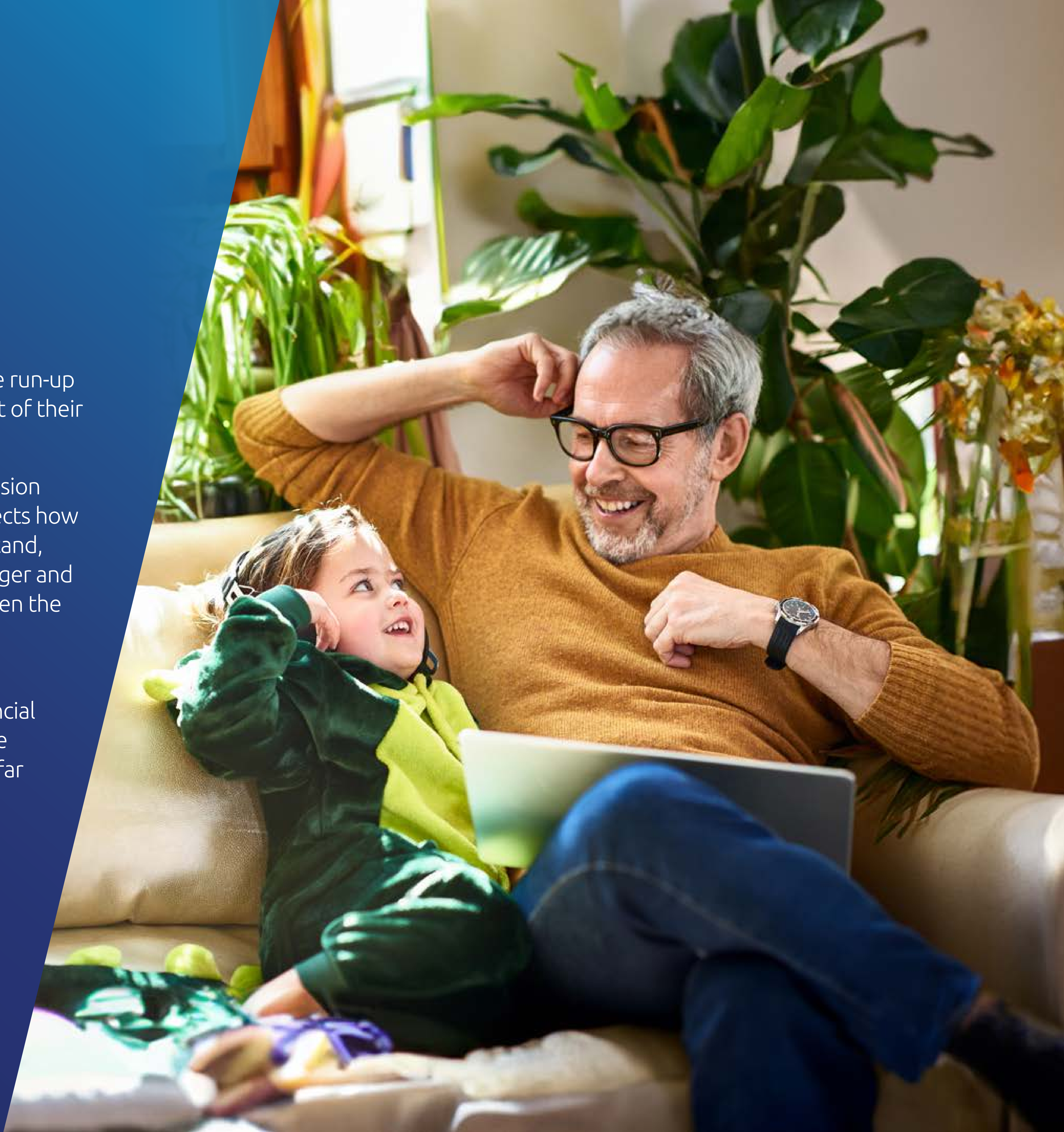
Introduction (continued)

Compounding uncertainty

Most people don't get help with their finances in the run-up to retirement, despite not understanding the impact of their decisions.

In large part, this is because regulations prevent pension providers from providing advice. This negatively affects how much money people have in retirement. As things stand, this problem is going to get worse as people live longer and become more dependent on the State, at a time when the working population is declining.

Although there is an advice market, it currently only serves a wealthy subset of the population. The Financial Conduct Authority's "investment pathways" initiative was meant to solve the problem, but it does not go far enough as they do not help consumers make good choices about how they will use their money.



Introduction (continued)

The road forward

Recent consultations from the Financial Conduct Authority (FCA) and the Department for Work and Pensions (DWP) have signposted a solution: pre-set retirement strategies on a cohort-by-cohort basis, together with targeted support for people to ensure they access the correct strategy. Savers should not be fully defaulted into these solutions, but should be helped to make the right choices for their retirement.

These guided defaults would be further enabled by the prospective launch of Pensions Dashboards. When consumers can use all their financial data they will be best placed to be able to make good decisions about their retirement. Trustees and IGCs have a crucial role in ensuring the best outcomes for members. Extending their remit alongside available data may permit more personalised defaults to be suggested to members.

Retirement decisions are naturally complicated. They reflect the varied circumstances and experiences that savers will have had across their working lives, and no solution will be right for everyone. Nevertheless, an environment should be created where savers can make sensible decisions while being supported by their provider or trustee. In addition, earlier engagement on retirement outcomes and decisions should be considered to increase consumer engagement which will add to differentiation in the industry.

Policy asks

- Allow us to help our customers better. We would like the FCA to create new forms of advice and targeted support to make it more accessible.
- Provide retirement solutions by default. We want to see the DWP follow through with its proposal to create a legal duty on Trustees and pension providers, to provide or signpost retirement solutions that are appropriate for their savers, and find ways to use consumer data so that savers are presented with relevant options.
- Encourage innovation in product design. Establish a framework across Treasury, the FCA and DWP to encourage innovation to ensure that we can innovate to provide the best solutions available.

Introduction (continued)

Conclusion

We believe that the opportunity to create better outcomes in decumulation through product innovation, better understanding of financial personality and personalised default solutions exists at this pivotal moment utilising innovative forms of advice and targeted support.

We welcome engagement on the activities and innovation to drive the move in this moment to rapid change going forward.

CHAPTER 1:

Why things need to change

The concept of retirement is changing. Gone are the days when someone would leave the workplace and enjoy a guaranteed income throughout their retirement.

Advancements in healthcare and trends towards healthier lifestyles, while far from universal, mean that more people can live longer, healthier lives – with longer and more fulfilling retirements.

Yet people are generally unaware of the decisions they will need to make in later life to make the most of their pension savings. One in five (19%) DC savers, equivalent to 5.8 million people, do not know what their retirement income will be, according to research by the think tank Phoenix Insights, part of Phoenix Group. And half of current DC savers are not on track for the retirement income they expect, given current saving behaviour. This equates to about 14 million people, with an average saving gap of £337,000[1].

With more and more people saving into a DC pension, we need to ensure the right framework exists to support people as they move from saving into a pension to accessing their pension. We encourage planning at an earlier stage.

People often find it hard and confusing when planning for their retirement as there are so many factors to consider. For example, people don’t know:

- How long am I going to live?
- What will happen to investment returns?
- Will inflation be an issue?
- How might my expenditure patterns change?
- Will I need to pay for social care?

[1] Phoenix Insights “Great Expectations: Are people’s retirement income expectation adequate and achievable?” September 2022

CHAPTER 1:

Why things need to change (continued)

Seven in ten (71%) pension savers with DC funds want help to choose how to access their pension, including being guided by their scheme to a ready-made retirement income option.[2]

When they enter retirement, people have relatively few products to choose from: annuities, drawdown, and encashment (featuring tax-free cash). People generally choose between them without help, in an all-or-nothing fashion that does not promote the best retirement outcomes. In fact, the Pension Policy Institute predicts four in ten (41%) retirees will be at high or medium risk of making poor retirement decisions.

71% of pension savers with DC funds want help to choose how to access their pension

[2] **Financial capability levels in the UK | Strategy for the UK** – FinCap

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Navigating at-retirement decisions: the advice and support gap

In the UK financial literacy is below the OECD average[3]. Many people struggle to understand how investment and retirement income products work. These struggles may become more acute in later life, due to the cognitive decline that many of us may experience. People therefore need professional support to make complex decisions that suit their personal circumstances. Yet few people are getting this.

Using an independent financial adviser (IFA) to get full regulated financial advice is, for many, the 'gold standard' in terms of securing outcomes for individuals. Taking financial advice between 2001 and 2006 resulted in a total boost to pensions and financial assets of £47,706 per individual[4]. But only one in five (20%) 50–64-year-olds have spoken to an IFA about their pension.

Meanwhile, only around one in five (22%) people of retirement age have used Pensions Wise, which aims to provide guidance on pensions options, according to research by the Institute & Faculty of Actuaries and YouGov[5]. Even among those that have used this free service, around half (54%) took no action as a result, according to research from the SMF[6].

Pension Wise is also unable to take account of other financial factors such as mortgages, debt, property or account assets like cash and stocks and shares ISAs (which the government rightly encourage savers to use).

Pension Providers are also limited by the regulatory environment in the support they can give customers. In particular, they are limited in the types of discussions they can have with customers, who often have little to no understanding of the products and implications. Similarly, communications aimed at supporting customers to save more for their futures are restricted as these are considered as "marketing".

This means there is a huge advice gap. A lot of individuals who can't afford advice, or choose not to take it, aren't getting the support they need when planning for retirement.

Making sub-optimal decisions may lead to people running out of savings, or experiencing a lower standard of living in retirement. The current proposals being put forward by the DWP and the FCA represent a golden opportunity to bridge the advice gap and ensure that people make the most of the money that has taken a lifetime to save.

Only 22% of people of retirement age have used Pensions Wise, which aims to provide guidance on pensions options.

[3] **What it's worth – Revisiting the value of financial advice** – ILCUK
[4] Institute and Faculty of Actuaries: **Freedom and Choice: Public attitudes seven years on**
[5] **Pensions guidance gap fuels £132bn savings shortfall** – Social Market Foundation. (smf.co.uk)

Why things need to change (continued)

CASE STUDY:

Australia: The retirement income covenant

In Australia, superannuation schemes are required to implement a strategy to help members to achieve and balance the three objectives of:

- Maximising expected retirement income
- Managing expected risks to the sustainability and stability of retirement income
- Having flexible access to expected funds during retirement

Schemes are given some flexibility as to how best to implement these objectives for their savers, but they are subject to assessment by the regulator (APRA). The 2023 review of the 'covenant' found a varied level of success in implementation.

They assessed schemes on three core elements:

- Understanding member needs
- Designing fit-for-purpose assistance
- Overseeing strategy implementation

Segmentation and data

One of the key areas examined was the way schemes used data to determine the wider financial situation of their members. This varied from some schemes considering pension wealth and Age Pension entitlement (equivalent to the State Pension, but means tested), while others took in more information about non-pension assets, income from a partner or relative, and other government support.

This reflects some of the challenges UK schemes will face with understanding wider financial circumstances. This data-driven process can lead to an effective segmentation and better solutions. The degree of segmentation and data gathering varied significantly across the market.

Information, advice and products

APRA also examined how experiences were tailored after data-driven segmentation was achieved, and what assistance was offered. This too varied across the market with some providers creating tools, product solutions, longevity products and regulated advice journeys.

Conclusion

The experience across the Australian market is still variable, but there is a clear drive from the regulator that is pushing creativity in the retirement space. Australian superannuation schemes benefit from scale and maturity, but key lessons can be taken for the UK. Having a clear obligation for schemes to cater for decumulation as well as accumulation will drive innovation and better outcomes.

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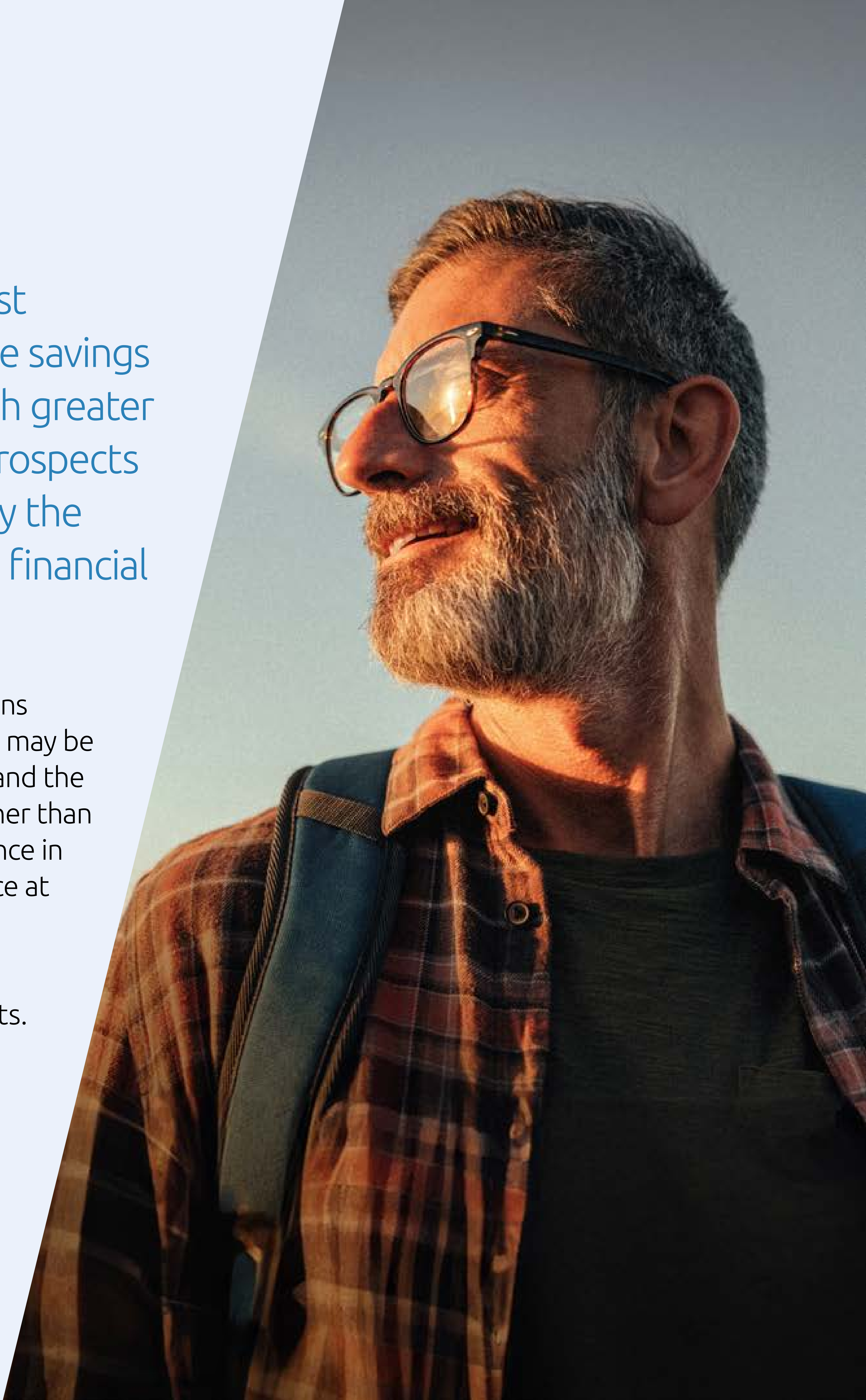
Making advice easier to access

Given the increasing complexity of peoples' financial lives, the vast majority of savers would benefit from financial advice, both in the savings journey and at retirement. People who receive advice end up with greater financial assets and are more confident about their retirement prospects than their non-advised peers, according to research conducted by the international longevity centre. So why do only 8% of people take financial advice each year?

Why don't consumers use advice services?

The FCA[7] recently found that:

- Six in ten (60%) consumers do not take financial advice because they do not think it would benefit them.
- Consumers think that guidance can help them to understand 'the basics'. Guidance often does not go far enough to help them feel confident to make a decision as they value a personal recommendation, which is not available through guidance (RDR/FAMR evaluation, 2020). The FCA's qualitative research found that consumers value human interaction in the advice process. They make very few complex financial decisions without human engagement. This may be a reflection on the cost of advice and the amount of retirement savings rather than actually needing a form of assistance in understanding and making a choice at the point of retirement.
- Four in ten (40%) advisers have a formal pot-size threshold for clients. And advisers that don't have a threshold tend to have a large average pot size anyway. The average assets held by an advised customer is around £150,000. Significantly above the national average.



Making advice easier to access (continued)

The FCA[8] sees this lack of support leading to the following outcomes:

- Consumers do not understand or are disengaged with their pensions – making them unprepared for retirement. Only 57% of DC pension holders read at least some of an annual pension statement in the 12 months to 2022. And only a quarter (26%) of them thought they understood the statement very well.
- In May 2022, there were at least 4.5 million non-advised UK consumers with investible assets of £10,000 or more held mostly or entirely in cash, and who had no plans to withdraw a significant proportion of their savings within the next five years. They are therefore at risk of having the purchasing power of their money eroded over time by inflation.
- Consumers are not investing enough in their pensions to meet their financial goals. More than half (59%) of DC pension holders aged 45-plus agreed in May 2022 that their pension alone would not be enough to live on in retirement. And only one in five (20%) DC pension holders had thought a lot about how much they should be paying into their pension.
- Consumers are making uninformed decisions when accessing their pension savings. More than one-third (36%) of DC pension holders aged 50–69 have never heard of income drawdown (where a consumer takes money from their pension(s) to fund their retirement), and 10% thought it gives a guaranteed income for life. Consumers risk getting ‘advice’ from unregulated sources, such as social media. Social media was used by 18% of investors in the 12 months to May 2022 – to research investing, to find opportunities to invest in, or to keep up to date with investments.

Increasing advice capacity and consumer uptake

Technology

The real value in financial advice comes from making a plan with a knowledgeable and empathetic adviser, who knows the tax system and comes to understand an individual’s life goals. But many of the administrative elements involved in giving financial advice can generate burdensome costs for the adviser and customer.

Great strides have been made in recent years with the use of back-office software to automate administrative tasks. In the near future we are likely to see increasing use of AI within IFA firms to further automate processes, and ensure that advisers do the work that adds the most value.

[6] The International Longevity Centre UK. “What it’s worth – Revisiting the value of financial advice” November 2019
[7] FCA. “Advice Guidance Boundary Review – proposals for closing the advice gap” December 2023
[8] FCA, “Financial Lives survey” 2020

Making advice easier to access (continued)

The digital infrastructure of the pensions industry and wider finance is also improving quickly. The number of pension schemes is dropping and those that remain are more likely to be run either by a large insurer or a modern administrator. Along with the creation of pensions dashboards, this should lead to a large reduction in paper-based work. However, some areas would still benefit from greater standardisation. The letter of authority process can sometimes depend on physical signatures, this causes unnecessary delay. An industry wide procedure should be agreed to digitise the process.

The digital infrastructure of the pensions industry and wider finance is also improving quickly.

Different models of advice

New models, such as simplified advice, as suggested by the FCA, might also make advice more accessible. Although it may not be easy to create a regime that is light touch enough to be different from full holistic advice, simplified advice is worth pursuing. It will serve those who are unlikely to obtain holistic advice, and could also help consumers become comfortable enough with the concept to want to receive full advice. The FCA proposals, if implemented well, could create stepping stones between simple information and full advice – therefore making the decision to take on an adviser less intimidating.

Charging models and trust

How is financial advice paid for? This has been an area of concern for both regulators and consumer groups. Some firms have started offering one-off advice on a fixed-fee basis, but by far the most common structure is an ongoing relationship, with an annual advice fee. However, consumers can find this model difficult to understand and it has been the subject of regulatory scrutiny.

The proposals around simplified advice also raise the prospect of introducing some cross-subsidisation for how and when advice is paid for, and whether this can be deducted from the pot that has been built up as an integral benefit for the consumer. This could be appropriate in wider circumstances where wider financial product information is held relative to the customer (e.g. a customer having a mortgage and a pension product with the same provider). The Retail Distribution Review (RDR) reforms were essential for driving out bad practice and misaligned incentives, but we believe that cross-subsidisation could help to tackle the advice gap.

CHAPTER 3:

What about the non-advised? A blueprint for reform

Several actions can encourage a better 'at retirement' landscape for pension savers who do not take financial advice. There is no single solution that will suit everyone. So a future system will be more successful if it encourages different forms of innovation and helps consumers to think about their finances as a whole.

We are therefore setting out policies that we believe will help to define the boundaries of what 'at retirement' solutions should provide as a minimum.

These policies would allow providers freedom beyond the boundaries to compete and offer different solutions.

Set out opposite are recommendations as to how this could be achieved, recognising that some of these changes can only be achieved over a longer period of time.

Short term

By working now to create the right expectations from the outset, policymakers can support the industry to evolve in the right direction. We recommend setting a vision of longer-term expectations and requiring governance bodies (both trustees and providers of contract-based schemes) to either align with that vision or explain why their scheme needs a different approach.

Putting the onus on the industry to outline why a particular balance is right, in particular circumstances, will open up the space for more sophisticated and innovative solutions.

The DWP's recent policy response for trust-based schemes – "Helping savers understand their pension choices"[9] – is a good start. The proposed duty on trustees to consider their membership and either offer, or partner with a third party, to provide access to decumulation options is welcome.

[9] **Helping savers understand their pension choices: supporting individuals at the point of access** – GOV.UK (www.gov.uk)

What about the non-advised? A blueprint for reform (continued)

Building on these ideas, we think that a long-term vision for taking retirement income from workplace schemes (which may be equally fluid and adapted to a retail world) should be guided by the following principles:

- Retirement solutions offered by providers and schemes should meet the needs of their customers and scheme members
- People should be able to choose a guided default path. For some people a default option is more desirable than a solution that requires them to take advice and fully engage. The current DWP proposal also calls for a backstop for those who do not make a decision.
- Guided defaults should be supported by a clear legal framework so that trustees/providers whose solutions meet required standards are not subject to undue risk; and
- Overall solutions that promote engagement and support members in making well-informed decisions, will ultimately be able to deliver a basic solution where members do not engage.

Our recommendations for achieving this vision are:

1. Providers and trustees should be required to set out their expectations for how members will take benefits from their scheme.

This should be evidence-based and align with members' needs, similar to the approach taken for default investment strategies in the savings phase. Trustees are obliged to understand the profile of individuals in their scheme, and define an investment strategy that best suits them as a cohort. Schemes could set out their approach in a statement of retirement principles, which should include various options. Collective Defined Contribution (CDC) could be one of the options trustees could choose to use, but the framework should be product agnostic. These suggestions could be significantly enhanced by changes to the advice guidance boundary; although some guided defaults can be implemented, the current regulatory framework restricts greater functionality.

The following considerations could apply:

a. Schemes should be able to set out different approaches for different cohorts of their membership. For example:

i. For pot sizes below a certain limit (possibly £10,000), the expectation might be to support efficient encashment.

ii. For slightly larger pot sizes, the expectation might be that members take a combination of both drawdown and annuity.

iii. For pot sizes above a certain point, the trustee/provider might expect to encourage members to take advice in order to tailor their retirement strategy, but should provide a standard solution where people do not.

CHAPTER 3:

What about the non-advised? A blueprint for reform (continued)

b. When setting their expectations, trustees and providers should consider the whole of retirement, rather than solely the at-retirement decision.

c. But savers/members should also be able to choose an alternative option, making full use of pension freedoms. They should be able to revisit these choices (to some extent) through retirement and schemes/providers should provide support for members to consider these alternative options; including signposting to, or having a relationship with, other providers if not offered within the scheme. It should be the trustee's/provider's responsibility to decide what options should be included.

d. Trustees/providers should be responsible for deciding whether options can be restricted to a single provider, panel, or whole of market, as long as it meets the needs of the scheme's membership.

2. Regulations should provide a clear framework, setting out the process for how trustees or providers that choose to do so are expected to discharge their duties in choosing an appropriate guided default.

If cohort level suitability for guided defaults can be demonstrated, and it can be shown that scheme or provider decisions have been made in the right way taking into account the right factors, liability should not extend beyond this.

This framework could include minimum quality standards, such as:

- Opportunities for members to engage with the decision-making process, and illustrations of potential scenarios where the guided default may not be appropriate.
- Being able to demonstrate that the guided default offers value for money. Schemes could choose to meet this requirement by applying a rigorous VFM assessment.
- Having suitable evidence to support the appropriateness of the selected guided default and alternative options.

Trustees are obliged to understand the profile of individuals in their scheme, and define an investment strategy that best suits them as a cohort.

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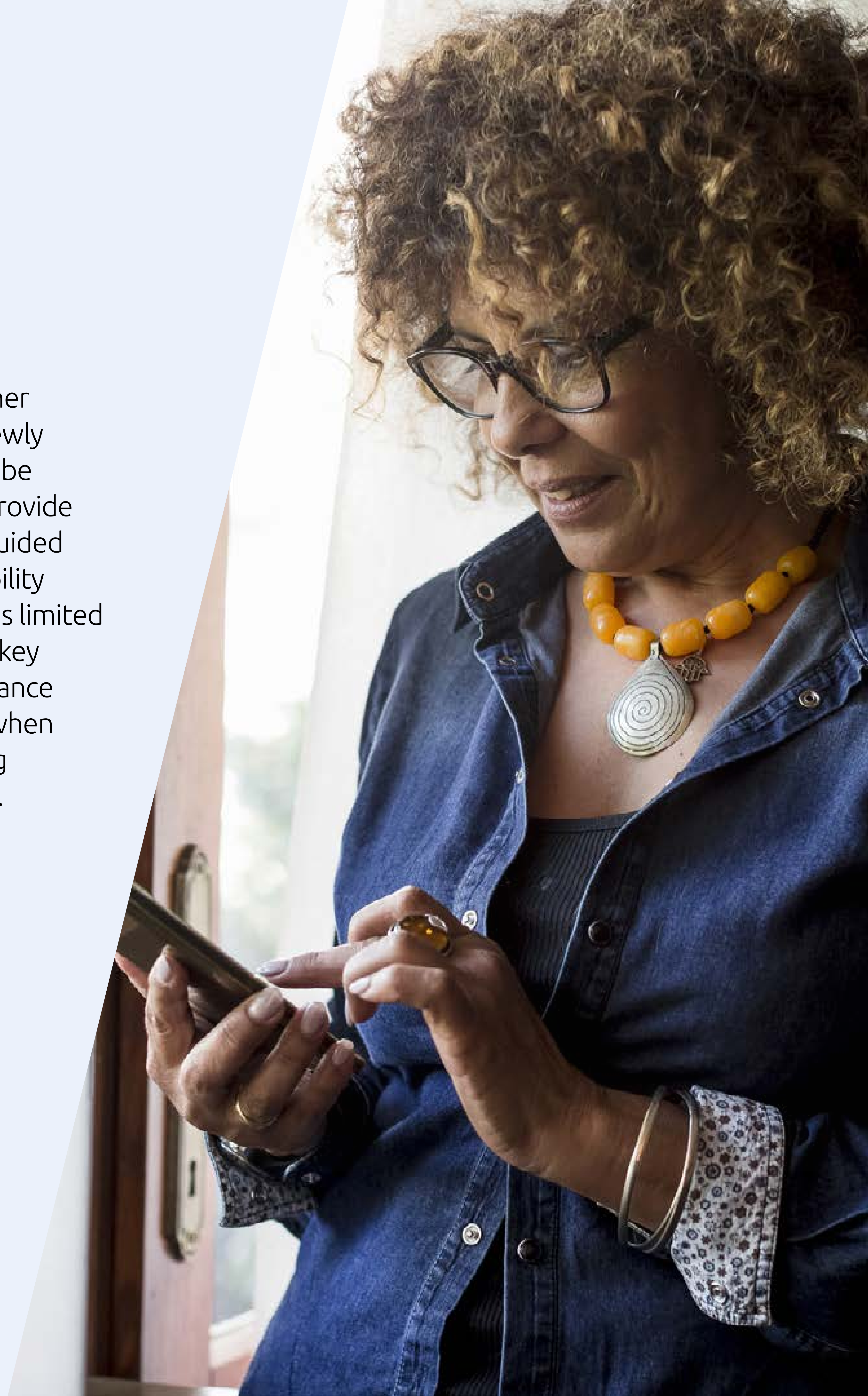
What about the non-advised? A blueprint for reform (continued)

3. An onus should be placed on providers/schemes to design their solutions with mechanisms to avoid members ending up in unsuitable solutions.

For example, if a member has chosen a solution that is designed for one purpose, but their behaviours are not consistent with this purpose, the design could include a mechanism for moving them to a different solution under an opt-out approach. For example, if a member selects an investment pathway designed to stay invested but then starts to regularly withdraw their money, this could trigger a process of engagement, ultimately moving the member to an investment solution designed for regular withdrawals, unless the individual expressly chooses to remain as they are.

These could greatly improve consumer outcomes. The FCA's proposal for newly defined "targeted support" that can be delivered by regulated firms could provide the legal framework necessary for guided defaults to function. Meanwhile, liability could be limited as trustees' liability is limited during the accumulation phase. The key will be to demonstrate good governance and document the processes used when selecting products, rather than being judged retrospectively on outcomes.



CHAPTER 4:

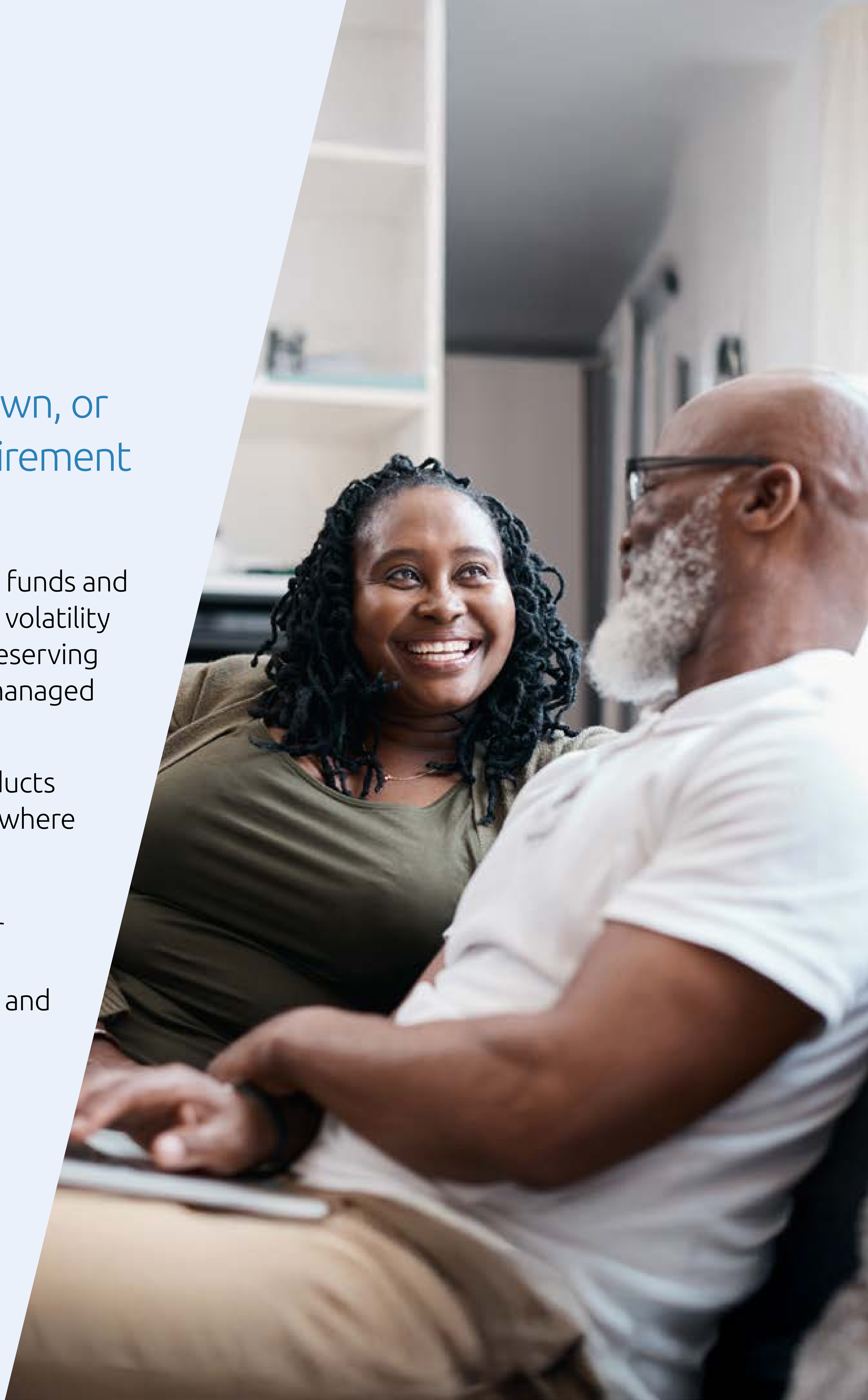
Product innovation

Currently, consumers tend to choose between annuity, drawdown, or cash. These products will continue to be the bedrock of the retirement income framework, but other structures might be better.

Alternative structures can be particularly helpful in an advised context, or within a default decumulation journey, where some of the complexity and options available can be explained. Products may be designed for one or more of the following purposes for better outcomes for consumers:

- Making it easier for consumers to access and manage the transition between drawdown income and guaranteed income, including, for example, accessing guaranteed income in different ways, such as within a SIPP. The evolution of guaranteed income products (guaranteed annuities) may allow for certainty at different points in the retirement journey.
- Reducing member financial risk through decreasing volatility.
- Increasing the range of drawdown funds and the evolution of funds that enable volatility in returns to be managed while preserving capital – for example, smoothed managed funds.
- Improving outcomes through products that offer investment risk pooling where financial personality of consumers is better understood. This includes products offering longevity and/or investment risk pooling, with the evolution of with-profits annuities and pooled-risk investment solutions.

These products can help us move away from seeing decumulation as a 'once-and-done' event, and help consumers to react effectively to changing circumstances, while giving them security.



CHAPTER 5:

Structural reforms to the pensions system

In the longer term, we believe policy development should focus on:

1. Effective and appropriate use of wider sources of data.

We see a huge opportunity to improve future decumulation solutions through the better use of industry and HMRC data. Knowing the level of an individual's State Pension and other private pensions could lead to materially better outcomes. Combining information and making it available to schemes/providers on a managed-consent basis will help to underpin default strategies, by, for instance, understanding whether people have other sources of income.

For example, a gateway between HMRC and pension providers to allow providers to access the details of an individual's State Pension could allow greater and more appropriate tailoring of solutions, with much greater ease for the customer. This could also help with the identifying of lost pots and ID verification.

The Pensions Dashboards, once established, could also be leveraged to allow a more holistic view of an individual's retirement savings. Again, this would allow greater and more appropriate tailoring of solutions. (Using this data depends on changes to the advice guidance boundary.)

These benefits need to be weighed against privacy issues and concerns that providers could exploit access to this data. However, with appropriate controls in place, the potential benefits of this data-sharing could be safely realised. For example, there could be requirements imposed to get individual consent. And there could be limitations to the data supplied (so providers could access bands or categories that members fall into, rather than accurate data points).

There is a big opportunity to improve future decumulation solutions through the better use of industry and HMRC data. Knowing the level of an individual's State Pension and other private pensions could lead to materially better outcomes.

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Structural reforms to the pension system (continued)

2. Review of application of tax and tax codes for retirement.

The current method of applying tax to individuals, in practice, is unhelpful from a consumer perspective. We often see the use of emergency tax codes, and the method in which tax is applied to a new generation of decumulation solutions may undermine many of the benefits that we seek to achieve (for example, predictability of income).

We recommend that an expert working group is established to explore these issues, and identify how the required tax can most seamlessly be deducted from future retirement solutions.

And finally...

We believe that the opportunity to create better outcomes in decumulation through product innovation, better understanding of financial personality, and personalised default solutions exists at this pivotal moment by using innovative forms of advice and targeted support. We welcome engagement on the activities and innovation to help drive the momentum in this moment forward, towards rapid change in the future.

We recommend that a retirement taskforce group is established to explore these issues and bring about change in overall outcomes for consumers through effective retirement solutions.

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