PENSIONS POLICY INSTITUTE

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DC savers’ needs under the new pension flexibilities

Summary

This Briefing Note provides an overview of the findings from research, conducted on behalf of AllianceBernstein by Opinium research, with over 1,000 individuals aged 40 and over who are actively saving into Defined Contribution (DC) pension schemes. This follows the announcement, at Budget 2014, that all restrictions on how individuals aged 55 and over can access their DC pensions will be lifted from April 2015 onwards.[1]

The research finds that individuals’ intentions around their DC pensions are characterised by high levels of uncertainty around two important factors that will have implications for the management of their pension savings in the run up to, and into, retirement:

- uncertainty around when they might retire, with 54% indicating that they might know vaguely, within a few years on either side, when they will retire, while 23% say they have no idea;
- uncertainty around how they will access their pension savings - at the time of survey, only 22% of respondents thought they knew how they would use their pension pot.

In addition the vast majority (87%) of respondents indicated that it was important to have flexibility around how they use their pensions funds.

This highlights the risks of making strong assumptions about precisely when individuals might retire and how they might access their DC savings. It also suggests that, even if active engagement with savers could be achieved, many individuals will not be in a position to make clear choices about timing and investments ahead of their retirement. The introduction of the new flexibilities from April 2015 onwards makes it less likely that individuals will purchase an annuity at the start of their retirement, and so makes these choices even more uncertain.

The findings of the survey suggest that, for a large majority of individuals invested in the default strategy in the run up to retirement (generally over three quarters of DC savers and much higher under automatic enrolment) this should be managed in a flexible way so that it is robust enough to manage this uncertainty and can accommodate a wide range of possible choices at, and into, retirement.

Background

At Budget 2014, the Chancellor announced the Government’s intention to remove any limits on the amount that individuals can withdraw from their DC pensions from age 55 onwards. The draft Taxation of Pensions Bill, designed to legislate for these changes, was published in August 2014 and is currently being debated in parliament.

These changes represent a radical change in the landscape for those approaching retirement with DC pensions. Ahead of these changes, three quarters of individuals retiring with DC pension savings used these to purchase an annuity[2] while the remainder either accessed their pension pot using income drawdown products or used the existing trivial commutation rules to access their savings as a lump sum.

As this was the case, many pension providers and asset managers used defaults of lifestyle strategies or target date funds. These generally place funds in higher-risk assets, such as equities, when individuals are younger and move them into assets such as corporate bonds, government bonds and cash, that are less risky, to protect an individual’s savings as they approach retirement. The default strategies had generally been managed, at least until recently, on the basis that the majority of individuals will withdraw the 25% tax-free lump sum and use the remainder to purchase an annuity. There are some similarities and differences between lifestyle strategy and target date funds, that are summarised in Chart 1.

Overall, the Budget changes,

by introducing more choice for savers, are expected to increase uncertainty amongst employers, trustees and providers around:

- **How the individual plans to use their DC savings in retirement** (the amount that they wish to withdraw at different stages, how they invest the remaining funds)
- **When they plan to retire** (as there are no longer any limits on how they access their DC savings from age 55)

Chart 1: Life style strategies versus target date funds

Sources sometimes refer interchangeably to lifestyle strategy and target date funds. However, there are the following similarities and differences between these funds:

Similarities

- Both place funds in higher-risk assets when individuals are younger and move these into less risky assets as they approach retirement
- Both types are managed with a retirement date or retirement window in mind
- Both types have assumed, at least until recently, that individuals will withdraw a 25% tax-free lump sum and purchase a level annuity

Differences

- Target date funds are overseen by professional fund managers who can make changes to both the strategic and tactical asset allocation in the event of changes to the markets or regulatory framework. In contrast, lifestyle strategy funds are generally pre-programmed to place funds in lower-risk assets as individuals approach retirement, and only change this approach at the discretion of trustees and pension providers
- Target date funds operate to a broad retirement window (e.g. 2032-34 fund) in contrast to lifestyle strategies that target a specific day, often linked to a birthday
- Target date funds can continue to pro-actively manage members' assets beyond their retirement date in contrast to lifestyle strategy funds that tend to 'set and forget' after reaching the assumed retirement date

From April 2015 a system will be in place where the wide use of defaults and inertia during the accumulation phase contrasts with the freedoms that individuals can now exercise when accessing their pension savings from age 55 onwards. This is likely to bring about challenges in that many individuals who have not been expected to make decisions around their pensions during the accumulation phase will be required to make complex decisions around how they should access their retirement income, unless appropriate default strategies into and through retirement can be designed.

Under the new flexibilities, it is expected that a much smaller proportion of DC savers will use their savings to purchase an annuity. While estimates around the level of take-up of annuities after April 2015 vary, many pension providers and other commentators have questioned the use of mechanistic lifestyle default strategies, in a system where it cannot be assumed that DC pension saving will culminate in the purchase of an annuity at a set date (e.g. age 65).

With the majority of savers likely to remain in default strategies, the pensions industry will face the challenge of managing them to accommodate these new flexibilities and uncertainties in a robust manner that is in line with the expectations of savers.

The DWP's guidance for qualifying schemes' default investment funds in DC schemes under automatic enrolment recommended that any pension scheme's default should take account of the characteristics and needs of those employees who would be automatically enrolled and should be put in place on the basis that those employees would not be engaged in making financial decisions.[3] As a result, the investment strategies of many DC pension schemes have already been reviewed during the past 5 years to take this into account. However, a recent survey of DC pension professionals, including trustees, found that 66% were looking to change their default strategy within the next 18 months, while 52% were planning to implement new retirement solutions following the removal of compulsory annuitisation.[4]

Research with DC pension savers

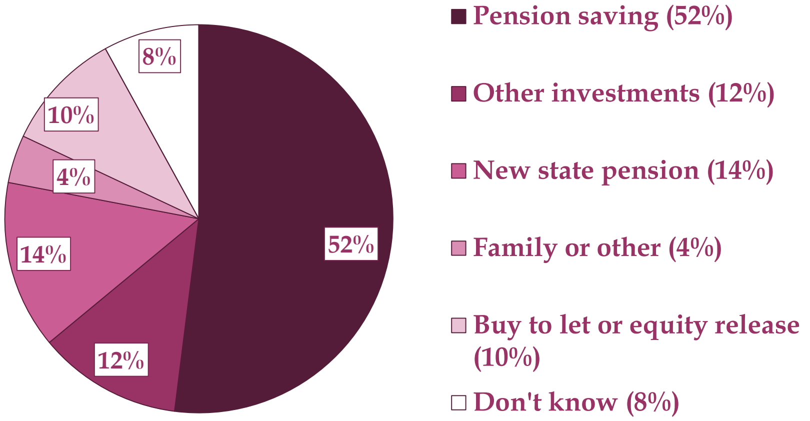
This briefing note draws on the results of an on-line survey conducted by Opinium research on behalf of AllianceBernstein. The survey was conducted with 1,003 active members of workplace and personal DC pensions aged 40 and over. The data was collected between 31 July and 4

August 2014.

Pensions are likely to remain an important source of income

52% of respondents expect pensions to be their main source of income in retirement while 14% and 12% expect their main source of income to be the state pension and other investments (including cash saving and property investment) respectively.[5] Chart 2 provides a breakdown of sources estimated to be the main source of income by respondents. Individuals for whom private pension income is not the *main* source of income may still have some private pension income. This highlights the importance of managing pension income effectively, with over half relying heavily on good outcomes from their pension savings.

Chart 2: Income from pension saving and the new state pension are most frequently estimated to be the main source of income in retirement



As expected, respondents expected to have a wide range of total pension pot sizes (excluding the state pension) at retirement: while 16% expected their pots to be worth less than £30,000 at retirement, 20% expected their pots to be worth more than £250,000. Women expected to have smaller pots, on average, than men; the mean expected value of total pension pots was £149,499 for men and £100,119 for women.

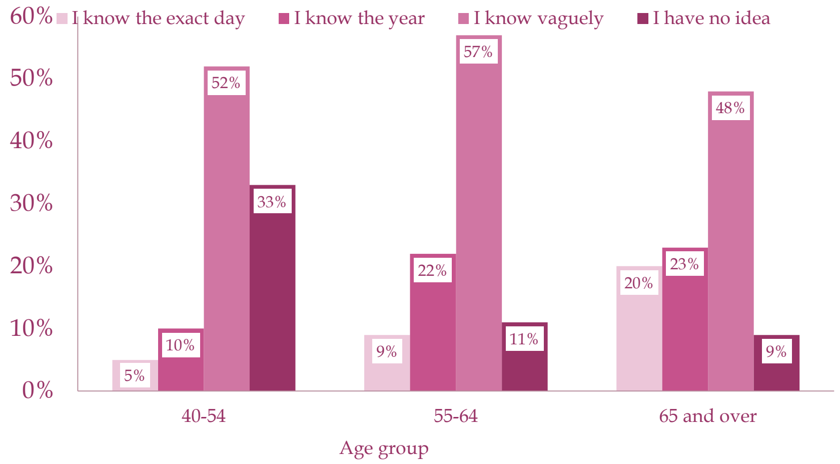
These amounts are high relative to average pension pot size for the population overall; in 2013, the mean annuity was bought with a pension fund of around £35,600 while the median annuity was purchased with a fund of £20,000.[6] However, individuals may have taken 25% of their pension pots as a tax-free lump sum prior to purchasing an annuity, meaning that their total pension pots may be a third larger than the annuity purchased. In addition, the amount estimated by respondents in this survey is the expected value of all of their pension pots combined, at retirement, while the mean annuity figure of £35,600, in 2013, may have been based on annuities purchased with only one pension pot. Finally, in this survey, individuals were asked to estimate the value of their pension pots at retirement and, therefore, may have included some level of investment return that they might expect to accrue by their retirement date. These factors may explain at least some of the difference between the responses that individuals have given as the anticipated value of their pension pots and the mean annuity that is currently purchased.

75% of individuals in this sample reported having more than one pension pot. The largest group of respondents, 61%, reported having 2 to 3 pension pots, with only 2% having more than 5 pension pots. This is high relative to other reports; for example, research conducted in 2012 found that, of those individuals aged 50 to 59, around two thirds of individuals with a DC pension pot had only one DC pension pot.[7]

Some of the pots described may, in fact, be DB pension schemes with, for example,

Chart 3: In all age groups, the largest group say they know vaguely when they will retire*

What retirement date have in mind for their retirement



Figures for those individuals aged 65 and over are based on a small sample of 56

some respondents using a DC pension pot to supplement their DB pension, which is expected to be their main source of income. This could have implications for how they wish to use their DC pension pot—for example, they may be happy to invest their DC pot in more risky investments or take it in cash at retirement. This highlights the risk of making strong assumptions around how individuals wish to use a DC pot in isolation from their wider circumstances.

Individuals are unsure about exactly when they will retire and how they will use their pension savings

The biggest group (54%) know vaguely, within a few years on either side, when they will retire, while 23% have no idea. Only 16% know the year and 8% know the exact day when they will retire.

For even those aged 55-64, who would traditionally be seen as approaching retirement, only 9% thought they knew the exact day and 22% know the year (but not the exact date) they will retire. 57% thought they knew vaguely when they will retire while 11% had no idea. Chart 3 shows how respondents in different age groups have responded.

Even where individuals indicate that they know when they will retire, subsequent changes in circumstances or their preferences may mean that they do not retire on this date; for example, health issues may mean that they retire sooner than predicted while insufficient pension savings may lead to them delaying the date of their retirement. Further research, for example using the English Longitudinal Study of Ageing, (ELSA), could explore the consistency between the expectations of those approaching retirement and their behaviour in practice.

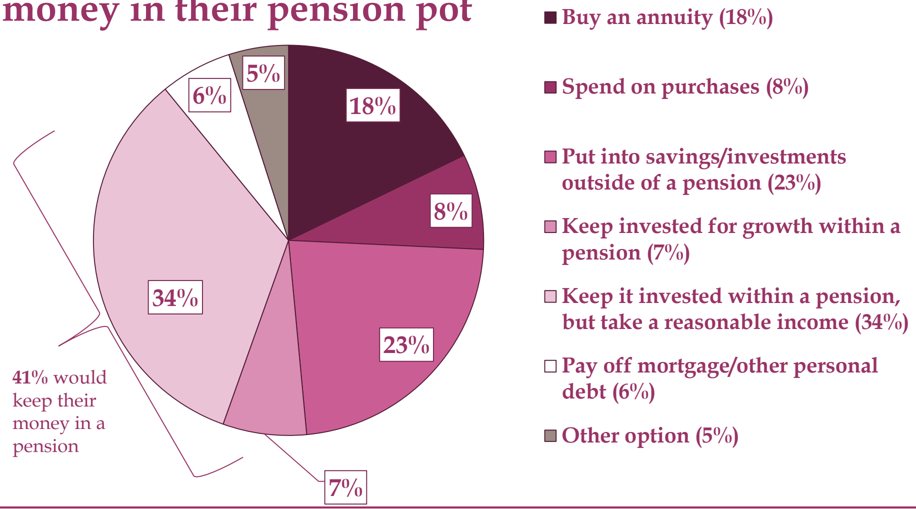
These findings should be considered in the context of an increase in the number of individuals working later; the employment rate for people aged 65 and over increased from 5% in 2001 to almost 10% in 2013. Two thirds of those individuals aged 65 and over in employment are working part-time.[8] These are likely to be on-going trends.

This suggests that the use of default lifestyle strategies with a pre-programmed retirement date may not best meet individuals' needs. It also highlights the risks of making strong assumptions about precisely when individuals plan to retire and might start to access their DC savings. With over three quarters of DC savers remaining in the default during the accumulation phase, and much higher levels in some automatic enrolment schemes (for example, over 99% of savers have remained in the default in NEST),[9] it is important that it is managed in a way that is robust to the wide range of possibilities now open to savers at retirement.

This is supported by the fact that in the survey over three quarters of respondents (78%) believed it was important that their investments would be managed to pro-

Chart 4: 41% of respondents plan to keep the majority of their money invested in a pension

What respondents intend to do with the majority of money in their pension pot



vide them with flexibility around their retirement date.

Individuals believe that it is important to have flexibility around how they use their funds

An even higher proportion, 87% of respondents, indicated that it was important or very important to have flexibility around how they use their funds and that their pension investments are invested to allow for this.

In addition, only 22% of respondents thought they knew how they would use their pension pot, with the proportion increasing with age—while 26% of individuals aged 55 to 64 thought they knew, this proportion increased to around half for individuals aged 65 and over.[10]

This suggests that, even those individuals who are of an age where they would traditionally draw down their pension funds may not yet know how they are going to do it.

This highlights the importance of maintaining flexibility, particularly during the de-risking phase (the period during which funds have traditionally been placed in less risky assets as an individual approaches an expected retirement age) and not locking in too early to a set path or objective—the assumption of a glide-path with 25% cash and 75% annuity hedging is far less likely to be appropriate for those approaching retirement from April 2015.

There may be a role for an extension of the default strategy that allows individuals to draw down part of their pension savings while they decide how they might use the remainder—for instance, they may eventually decide to purchase an annuity at a later age, such as age 75. Rather than their savings be left to plateau after a set expected retirement date it may also be more appropriate to continue to manage their investments and maintain some degree of risk in their asset mix.

Of those individuals who have decided, there appears to be a strong appetite for retaining the majority of their DC savings in a pensions wrapper

Of those respondents who have decided how to use their pension pot, 41% expect to keep it invested within a pension. Of this group, 83% (34% of those who have decided how they will use their pension pot) expect to take a reasonable income while keeping it invested. In addition, 23% expect to put this money into savings and investments outside a pension. In contrast, only 18% plan to use their pension pot to purchase an annuity. Chart 4 shows how individuals say they expect to use their pension pot.

Under the current rules around the bequest of pensions, inherited pensions are tax-free if the fund-holder dies under the age of 75 without taking any savings out as a lump sum or income draw-down (this does not apply to annuities). In this way, the current rules may incentivise individuals to leave their pension savings untouched until the age of 75, if they can afford to do so.

Overall, individuals with smaller pots say they are more likely to spend their pension pot on purchases while those with larger pots are more likely to say they will keep it invested.[11] This situation is consistent with the current inheritance rules under which there are incentives to leave pension savings untouched until the age of 75 (although this may not be the rationale for these individuals choosing to keep pension savings invested).

The Chancellor's announcement on 30 September 2014[12] around changes to the taxation of bequests of pension pots, provided that these are not annuitised, means that there is no longer an incentive to leave pension savings untouched. As things currently stand, the beneficiary can pay 55% tax on the pension that they inherit if the fund-holder dies under the age of 75 and has taken money out of the pot, or they die over the age of 75.

Under these proposals where the fund-holder dies under the age of 75 inherited pensions are tax-free. Where an individual dies over the age of 75, beneficiaries are able to access the pension funds flexibly and pay tax at their marginal rate of income tax. The extent to which this changes behaviour will reflect the extent to which the previous rules were incentivising those individuals aged under 75 to leave their savings untouched.

All of the above highlights the potential demand among savers for prudent drawdown strategies that will allow individuals to start drawing down a pension income from their DC savings without fully committing to an annuity or a final course of action.

These responses suggest that, in contrast with the purchase of an annuity, many individuals are likely to continue to benefit from investment growth on their assets and interest on their savings beyond retirement. In this way, the new rules provide an opportunity for retirement assets to be managed in a way that delivers higher rates of return than (on average) might have been experienced from an annuity. However, savers will also face the risk of their assets being adversely affected by market downturns.

In particular, with 23% planning to put the majority of their pension saving into another saving or investment vehicle there is also a risk of potential consumer detriment, for example:

- If savings are placed in very low return investments;
- If savings are placed in excessively risky investments not designed to generate a stable source of income;
- If savings are placed in products with higher charges and advice costs;
- If individuals draw down their pension assets too rapidly (for example because they underestimate their life expectancy), prematurely exhausting their pension pots, or do not draw down their funds for fear of running out of capital.

The level of scrutiny and governance around how savers are using their DC pensions beyond retirement is likely to increase as a result of the Budget 2014 changes with a wider and less familiar range of options available to them.

Challenges around understanding of pensions and saver engagement

Decisions around pensions are notoriously complex, and the new pension flexibilities announced in the 2014 Budget are expected to make them more complex. At the same time, there is widespread recognition that there are varying levels of understanding around pensions within the UK population, with poor financial skills being prevalent.[13]

This survey found that just under half of respondents, 46%, understood how the changes in the UK DC pensions rules, due to come into effect in April 2015, will affect them. However, this does not guarantee that their understanding is correct, or that they understand all aspects of the changes.

A slightly larger proportion, 48%, were aware that the rules were going to change but had not yet considered how the changes might affect them while a very low proportion, 6%, did not know that the rules are going to change.

A larger proportion, 63%, of those individuals expecting to retire in the next 12 months were aware of how the rules would affect them with no-one within this group being unaware of the changes.[13]

In addition, those individuals who expected to receive larger pension pots on retirement were more likely to be aware of how the new pension rules will affect them—68% of those with pension pots estimated to be worth over £250,000 were aware of how the rules will affect them compared to 38% of those with pension pots estimated to be worth less then £30,000. This may be because those individuals with higher levels of wealth are more likely to have a financial advisor who has made them aware of these changes.

Those individuals with pension pots expected to be worth £30,000 are likely to have more restricted choices and less access to financial advice around their pensions. Therefore, it is likely that any guidance provided to individuals as part of the new pension flexibilities will be one of the principle sources of information available to individuals with smaller pots that explain the options available to them.

Chart 5: Respondents tended to over- estimate the index-linked annuity that a £50,000 pension pot would purchase

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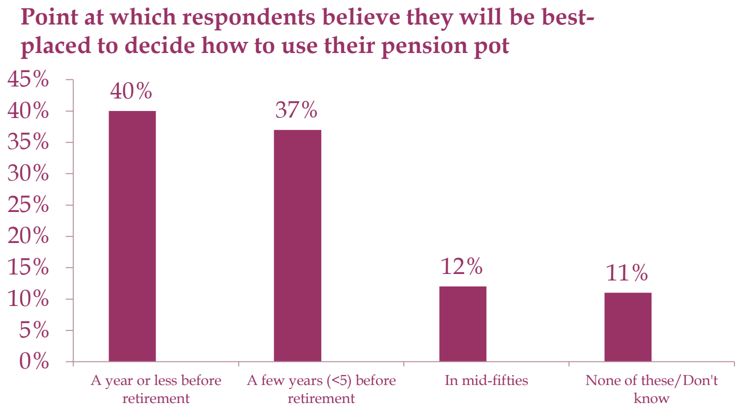
In order to measure respondents' understanding around the annuities market as one component of retirement income provision and as a way to benchmark potential returns from pension saving, respondents were asked what level of index-linked annuity a £50,000 DC pension pot would purchase. Around 20% opted for the response nearest to the amount that this pot could purchase, £1,500, while 43% overestimated the amount, 7% underestimated this and 29% were unwilling even to hazard a guess.

This highlights the fact that, despite the high profile of the Budget changes in the national press, the majority of savers may be unware of the new flexibilities, and the majority will struggle to benchmark what income they might be able to receive from their DC savings, whether from an annuity, drawdown, or other sources.

The Government believes that the provision of financial guidance is important in enabling individuals to navigate the changes announced in the 2014 Budget and has announced its plans for guaranteed free and impartial guidance to enable individuals to navigate their new pension choices, known as the 'Guidance guarantee'. The Government has indicated that any guidance should be provided by independent organisations such as The Pensions Advisory Service (TPAS) and Citizens Advice. However, a pilot of pensions guidance has found take-up of just 2.5%.[14]

This re-enforces the expectation that—as with the accumulation stage—there will be a substantial group of individuals who do not wish to engage in decision-

Chart 6: The largest group think they will be best-placed to make the decision about how to use their pension pot less than a year before retirement



making around their retirement provision. This group's pension savings are likely to be invested in a default strategy and it is important that it is sufficiently flexible to meet their needs.

In terms of when they might make a decision around how they will use their pension pot, the largest group, 40%, indicated that this might be during the year approaching retirement while 37% indicated a few years before retirement—responses are shown in Chart 6.

This may represent an additional challenge for those responsible for designing the default strategy where an appropriate strategy would frequently be selected many years before an individual's retirement date, particularly where individuals do not know when they will retire. Again, this suggests that, in respect of the default strategy, these should be sufficiently robust and flexible to meet their needs.

The PPI is grateful to AllianceBernstein for sharing the results of this consumer survey.

The PPI is currently undertaking a research series on *Transitions to Retirement* which will explore the complexity of decision making for savers in Defined Contribution (DC) pension schemes at retirement, the scope for innovation in developing flexible retirement income solutions in the UK, and the implications of the new Budget freedoms for providing defaults and improving member engagement and communications. The first report in this series will be published in November 2014.

1 H M Treasury (2014) *Freedom and choice in pensions*
2 *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/301563/Pensions_fact_sheet_v8.pdf*
3 DWP (2011) Guidance for offering a default option for defined contribution automatic enrolment pension schemes
4 SEI (2014) *Defined Contribution Survey July 2014*
5 This figure may include some respondents who expect their DB pensions to be their main source of income in retirement
6 ABI (2014) *The UK Annuity Market: Facts and Figures*
7 IFS (2012) *Fund holdings in defined contribution pensions*
8 DWP (2013) *Older Workers Statistical Information Booklet*
9 http://www.professionalpensions.com/professional-pensions/news/2285398/nest-99-of-members-in-default-fund
10 These findings are based on a small sample size and should be treated as indicative
11 These findings are based on a small sample size and should be treated as indicative
13 https://www.gov.uk/government/news/chancellor-abolishes-55-tax-on-pension-funds-at-death
12 MAS (2014)
13These findings are based on a small sample size and should be treated as indicative
14 http://www.moneymarketing.co.uk/2015140.article?cmpid=pmalert_590745

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