

Investment Association response to the FCA's 'Retirement income market study: Interim Report'



30th January 2015

General comments

1. The Investment Association¹ is a long-standing supporter of greater flexibility in the provision of retirement income, allowing pension savers access to the right product at the right time in their lives. We are committed to working with the Government and the FCA to ensure that the 'freedom and choice' reforms are a success for pension savers.
2. We are neither an inherent advocate of drawdown nor a critic of annuity products. For many people, some form of annuitisation at some point in retirement is likely to be desirable. Equally, there is considerable scope for investment products, such as income funds or income drawdown, to support retirement income provision in a more widespread manner. The previous policy environment did not allow for such diversity.
3. Indeed, we believe that annuitisation and investment products, while both being ways of turning a DC pension pot into an income stream, serve different purposes. Annuities should be properly seen as providing longevity insurance while investment products provide an exposure to growth and income assets, giving individuals the opportunity to earn returns not available to them via traditional insurance products. In neither approach is it possible to fully eliminate risk – instead different risks are borne by the member with the choice of product representing a trade-off between these risks.
4. Investment products will expose members to investment risk and the risk of exhausting their fund if withdrawals are not made in a sustainable manner. However, when they come with a reasonable exposure to growth assets they may provide better protection against inflation risk² and possibly allow for a higher income than an annuity.
5. Annuities, on the other hand, provide protection against outliving one's savings and provide a secure and guaranteed income. However, on current behaviour, where most annuities sold in the UK are nominal, there is no inflation protection³ and even though the FCA's work has shown that annuities remain good value when measured on a 'Money's Worth' basis⁴, the inevitable consequence of falling long term interest rates and unanticipated increases in longevity is the low rates that have been seen in the annuities market for a number of years now.

¹ The Investment Association represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5 trillion of assets in the UK on behalf of domestic and overseas investors.

² Of course this will depend on the investment strategy followed; but any sensible retirement income investment strategy will have a reasonable allocation to assets that are more likely to provide protection against inflation than the standard fixed income portfolios backing annuity contracts.

³ It is of course possible to purchase inflation-linked annuities but these are more expensive and for reasons unknown, not as popular with consumers.

⁴ FCA Occasional Paper No. 5, 'The value for money of annuities and other retirement income strategies in the UK', December 2014.

6. Low annuity rates are particularly apparent at the ages where they are most typically purchased – ages 60 and 65. At such young ages, where the likelihood of living for many more years is still high, a product that insures against outliving savings is predictably expensive. Annuities would be far better employed later in life, when their value in providing longevity insurance is higher.
7. The real benefit of the pension freedoms is that there is no longer a binary choice between investment and insurance products, as was effectively the case under the pre-Budget 2014 arrangements. The new environment allows for sensible combinations of these classes of products which allow individuals to shape their retirement income in the way that is best for them. We believe there is a space for both investment and insurance products within a good retirement income strategy. The key is to make sure that individuals purchase the right product at the right time.

Comparing annuities and drawdown

8. As set out above, we do not see annuities and drawdown as competing products, but as complementary ones. Indeed, the debate has long since moved on from being about whether individuals should drawdown or annuitise. Increasing longevity has challenged conventional assumptions about the optimal age to annuitise and the best age to purchase an annuity is now up for debate. What is clear is that the benefits of risk-pooling are not realised until later in life – and certainly not at the ages of 60 and 65, when the majority of annuities are currently purchased.
9. This in turn leads to the question of how to turn a DC pot into a sustainable retirement income. Some important analysis in this regard was set out in a 2009 research [paper](#) by Maurer and Somova⁵, published by the European Fund and Asset Management Association (EFAMA), which demonstrated that the optimal retirement income strategy at age 65 would for many people involve holding a proportion of pension assets in equities early in retirement and switching to bond holdings and annuities progressively over time. Relative to annuitising fully at age 65 individuals following this optimal retirement income strategy can expect to achieve a significantly higher retirement income, at a comparatively low risk.
10. We have also conducted our own [research](#), published in 2008, looking at the question of sustainable drawdown, including the calculation of the Money's Worth of annuities and drawdown⁶ under different withdrawal strategies. This work demonstrated that drawdown had considerable scope to provide good returns to pension savers. Where there are risks involved in drawdown – particularly where fixed monetary withdrawals are made – it is possible to construct withdrawal

⁵ *'Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees?'* Raimond Maurer and Barbara Somova, 2009, published by EFAMA.

⁶ For income drawdown strategies, our research used a Money's Worth calculation to estimate the likely return per £1 of the original pension pot that would be received in retirement, when compared with the risk free rate. In this way, Money's Worth, rather than being a measure of the value for money available from a drawdown product, is instead used as a way of illustrating the potential return in an income drawdown strategy. A value greater than one, as we frequently find when modelling returns in income drawdown strategies measures a likely return compared to the risk free rate as a proportion of the original premium.

strategies that are sustainable and provide stable income streams. Indeed, we believe that sustainable withdrawal rates can be embedded within drawdown strategies to avoid putting the onus on individuals to make difficult decisions about how much money to withdraw.

11. One of the perceived risks of drawdown is that individuals can exhaust the fund and run out of money. There are two points to make here. Firstly, that it is perfectly possible to create a withdrawal strategy that, by construction, avoids an individual exhausting their pot. It is fixed monetary withdrawals that pose a far greater risk, as our 2008 paper shows. Secondly, that DC pension entitlements must be seen in the context of other resources available to individuals to fund their retirement. Many will have access to other DC or DB entitlements and other sources of income, including the State Pension and access to means-tested benefits. These State entitlements ensure that it is impossible for anyone to 'run out of money'.
12. We read with interest the FCA's recent analysis⁷ on the value for money of annuities and other retirement income products. While we recognise that drawdown will not be suitable for everyone, particularly those with strong loss aversion and low capacity to absorb investment losses, we believe that the comparisons between drawdown and annuitisation in the FCA's work are made on the basis of stylized assumptions about asset allocation that are not representative of how a drawdown product would work in practice.
13. Buying an annuity is akin to investing in bonds since the rate received at least partially reflects the underlying portfolio used by the insurer to back the annuity contract. That being the case, investing in risk-free assets and then drawing down offers no better return than an annuity, but without the longevity insurance. Such a strategy would make little sense in investment terms. At the other extreme, a 100% equity strategy is clearly too risky for drawdown, since some volatility and risk management is required given individuals' limited capacity to bear capital losses at that stage of the lifecycle. Our 2008 research shows that multi-asset solutions are possible and represent a trade-off between risk and return that are appropriate for the purposes of a drawdown solution.
14. Performance/outcomes are one element needed to compare the value for money of drawdown and annuities. The other element is cost. But comparisons between the two products on the grounds of cost are fraught with difficulties because it is not clear what the cost of an annuity is. In drawdown, the product charges are known ex-ante and will be captured in an Ongoing Charges Figure or pension account equivalent. However, the price of an annuity is implicit in the rate quoted to consumers. While the annuity rate provides a clear product outcome to the consumer, it does not represent the real economic cost of the product – the payment stream is not the price.
15. While Money's Worth is a helpful measure in assessing overall value for money in the case of an annuity, the difficulty in quantifying the uncertainty inherent in drawdown means that it is not possible to interpret the Money's Worth figure in quite the same

⁷ See footnote 4.

way for drawdown. Although our own research did quantify comparative Money's Worth figures, we recognise that these do not provide like-for-like value for money metrics. We would therefore be very keen to work with regulators and industry to develop measures that allow for better comparisons between annuities and drawdown.

The future market for drawdown

16. Behavioural Economics has provided a large evidence base on the importance of defaults and more recent research⁸, specifically in the context of the 'freedom and choice' reforms, has underscored the importance of default arrangements in the decumulation phase. For many, a default based on a combination of investing through retirement and annuitising will be the optimal solution, although it is not yet clear what appetite there is among pension schemes for offering a default.
17. Such defaults will necessarily be simplified, non-advised offerings and should have appropriate withdrawal rates embedded within the strategy, thereby protecting individuals from running down their fund too quickly (and indeed from not drawing down enough). We may see different funds with varying risk levels and withdrawal rates to suit differing circumstances. For the non-default portion of the market, the choice architecture around drawdown products will be of vital importance.
18. We agree with the FCA's view that opaque charge structures in retirement income products are undesirable. The work on enhanced transparency of investment charges and transaction costs currently taking place should equally apply to drawdown products. As we have emphasised, consistency of terminology and methodology is essential. In particular, the focus on the Ongoing Charges Figure (OCF) is a key component to ensure comparability of investment charges. We will shortly be issuing a position paper on transaction costs and investment charge disclosure that sets out our view of a disclosure framework that could be used to apply to any investment product, including drawdown.

Regulatory treatment of annuities and drawdown

19. The inherent attraction of annuities for regulators and policymakers is understandable given the guarantee of pay out regardless of market conditions and their efficiency as a means to pool mortality risk. The latter is a particularly important consideration later in retirement, both from an individual and public policy perspective. Allied to the expectation of little active consumer engagement and the tendency of scheme members to remain in default arrangements once enrolled, it appeared that the tendency to buy a level annuity was seen as an acceptable default.
20. We believe that in the new retirement income market, this tacit view of annuities as the default needs to change. Annuities, like drawdown products, are not riskless – as discussed above, they come with a different set of risks. For alternative products to gain legitimacy, it is important that regulation ensures all retirement income products

⁸ 'Supporting DC members with defaults and choices up to, and through retirement', Pensions Policy Institute, January 2015.

are treated equally and that the industry and the FCA are clear about the risks and benefits of all product types. Unless industry, policymakers and regulators move away from a view of one product type as a default, it is unlikely that pension savers will benefit from a flourishing retirement income market.

Responses to FCA proposals

1. We propose to require firms to make it clear to consumers how their quote compares relative to other providers operating on the open market.

Please set out your views on:

1A: Whether the proposal could contribute to addressing the concerns we have identified?

1B: How could the proposal be best implemented, and/or how could practical issues be resolved?

1C: What information could be feasibly provided over the phone and in writing?

1D: How the proposal could be applied to other retirement income products, for example income drawdown?

21. We recognise that the FCA's Retirement Income Market Study was originally focussed on the annuities market, before being widened in the wake of the 'freedom and choice' reforms to consider other retirement income products. However, the risk here of focussing on annuity quotes is that annuities will continue to be seen as the default. Equally, we recognise above the difficulty of comparing the costs of annuities and drawdown and we would re-iterate our offer to work with the FCA to help develop a framework for comparing the two.

22. As far as comparing the costs of drawdown products are concerned, our forthcoming paper on disclosure of investment charges and transaction costs will set out our view of a meaningful and consistent disclosure framework that could be applied to any investment product, including income drawdown, and which would facilitate comparison between those different products.

2. We recommend to both the pensions guidance service and firms to take into account framing effects and other biases when designing tools to support consumer decision-making.

Please set out your views on:

2A: Whether the proposal could contribute to addressing the concerns we have identified?

2B: How the proposal could be best implemented, and/or how could practical issues be resolved?

2C: How the proposal could be applied to UFPLS or other products?

23. We welcome the emphasis on Behavioural Economics, in particular the potential for a variety of techniques to be used, moving beyond the 'nudge' approach that

characterises (successfully) auto-enrolment. In this regard, the complex nature of retirement income choices does present a significant challenge. For example, the FCA paper looks at possible ways to frame an annuity decision (Figure 36) by simplifying one dimension: the income certainty. However, there is still the issue of how to take into account the effects of future inflation on consumption. Clearly, there is much more for regulators and industry to do in this area.

3. We will work with Government to develop an alternative to the current wakeup pack. Behavioural trialling of the wake-up pack would allow us to assess the impact on consumers' awareness of their right to shop around, and the number of people who exercise their open market option. We would like to hear from any firms that are interested in assisting us with this process.

3A: What should the proposed content of future at-retirement communications be?

3B: Whether there is any other significant information that should be included in these communications? If so, please state the information required and why it should be included.

3C: Which aspects (if any) of the ABI Code we might consider incorporating into our rules in the pensions and retirement area? Please set out any additional measures that are not currently in the ABI Code that should be incorporated into our rules.

24. At-retirement literature will need to evolve to reflect both a much more diverse retirement income market and ensure that individuals understand the consequences of moving significant pension capital outside of the pension system (i.e. income tax liabilities). It will need to strike the right balance between providing preliminary information and signposting to sources of additional support and/or more detailed information. A central challenge is going to be the timing of such communications and how this interfaces with the availability of the Guidance Guarantee. We firmly believe that the Guidance Guarantee should neither be a one-off point in time entitlement nor be based on individual pension accounts. Instead, it should develop to support what may be decision-making across an extended period of time. In practical terms, the Pensions Dashboard (as per below) may emerge as a crucial part of the tool kit.

4. In the longer term, we recommend that a 'Pensions Dashboard' is created which:

- **can be accessed by UK consumers at any time through a personal log-in;**
- **sets out an individual's entitlements including all of their accumulated DC pension savings; and**
- **could be developed over time to allow consumers to view all of their other sources of retirement (such as DB and state pension entitlements) in one place.**

Please set out your views on:

4A: Whether the proposal could contribute to addressing the concerns we have identified?

4B: Whether, beyond those we have identified, you foresee any difficulties implementing this proposal?

4C: How this proposal should be implemented and by whom?

25. We strongly support the idea of a Pensions Dashboard, something that we articulated to the DWP as part of its work on automatic transfers of DC pension pots. Giving individuals access to all their different sources of retirement income, including State pension, in one place should aid decision making over how to access their DC pot(s). A holistic view of resources available for retirement should lead to superior outcomes for individuals.
26. While others will be better placed to comment on the technical practicalities of creating a Pensions Dashboard, our understanding is that a large centralised database is not necessarily required (or desirable for a variety of reasons). The technology exists for an online portal onto which the State and pension providers can connect to create individual records at a log-in point of time.

5. We will continue to monitor the market and are seeking views on whether there are any particular aspects (in addition to those set out below) that we should monitor.

Please set out your views on:

5A: The proposed monitoring activities set out above.

5B: Any additional aspects that we should consider monitoring.

27. The market will evolve over time. Product development lead times, combined with the evolution of savings behaviour and the maturing of the DC market, will necessarily see considerable change in the coming years. In this context, market monitoring is important, but we would emphasise the need to ensure a level playing field for retirement income products.