Fixing the freedoms

Helping smaller savers get the most out of the pension reforms

An Age UK Discussion Paper, written by Dominic Lindley, independent Research Consultant.
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Summary

In his 2014 Budget, the Chancellor at the time – George Osborne – took the pensions industry by surprise by sweeping away the rules which previously required pension savers to turn their savings into an income by age 75. One of the key objectives of these new freedoms was to allow pension providers much greater freedom to innovate and create products and processes which better met the evolving needs of consumers. Empowering consumers to make their own choices was also predicted to stimulate innovation and competition in the market.

"The shape of the market will…be driven by the choices consumers make, placing power back into the hands of savers. The government expects this to stimulate innovation and new competition in the retirement income market, with providers creating new products to satisfy individual consumer needs and meet new social challenges such as funding care later in life." – HM Treasury, Pension Freedoms Consultation

The changes took effect in April 2015, but four years later consumers are at risk of paying too much tax, taking too much risk, giving up valuable guarantees and being subject to high charges. Many consumers have been recommended to transfer out of secure defined benefit (DB) pension schemes so that they could cash in their pension entitlement and in those cases poor advice has been widespread. There has been limited product innovation with many consumers with small to medium-sized pension pots lacking access to universal, good value and appropriate products. Inertia still rules the market with limited shopping around.

Research by the Financial Conduct Authority (FCA) found that income drawdown has become the new norm and is increasingly being accessed by consumers without advice and lacking the support of an adviser. The Government's Pensions Wise guidance service has been receiving good feedback from those who access it but only 1 in 10 consumers accessing their defined contribution (DC) pension pots have used the service,[i] highlighting a serious shortcoming in George Osborne's 'guidance guarantee'.

Innovation has not met expectations and that which has taken place has failed to meet consumer need. Although the industry will continue to develop new and innovative products and processes, existing market barriers mean these may not be aimed where they are most needed – at consumers with small to medium-sized pension pots who are not shopping around and accessing income drawdown or taking an annuity from their existing pension provider.

Method

This research was commissioned by Age UK to investigate the development of retirement income products, and written by Dominic Lindley, an independent consumer consultant and author of 'Dashboards and Jam Jars', a report published by Age UK in December 2014. This new report follows a series of interviews with a number of experts from across the pensions industry, and aims to provide an evaluation of how the retirement income product market has evolved since 2015 and make recommendations about how to improve consumer outcomes.

Key findings from the research

There has been **limited innovation since the introduction of the Pension Freedoms**. New guaranteed drawdown products have been launched but then withdrawn. New tools were launched to help manage income drawdown but these were mainly aimed at advisers and only reached a small part of the market. The most significant innovation has been towards introducing new investment choices and reviewing default investment options. The main step forward for lower-income savers was the introduction of Pensions Wise, described by experts interviewed for this report as a positive innovation.

Pension providers noted the **significant impact of the pension freedoms,** for which getting ready and designing a good customer experience has been the focus, rather than the introduction of new products and processes. Some also believed that new products were not necessary at this point, and that innovation should be more about making changes to existing products rather than introducing new ones. Consumer representatives and some pension providers were more likely to see the limited innovation being partly due to customer inertia and lack of demand-side pressure on providers, as well as business models which are focussed on retaining existing customers.

Innovation was seen as being most needed for those with small and medium-sized pension pots who were accessing income drawdown without advice. Consumers in non-advised drawdown were making complex decisions without access to impartial advice or support. They were at risk of paying extra tax, being in inappropriate investments, paying high charges or withdrawing so much that they ran out of money or had to cut the level of income they were taking. There had not been innovation aimed at these consumers to provide them with a good-value, simple to understand product which required minimal consumer engagement, delivered them a reasonably reliable income and protected them from exhausting their pension fund.

Default pathways were widely supported, which was generally interpreted as a default pathway for asset allocation in the run up to and post-retirement. However some wanted this to be expanded to include default communication pathways, decision-making pathways (ensuring that consumers consider other issues such as maximising state pension income and income from other financial assets) and default withdrawal pathways (suggesting minimum and maximum levels of withdrawals and warning people if they strayed outside these limits).

For many pension providers, the key objective was to improve consumer engagement with their pensions and improve access to advice. For others, improving engagement was seen as important but not enough on its own to stimulate innovation. While many thought that an income drawdown comparison tool would be introduced, no one thought it would actually have much positive impact. Improving engagement was valuable but would not lead to innovation aimed at those with small to medium sized pension pots.

Consumer representatives (and some pension providers/IFAs) thought that the following would facilitate the most innovation to the greatest number of consumers:

- **greater access to default impartial guidance;**
- **improvements in governance of pension schemes (including allowing NEST to provide retirement income products);**
- **regulatory intervention such as a charge cap for income drawdown; and**
- **the Pensions Dashboard;**

There was **a general concern amongst many of the interviewees that at some point over the next few years there would be some sort of scandal associated with the Pension Freedoms**. The problems surrounding inappropriate advice around Defined Benefit transfers and the rising number of pension scams were seen as worrying trends.

A market downturn or a sustained period of poor returns could cause losses for many people who had not understood the risks of their drawdown fund or are holding inappropriate investments. Since the introduction of the reforms, markets have continued to grow. However this will not always be the case, and when there is a downturn people risk having to cut their income or running out of money altogether. Individuals' responses to any market downturn would have a significant impact on the final level of income they received – for example if they withdrew too much or sold assets after they had fallen significantly in price then they would never be able to get back on track. People may well complain to their provider if things do not go smoothly.

Consumers accessing income drawdown without advice are not being given the right level of help or support. Even some pension providers acknowledged that, at the moment, the best way to minimise regulatory risk was to say nothing to their customers. As one IFA put it – we are sending people out into potentially stormy waters unprepared.

Are we expecting too much of consumers?

Consumers with small to medium-sized DC pension pots face a series of complex decisions about how to access their DC pension pots to generate a retirement income. They are expected to:

- Access Pension Wise guidance or seek independent financial advice
- Maximise state pensions and means-tested benefits
- Gain a full picture of all pension and other assets
- Consider merging small pots
- Be aware of taxation
- Consider using DC pensions to repay expensive debt
- Maximise income from other financial assets
- Decide on which retirement income product they want and whether they prefer the lower secure income from an annuity or the potential for a higher income from income drawdown balanced by the risk of running out of money.
- Take difficult decisions about income drawdown including where they should be invested and how much they want to withdraw each year, reviewing their choices regularly to ensure that they are on track.
- Shop around for an annuity and declare medical details to qualify for a higher rate

The impact on consumers

- Around 18,000 consumers could be fully withdrawing their DC pension each year when they could be entitled to other means-tested state benefits.[ii]
- Consumers surrendering valuable guarantees are losing out on around £130 million a year.[iii]
- Consumers have already paid around £2 billion more tax than the Government expected the Pension Freedoms to generate, with many people withdrawing their entire pot being particularly at risk of paying more than necessary.[iv]
- Those consumers who take out more cash than they need or do not invest their savings efficiently are particularly at risk of adverse outcomes.

- Around 150,000 people are paying £40 million to £50 million more a year in charges than necessary - because they are in a fund charging more than an annual charge of 0.75 per cent.[v]
- Around 30,000 people using income drawdown are inappropriately invested in cash, when they could receive 37 per cent more income on average throughout their retirement by holding assets which could generate greater long-term investment returns.[vi]
- Consumers are still failing to shop around for annuities or being automatically offered higher rates if they have medical or lifestyle issues.
- Good investment returns up to September 2018 have masked the risks to consumers inherent in complete pensions flexibility, but a market downturn could risk over 90,000 consumers running out of money unless they cut the amount they are taking out.[vii]

Conclusions

The Pension Freedoms have been very popular to date and it is important to note that the greater flexibility will benefit some people – for example bereaved partners or people with terminal illnesses. However, consumers without these special requirements are running risks that they may not be aware of or prepared to weather in the event of a market downturn.

Without strong and quick action the level of detriment will increase as more consumers will reach retirement. Engaging and empowering consumers by providing them with information and encouraging them to take up guidance is important but that alone will never be enough to help consumers with small to medium-sized pension pots get the best possible retirement income. Even if they want regulated advice, they may not be able to afford it and advisers generally prefer to take on clients with higher levels of wealth.

The Government and the FCA cannot expect that the market will deliver innovative, appropriate and good value products for these consumers. There needs to be a far more proactive approach to ensure that these consumers get a good deal and that when a market storm hits it does not destroy trust in pensions and the hopes of thousands of consumers for a comfortable retirement. The onus should be on Government to make it easy for people to take reasonable decisions, through increased use of default options.

Recommendations

1. Consumers cashing in their pension

Clearer warnings on tax payments and a chance to think again on withdrawals

The size of some of the pots being withdrawn means that consumers are very likely to be pushed into a higher rate tax bracket. Thousands of consumers every year are paying more tax than necessary – providing a windfall for the Treasury but reducing their levels of retirement income.

Recommendation:

- The risk warnings about paying more tax than necessary need to be strengthened and personalised for consumers, depending on their tax position.
- Consumers should be sent a personalised form showing the actual amount of tax they have paid and be given the opportunity to pay all or part of the money back into the pension scheme and receive the tax back.
- Consumers wanting to access their pot in one go should be automatically offered an option to take payments over a number of years before accessing their cash.

Better rates on cash deposits

With 52 per cent of pension pots being fully cashed in, it is important that when consumers do this they should receive the highest possible interest rates. It is concerning that mistrust of pensions is causing some consumers to withdraw their pension fund and hold it in cash – eroding the capital and income they have available due to increased tax payments.

Recommendation:

- Pension providers should be required to offer access to better paying cash deposits within the pension. Decisions about how quickly to withdraw money from their pension will also be affected by holdings of other financial assets.

2. More suitable products

Enable NEST to offer retirement income products

The development of more suitable retirement income products for those with small to medium-sized pension pots is unlikely to be driven by the choices made by consumers, who have little power in the market place. Instead, decisions made by pension schemes, which are not necessarily built on consumer demand, are at its core.

Recommendation:

- It is vital that the Government enables NEST to offer retirement income products as soon as possible.

Charge cap for income drawdown pensions

Understanding and comparing the total charges for an income drawdown pension is very complicated. It is very difficult for consumers to compare the cost of different schemes, shop around and switch to better value arrangements. In spite of the recent announcement that the Money Advice Service will launch an income drawdown comparison tool, there are weak competitive pressures on pension providers to reduce income drawdown charges. Not all pension providers are required to act in the best interests of their customers, and drawdown is exempt from the 0.75 per cent annual charge cap applying to qualifying pension schemes for automatic enrolment. This is a recipe for disaster.

Recommendations:

- We should not repeat the mistakes of the annuity market where firms and regulators relied on information disclosure and the availability of comparison tools to encourage consumers to shop around, under-estimating the effect of inertia in this marketplace. This approach led to millions of consumers losing billions of pounds in poor value products.
- The Government should immediately introduce a charge cap for income drawdown.
- The Government should expand the cap on exit charges to cover all early exit penalties (apart from Market Value Reductions) which could be incurred by consumers switching their pension before the age of 55.

Better investment pathways and stronger governance

Consumers should be given a simple choice between investment options in retirement with capped charges. It is important that those responsible for specifying retirement income processes within pension schemes have strong duties to act in the best interests of pension scheme members. This should include requirements to ensure that all annuities, income drawdown and other retirement income products available through the scheme offer value for money.

Recommendations:

- The FCA should implement its proposals for consumers to be given the option of three simply described investment pathways, and for consumers wishing to remain in cash to be required to make an active choice to do so.
- Instead of adopting a wait and see approach, the FCA should immediately introduce a charge cap for investment pathways and drawdown arrangements.
- It is important that those responsible for specifying retirement income processes within pension schemes have strong duties to act in the best interests of pension scheme members. This should include requirements to ensure that all annuities, income drawdown and other retirement income products available through the scheme offer value for money.
- The scope of the Independent Governance Committees, which provide governance for contract-based DC schemes, should be expanded to cover retirement income products, processes and charges.

Help consumers in drawdown use their savings wisely

Given current withdrawal rates, a market downturn could result in thousands of consumers running out of money. More needs to be done to help consumers develop an appropriate withdrawal strategy that mitigates the risks they face throughout the rest of their lives. This includes both the risk of running out of money, and the risk of not spending at a sufficient rate.

Recommendations:

- The FCA and pension providers should provide guidance to consumers about what represents a sustainable withdrawal rate and a traffic light system should be developed to highlight the risk of running of money.
- Pension providers should develop new tools to help people budget, control their spending and set aside money for future goals. Once consumers have made a plan, specific alerts can be used if consumers are departing from it or at risk of running out of money.
- Such tools must be available for non-advised consumers, as well as those who are advised.

A better annuity market

Too few consumers shop around for annuities, in spite of significant gains from doing so, and 18 years of intervention in the annuities market have had barely any impact. Annuities will remain an important source of retirement income for many consumers but are more likely to be bought later in life when rates are better. This could mean that consumers become even less likely to shop around and switch.

Recommendations:

- An annuity clearing house should be established, as in Chile, to help consumers maximise their income and prevent them from being defaulted into a poor product.
- The ABI should resume the collection and publication of all annuity rates including insurance companies which only offer annuities to their existing customers.
- Pension providers should be required to compare their own internal rates against those which were available through the clearing house.
- Pension providers and intermediaries should also be required to ask specific medical questions when selling an annuity and to automatically provide enhanced annuities to those consumers eligible for higher rates.

3. Helping consumers get the most from freedom and choice

Comprehensive Pensions Dashboards

Pensions dashboards are a service helping people view and interact with their pension savings. The saver would be able to see all their pensions from throughout their working life in one place, alongside their State Pension entitlement, which would aid with retirement planning and engagement.

Recommendations:

- To make effective decisions about retirement income consumers will require comprehensive and consistent information to be made available on Pensions Dashboards.
- Consumers must have clear rights to their data, and effective supervision and regulation of Pensions Dashboard providers is essential – it must become a regulated activity.
- There must be universal coverage of all pension schemes for the Dashboard to be fully effective, including the State Pension.
- In due course, dashboards should be extended to cover all financial assets.

Default guidance with an independent opt-out process

All consumers should receive pensions guidance or financial advice prior to accessing their pension. Pension Wise has proven to be effective at helping people understand their options, however at present it has very low take-up, estimated to be only 10 per cent of people accessing their DC savings.[viii]

Recommendations:

- There should be three options for consumers: to take regulated advice; access Pension Wise; or go through an opt-out process.
- In order to boost take-up, the Government and the FCA need to make accessing guidance the default whereby people either have an appointment, or go through an opt-out process.
- The opt-out process should be managed by the Money and Pensions Service to ensure the process is impartial and independent, so as to avoid providers putting pressure on their customers to make decisions that may not be in their best interests.

Clearer warnings about impact on state entitlements

Drawing a private pension may affect your right to claim means-tested benefits or state funding for social care. There should be specific retirement risk warnings about the potential impact.

Recommendation:

- The retirement risk warnings should be amended to include specific warnings about the possible impact on named means-tested benefits, and a specific warning about the funding of social care.
- Decisions about how to access small DC pension pots must be aligned and integrated with decisions about accessing the State Pension and should be addressed by Pension Wise, in Wake-Up packs and in discussions between consumers and their pension provider.

Provide extra help and support to vulnerable customers

In other financial services, for example banking, significant steps have been taken to identify and support vulnerable consumers. Pensions must follow and improve on emerging good practice.

Recommendation:

- The FCA should require pension providers to introduce new policies on the treatment of vulnerable customers. This includes having processes in place to identify vulnerable customers, provide them with appropriate help and support and to test whether that help and support is meeting their needs.
- This should also apply to pension providers with online business models and require them to analyse data to identify potentially vulnerable customers.

Protect pension guarantees

Despite the risk warnings in place and the requirement to seek advice, many consumers continue to give up valuable guarantees, for example Guaranteed Annuity Rates, potentially losing out on thousands of pounds. For those who do exit from their scheme and are surrendering guarantees and enhancements, clearer information is required.

Recommendations:

- Pension providers, alongside the guidance and advice process, should do more to ensure that consumers are aware of the total value of the guarantee they are giving up.
- Pension companies should offer an enhancement of policy values for those consumers who surrender the guarantee, and the FCA should work to ensure

Stronger action to end inappropriate Defined Benefit transfers

The dramatic increase in DB pension transfers combined with the concerns about poor advice means that thousands of consumers may have inappropriately surrendered valuable guaranteed income. This has been found to be the case for British Steel Pension Scheme members, who have "been exploited for cynical personal gain by dubious financial advisers".[ix] Even with the FCA's new rules there will still be strong financial incentives for financial advisers to recommend a transfer out of a DB scheme, which risk distorting advice.

Recommendation:

- The FCA should ban the practice of contingent charging where a fee for advice is only paid if the DB transfer goes ahead. Strong enforcement action needs to be taken against those responsible for inappropriate advice.

Survey of the extent of innovation since the introduction of the Pension Freedoms

The research behind this report included interviews with a number of different figures from across the pensions industry, including advisers, providers, consultants and consumer groups. These were conducted anonymously, with participants answering a standard set of questions designed to investigate the impact of pensions freedoms and choice.[x]

Most interviewees described the levels of innovation as limited. There was generally disappointment that there had so far not been the level of innovation expected prior to the introduction of the Pension Freedoms. IFAs, consumer representatives and some pension providers stressed the demand side barriers to innovation and the lack of incentives for firms to introduce new products and processes. Pension companies stressed the amount of work spent introducing the freedoms, that new products had been released (although had subsequently been withdrawn) and said that given time more innovation would emerge.

> *"It has been stunted in terms of growth and innovation. It has been anaemic at best. In the early days we had a few providers coming into the market with new products or rebranded versions of their existing third-way products. But virtually all of those have disappeared. With MetLife, AXA and Aegon have all withdrawn their third-way products from the market. We are beginning to see things happen on the technology side to support drawdown but it is still very, very, very small in comparison to the size of the market and the demand out there for support and appropriate and good value products and services." – IFA*

> *"Initially right after the Pension Freedoms went live there was very little innovation as providers were focussed on delivering the basic product and services that went with the Pension Freedoms." – Pension Provider*

> *"There is no doubt lots of innovation which could be done and will be done in months and years ahead but we shouldn't expect so much when demand side competition is weak, and particularly bad for people who do not get regulated financial advice. The demand side is weak. Consumers do not buy this on a daily basis. People are buying a product and they don't know anything about it and in many cases were not expecting to purchase." – Pension Provider*

Whilst a number of providers continue to develop products and approaches, these have yet to be rolled out and there continues to be concern at the approach of the wider market.

New tools

All providers interviewed had refined their wake-up packs and developed or refined new digital tools which offered consumers a basic and static comparison between the different options available under the Pension Freedoms. These included taking the entire pension fund as a lump sum, buying an annuity or entering income drawdown, covering factors such as the amount of tax that could be paid if the fund was withdrawn or how long the fund might last for in income drawdown compared to average life expectancy.

There had been some innovation in the development of sophisticated modelling tools which were intended to help manage drawdown, aiming to provide information about the sustainable level of withdrawal and updates based on the performance of the fund, but these were currently only available to advisers. Most firms did not provide non-advised consumers using drawdown with sophisticated modelling tools with updates about sustainable withdrawal rates or protections against withdrawing too much or too little.

Robo-advice, which is a relatively new tool although already in operation prior to the pension freedoms, provides people with an automated alternative to a traditional financial adviser, often at a more affordable price. It amounts to the provision of investment or other financial advice through a series of automated algorithms rather than the face-to-face option, although it can be combined with this element too.

The LV Retirement Wizard service, providing fully regulated robo-advice, was noted as a positive example of innovation by virtually all interviewees. This was available to those with a pension fund of up to £150,000 and charged £199 for the advice and £499 for implementation. Fully regulated advice was said to have significant advantages in that it provides a specific recommendation to the customer and also allows access to the Financial Ombudsman Service (FOS).

Robo-advice was seen as having significant potential, and it was suggested as an affordable, accessible and non-intimidating way to improve access to advice for people with small to average-sized pension pots. However there remain a lot of challenges:

- Customer acquisition could be seen as a problem and research participants did not take for granted that consumers would be able to identify, choose and find an appropriate robo-adviser.

- Customers searching online for a robo-adviser could be tricked into entering their details into a site offering a comparison service but which actually harvests their data and sells it on.

- Robo-advice services could require customers to make significant efforts in terms of gathering information and inputting it into the system – there was not yet an effective way for the service to automatically pull in customers’ details and product holdings.

- Getting customers to pay for a robo-advice service might be difficult.

Other positive examples of tools included the Timeline app, the AEGON Retire-Ready proposition and the Royal London Drawdown Governance Service.

Innovation in retirement income advice and modelling tools

> *"Right now, a lot of the things are happening in the innovative tools space. This is primarily focussed on advisers…There is the Timeline app which is used by financial advisers. Royal London has a Drawdown Governance Service (DGS) which is exclusively for advised sales / advisers…It calculates an Income Sustainability Score based on the percentage of scenarios which leave a sufficient amount in the portfolio at the end of the target period to secure a single life, level annuity with no guarantee… In summary, three years down the line – the industry is still basically trying to figure out what tools are needed and launch the tools to advisers to test them. These innovative tools have not yet been made available to consumers." – IFA*

LV Retirement Wizard

LV= Retirement Wizard is billed as the UK's first online full retirement advice service. The online tool is suitable for Defined Contribution (DC) scheme members within three months of wanting to access their pension and with a pension pot of up to £150,000.

- Expert personalised financial advice from the comfort of their home
- Telephone support from professional, UK based financial advisers
- Lifetime annuity recommendations from the whole of market
- Affordable, low-cost solution compared to traditional advice
- Personal information saved automatically and held securely
- No obligation to buy the products recommended

1. Fact-find

Members complete an online fact find, answering questions about their finances and objectives in retirement.

2. Report

They receive a personalised detailed advice recommendation offering product recommendations.

3. Implement

If they wish to proceed, then telephone advisers can set up their product for an additional fee or they can shop around.

Timeline app

- Helps calculate the sustainable withdrawal rate: the highest percentage the consumer can withdraw from their pension each year without risking running out of money.
- Shows how the sustainable withdrawal rate varies depending on the assets held in the consumer's portfolio
- Uses academic research, historical returns and mortality data to assess how a retirement strategy might fare under various market conditions.
- Uses cohort longevity projections to show the chances of a client living till any age up to 120. And the odds of their portfolio lasting this long.
- Allows the modelling of a variety of withdrawal strategies such as adjusting the amount taken out for inflation or the performance of the investments.

Royal London Drawdown Governance Service
Uses the information advisers provide to calculate an Income Sustainability Score (ISS) for each of their clients. The ISS is calculated based on the percentage of scenarios that leaves a sufficient amount in the portfolio at the end of the target period, to secure a single life, level annuity with no guaranteed period. The ISS is then used to assign an outlook rating, on the scale of 1 to 5:

1. Green - meaning that the drawdown plan is on track
2. For review
3. May need attention
4. Needs attention
5. The plan needs urgent attention.

- Proactively track their clients' progress against their score every quarter and highlight any changes.
- Provide the information the adviser needs to review drawdown clients quickly and easily and produce client reports.

Further views from the research:

"The other aspect where there was innovation was around how to engage consumers. We radically overhauled our wake-up packs to ensure that individuals understood that they had a range of options under the Freedoms which they hadn't previously had. We got the wake-up packs down to three pages with an A3 pamphlet which brings out the various options. It takes quite a lot of innovation and was a challenge to get something as streamlined as that. We also developed digital material which is available on the website. This was aimed at helping consumers and giving them tools to look at the different options and consider what might work for them and to give them a better understanding. We want people to take advice but the tool was there for people who wanted to use it or if an adviser wanted to point their clients to the tool." – Pension Provider

"There has been some innovation in how consumers can be helped to make better decisions. There is AEGON's Retire Ready proposition. There is the LV Retirement Wizard. From a traditional pension product provider perspective these have been the two most high profile and successful tool innovations. Taking you through a few questions, helping you figure out what type of income you want, guaranteed or flexible, and if it is flexible how much you want. If at any point you start to get a bit confused then you can drop out of the process and speak to a real person which is incredibly important for these types of tools." – Pension Consultant

"We do have guidance tools as well which also support the customer journey. But we moved to full advice as customers said that when they had educated themselves enough they said they would just like somebody to "tell me what to do and recommend a particular solution or product for me". The only threshold that can get to recommendations is regulated advice. If you want to

go the whole nine yards with customers and get to the stage with customers where you have told us about your needs and preferences and I will take that and make specific recommendation about what product to buy and by the way if I have got that wrong then you can come back and complain and sue me, it is only regulated advice which can deliver to that level of assurance." – *Pension Provider*

New Products

Hybrid products
Following the launch of the Freedoms, there was hope that more firms would launch products which mixed elements of annuities and drawdown – by offering a guaranteed income but with flexibility and upside potential. These hybrid products, sometimes referred to as Guaranteed Drawdown products, combine drawdown with longevity insurance to provide a lifelong secure income, but with the flexibility to take extra withdrawals and the chance that the level of income could increase if investments perform well. A number of providers had launched or rebranded existing products with the three largest being Met Life, AXA and AEGON. These products were marketed on the basis that they offered a secure income, flexibility and the potential for growth.

These were all available only through advisers and were not sold directly to consumers, meaning that most consumers with small to medium-sized pension pots without an adviser were unable to access them. The largest investments in these products came from DB transfers where financial advisers used the presence of guarantees to help justify giving up the guaranteed income from the DB pension scheme.

In March 2017, the Government noted that although no suitable hybrid products were currently available to the mass market of consumers without advisers, pension providers had predicted that product development would proceed at pace now that they have had time to respond to the reforms.[1] Nearly two years later the situation looks very different. There had been limited take-up of the hybrid products on the market. All of the Guaranteed Drawdown products which had been launched/rebranded had been withdrawn – no replacement products had been launched.

Interviewees saw little prospect of these products re-emerging. IFAs note that these products were expensive, complicated and offered only low levels of guaranteed income (and even this was not inflation-protected). They thought it likely that, instead, those customers wanting some element of security would buy a combination of annuity and drawdown or use conventional drawdown with such low levels of income drawdown that it would be very unlikely that consumers would run out of money. Pension providers noted that there was little demand for new products, that it was a struggle persuading risk-averse advisers to recommend new types of products and they were too complex to be sold directly to consumers. The current economic

[1] DWP (2017), NEST: Evolving for the future – Government response

environment also meant that the cost of providing guarantees was expensive and unless this changed there was little appetite to enter the market.

Some interviewees thought that these products would never be suitable for consumers with small/medium-sized pension pots. Others thought that these sorts of guaranteed drawdown products could represent a suitable default option – as they would allow consumers to preserve flexibility and potential upside whilst avoiding them exhausting their pension fund. However, this was currently a moot point as there was nothing available in the market and little prospect of them being re-launched. Overall, this meant that consumers entering drawdown would still be subject to investment risk and the risk of having to cut their level of income or exhausting their pension fund.

> *"Clearly these [hybrid] products were not good value for money. They were too expensive. The charges were obscene. 1.3-1.5 per cent before you even add anything else on, and the advisory fee and the product/platform charge. The guaranteed income was also so low – 3 to 3.5 per cent in the main. The income is also not index-linked so doesn't maintain your purchasing power. Overall there would be no improvement over the situation where you had a basic balanced portfolio and were regularly taking out money – these products didn't offer anything beneficial. The chances of running out of money when you are taking such low withdrawals are low or practically non-existent…Intuitively, consumers and likely advisers recognised this and this is a reason why the products didn't sell. There was not a lot of sales of these third-way / guaranteed drawdown products….At the moment it looks like attempts to combine elements of drawdown and annuities are probably not going to work or be commercially viable]within a single product wrapper]." – IFA*

> *"What I would like to see is how feasible is it for a modest form of guarantee – protecting against absolute loss is not to be dismissed. If you are keeping people invested then the number one aim is to protect them against volatility and downside risk. Therefore some kind of protection against absolute loss would be good. You could say that it must have these characteristics. You need a group of people in a room looking at what is viable and cost effective." – Pensions Expert*

> *"I am always a little bit wary of defaults as it can suggest that engagement has failed – but if you were to think of what would happen if people refused to make a decision what would you do? Defaulting them into an annuity is not acceptable. Putting them into drawdown with absolutely no checks and balances might be a default but it is also problematic. So at a high level the idea of putting someone into drawdown with a guaranteed underpin might seem like the right conceptual default but it is quite a complex product so many might not be comfortable pushing out to the mass market without advice. Maybe if interest rates bounce back up and the world will be different and then the idea of locking-in and having a guarantee might be more attractive and might remerge." – Pension Provider*

"Some of the population of advisers were using [the Guaranteed Drawdown Product] to recommend to people transferring out of a DB scheme, as consumers were giving up a DB pension but they still wanted a minimum level of income to cover essentials. DB transfers tended to be larger case sizes and above average case sizes." – Pension Provider

"The conclusion from advisers was that in many cases it was more cost effective to get two products rather than one [product] which charges fees which required heroic investment performance to justify it." – Pension Provider

Table: Hybrid / Guaranteed Drawdown products launched and withdrawn from the market

	AEGON Secure Retirement Income	*AXA Secure Advantage*	*Met Life*[2]
Brief description	Hybrid annuity and flexi-access drawdown product	Marketing on basis that it offers: Flexibility to change your mind Potential for growth Secure income for life[3]	Guaranteed Drawdown: Combining the certainty of an annuity with the flexibility of a drawdown pension, offers the reassurance that their income is protected, while still having the potential to grow. It gives them the flexibility to change their mind in the future.
Types of guarantees offered	A guaranteed income for the rest of life – percentage depends on the starting age. If aged 70 then guaranteed income on £100,000 would be £4,050 (4.05%) The "Monthiversary" features looks at the value of the investments each month. At the end of	A guaranteed income for the rest of life – percentage depends on starting age – if aged 65 then 3.75% At each plan anniversary the value of the amount in the Investment compartment will be assessed and if it has increased	A guaranteed income for the rest of life – percentage depends on starting age – if aged 65 then 3.5% Secure Income Reviews increase the Secure Income Base to the current value of the investment if this has grown to more than the

[2] http://www.tenet.metlife.co.uk/uk/Intermediaries/PDF/RPPRODUCTSUMMARY-WM1600386_020721SEP2016.pdf
[3] https://web.archive.org/web/20160426214139/http://axawealth.co.uk/Adviser/Products-and-services/Retirement-products/Guaranteed-income/

	each year the highest "Monthiversary" is used to recalculate the new guaranteed income – so if at the end of year one the highest level was £105,000 then in the example above the guaranteed income would increase to £4,252	then the higher amount is used to increase the income amount.	existing Secure Income Base on the review date. If the Secure Income Base is higher than the current fund value on the review date it will remain unchanged. If income is deferred the Secure Income Base is guaranteed to increase by 3.00% p.a. compound.
Investments	Secure Retirement Income offered two Aegon SRI Managed Volatility funds – Cautious and Conservative – which have typical equity weightings of 40-45% and 30-35% respectively.	Secure Advantage offered 3 investment options. Equity exposure of either 40%, 50% or 60%	To provide the guarantees associated with the Secure Income Option and Secure Capital Option MetLife uses Active Asset Allocation. The MetLife Active Asset Allocation moves the investment between a Growth Asset and a Secure Asset. When investing in the Secure Income Option or Secure Capital Option using the MetLife Active Asset Allocation, the consumer must select the maximum equity exposure from a range offered.
Method of providing guarantees	"Any guarantee is based on the ability of the issuing insurance company – in this case AEGON Ireland plc – to pay it. If, for example, that company no longer existed then the		Met Life uses a hedging programme to manage the risk of the guarantee and switches investments between the growth funds and investments in Government bonds.

	guarantee it provides would be affected.”		If the hedging programme were to fail then shareholders of Met Life would meet the guarantee unless the firm collapsed.
Charges	Product charge of 0.3% of the value of the investments in the SRI account Investment charge of 0.53% Guarantee charge of 0.90%-1.15% for the guarantee (applied to the total base of guaranteed income) Additional guarantee charges of 0.5% if joint-life option or death benefit guarantee is selected (applied to the total base of guaranteed income) Total charges of 1.73%-1.98% for single life and 2.2%-2.48% if joint-life or death benefit guarantee	Product charge of 0.45% Investment charge of 0.5% Guarantee charge of 1.25% Total charges of ~2.20%	Product charge of 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 of 0.55% Guarantee charge (for providing the income guarantee) – 0.60% Total charges of ~1.95%
Flexibility	Amounts in excess of the guaranteed income can be withdrawn and reduce the level of guaranteed income. If entire amount is cashed-in then there may be an additional charge	Additional withdrawals can be taken and will reduce the income base used to calculate the guaranteed income	The Secure Income Base will be reduced proportionately by any Payments Out of Secure Income Investments such as switches out or transfers out.
Death		When the plan starts customers have to choose on	The value used to provide the death

		death to either receive the value of the investment compartment or the amount initially paid into the investment compartment less any guaranteed income payments	benefit is the higher of: • the initial Secure Income Base less any guaranteed income taken (reduced by payments out); • the value of your investment.
Date launched	July 2015 - Announcement	Existing product was relaunched in May 2014 and May 2016	Existing product was relaunched in Sep 2015
Distribution channel	Advised only	Advised only	Advised only
Still on market or withdrawal date	Withdrawn Feb 2018	Withdrawn October 2016	Withdrawn July 2017
Reason why withdrawn	Lack of demand for the product and the low interest rate environment.[4]	The decision to stop the distribution Secure Advantage was taken following a detailed strategic review of the market, and the economic and regulatory factors affecting the sale of the product.	Low interest rates have made it difficult for the product to deliver value for the company.

Deferred annuities
Another option for consumers to gain some element of security would be to purchase a deferred annuity. This would allow the consumer to go into drawdown but at the same time to buy an annuity immediately which would only pay out from a defined age, say 75 or 80. However it was noted that there is not currently a significant market in the UK for deferred annuities, and very little appetite amongst insurance companies to write deferred annuities.

Investment approaches

Default investment approaches
Pension schemes have generally reviewed their default investment approach and many now broadly offer a trident of investment options in the run up to retirement,

[4] FT Adviser (2018), AEGON pulls the plug on guaranteed drawdown

plus a default option if no choice made. These three default options / glide paths could be broadly categorised as those targeting:

- Cash withdrawals (majority cash)
- Secure income (mixture of bonds and cash)
- Income drawdown / invest into retirement (mixture of equities, bonds or a multi-asset fund)

The new default option could be one of these approaches or it could be another investment mix such as a multi-asset fund, depending on decisions made about what was appropriate given the pot size and member characteristics. These were designed to maintain the flexibility for members to move into one of the three options above at any time – and could be, for example, one third equity, one third diversified growth assets and one third fixed income. The investment approach for consumers typically remained fixed post retirement and did not change as consumers moved through retirement.

Drawdown portfolios
There has also been innovation in the investment approaches used for drawdown. This has typically been through the launch of a variety of multi-asset funds which consumers and their advisers could invest in throughout drawdown. Pension companies launched four or five different portfolio options, which were normally graded by the percentage of equities in the fund. The lowest has between 0 and 30 per cent invested in equities with the highest between 40 and 80 per cent. The fund with the lowest percentage of equities would often be described as "lower" risk, whilst those with higher percentage of equities would be described as "medium" risk, "higher" risk or "highest" risk. However, it is not often explained clearly what that risk rating related to, as it could be either the level of volatility in the value of the pension fund (associated with a higher holding of equities), or the risk of running out of money in retirement (associated with a lower holding of equities). Total explicit charges for investing in these multi-asset funds varied from 0.4 to 0.7 per cent for some of the lower cost funds to 1 per cent or higher for others.

There had also been innovation in the introduction of three other different approaches:

1) **Yield-based approach / income funds**: New funds have been launched which invested in assets which were naturally income generative. This divided opinion among research participants - some saw it as intuitively making a lot of sense for consumers, while others raised issues. For example, some felt that consumers with small to medium-sized pension pots would be unlikely to be able to generate sufficient income from the yield on the investments without touching the capital, and that some of the assets in these types of funds could see large falls in periods of market turmoil.

2) **Volatility controlled funds**: These funds were designed to de-risk (sell riskier assets) during periods of volatility and avoid the risk of consumers having to sell assets at low values during periods of market turmoil. Some interviewees saw these as positive, reducing the chance of large falls in fund values in the early part of retirement depleting a consumer's pension pot. Others expressed concern that the

volatility control mechanism might not work, frequent trading would add to cost and even if it did protect against volatility it would not protect against a sequence of poor returns which would cause consumers to run out of money. Through the marketing, volatility controlled funds could give consumers (and possibly advisers) a false sense of security.

3) **Bucket approach**: This divided the investments into three buckets:

1) Short-term bucket in cash for short-term spending
2) Medium term bucket in a cautious investment strategy for medium term spending
3) Long-term bucket in equities for longer term spending / inheritance.

This might not have much advantage in terms of higher returns over just having a balanced portfolio but did have the advantage of controlling behavioural biases which could cause consumers (and their advisers) to sell assets when markets have fallen.

> *"The first iteration was moving from an annuity targeting default to something which gives consumers a bit more flexibility and that will typically mean an end point which has one third equity, one third diversified growth assets and one third fixed income. In light of having some real hard evidence at scheme level as to what that particular population are going to do then that is mostly where we have ended up with clients. There have been discussions about having one default – but also putting in place two or three alternative glide paths for those individuals who might want to take one route or another." – Pension consultant*

> *"We have developed some new multi-asset default funds which are designed for the new Pension Freedoms. People who don't know what they are going to do when they are going to start taking an income. So we created new default funds which are more suited to undecided people. We also have default funds/lifestyling approaches for those who have already decided what they are going to do of the three options – (1) cash (2) annuity (3) drawdown. This is effectively 4 different defaults – A default, default and 3 different options for those who have already made a retirement income decision." – Pension Provider*

> *"Volatility managed: The second approach is where providers create volatility managed solutions. That can be very dangerous. How do you control volatility? Pension providers do this by reducing the equity content just to keep the volatility within the boundaries that are set. This also doesn't solve the sequence risk problem – that the sequence of returns is poor and that there are poor returns in the early part of retirement. Volatility and sequence risk are different. Also, if you are thinking about longevity risk then you need more equity content in the portfolio not less. Overall, this solution doesn't add up." – IFA*

> *"There is a view that in the decumulation/drawdown space customers are more sensitive to downside risk. Whilst we have portfolios designed for*

> *accumulation, the drawdown portfolios are designed to minimise downside risk as they have less capability to recover from shocks." – Pension Provider*

New ways of distributing products to consumers

The only notable innovation in the distribution of products has been increasing use of the workplace as a means of distributing retirement income products. Providers of robo-advice or retirement income services had entered into partnerships with employers or other workplace schemes such as Master Trusts as a means of getting consumers to use their services.

> *"At product provider level and at scheme level – your employer or product provider or scheme will offer some sort of at-retirement service. In the old days you offered an OMO annuity process. What we will hopefully see is some of those more specialist retirement players – like JUST teaming up with product providers or teaming up with employers or advisers. The Wealth at Work proposition is part engagement and they now offer a retirement service and guidance services and they will come into an employer and give one on one service to people within 5 years of retirement and then people can pay for explicit advice." – Pension consultant*

How have these innovations improved outcomes for consumers?

Several interviewees either noted that there had been little positive innovation aimed at consumers with small to medium-sized pension pots, or that it was too early to judge whether outcomes had been made better or worse. For example, it would take a long time to judge whether consumers had benefitted from taking out the drawdown products which had been available with guarantees.

Investment performance since the introduction of the pension freedoms had also been positive and many interviewees noted that this meant that consumers using income drawdown had not yet experienced a market downturn which would lead them to risk running out of money or cutting the level of income they were taking. Consumers' annual statements would show a growing value of their investments even if they were withdrawing around 6-8 per cent a year.

In terms of how innovation had improved outcomes the following points were made:

- Most consumers were now able to access the Pension Freedoms and new investment choices and approaches had been introduced.
- New online advice tools were available although take-up remained low and tools helping to monitor performance of income drawdown portfolios had only been aimed at financial advisers.
- The very existence of the Pension Freedoms may have encouraged people to pay more into their pensions.
- The availability of impartial advice through Pension Wise had been an important innovation and those who accessed the guidance had seen better outcomes.

"The very development of the Freedoms encouraged people to put more into their pensions as they saw it as a more attractive savings product and this improved outcomes. The changes in the lifestyling investment strategies can help get individuals into the right fund for them before retirement. The fact that people no longer need to buy an annuity has been a positive for some people in terms of flexibility and aspirations to leave an inheritance." – Pension Provider

In what areas of the market is innovation most needed to help those with small and medium-sized pension pots?

Most frequently, research participants felt that innovation was most needed in the non-advised income drawdown market. Consumers in non-advised drawdown were making complex decisions without access to impartial advice or support. They were taking the path of least resistance and were often not engaging with their options or exploring the full range available. Non-advised customers had often not thought about the investment choices they had in drawdown or were daunted by the range of options available.[xi] There were also lower rates of shopping around and switching among non-advised customers compared to those who received regulated advice. 94 per cent of non-advised drawdown sales have been to existing customers, compared to 35 per cent for advised drawdown sales.[xii] All of these factors mean that non-advised drawdown customers are at risk of paying extra tax, being in inappropriate investments, paying high charges or withdrawing so much that they would run out of money, or have to cut the level of income they were taking.

Other desirable innovations put forward by interviewees included:

- Products which deliver a reliable (but possibly not absolutely guaranteed) income stream in retirement, these could be some form of low risk drawdown or a new form of Collective Defined Contribution scheme.
- To prompt and encourage those with small and medium-sized pots to access impartial guidance and advice rather than just accepting what they were offered by their existing provider/scheme.
- Development of robo-advice services enabling consumers with small and medium-sized pots to access better value advice services appropriate to their needs.
- To promote engagement by consumers with their pension pot and decisions about retirement income.
- The creation of Pensions Dashboards enabling consumers to aggregate their pension pots and encouraging them to consolidate their pension pots in one scheme.

"The challenge for providers is building engaging and simple solutions to steer people through the management of their pension pots. We spent a lot of time on the Financial Advice Market Review (FAMR) – but there are thousands of people who will not pay for advice. We have to step up to that challenge – having a help desk who understand it and walk through the decision-making process is very important. Then if you have online tools and simple pathways then it becomes less painful for the customer." – Pension Provider

“Some companies are focussed on selling products but you need to look after the customer for 20 years. [We offer] an automated way of supporting advisers and customers to highlight to customers when they are going off track. We are focussing on advisers and making the cost of providing drawdown advice a lot lower.” – Pension Provider

“The growth of free and impartial guidance has been positive. There is a limit to which demand has been stimulated. But I hope this will improve in the future where it is more widely available and the guider has no stake in your retirement income decision.” – Consumer Representative

Main barriers to innovation

All interviewees noted that despite the introduction of the pension freedoms giving consumers additional choice there remained significant barriers to innovation – particularly for innovation aimed at non-advised customers.

Innovation could be costly and unlikely to lead to far greater revenue from non-advised customers. In terms of where they were looking to attract new customers, non-advised customers were not a priority for the majority of pension firms. The average pot size for DC pensions remained small, particularly for those not taking advice before entering drawdown or buying an annuity. Consumers with small to medium-sized pension pots were less likely to know where they were invested or what fees they were paying. Small to medium-sized pension pots generated less revenue in charges and were also far more likely to be fully withdrawn – meaning that the amount of revenue firms could gain from attracting these customers was expected to be low. Pension companies could profit more from retaining inert customers and did not need to innovate to make money. Cutting charges would be unlikely to lead to them attracting more non-advised customers to offset the reduction in profit they would suffer.

The key barriers to innovation cited by interviewees included:

- The weak demand side and the behavioural biases associated with making decisions about retirement income
- Business models which meant that some firms were more interested in retaining their existing customers than attracting new ones
- That the product where innovation was most needed – non-advised drawdown – was not a priority for many providers in terms of attracting new customers.
- The boundary between advice and guidance which some said made pension companies wary about providing more help to consumers
- Risk aversion among financial advisers and pension firms making them reluctant to develop and recommend innovative new products
- The sheer amount of resources which were needed to ensure that products, processes and staff could deliver the Pension Freedoms
- The low interest rate and macroeconomic environment meant that it was expensive to provide guarantees

"Consumer inertia – the inertia provides the opportunity for a profitable market without innovation. There is no real incentive to innovate. There is a weak demand side and most consumers don't know what they want. Innovation and setting up new systems is expensive. Consumer inertia give you a profit with little effort. The public policy framework is not pushing it. The Government announced that the product innovation would happen but there is nothing to encourage it." – Consumer Representative

"There is the weak demand side and providers with big backbook business models who are more interested in retaining these customers rather than attracting new ones. Those are very powerful factors." – Pension Provider

"*The challenge is the interest rate environment. The cost of providing guarantees is naturally expensive. That is a challenge. Also, in general there is quite a lot of change and that restricts resources available to develop new products." – Pension Provider*

"The FCA's boundary between guidance and advice is a barrier. There is always the fear of inadvertently straying across the advice boundary due to personalisation. The FCA has worked quite hard to clarify boundaries and there is still room for more personalisation without it constituting advice." – Pension Provider

Concerns about non-advised drawdown

Virtually all interviewees expressed concern about the proportion of consumers accessing drawdown without advice. This concern was also expressed by pension companies – although some also noted that they were not seeking actively to attract non-advised drawdown customers. The costs of accessing advice about income drawdown could be high and consumers with small to medium-sized pension pots might not be able to afford it. This meant that they might not understand the product. For example, FCA research found that just 42 per cent of consumers who had accessed a DC pension identified that the value of their fund being used for income drawdown could go up or down.[5] Consumers using non-advised drawdown were very unlikely to shop around and there was the risk of incurring high and complex charges.

The bull market had delivered good investment performance and this would mean that problems with non-advised income drawdown had not emerged yet. There was very little guidance provided to consumers using non-advised drawdown about the sustainable level of income which they could expect to take from their fund. There was little action being taken to help non-advised drawdown customers develop sustainable withdrawal strategies. This meant that many could be at risk of running out of money or having to cut the level of income they took from the fund. Making the wrong decision in the early part of retirement could devastate the value of the fund and make it virtually impossible to get back on track. However, there was also the risk of under-consuming and having a poor standard of living. There was also

[5] FCA (2017), Financial Lives, Page 89

concern that, at the moment, the best way for pension providers to protect themselves against risk was to not communicate with customers in ways which could nudge or encourage them towards a particular course of action.

> *"It is important to note that we have been living in a bull market for the entire period since the introduction of the Pension Freedoms. When the market goes pear shaped then we see the beneficial impact of having a well thought out withdrawal strategy and having a plan in place and monitoring it. Bear markets we have seen tend to be temporary – but what consumers do during that very severe market correction (when it does happen) will actually have a massive impact on the overall outcome. You can't wait until the storm comes to prepare your boat – you have to do it before you start the journey. We are sending people out unprepared into potentially stormy waters." – IFA*

> *"If you are in income drawdown and making losses in the early years of your retirement that you were not expecting then you can have Warren Buffet running your money and you won't be able to get back on track for a comfortable retirement. This is due to pound cost ravaging – taking out money when markets have fallen has a greater impact on the overall value of your fund." – Pension Provider*

> *"There is always going to be the regulator saying why didn't you write to that customer – but it often feels as though taking no action is the best way to box off regulatory risk. This doesn't serve customers very well." – Pension Provider*

Default pathways

Interviewees discussed a number of different default pathways which commanded varying levels of support. All felt that there should be some form of default investment pathway. Others noted that retirement income decisions were difficult and required some level of personalisation as every customer was different – in their circumstances, attitude to risk and other pensions and financial assets. Four types of default pathways were discussed in the research:

- **A default communications pathway** – this would go way beyond the current wake-up pack approach and would start early, build over time and continue post-retirement. There was support for mid-life MOTs and mid-retirement wake-up packs. However, there was a spectrum of opinion regarding how effective these activities would be.

- **A default decision-making pathway** which guided the consumer through the decisions they needed to take including maximising state pensions, taking up guarantees, consolidating their DC pensions in one place, maximising income and returns from other financial assets. Some thought that this should also include consideration of other products such as equity release.

- **A default asset allocation pathway** (or in reality a number of different pathways) which gave the consumer a choice of between three different funds graded according to risk and final objective. For those who made no choice there would be a medium risk multi-asset default fund. These pathways would continue to evolve after retirement, with some thinking that the ultimate aim would be to secure an annuity (or a combination of securing an annuity and inheritance) later in retirement at say age 80-85. This could involve the gradual or phased annuitisation of the consumer's pension fund to enable them to secure an appropriate level of income, while leaving surplus money invested in income drawdown. Others thought that the pathways should remain invested and should not target the purchase of an annuity.

- **A default withdrawal amount pathway**, which provides a clear steer to the consumer about what represented a sustainable withdrawal rate from their pension and how this would have to change if investments performed poorly. The intention was that this should control risk and volatility (of asset value and income) and provide a smooth, inflation linked income in the early part of retirement – but with the flexibility to take lump sums if required. This could be similar in nature to the old Government Actuary's Department (GAD) rates – with an average and an overall cap on how much money can be withdrawn each year – and provide guidance on how much a consumer could take and the maximum they should take. This would be an ongoing pathway and would provide prompts if consumers were taking too much (or too little). This approach brings an additional layer of complexity as a default withdrawal rate would also be determined by the overall investments in the fund. Even if the investments were low risk, the default withdrawal rate could also be low as holding low return investments increased the probability of running out of money. The default withdrawal pathway would continue until the consumer ran out of money or would stop at a particular age with the balance used to buy an annuity or secure an inheritance.

  "Default pathways and default asset allocation are needed. It is so useful to have a number of layers to protect for customers. Defaults is dealing with customers who fail to engage and that will be an expected outcome. We have to put things in place for the many who don't want to pick up the phone and talk about it. Default pathways could allow people to select between three different funds. As customers get older there would post retirement lifestyling as the investments continued to change." – Pension Provider

  "Sometimes we leave it too late to communicate their options to people. We have to get better at having default communication pathway which start earlier and builds over time. So planning for retirement is not a big surprise and people don't leave it too late to consider their options. That would be the best outcome we can hope for from the FCA's retirement outcomes review." – Pension Provider

  "In terms of thinking about default withdrawal rates. We would be going back to GAD rates – there was some logic in having some basic level of drawdown and a higher cap. But any attempt to move back to that would cause problems for whichever politician suggested it. You might still communicate in the current climate – "Here is the most you should take?" "If you want to keep going throughout life then you shouldn't be taking more than X?" It would

almost be like the triannual review but without a requirement to reduce it." – Pension Provider

"What about the default portfolios in retirement? Should there be 3 or 5 different choices? One thing that is interesting is how to define the risk and grade the risk. The vast majority of pension providers focus on volatility and equity content as the definition of risk. A high equity content portfolio is considered to be risky. But actually in retirement, given the longevity risk in drawdown, I am not sure that the industry is using the right approach to think about risk and to illustrate to consumers. In the context of longevity and the uncertainty about how long you might live then you need to have more equity content in the portfolio rather than less. If someone wants to invest entirely in bonds in what the pension provider might call a low-risk portfolio then they should seriously buy an annuity. We need to think long and hard about how we define risk and communicate it to consumers. We need to move away from using volatility and standard deviation as a measure of risk." – IFA

NEST Blueprint for retirement income

In 2015, following consultation NEST published six key principles for core retirement income products and a blueprint for retirement income. However, following a call for evidence the Government concluded that "Given the reassurance we received from the industry regarding their intention to innovate, Government does not propose that NEST should begin to offer additional decumulation options at this time." This meant that the blueprint was not introduced although the Government pledged to keep NEST's role in offering retirement income products under review.

The blueprint was designed to provide a sustainable income for life. The six principles were:

1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions.
2. Savers should expect to spend most or all of their pension pots during their retirement
3. Income should be stable and sustainable
4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements
5. Providers should look to offer flexibility and portability wherever possible
6. Inflation risk should be managed but not necessarily hedged

NEST's blueprint for retirement income comprised three building blocks:

- **An income drawdown fund**: At age 65 around 90 per cent of the member's pot would be allocated to an income-generating investment portfolio. Each month from then on an income would be paid out from this pot. In most scenarios this income would increase year on year in line with inflation. Before age 85 the member can take this money out if they change their mind or the money can be passed on should they die. If there is extra money above what is needed to pay the member's expected income level, this will be transferred into the cash lump sum fund for a member to spend as they please.

- **A cash lump sum fund**: The 10 per cent of the member's pot that is not allocated to the main portfolio is set aside in cash-like investments so as to be accessed on request at any point in retirement. This is the cash lump sum building block.

- **A later life protected income**: From age 65 to 75, a monthly payment goes towards building up a later life protected income. This is in addition to charges. NEST expects this amount to be between 1.5 and 2 per cent of the pot each year. The payments towards later life protected income would be allocated to a different portfolio that would be used to obtain that income. Importantly, before the member is 75, the member can still get this money back should they change their mind. Should they die, then this money can be passed on. After age 75, the payments towards later life secure income are locked into a mortality pool. From age 85 this building block pays income to the member.

Regulation and the FCA's retirement outcomes review

Interviewees were asked to discuss how changes to regulation could be used to promote innovation and what changes they would like to see as a result of the FCA's Retirement Outcomes Review. The following requests were made of the FCA and Government:

- Keep the focus on non-advised drawdown where there was the greatest risk of detriment for consumers.
- Make it clear to pension firms that they could not just sit back and do nothing for and say nothing to their non-advised drawdown customers. The FCA had to make the risks of inaction greater than the risks of action. Pension providers must be required to provide some help and support to these customers.
- Support the development and roll-out of robo-advice business models. They were positive about the FCA's Advice unit and Sandbox – the regulator was not lacking intent or initiatives, but these had not yet had a measurable impact.
- Implement the Pensions Dashboard; there was increasing concern that this would not now be available by the 2019 Government deadline.
- there was widespread support for the Government's planned drawdown comparison tool but no interviewees (even the pension providers) thought that it would make any significant difference. Drawdown comparison was thought to be too complex and investment performance (returns and volatility/sequence risk) needed to be considered alongside charges.
- Develop the idea of default pathways and prompt a debate about what should be offered.
- Implement default guidance – consumer representatives and some pension providers believed the FCA should take a strong line on implementing a

robust system of default guidance. Other pension providers supported greater availability of guidance but stopped short of making it the default.

- Clarifying the distinction between advice and guidance – some thought this was very important, others felt that it was already clear and wouldn't make any difference.
- Introduce a charge cap for income drawdown – strong support from consumer representatives, limited support from IFAs and no support from pension providers. Pension providers stressed the importance of value for money (which to them was different to the level of charges) and the need to ensure that individual consumers were not overcharged.
- Expand the remit of the Independent Governance Committees to retirement income products, but noting that the effectiveness of IGCs in securing value for consumers had not yet been assessed.

"The drawdown comparison tool may one day help, a bit, but it is a really ambitious project and the prospect that it going to seriously affect high volumes of market behaviour seems unlikely." – Pension Provider

"We need to remove the ban on NEST offering income drawdown products. It is a sufficiently large number of people and they are the most vulnerable and there is no good reason why these people should not be supported." – Consumer Representative

"The FCA will now be gifted an opportunity to create default guidance. They should take a very firm line that the industry should not intervene on the referral scheme. You should not be able to access your scheme until you have obtained guidance/advice. There is absolutely no reason why you should say there is freedom but you have to be referred. The opt-out discussion should not be owned by the provider. The guidance that they are defaulted to should be free and impartial." – Consumer Representative

"The consumerist in me likes a charge cap but the capitalist doesn't. But in the financial services industry the investment management side of things doesn't succumb to the same competitive price pressure that works in other industries. I am inclined to support a cap on charges. We have it on DC schemes used for automatic enrolment. If you accept that increases in the number of consumers using income drawdown is something that is encouraged by Government policy just as auto-enrolment was then we need to protect people. We are encouraging people down the route of drawdown and we need to ensure they are paying a reasonable charge." – IFA

FCA's Retirement Outcomes review

Over one million DC pension pots have been accessed since the pension freedoms were introduced. The FCA's retirement outcomes review is examining how the market has evolved. The review has found that:

- **Accessing pots early has become 'the new norm'**. 72 per cent of pots have been accessed by consumers under 65, most of whom have taken lump sums. Taking benefits early could mean that there is less available when they actually retire or the money has to last for a longer period.
- **People withdrawing pots typically have other sources of income**. Over half (53 per cent) of pots accessed have been fully withdrawn. 90 per cent of these were smaller than £30,000 (60% were smaller than £10,000) and 94 per cent of individuals making full withdrawals had other sources of retirement income in addition to the state pension.
- People do not seem to be squandering the money, **but risk paying too much tax and missing out on investment growth and valuable guarantees**. Over half (52 per cent) of the fully withdrawn pots were not spent but were transferred into other savings or investments. Some of this is due to mistrust of pensions. Mistrust is an issue in itself, but can also give rise to direct harm if people pay too much tax, or miss out on investment growth or other benefits.
- Drawdown has become much more popular. **Twice as many pots are moving into drawdown than annuities**. Before the pension freedoms, over 90 per cent of pots were used to buy annuities.
- **Very limited shopping around**. Most people choose the 'path of least resistance'. They accept the drawdown option offered by their pension provider without shopping around. 94 per cent of non-advised drawdown sales were made to existing customers. This suggests limited competitive pressure to offer good deals. Only one third of people are shopping around and buying an annuity from an alternative provider. Annuity providers are leaving the open annuity market, reducing choice for consumers. People who do not switch or take advice are at risk of receiving poor annuity rates.
- **People buying complex products without advice are potentially being exposed to excessive costs and risks**. Many buy drawdown without advice but may need further protection to manage their drawdown effectively. The proportion of drawdown bought without advice has risen from 5 per cent before the freedoms to 30 per cent now. Drawdown is complex and individuals need to manage longevity and investment risks by choosing appropriate investment and withdrawal strategies. There is a question about whether further support and protection is needed to manage drawdown effectively.
- **Limited product innovation**. There have not been retirement income products emerge for the mass market that combine flexibility with an element of guaranteed income.

The future of the Pension Freedoms

The majority of interviewees supported the continuation of the Pension Freedoms (or acknowledged that it was unlikely to change). However, several also pointed out the contradiction in policy where the accumulation phase was all based on harnessing inertia and protecting consumers from excessive charges. At retirement, consumers are expected to become informed, engaged and willing and able to access good sources of independent advice and guidance. This was unrealistic and it meant that, in the short term, consumers would not be able to drive innovation. Commercial drivers also meant that innovation might not be aimed at non-advised consumers with small to medium-sized pension funds. Innovation would need to be driven by Government or regulatory intervention or decisions made by pension schemes for non-commercial reasons or by those schemes with clear fiduciary duties to act in the best interests of members.

There were suggestions for reforming the Pension Freedoms, which included increasing the minimum age to 60 or above, setting limits on the amount that could be taken out through drawdown or implementing some requirement for a minimum amount of secure income before all of the pension fund could be accessed.

Even those who supported rolling back or limiting some elements of the Pension Freedoms acknowledged that it was very unlikely to change in the short term.

Notes on a scandal

There was a general concern among many of the interviewees that at some point over the next few years there would be some sort of scandal associated with the Pension Freedoms. The problems surrounding inappropriate advice around Defined Benefit transfers and rising pension scams were seen as worrying trends.

A scandal was most likely to come from either a market downturn or a sustained period of poor returns – causing many people who had not understood the risks of their drawdown fund or were holding inappropriate investments to suffer losses. They would risk having to cut their income or run out of money and would probably complain to their pension provider or financial adviser. The actions that individuals took during any market downturn would have a significant impact on the final level of income they received – for example if they withdrew too much or sold assets after they had fallen significantly in price then they would never be able to get back on track.

The pension providers acknowledged this problem and the need to do more – particularly for non-advised drawdown customers. They recognised that some providers (but not themselves) could be sitting on a ticking time bomb of customers who had not understood the product they had taken out and would be unhappy with its performance in a market downturn. This would inevitably cause detriment to customers and would also damage the reputation of pensions and the industry. There was no safe harbour for either customers or the industry.

“If I was a provider with a lot of non-advised drawdown customers the biggest risk is that there is a big fall in the stock market. People will start saying ‘What has happened to my pension?’. That will fuel a media frenzy. People will be looking for someone to blame. Will it be providers, Government or regulators which are blamed or will it be a mix? We need to keep reminding ourselves that the Government introduced freedoms and said that people could be trusted with their money. Industry is trying to offer freedoms in a way which protects customers in a proportionate manner but which doesn’t run against the pension freedoms theme. The non-advised market is where we have the biggest concern and where we need to do more to protect end-customers.” – Pension Provider

“There is a lot of risk there and I would be concerned if I was working for a provider which left people sitting in something unsuitable. When we looked at customers if they were sitting with higher than expected allocation of cash then we would write to them. There are a number of providers sleepwalking into a time bomb as whilst we have had decent returns for the past few years other providers haven’t put in place mechanisms in check the suitability of the investments.” – Pension Provider

“We have been working with behavioural economists and focus groups to understand better the dynamics of clients’ decision making. In a downturn what you shouldn’t do is send out an email saying “don’t panic”. It turns out that is counterproductive because they hadn’t noticed and the email sparks anxiety and if they anxious then they are already going to ring you up. Sending an email out proactively will make the situation worse.” – Pension Provider

“Should you say that you are taking more than double the income what is sustainable and so you might need to slow down? Where do you stop? There is a bigger question mark here and I am not sure how it can be resolved which properly balances individual freedoms with provider responsibility. Providers shouldn’t be held accountable for something where customers are doing anything which doesn’t look that sensible. There is a fine line to be drawn – on the one hand obvious things which you should encourage consumers to reconsider and on the other hand everything else which might be legitimate and you don’t have enough insight into the person’s aims to assess it. This points to why advice is helpful in this market.” – Pension Provider

Vulnerable consumers

The industry needed to do more to consider the needs of vulnerable consumers. More customers would be interacting with their pension providers and seeking to manage their money later in life. This was a challenge where consumers were only interacting with their pension provider online.

“Vulnerable customers – we should all be doing a fair bit of work internally on vulnerable customers. The industry is not where we should be on vulnerable customers. There will be increasing numbers of customers managing pension pots into later life – physical and mental impairments are going to be more

difficult. We should be talking to Alzheimers Society and talking to people about putting in processes. Customers self-managed investments for years and then appointed adviser and a few weeks later rung up to complain – forgotten appointed adviser. Really important area and CSR challenge. Much harder to protect people in online situations – much harder to recognise vulnerability and put in place appropriate protections where customers are only interacting with you online." – Pension Provider

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[i] Financial Conduct Authority (2017), Retirement Outcomes Review interim report.

[ii] Among a sample of consumers who had fully withdrawn a DC pension pot worth at least £10,000 and had no or low other DC or DB pension savings, between 13% and 16% said that they had sources of income from other state benefits. Across all consumers who had fully withdrawn their DC pot 12% said they had sources of income from other state benefits; (Financial Conduct Authority (2017). Retirement Outcomes Review interim report). The research did not examine whether these were means-tested benefits and whether the consumer suffered a loss of benefits due to accessing their pension. DWP data suggests that of those aged 55-69 both above and below State Pension Age between one half and two-thirds of those claiming state benefits are entitled to means tested benefits; (DWP (2017), Benefit Combination Caseloads Statistics; Working Age DWP Benefit Caseload, State Pension Age DWP Caseload. Including those with some entitlement to Housing Benefit, Pension Credit and Universal Credit). Assuming that one half of those consumers with income from other state benefits are entitled to means-tested benefits would mean that around 18,000 consumers each year are fully withdrawing their pension pot when they are entitled to means-tested benefits

[iii] Of the pensions accessed which offered a GAR between April 2016 and June 2016, just over half of consumers failed to take up the guarantee. 78% of these pots were worth less than £30,000 and 22% more than £30,000; (Financial Conduct Authority (2017). Retirement Outcomes Review interim report). 60% of consumers are assumed to lose out from failing to take-up the guarantee and the average loss from failing to take-up the guarantee is around 30% of the pension pot.

[iv] Office for Budget Responsibility (2014), Economic and Fiscal Outlook March 2014; Office for Budget Responsibility (2017), Economic and Fiscal Outlook November 2017

[v] Distribution of charges in non-advised drawdown is taken from Chart 21 on page 51; Financial Conduct Authority (2018), Retirement Outcomes Review final report. This shows that around 70% of non-advised drawdown customers are paying more than 0.75% in charges each year. This figure shows the assumed saving for non-advised drawdown and non-advised UFPLUS customers paying more than 0.75% a year if their charges were to be reduced to 0.75%. The number of non-advised drawdown and UFPLUS customers is calculated from the time period from introduction of the pension freedoms through to March 2018.

[vi] 18% of consumers are inappropriately invested in cash taken from Figure 12 on page 36. FCA calculates that consumers could get 37% more income over a 20 year period if they were invested in a mix of assets instead of cash. Financial Conduct Authority (2018), Retirement Outcomes Review final report.

[vii] FCA data shows that 90,000 consumers are currently withdrawing 8% or more of their pension fund each year. Financial Conduct Authority (2018), Data bulletin, September 2018

[viii] Financial Conduct Authority (2017), Retirement Outcomes Review interim report.

[ix] Work and Pensions Committee (2018), British Steel Pension Scheme, Sixth Report of Session 2017–19

[x] The author would like to thank all participants for their time and valuable insight

[xi] Financial Conduct Authority (2017), Retirement Outcomes Review interim report, page 85

[xii] Financial Conduct Authority (2017), Retirement Outcomes Review interim report, figure 22, page 49