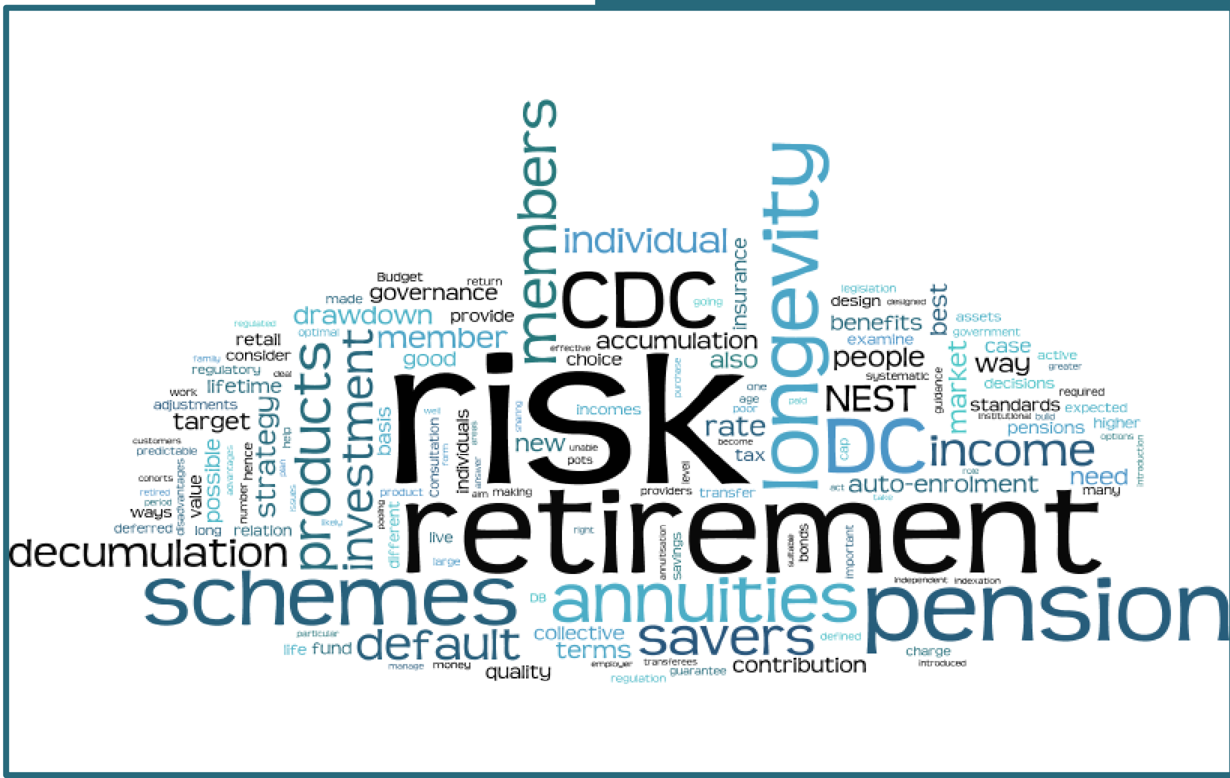
Independent Яeview of Retirement Income: Consultation



Edmund Cannon

March 2016

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Introduction

On 29 May 2014, Rachel Reeves MP, the Shadow Work and Pensions Secretary, launched an **Independent Review of Retirement Income** to look at how to boost defined contribution (DC) savers' retirement income. This review is led by Professor David Blake, Director of the Pensions Institute, with Professor Debbie Harrison of the Pensions Institute as a senior consultant.

A consultation document[1] was published on 24 November 2014 with a response deadline of 20 February 2015. David Blake invited me to summarise the responses to the consultation document which I do in this report.

I have tried to provide nothing but a summary and to avoid putting my own interpretation on the responses: obviously in summarising verbal questions, it is impossible to avoid some degree of interpretation.[2] Before being asked to take on this task I had submitted a response of my own (I was the only UK academic to do so): since then, I decided that in the interests of impartiality it would be better to withdraw that response. One of the responses explicitly questioned whether the Review was genuinely independent. I have written this summary without any input from David Blake and Debbie Harrison other than an initial discussion about presentation. My own preference for government policy to contain an element of compulsion is not relevant here as I take the new pension freedoms as given.[3]

A total of 30 responses were received from a variety of individuals and organisations, the largest single group consisting of ten insurance companies or pension providers, eleven consultants of various types and one lawyer. The following eight organisations also provided submissions: the 100 Group of Finance Directors (100 Group); AGE UK; the Association of Consulting Actuaries (ACA); the Confederation of British Industry (CBI), the Institute and Faculty of Actuaries (IFoA); the National Association of Pension Funds (NAPF); the Society of Pension Professionals (SPP); and the Trades Union Congress (TUC). Six of the respondents asked that their submissions be confidential (and some of the other respondents were ambiguous on this point) and for this reason I have not provided a breakdown of the other respondents in order to preserve anonymity. They are, however, gratefully acknowledged in the main report.

The consultation document consisted of 76 questions in five sections. Not every respondent answered every question and the total numbers of question-responses was 956. Relatively

[1] Blake and Harrison (2014) "Independent Review of Retirement Income: Consultation Paper", Pensions Institute, Cass Business School. Reproduced in Appendix A.

[2] In particular, not all respondents used the template provided, so I had to assign material to questions.

[3] As I say in the text: I decided to remove my submission from the summary to make it easier to be impartial. My submission is available on my website. The only important substantive point therein refers to my ongoing research on the marked for deferred annuities in the 1950s.

few responses were received to the final three sections on longevity risk, NEST and collective defined contribution schemes, but many more responses were received on the first two sections about how to ensure savers get the best products and supporting savers to make the right choices.

The consultation document contained an initial introduction and then some background and introductory material in each of the five sections (the full text is in the appendix). I have summarised the consultation document material in the main text of this report, while the questions are re-produced verbatim (paraphrases and material from the consultation document is in a blue font and the material that I have added is in a black font). Some of the respondents did not agree with all of the underlying assumptions in the consultation documents and I draw attention to that throughout the document.

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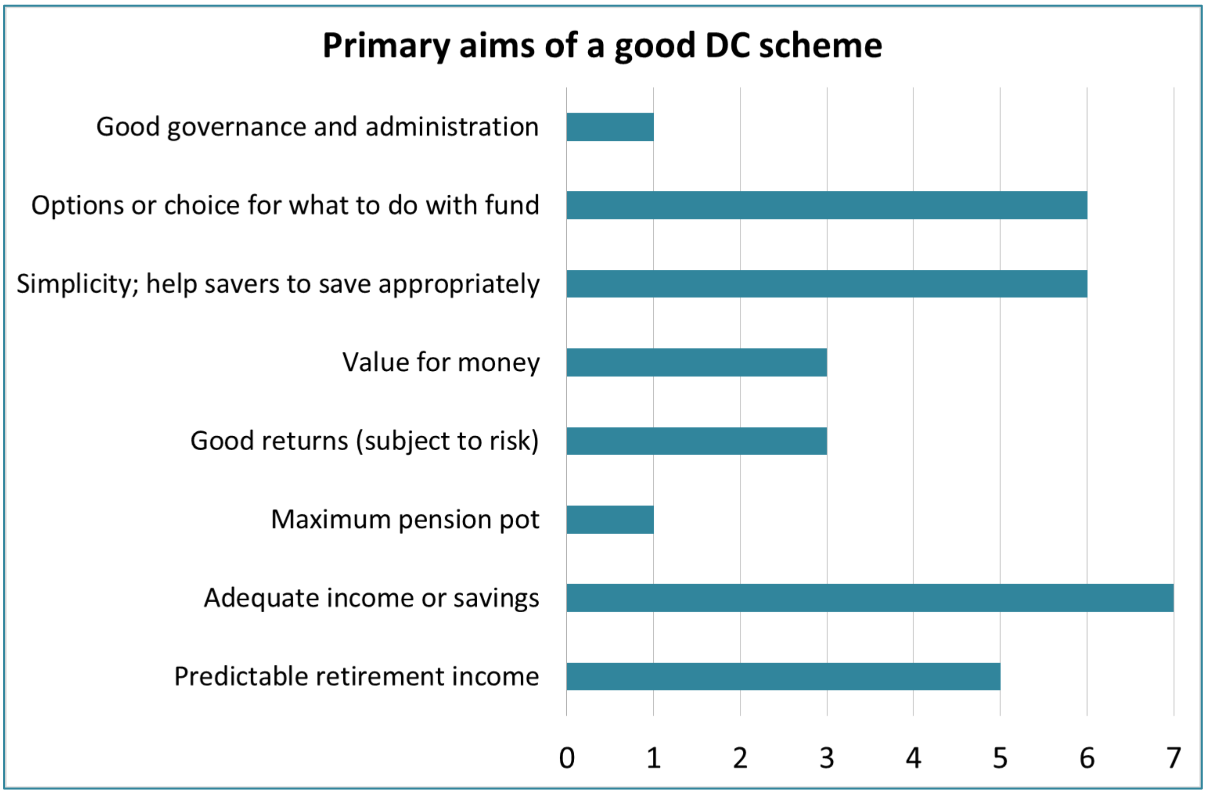
March 2016

1. How to ensure that savers can get the best products in retirement

The 2014 Budget removed the requirement to buy a lifetime annuity at retirement and opened up the possibility that new types of retirement product would become available. In this section the consultation document elicited responses on what new products would be suitable and what governance and quality standards would be appropriate for these products. In addition respondents were asked about how longevity insurance could be combined with scheme drawdown to ensure that savers do not run out of money before they die.

1. (a) What should be the primary aims of a 'good' DC scheme? Please explain.
(b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined?
(c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?

There were twenty-six responses to this question. There was considerable variety in the responses to parts (a) and the most common aims mentioned are summarised in the following figure (n.b. that some responses contained more than one aim).



One possible issue is whose aims are being considered, since the aims of employers might be different to those of the savers: from an employer's perspective, the primary aim is to ensure agreed contributions are made and ensure good governance of the savings scheme.

Thirty-one per cent of responses mentioned a pension income as being a primary aim of a DC scheme. In some cases this meant a predictable income:

> *"(Consultant) ... the purpose of a pension is to give someone a (predictable) income in retirement. It is an insurance product for which you save, not just a savings product. For those who will die with liquid assets, no matter how long they live, it is not very important. For others it is a vital service."*

However, in some cases, respondents noted explicitly that predictable income was the aim of DB rather than DC schemes:

> *"(SPP) By definition, a defined contribution scheme cannot provide a predictable income in the way that a defined benefit scheme can.*
>
> *We suggest that important elements of a good defined contribution scheme are efficient investment, with appropriate attention to risk and appropriate options for providing income at retirement."*

One respondent argued that this was due to changes in what was expected from or appropriate for a pension:

> *"(100 Group) ... given the fact that today's workforce is highly mobile, it seems questionable whether most employers are ever likely to want to sponsor schemes that will provide members with a predictable income in retirement. The days when employees accrued a full 2/3 pension in a single scheme sponsored by a single employer are gone (except perhaps in the public sector). The emphasis has to be on employees receiving appropriate and timely information (from employers, schemes, providers and Government) as well as being given the opportunity to access guidance and advice. This will assist them in taking the appropriate decisions over individual contribution levels, investment choices, retirement age and decumulation options to ensure the best outcome for their own individual circumstances."*

However, many respondents either implicitly or explicitly did not think that the distribution phase was an important component of a DC scheme, instead suggesting that a DC scheme was primarily a long-term savings vehicle directed towards retirement, for example:

> *"(Pension provider) A good DC scheme should aim to provide value for money for its members. We do not believe that providing solutions for the decumulation stage should be a key element of the scheme's aims, although the scheme should ensure that members have a route to access appropriate products and are adequately prompted to engage and receive the level of advice / guidance appropriate to their circumstance."*

Among the ways to increase the size of fund were maximising return (usually explicitly risk-adjusted) and engaging savers so that they made adequate contributions.

Twenty-three per cent of responses said that flexibility and choice were important, three of them explicitly saying that this was due to the heterogeneity of savers and their diverse needs.

"(Consultant) Research by the International Longevity Centre[4] *has found that there is no such thing as a typical 'older consumer' and that spending patterns in later life are really quite diverse."*

There were fourteen responses to 1(c). Thirty-six per cent referred to low charges and costs, although recognising that higher charges could be justified by better quality products. One response was quite specific on acceptable charges:

"(Lawyer) From a value for money perspective, the starting presumption is that the scheme's total expense ratio should be below 0.75% (in the absence of exceptional circumstances such as unanticipated costs from legislative change or in circumstances of winding-up)."

One response said that it was important for charges to be comparable, using a single metric analogous to the APR (suggesting the reduction-in-yield measure); alternatively another response suggested that there should be guidelines on fees for different products. Other responses provided vaguer measures or ones harder to measure such as maximising income, maximising return or efficiently moving income from the period when the saver was working to when retired. On the other hand, three responses thought that value for money was either so subjective or so difficult to measure (ex ante) that it was not a useful metric.

SUMMARY: Responses to this question were quite varied (and some respondents listed many desiderata while others noted just one). However, there was surprisingly little agreement amongst pension professionals about what the aims of a good DC pension scheme should be. With this important point in mind, three themes did stand out as being important. First, the level of pension savings should be adequate. Second, pension savers need choice and flexibility. Finally, pension savers needed simplicity to help them engage with the process.

2. (a) Do you agree with the breakdown of risks listed in the Introduction?

2. (b) Are there any important risks we have not identified?

Out of nineteen responses, 95 per cent agreed or largely agreed with the breakdown of risks. Four emphasised the risk that contributions could be too low. One response said that risks in the decumulation phase were not relevant (consistent with the view that a DC scheme is primarily a long-term savings vehicle as mentioned above), but another wanted to emphasise longevity risk.

[4] International Longevity Centre (2014) 'Financial wellbeing in later life' available from http://www.ilcuk.org.uk.

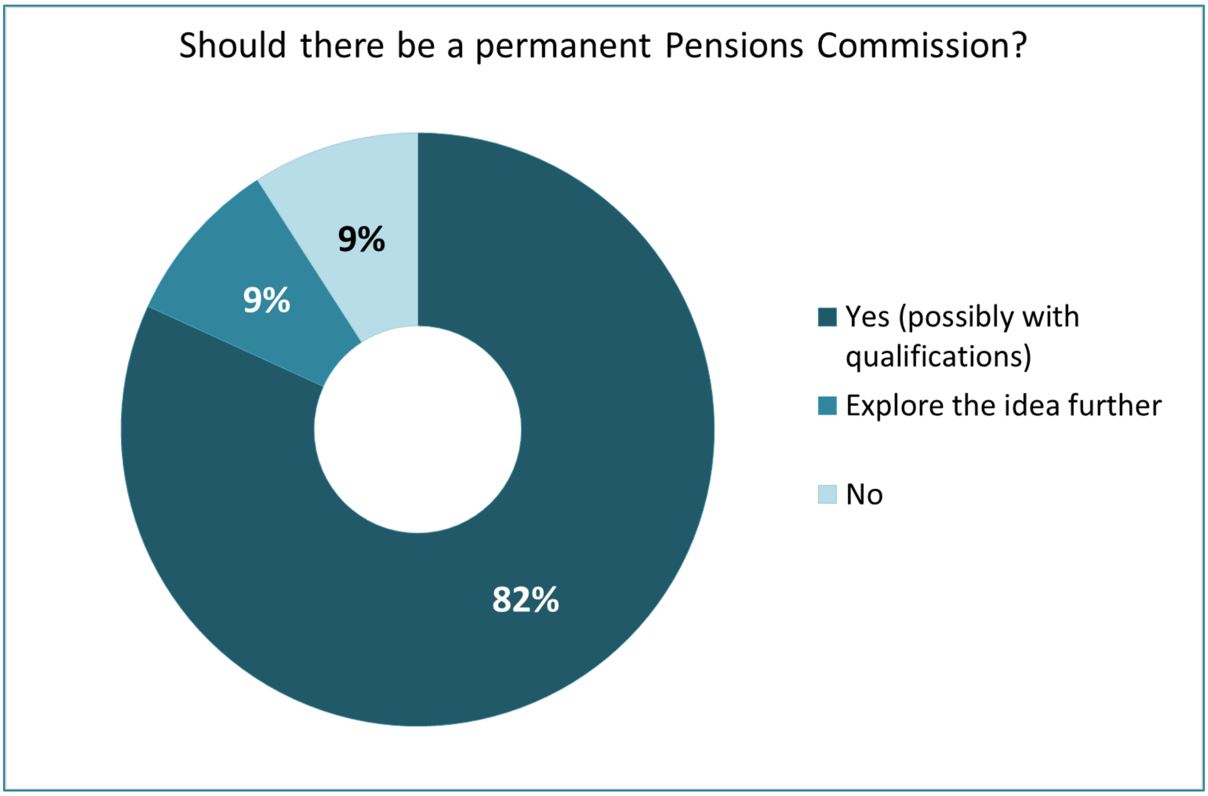
SUMMARY: Ninety-five per cent of respondents agreed or largely agreed with the breakdown of risks. Additional risks (or issues) were also mentioned: health and long-term care risk; risk via shocks to a partner or family; lack of engagement by savers; sequence of return risks and shocks; delays in realising that mistakes had been made and consequent delay in remedial action; the risk that regulation might stifle competition and raise costs. [5]

[5] For convenience, the risks are listed here:

- Contribution risk – The risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts
- Retirement timing risk – Uncertainty about when the scheme member will retire and/or begin to make withdrawals
- Product choice risk – Uncertainty about how the scheme member will make withdrawals, not least because of the very large set of choices now available
- Investment risk – The risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement. A particularly important example of investment risk is sequence-of-returns risk
- Inflation risk – The risk that inflation is higher than anticipated
- Interest rate risk – The risk that interest rates are low at the point of annuity purchase
- Longevity risk – The risk that individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk)
- Cost risk – The risk that the total costs of running the pension scheme during accumulation and decumulation are higher than expected or understood
- Political risk – The risk that the Government changes the rules in an adverse way (e.g., reduces the level of tax relief)
- Regulatory risk – The risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates)
- Demographic/cultural risk – The risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK)
- Market conduct risk – The risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members); fraud and the activities of scammers would be included here
- Behavioural risk – The risk that scheme members behave in a way that is not considered to be rational (i.e., is not in their long-term interests, since they make short-term decisions that they subsequently regret and are unable to learn from past mistakes). Inertia and lack of engagement would be included here, as would be the risk that members fail to understand the risks they face

2. (c) To deal with political risk, would it make sense to have an independent Pension Commission to set pension policy (similar to the independent Monetary Policy Committee)?

From twenty-two responses, 82 per cent were in favour of a permanent Pensions Commission.



In most cases, this was explicitly due to the perceived short-termism of governments:

> *"(Insurance company) The phrase 'unprecedented change' seems to have been used in relation to the pensions industry on an annual basis over the past few years. … We are supportive of an Independent Pension Commission (IPC) if part of its mandate is to provide long-term stability."*

Several responses made the point that pensions are already a divided responsibility between the Department for Work and Pensions and HM Treasury and therefore it was not clear how a Pensions Commission would fit in. Among those who were positive, many said that the effectiveness would depend on the remit and none seemed particularly keen on the

- Financial knowledge and understanding risk – The risk that a member's financial knowledge and understanding are insufficient for the member ever to make an 'informed' choice
- Mental impairment risk – The risk that a scheme member's mental faculties are reduced due to the onset of dementia, for example.

Monetary Policy Committee as a model: alternative models were the Low Pay Commission or the Office for Budget Responsibility.

> *"(TUC) The establishment of a new Pensions Commission would have the potential to inject an ethos of evidence-gathering and analysis coupled with a long-term perspective into pensions policy, which can too often fall victim to an administration's short-term electoral calculations. However, to be effective it would have to operate according a very different model than the Monetary Policy Committee. … a committee containing representatives of the social partners, employers and employees, could play a valuable role by considering the evidence regarding the effectiveness of prevailing pensions policy and alternative courses of action."*

The responses that were against a commission argued that pensions could not so easily be delegated to an independent body:

> *"(Consultant) pension provision is inherently a political issue, so to hand it over to independent experts would be profoundly mistaken."*

SUMMARY: There was strong support from 82 per cent of respondents for a permanent pensions commission in some form or another. Only nine per cent were opposed to a pensions commission.

3. (a) Do you expect products with longevity insurance (e.g., a lifetime annuity) to remain an essential component of a well-designed retirement programme?

The twenty-three responses to this question were unanimous that products with some form of longevity insurance would be an essential component for at least some pensioners. Several quoted either their own or other research showing that significant proportions of pensioners expressed an interest in some form of longevity insurance. Three companies referred to a figure of 70 per cent favouring a guaranteed income in research by ILC-UK. For example:

> *"(Insurance company) We strongly believe that annuities will continue to play an essential role in peoples' retirement planning. Underpinning the concept of pension saving is the wish to provide income security for the whole of one's retirement and to ensure that someone does not run out of retirement funds before they die. It is also fundamental to a pensioner's 'peace of mind' and for their families. Recent research from the ILC-UK suggests that nearly 70% of all those with DC pots favoured their pension to deliver a secure guaranteed income for life over anything else. While current low interest rates remain, people should be encouraged to annuitise in stages, and schemes should support this."*

Other responses came up with figures also suggesting a high proportion putting at least some of their wealth in guaranteed income:

> *"(Insurance company) Our research tells us that a group of customers will want the certainty of income in retirement that an annuity provides. In research covering 1,000 of our customers, 18% said they would look for*

their pension to provide them with income only, with a further 54% indicating they wanted a mixture of lump sums and income."

"(NAPF) NAPF research among pension savers, both qualitative and quantitative,[6] reveals that the majority of savers want to use their DC pension to generate a regular income in retirement. In response to a question that gave them a (forced) choice between a regular lifetime income and flexible access to a pot of money that might not last their whole retirement, 82% chose the former. However, the research also highlighted, in common with several other studies, the poor perception of annuities. The NAPF supports measures to improve the functioning of the annuity market, including the recommendation by the FCA to require FCA regulated firms to provide their customers with a comparison of their annuity rate with the open market, showing not only the annual difference but also the estimated lifetime difference.

We therefore anticipate that some form of longevity insurance will remain attractive to many reaching retirement, whether in the form of lifetime annuities or some other form of deferred insurance. The NAPF supports the development of new retirement income solutions that can deliver value for money to those with modest pension."

Among the possible forms of insurance suggested were conventional annuities, conventional annuities purchased after retirement (e.g. at age 75), and deferred annuities, where a deferred annuity might be purchased via a regular premium payable paid in retirement (sometimes these products were described in the language of "long-stop" insurance). This would involve produce innovation:

"(Consultant) ... we see new types of longevity protection products being produced that will allow clients to buy 'long stop' deferred longevity protection that will be mixed with other capital & income units to produce the overall income solution."

SUMMARY: All respondents agreed that some form of longevity insurance would be needed at some point in retirement. However, there was a diversity of opinion about how this should be achieved. The two most commonly suggested options were to purchase an annuity later in retirement or to purchase a deferred annuity, possibly via the payment of regular premiums. Product innovation would be needed to deliver such products in practice.

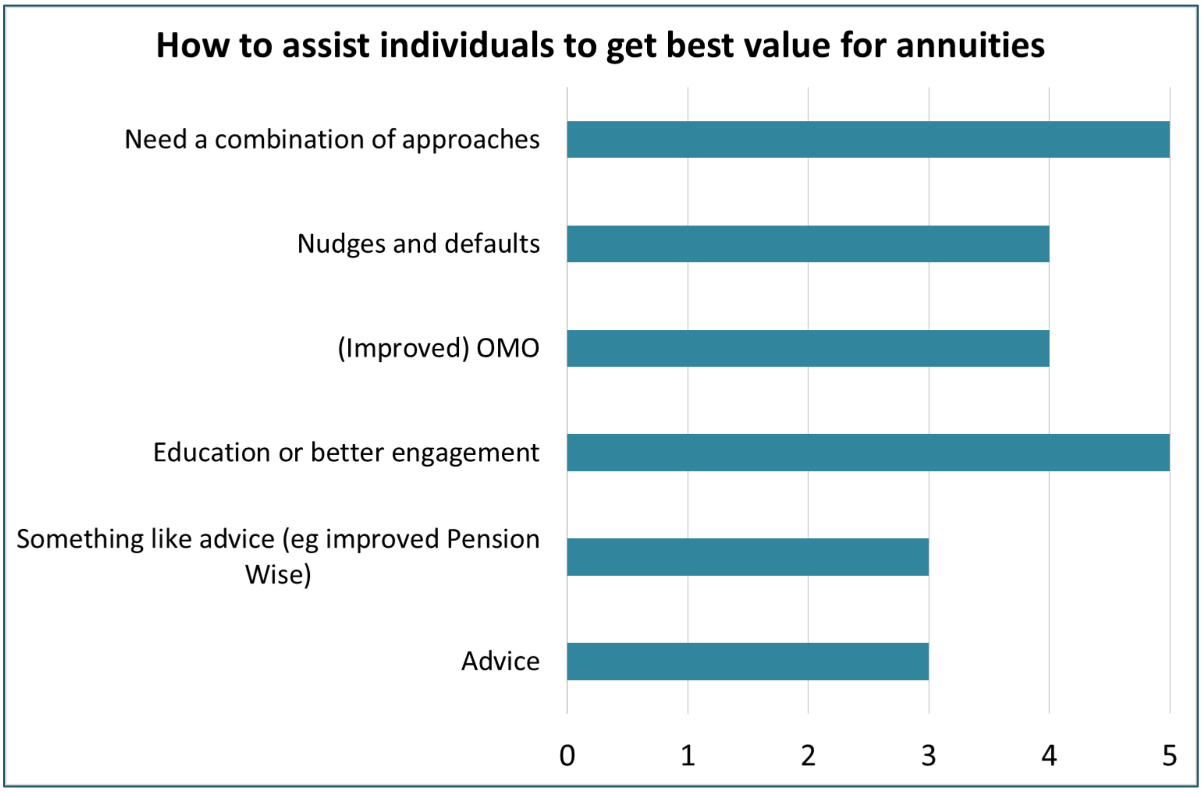
3. (b) How should those individuals who continue to buy lifetime annuities be assisted to obtain the best value products for their circumstances?

There were twenty-one responses for part (b), of which 24 per cent said explicitly that it would be necessary to have a combination of approaches. One response emphasised that a certain amount of inertia on the part of savers should be accepted as inevitable. The most

[6] Understanding Retirement, wave I.

common responses are illustrated in the figure below (some respondents made more than one suggestion).

Fourteen per cent of responses thought that advice would be suitable, but other respondents suggested that there should be improved guidance or a level of help between advice and guidance (this suggestion also occurs for other questions). While some hoped that Pension Wise could fulfil this role, others thought that it could not do this at present.



Alongside advice there were several suggestions for improving take-up of the Open Market Option (OMO), which was not felt to be adequate currently:

> *"(Pension provider) The operation of the at-retirement market has been unsatisfactory for some time, and this is partly why the Government's reforms are so welcome. Even a cursory examination reveals that the current Open Market Option is, at best, a shop window – with no means of buying the end product or assurance that the shop window is correctly representing the product on offer. Furthermore, many savers lack the awareness or confidence to make the most of the Open Market Option. We would like to see more tools developed to easily compare annuity products. There is a clear requirement for creation of a functioning non-advised market, and indeed a more liberal regulatory framework for broker-sourced income products."*

One suggestion for how this could be achieved was as follows:

> *"(Consultant) There has to be a fully open market where all types of longevity protection (lifetime annuities, deferred, etc.) can be compared side by side with a common method of evaluating them. All purchases*

should be through a competitive infrastructure e.g. a portal, comparison site etc. to ensure the client is fully aware of the competition before purchasing.

Alternatively, a reverse auction facility could be established with a standard application form, common underwriting such as the Common Quote Request Form (CQRF) where providers then bid for a number of days based on the data & the client can then easily fulfil their choice without having to go through further application stages."

SUMMARY: A quarter of respondents suggested explicitly that it would be necessary to have a combination of approaches to ensure that individuals who choose to buy annuities get value for money and purchase appropriate products. The range of suggestions from other respondents also suggested that no single option would be adequate. So to help individuals get best value from annuities, they would need a mixture of nudges, better education, better market provision and better advice/guidance.

3. (c) If individuals do not purchase lifetime annuities, how does an individual hedge their longevity risk in retirement?

There were twenty responses to what do to without an annuity. One view was that without an annuity there are few options available and that there was likely to be under-consumption:

"(Lawyer) The member could attempt to under consume his retirement savings by living off the income and not the capital of his retirement savings (e.g. his dividends and interest income). Alternatively however the member could choose to buy an irredeemable bond, where available, which would provide a nominal level of income which would continue for the member's life (and beyond) but would be subject to the impact of inflation. Such an irredeemable bond could be passed on to the deceased individual's survivors/heirs."

"(Pension provider) There are few options for hedging longevity risk in retirement without using a lifetime annuity. The most straightforward is to draw an income at a level designed to last beyond maximum life expectancy. This could lead to a potentially lower standard of living than that which could have been obtained from an annuity as well as not eliminating investment risk."

In the absence of annuity purchase, several responses suggested that there could be new products. Most of these were variations on deferred annuities, although it was also suggested that savers could insure against living beyond their life expectancy or presumed date of death. Many responses noted that, in the absence of this, the remaining possibility was to rely upon the family. One response noted that this was not an issue for sufficiently rich individuals.

SUMMARY: Most respondents suggested that new products, typically some form of deferred annuity, would be necessary to help individuals hedge longevity risk if those individuals chose not to buy a conventional annuity at retirement. Without some form of annuity product, the main alternatives suggested were additional saving (and hence under-consumption) and/or reliance on family support.

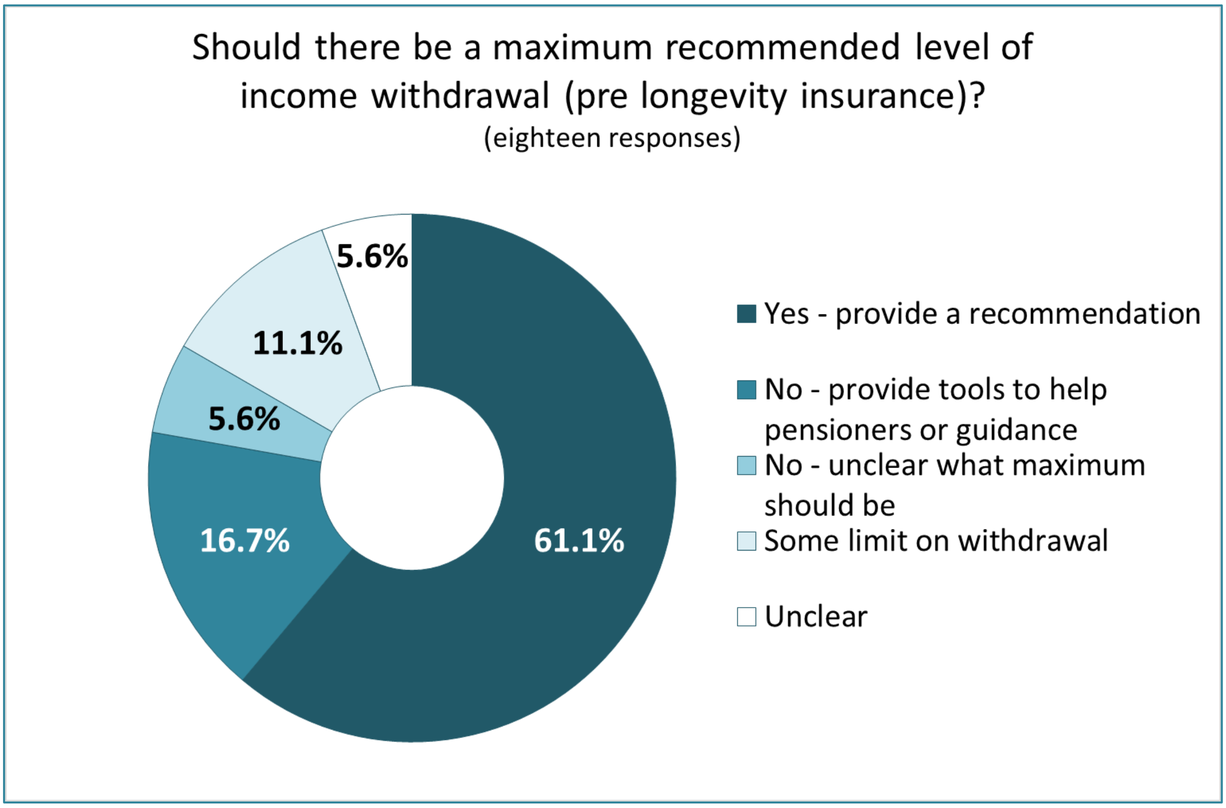
4. ***(a) Where annuities are purchased later in retirement, what are the most effective and efficient products for providing income in the period between retirement and the age at which the longevity insurance comes into effect?***
(b) Should such products have a maximum recommended level of income withdrawal?
(c) If so, how should that level of income be determined?

Of the eighteen responses to this question, 67 per cent explicitly mentioned drawdown products and most of the remainder describe investment strategies similar to drawdown, but emphasising flexibility (for example: bond-laddering). Many responses referred to the advantages of drawdown, in particular guaranteed drawdown:

> *"(Consultant) …as guaranteed drawdown products combine flexibility and longevity insurance, they are far more adaptable to different circumstances than conventional annuities."*
>
> *"(Consultant) Income drawdown products will be the best way of dealing with retirement income and the point at which longevity insurance needs to kick in. The criteria for when it should kick in should be a base level of assets against an assessment of health and family history. ...*
>
> *An alternative approach - which goes back to the concept of 'big government' is to create a DB equivalent of NEST which guarantees a basic defined benefit with additional contributions working in the form of the old AVC's which formed a separate pot. ...*
>
> *DB NEST would be able to insure against such risks if that was the route chosen or the government might choose to provide a floor for those that have gone down the NEST route. There would need to be some rules for good behaviour in this respect."*

Several emphasised that members might need guidance or information on drawdown products and several suggested that drawdown products should or could have guarantees. Only 17 per cent of responses mentioned term-certain annuities.

Sixty-one per cent of the responses also agreed that there should be a recommended maximum withdrawal (in one case it was suggested that there should be a recommended withdrawal limit instead of a maximum): there was near unanimity that there should not be a compulsory maximum. Two alternatives were either that schemes should provide warnings if funds began to deplete too quickly or that there should be repeated guidance to help pensioners decide. One response noted that it would be difficult for an individual scheme to suggest a limit if a pensioner had more than one pension. Only two responses wanted limits: one wanted relatively high maxima with additional discretion from an actuary to draw lump sums and one wanted funds to remain in place to ensure that a minimum level of income was reached (after taking into account the state pension).



There were fewer suggestions on how to calculate the maximum, ranging from use of GAD limits to rules of thumb. Some responses thought that the recommended maxima should depend on a variety of factors and thus be more personalised:

> *"(Lawyer) ... a starting point could be the tables which the Government Actuary's Department has published in connection with the pre-Budget 2014 income drawdown regime."*

SUMMARY: There was considerable agreement that drawdown was appropriate in the early period of retirement, with two-thirds saying this explicitly and the remainder suggesting approaches very similar to drawdown. Several suggested that drawdown products should or could have guarantees. There was also strong support for recommendations or guidance on the maximum that should be drawn down each year. Very few responses provided suggestions for how to calculate this maximum. There was little support for a compulsory maximum level of income drawdown.

5. *What are the advantages and disadvantages of scheme drawdown (i.e., where the scheme provides an income to the retired member prior to the purchase of an annuity)?*

There were eighteen responses to this question and the answers were generally long and quite varied; many of the responses discussed individual drawdown as well.

A half of the responses referred to economies of scale or to lower costs benefitting the members:

> *"(Consultant) Scale (for investments and fees), and a prudently managed pre-defined process instead of potential ad-hoc decisions seem to be the advantages."*

However, some responses noted that this would not necessarily be the case for small schemes, which would not benefit from economies of scale and might struggle to administer drawdown effectively, especially if they needed to provide different options to individuals with diverse needs.

Another possibility was that scheme drawdown could allow individuals who wished to remain invested to do so:

> *"(Insurance company) It seems unlikely that Trustees will take on the management of individual clients' drawdown portfolios because of the risk, so scheme drawdown may appeal (to a limited extent). This is particularly the case if an individual plans to remain invested for a prolonged period of time."*

The importance of being able to remain invested was partly due to the ability to avoid annuitisation risk (i.e., having to purchase an annuity when annuity rates were low – an issue raised by seventeen per cent of responses) and partly do defer annuitisation:

> *"(Lawyer) The main advantage, in the current marketplace, is to give the member the option of not purchasing an annuity at a time when the effect of quantitative easing is to 'rig' the gilts market. Investors should, in general, be wary of purchasing assets in a rigged market. [See, for example, Daines, Joyce and Tong (2012)[7] as to the impact of quantitative easing on the yield on long-dated gilts.]*
>
> *Another advantage would be to give the member the option to live off, for example, the income from his retirement savings until he attains the age (e.g. 75) where the pooling of longevity provides a material uplift in the application of the member's retirement savings by way of a single premium to purchase an income stream for the remainder of the individual's life."*

[7] Martin Daines, Michael A S Joyce and Matthew Tong "QE and the gilt market; a disaggregated analysis" Bank of England Working Paper 466, October, 2012.

However, this flexibility was not seen as being without risk:

> *"(Insurance company) Scheme drawdown has the potential to reduce costs and help manage risk over individual drawdown in the early part of retirement. However, for those with limited to average pension pots, the risks on how much will be left in a pot that can be used to purchase an annuity, are more significant. We therefore believe that any scheme solution should contain active measures to manage the annuitisation risk including cohort investment strategies, phased annuitisation and deferred annuity purchase as appropriate."*

A second area of advantage was that individuals would be in a scheme overseen by trustees and therefore might benefit from better governance of the scheme (raised by 28 per cent of responses). However, some of these responses noted that this shifted more responsibility on to the trustees and questioned how much additional responsibility trustees could realistically take on. A further concomitant disadvantage was whether the scheme's actions could be construed as advice.

The following respondent raised the issue of whether appropriate advice would be available and continued:

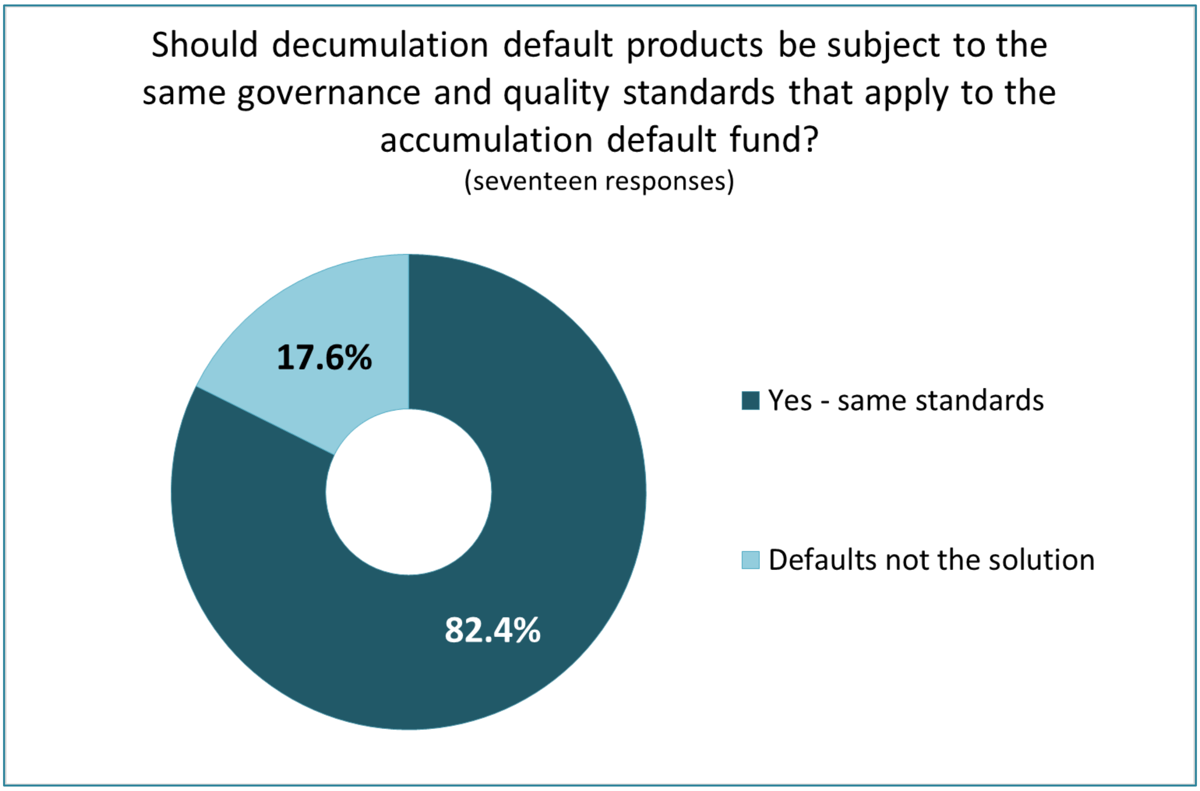
> *"(Insurance company) Schemes may offer a version on drawdown direct from the scheme (i.e. UFPLS) which has not been specifically designed for the retirement income market and may not be regulated by the FCA. These run the risk of individuals making poor and potentially short sighted decisions which they live to regret.*
>
> *Trustees may be unwilling to offer drawdown direct from the scheme (i.e. UFPLS style), as it brings additional cost and liabilities. DC members will therefore have to transfer to a provider which offers this facility or other income drawdown facilities."*

Another response worried not only about the regulatory issue, but how this would fit with the proposed approach to members with more than one pot (also discussed in questions 20 and 21):

> *"(Insurance company) Currently the FCA regulates drawdown but does not regulate schemes, therefore there would have to be a new regulatory framework to govern this. ...*
>
> *[Scheme drawdown] does not sit well with the proposed aggregator framework. If the member is in a scheme at retirement but has other pots within an aggregated pot would the latter also provide drawdown? If this is the case there would have to be infrastructure built for a decumulation facility within each aggregator scheme."*

SUMMARY: There were a variety of responses to this question and very few respondents were certain whether the advantages outweighed the disadvantages. Respondents were clear that scheme drawdown might have the advantages of lowering costs through economies of scale and providing better governance. However, economies of scale might be absent for small schemes which would find it difficult to cater for the diverse needs of different members. While improved governance would be an advantage for members, some schemes might struggle to take on the additional responsibility of looking after funds in the drawdown phase, and so this was potentially a disadvantage for the trustees, especially since the regulatory framework for this is not sufficiently clear.

6. (a) Should decumulation default products provided by, say, large-scale master trusts, be subject to the same trustee-based governance and quality standards that apply to the accumulation default fund?
(b) Where decumulation products are offered by contract-based schemes, should they be included in the requirements for the new Independent Governance Committees to provide governance and quality standards and to assess value for money?



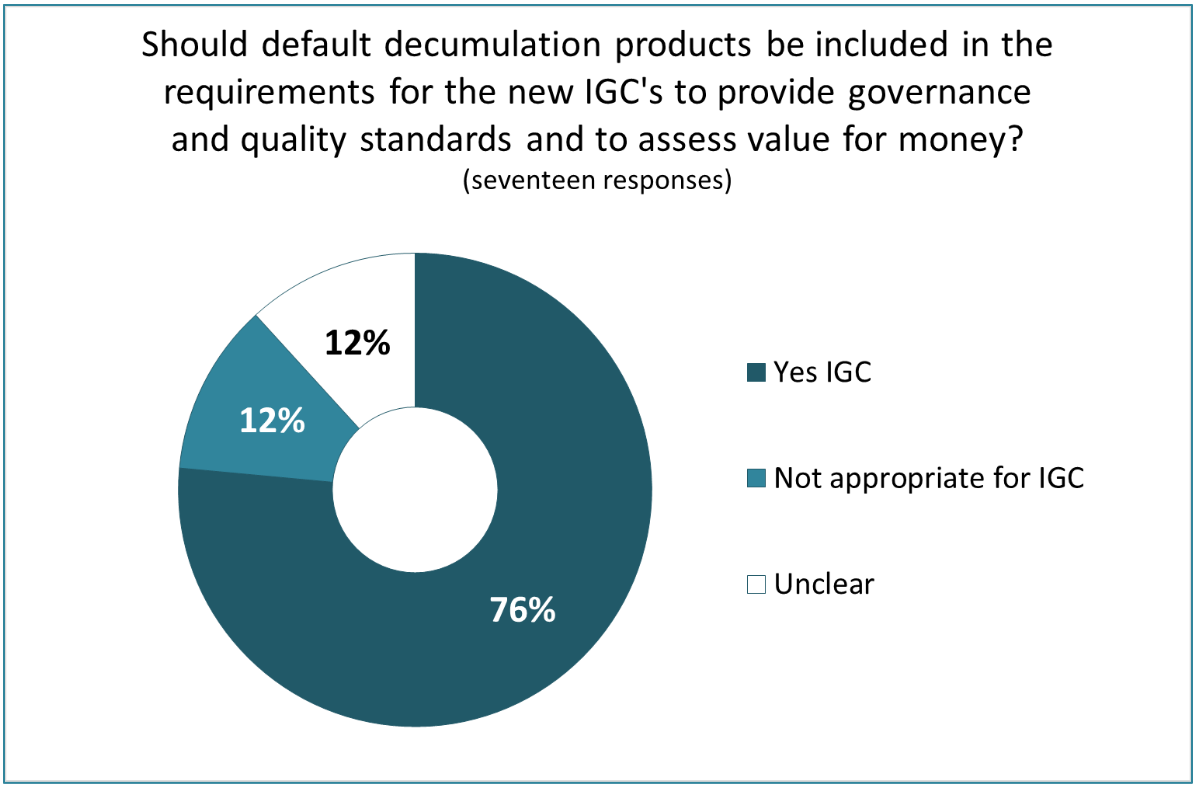
There were seventeen responses to the first part of this question and 82 per cent agreed that there should be the same standards.

> *"(Consultant) Decumulation products need the same protections as for the default accumulation funds, otherwise they will become the next area for mis-selling and abuse. There is also a wider policy issue because not all current DC scheme rules would allow for decumulation - with members having to consider moving their pots - there needs to be greater policy thought given to this area."*

Some responses rejected the premise of the question that there should be a default. One view was that removing defaults was an important way to improve engagement and hence outcomes.

> *"(Pension provider) When it comes to decumulation, the individual should be effectively forced to make an active decision to receive retirement income. The failure of the OMO to date has, in part, been down to inertia and default."*

Alternatively, two responses were less critical of the principle of a default, but felt that it might prove impossible to devise an appropriate default.



Of the seventeen responses to the second part of the question, 76 per cent agreed that governance from the Independence Governance Committees (IGCs) were appropriate.

> *"(AGE UK) All pension products should be subject to high governance standards. In our response to the FCA consultation on IGCs, we argued that incorporating decumulation, in particular income drawdown, products under Independent Governance Committees' remits will help ensure that such products are managed and delivered to a higher standard.*
>
> *We are pleased that the Financial Conduct Authority has agreed to consider extending the IGCs remits in future – this consideration should be changed into a firm commitment to do so."*

The remaining 24 per cent thought that Financial Conduct Authority (FCA) rules were sufficient or that it was inappropriate or unhelpful to involve IGCs.

SUMMARY: Eighty-two per cent of responses accepted the principle of a default decumulation product, while 76 per cent thought that the decumulation phase should be governed by the same governance standards in master trusts that apply to the accumulation default fund and should be overseen by IGCs in contract-based schemes. But a significant minority were unhappy with defaults, despite the fact that people were free to opt out of a default, and thought that IGCs were not appropriate, preferring instead to rely on existing FCA rules.

7. (a) What could be the typical total expense ratio (TER) for a default drawdown product provided by a large-scale master trust?
(b) How might this TER compare with individual drawdown products sold in the retail market?
(c) Can you give any examples of TERs for retail drawdown products?

There were seven responses to this question and some said explicitly that it was difficult to say since these products are still under development. Only two numerical figures were given for a default drawdown product: (i) accumulation plus 0.25 per cent; or (ii) less than or equal to 0.5 per cent One respondent was aware of TERs as high as 2-4.5 per cent for some retail drawdown products. It was generally agreed that default products would be cheaper than retail products, mainly due to the issue of advisory costs to retail products.

SUMMARY: Very few respondents were prepared to say what a typical total expense ratio (TER) should be for a default drawdown product. However, one respondent suggested that the TER should be no more than than 0.5 per cent, while another suggested it should be equal to accumulation TER plus 0.25 per cent. The small number of responses to this question noted that it is difficult to answer while new products are still being developed. Default products should be cheaper than retail products, but retail products, it was noted, can be expensive.

8. (a) Should scheme default drawdown products be subject to the charge cap?
(b) Should this be the same as for accumulation (i.e. 0.75%) or is there a case for a higher cap? If higher please explain why and what the difference might be?

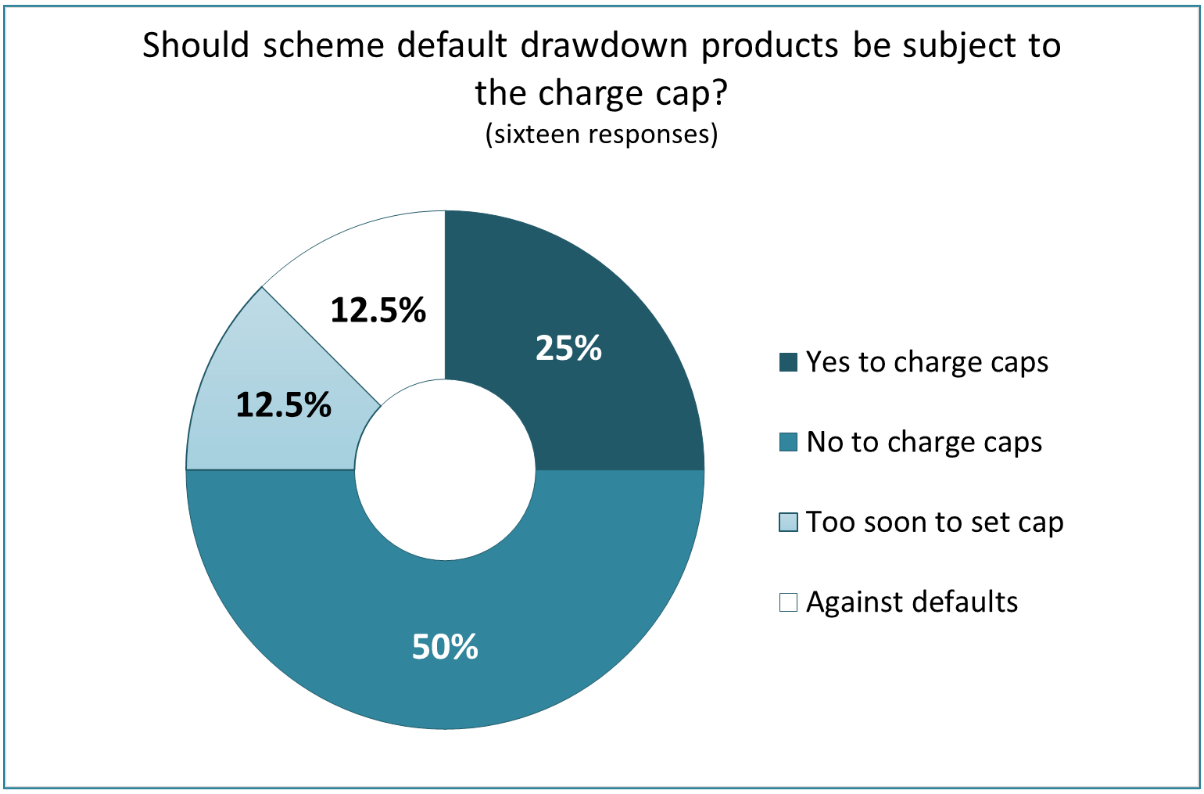
There were sixteen responses to this question. As with the responses to question 6, not all responses agreed with the concept of a default drawdown product. Of those that accepted a default, a half were against caps.

Two responses observed that it was difficult to set the cap because the market is immature and so it is difficult to find a benchmark. As one response said

> *"(Insurance company) Once all costs and charges have been identified, some sort of overall cost measure may be the best way of ensuring good value. In the meantime, the FCA needs to be tracking costs on new products as they arise, and acting quickly if products are launched with charge structures or levels that are not transparent and fair."*

Others took the view that caps could inhibit the development of the market or that governance rules were sufficient. However, some responses thought that a charge cap could be beneficial

> *"(AGE UK) We believe there is a strong case for controls on the costs of drawdown and other alternatives to an annuity. Consideration should also be given to how charges – and other costs – are levied against drawdown products. However, this is not straightforward because of the very wide range of charges that may be levied. ... Once all costs and charges have been identified, some sort of overall cost measure may be the best way of ensuring good value. In the meantime, the FCA needs to be tracking costs on new products as they arise, and acting quickly if products are launched with charge structures or levels that are not transparent and fair."*



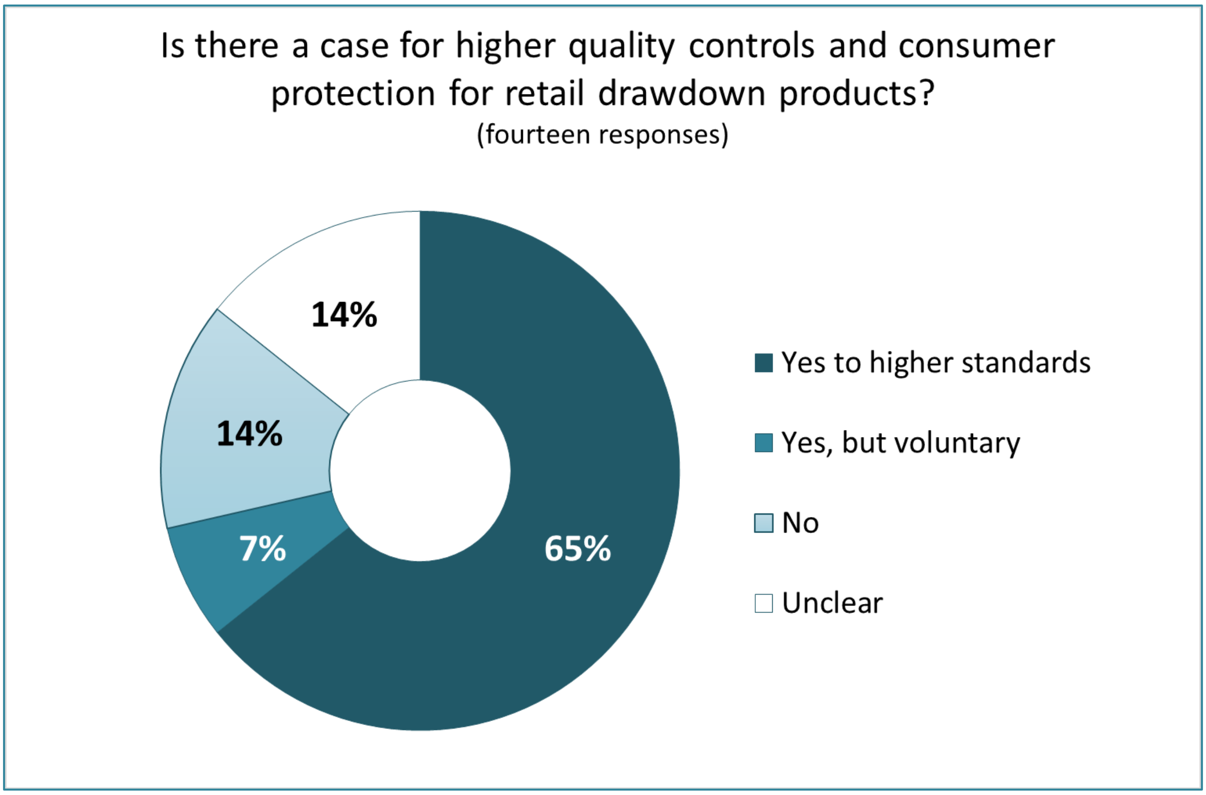
SUMMARY: Sixty-three per cent of responses were against a charge cap on scheme default drawdown products, at least in the short run.

9. Retail drawdown products will be sold via regulated advice and they will be purchased via non-advice (execution-only). Is there a case for:

(a) Higher quality controls and consumer protection in relation to risk and costs? Explain.

(b) Making retail products subject to a charge cap? Explain.

Of fourteen responses, 65 per cent thought that there should be higher quality controls, albeit one thought this should be voluntary.



None of the twelve responses to the second part of the question were enthusiastic about charge caps on retail products and 67 per cent were unambiguously against.

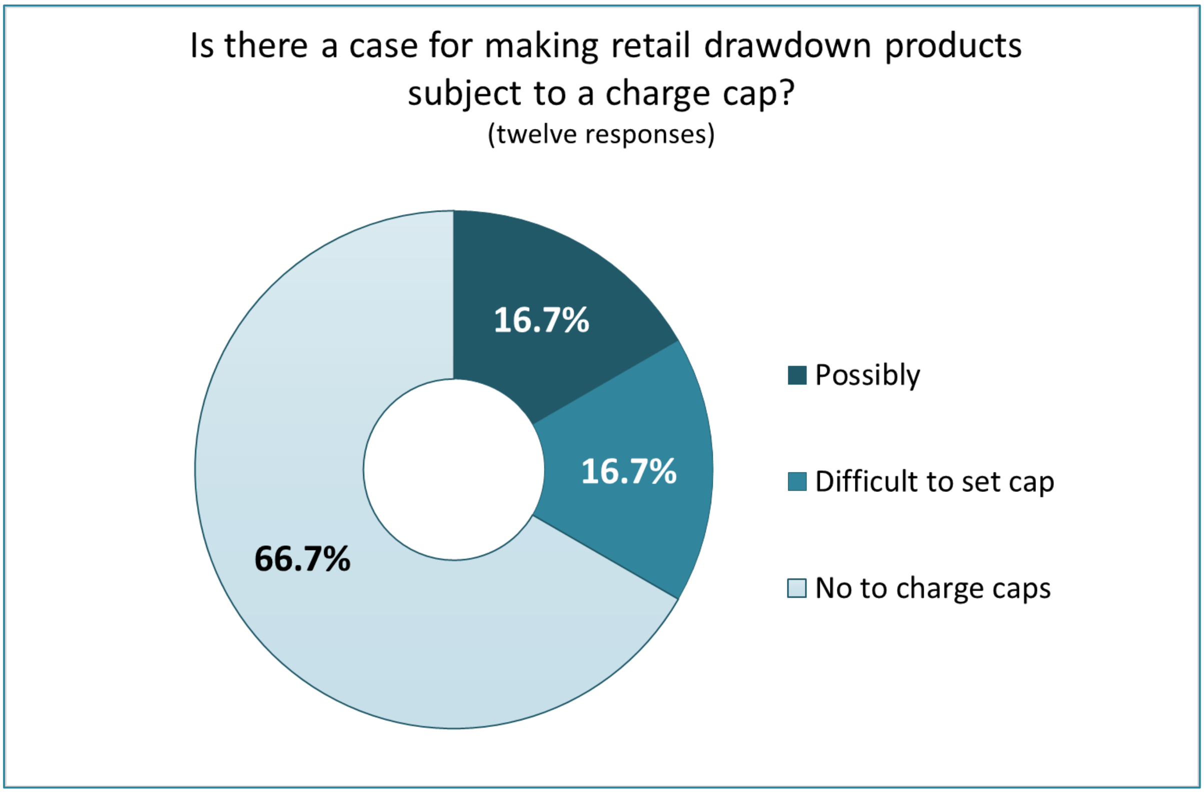
This was partly because active purchase was seen to be different:

> *"(Pension provider) … the Government adopted the principle that it should only apply in default funds and not where the individual has made an active choice. This is a sound principle and we see no reason for charge capping to be extended to products where the consumer has made an active selection."*

As with the responses to question 6, responses were concerned about stifling innovation and many also pointed out that charge caps were a blunt instrument if they did not improve outcomes.

> *"(IFoA) While we welcome the focus on charges, the main impact of any legislative change should be to obtain good outcomes for scheme members. This is particularly important for complex products such as retail drawdown, as there is a risk to the quality of information and / or advice provided to the customer. We suggest the market for these products will become more competitive under the new freedoms."*

> *"(Consultant) All retail drawdown products should be subject to consumer protection and regulatory protection otherwise we create the next mis-selling scandal. But provided there is proper transparency on costs I would veer away from a cap. It interferes with the market producing products which have benefit for consumer and provider."*



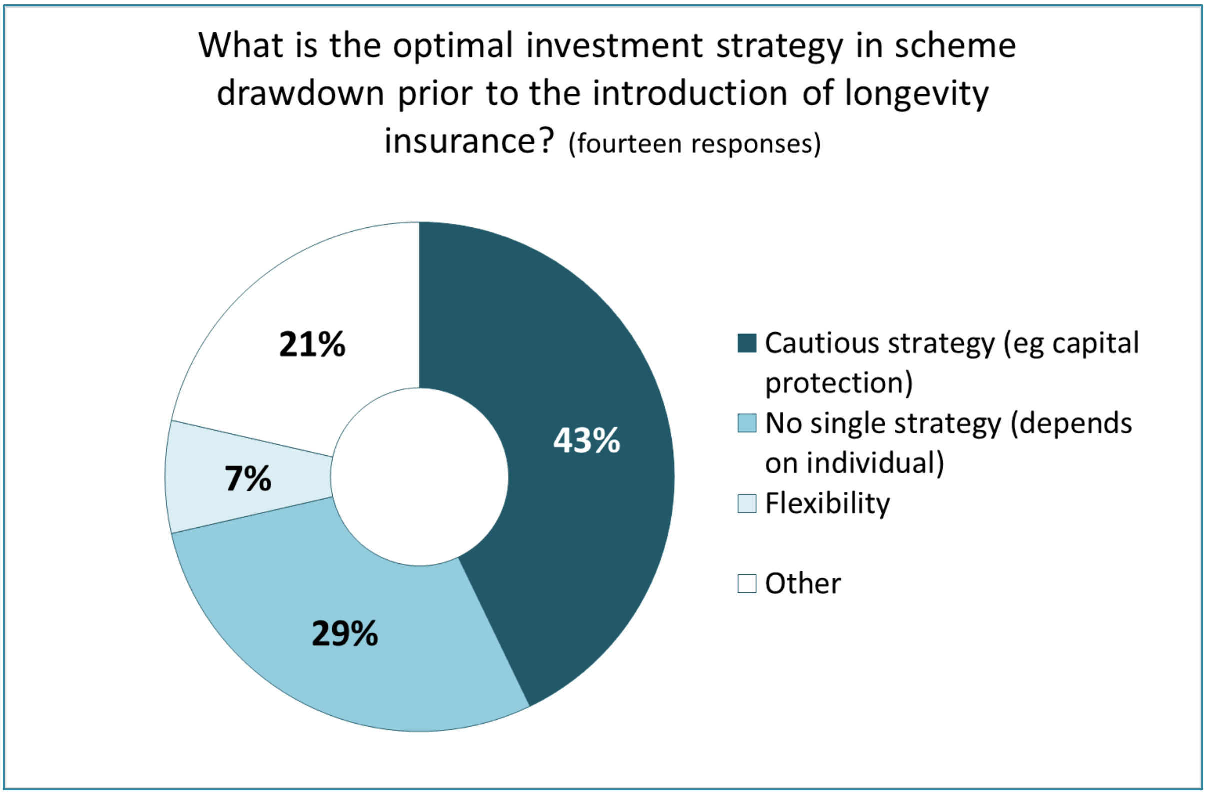
One response did suggest that charge caps could be treated similarly to the accumulation phase:

> *"(Lawyer) A similar approach could be applied in this area to that which applies during the accumulation phase (see, for example, in the occupational pension scheme world, the Occupational Pension Schemes (Charges and Governance) Regulations 2015 and the corresponding provisions in the personal pension scheme world)."*

SUMMARY: Overwhelmingly, there was support for higher quality controls on sales of retail drawdown products, with 65 per cent of responses favouring this. However, there was virtually no support for a charge cap on retail drawdown products, on the grounds that it would stifle innovation, with two-thirds being explicitly against a cap.

10. What is the optimal investment strategy in scheme drawdown prior to the introduction of longevity insurance?

There were fourteen responses to this and there were two main themes. Forty-three percent of responses emphasised that while the investment strategy should aim for growth, it should follow a low-risk strategy, and in three cases the responses explicitly mentioned protecting the capital. The other common response - from 29 per cent of respondents - emphasised the importance of recognising the different needs of different members.



The idea that there was no single strategy was driven by the fact that individuals have different needs:

> *"(Insurance company) We do not believe that there is one particular asset strategy, but any strategy has to take into account the circumstances, the risk tolerance of the individual, and the size of the pension pot. This will broadly apply to annuities, equities, bonds and cash."*

Where risk needed to be controlled it depended upon the likely annuitisation strategy:

> *"(Consultant) My strategy would be relatively cautious here, aiming for real value preservation (real zero return as a minimum). The drawdown period is short, typically lasting a few years only, therefore the usual long-term optimisation strategies of the accumulation phase with sufficient risk-taking are not valid here. Capital loss in a few unlucky years may have a serious impact on annuity levels. This does not have to apply to amounts to be left for inheritance, but that should be handled separately. Additionally, the investment strategy should minimise annuitisation risk as much as possible, by purchasing batches of deferred annuities and by matching the duration of the portfolio to that of the annuity product."*

Another response felt there were some options to reduce volatility of returns:

> *"(Insurance company) Optimal investment strategies can vary significantly, depending on individual circumstances. However, recent innovative investment strategies seek to respond to market conditions by controlling volatility while smoothing investment returns."*

One response felt that managers needed flexibility to take into account changing investment opportunities:

> *"(Pension provider) In one word, flexibility. Over recent years the returns delivered by bonds and gilts have outweighed those from equities, but this is not historically typical. Therefore any investment strategy must be effectively unconstrained within parameters set by the manager, to enable it to continue to provide an income whilst relatively unaffected by macro factors. This need for actively controlled flexibility is again a reason why we do not consider a price cap to be appropriate ..."*

Finally, another response suggested that the question was not really valid, as drawdown could include longevity insurance:

> *"(Consultant) I think the question is probably invalid as longevity protection can be introduced in drawdown using the new propositions, that then frees up the remaining fund to expose itself to a greater risk & reward strategy. Therefore a drawdown plan without longevity protection is a greater risk than one with it. If the investment element of the portfolio benefits from guarantees then this is especially the case."*

SUMMARY: The strongest theme from responses to this question was that the investment strategy in scheme drawdown prior to the purchase of longevity insurance should be fairly cautious, namely to provide growth of the fund while reducing risk, with 43 per cent explicitly naming this as the appropriate strategy. However, 29 per cent of respondents noted that individuals have different needs and so there was no single strategy that would be appropriate for all individuals.

11. What are the advantages and disadvantages of institutional annuitisation (i.e., where annuities are provided on a bulk basis either by the scheme (self annuitisation) or by an insurance company, rather on a retail basis as currently)?

There were twelve responses to this question. Many recognised the benefits of economies of scale and possibly lower distribution costs. In one case, this was because it was felt that individual purchase was itself problematic:

> *"(TUC) A competitive annuity market shaped by informed consumers shopping around to find the best deal has been shown to be little more than a theoretical ideal. Consumers struggle to understand the differences between financial products, give insufficient weight to factors such as indexation, and tend to favour poor value products from existing providers. Providers have proved happy to accept the extra profits provided by this near-captive market. Institutional purchasing would move some pricing power away from the providers."*

But there were concerns that this is really making a DC scheme more like a DB scheme and hence not really appropriate.

> *"(Consultant) Institutional solutions always provide scale and help to lower prices. On its own, from a risk pooling perspective, a large pool of*

annuitants brought to an insurance company should not lead to different rates than when the individual requests quotes, as the pool should be available for the insurance company anyway (in the lack of that – or reinsurance – it should not provide annuities). If perfect competition, transparency and financial literacy prevailed in general, then the two solutions ought to lead to equal results. However, as these conditions do not apply, institutional annuitisation may help, due to professionalism and better negotiating power on behalf of scheme trustees."

"(Insurance company) ... There are also risks associated with scheme annuities; for example that the scheme is now taking on risk (in estimating future investment returns and longevity) and so becomes rather like a DB scheme. This can be contrasted with this most existing DC schemes that have well-matched assets and liabilities with very little risk other than operational error or fraud. Hence the schemes would need to acquire the infrastructure and costs relating to risk management, similar to DB schemes ... This also raises the question of who is holding the ultimate liability if things go wrong ... Could DC accumulation members' funds also be at risk? If so this will need to be made clear to them. If not, a backer of last resort is needed (e.g. the employer, PPF or state). Who would be willing to take this risk on?"

Since many schemes are quite small, the economies of scale from bulk purchase would not be large and there are corresponding disadvantages for members who would be better opting out to get enhanced annuities through medical underwriting:

"(Consultant) Institutional annuitisation is mainly disadvantageous & rarely delivers 'positive client outcomes' as the client hardly ever gets best value for money in bulk deals because they don't take individual client life expectancy in to account."

However, it should be noted that several responses to question 12 below explicitly said that this need not be a problem.

SUMMARY: Institutional annuitisation has the obvious advantage of scale and potentially the disadvantage of not being suitable for the individual, if not individually underwritten. Another disadvantage was that the scheme would be creating DB-like liabilities and the question was raised about who would ultimately underwrite these liabilities (employer, PPF or state) if the scheme underestimated the longevity and investment risks. Some respondents were uncertain whether the advantages outweighed the disadvantages and overall there was no clear majority one way or the other.

12. Could institutional annuitisation deal with the individual underwriting of annuities and still encourage competition from providers in the open market to maximise consumer outcomes (e.g. in the case where a retired member has a medical condition which reduces their life expectancy)?

There were eight responses to this question and only one response thought that this would be difficult. Half of the responses were very confident that this was possible and some said that they had experience of combining the two. One respondent linked this to the idea of a reverse auction:

> *"(Consultant) Yes, using the reverse auction process outlined above [in response to question 3]. In this scenario, the scheme would only pay the annuity to the member once they & their spouse (if they have one) had been underwritten. The annuity provided would be sourced for them by the scheme but may be provided by a range of different providers."*

Some responses noted that individuals need to be given the possibility to opt out which could result in the highest mortality individuals leaving anyway.

SUMMARY: The overwhelming majority of responses thought that institutional annuitisation could deal with individual underwriting and still encourage competition from providers.

13. (a) Would a market for advanced life deferred annuities be viable? (b) What is the likely demand for advanced life deferred annuities?

Of fifteen responses, 60 per cent thought that there would or possibly could be a market, but others thought that there would be problems with supply (due to capital requirements making the products expensive) or demand (due to the long-run nature of the product and possibility of death before payout). Responses referred to the market in the USA both to argue that there would and there would not be a market for deferred annuities. Demand was expected to be low, unless possibly the product was part of a default. One particular concern was that EU regulations requiring unisex pricing would be an obstacle such products

> *"(Consultant) a market for longevity-insurance [i.e. deferred] annuities is not viable in the UK because they are offered only on a unisex basis. The difference in life expectancy by gender at older ages makes these annuities unfavourable to males, so in principle they would only be offered based on female mortality rates. To my knowledge, nowhere in the world is there a viable unisex longevity-insurance market."*

Alternatively, one suggestion was that the market for deferred annuities could increase if linked to long-term care products. Two responses suggested that deferred annuities would benefit by being sold as multi-premium policies, with premiums being paid out of a drawdown product until a given age (e.g. from age 65 to age 80) at which point the deferred annuity would come into payment.

SUMMARY: Sixty per cent of respondents thought that there could be a market for advanced life deferred annuities, but it is clear that there would be significant problems to be overcome to achieve this. To make the product more attractive, some respondents suggested it could be paid for in instalments.

14. Is there likely to be demand for inflation protection?

There was almost unanimity from the seventeen responses that individuals want inflation protection but are not prepared to pay for it at current prices.

> *"(Consultant) There seems to be a dichotomy here, as surveys show that people are aware that a lifetime real value protection of pension payouts would be desirable, but they still don't favour real annuities – probably due to higher prices. More demand for inflation protection could be created by better communication, explaining why a level annuity leads to difficulties in later years, and including such products in the default provision."*

There was a little confusion over whether this question referred to immediate or (advanced-life) deferred annuities (i.e. a follow-up to question 13) and one respondent noted that deferred annuities without inflation protection would not be very valuable by the time of payment. Several responses noted that inflation is currently low.

SUMMARY: There was virtually unanimous support for the idea of inflation protection, but respondents doubted whether individuals would pay the high price needed to buy it.

15. What are your views on the proposals by HM Treasury to allow annuities to have more flexible payment terms by:
(a) allowing lifetime annuities to decrease
(b) allowing lump sums to be taken from lifetime annuities
(c) removing the ten-year guarantee period for guaranteed annuities
(d) allowing payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000?

There were nineteen responses to this question and 68 per cent were supportive of all or some of these possibilities. For example:

> *"(Insurance company) The above [list of annuity options] appears to be reasonable, allowing a level regulatory playing field between flexible annuities and income drawdown."*

However, one response thought that deferred annuities would be a superior method and eight thought that the complexity of so many products would create problems.

> *(Consultant) "I think annuity products do have a place and it is right that there are commercial advantages to providers offering them - so we should not water these down as products"*

Some respondents were positive, but still thought that the complexity would create problems which might be addressed by advice or just accepted.

"(Pension provider) We are generally supportive of the proposals, although such freedoms are prone to be misused or misunderstood by a few."

"(Consultant) Without the specifics, in general more flexibility ('freedom') in annuities potentially leads to a bigger number of customers making decisions regretted later and to longevity risk managed more poorly. As a minimum, default solutions should not include such elements which hurt the principle of lifetime real value protection."

One response suggested that these products were only suitable for a minority of the market:

"(Consultant) All of these proposals provide welcome options in principle. However, they are generally not appropriate for members with small pots and little or no other household wealth or income other than the state pension. That group currently comprises a large majority of DC scheme members, and as the number of members with legacy DB to augment their DC pots falls, the proportion will increase. Without a substantial increase in contributions to DC schemes over a long time, that position will not improve. Consequently, in practice these options may confer limited benefit for most members – and possibly cause problems by raising expectations that cannot be met."

SUMMARY: There was a clear majority in favour of some or all of these options to increase the flexibility of annuities' payment terms, with 68 per cent of responses supporting at least one of the options. But many respondents also raised significant concerns that such products would increase complexity and potentially confuse customers: in addition to this, many of the suggested products would only be suitable for a small component of the market. So, at best, one would say that there was qualified support.

16. What are your views on U-shaped or J-shaped annuities?

There was less enthusiasm for these annuity products than those in the previous question: of sixteen responses, only half were enthusiastic. As well as a concern about complexity, some responses suggested that it would be difficult to know where the minimum of the "U" should be and hence difficult to design appropriate products. Alternatively, these more complicated income streams could be achieved by more straightforward mixtures of drawdown and annuitisation.

"(AGE UK) At present, there is a lack of knowledge about consumer spending in retirement. While a U-shaped spending curve is intuitive, and may be correct, there has not yet been a sufficient analysis of longitudinal spending data to confirm this.

Also, as most people's expenditure has to date been restricted to taking a tax-free lump sum and the subsequent purchase of a level or index-linked annuity, this may have led people to spend in a particular way that may not have met their needs."

SUMMARY: There were mixed views on the provision of U- or J-shaped annuities, with responses fairly evenly divided between those for and those against. A particular issued raised was where the minimum of the "U" should be. It was also suggested that these more complicated income streams could be achieved by more straightforward mixtures of drawdown and annuitisation.

17. Should DC retirement products and decumulation strategies be linked to the single tier state pension? If so, how?

The seventeen responses to this were mixed. Some emphasised that the state pension itself was too complex or uncertain to link in to DC pensions; others worried about the uncertainty of the DC pension until relatively near retirement. Thirteen responses were generally enthusiastic or enthusiastic in principle, but the emphasis was on providing information to help individuals deal with their individual circumstances.

> *"(Consultant) it is hard to see how this would be helpful on a universal basis, given the complexity around decumulation strategies and the difference between individual circumstances."*
>
> *"(AGE UK) In planning for retirement it is important that all sources of retirement income are accounted for, including state pensions.*
>
> *In some circumstances, deferring your state pension or buying additional state pension can provide more income than buying an annuity. People approaching retirement and who are at or near state pension age should consider how to maximise income from all sources, and this should be reflected in default strategies.*
>
> *This raises two further issues for public policy:*
>
> *(a) How individuals can look across all their expected pensions income, public and private. We would like to see a single 'dashboard' covering all pensions. The possibility of a single pension forecast has been explored in the past, and should be re-visited ...*
>
> *(b) The need for certainty in the state pension system. Any changes need to be introduced with sufficient time and publicity for people to be able to plan ahead. In particular, we would like to see the triple lock enshrined in legislation ..."*
>
> *"(Consultant) Yes, they definitely should – and payouts from different saving schemes should also be combined. For instance, if there exists a floor and a cap for strongly recommended annuitisation (for very low levels not feasible, for high levels not necessary), these should take all sources into account. Cooperation on behalf of state and private pension providers is required to do this, and presumably one entity should be made responsible to manage the exercise (DWP, TPR, FCA, NEST?)."*

SUMMARY: Respondents disagreed on whether retirement products should be linked to the state pension. While many thought that it was a good idea in principle, there were issues about complexity of pensions in practice, which might make linking the two infeasible.

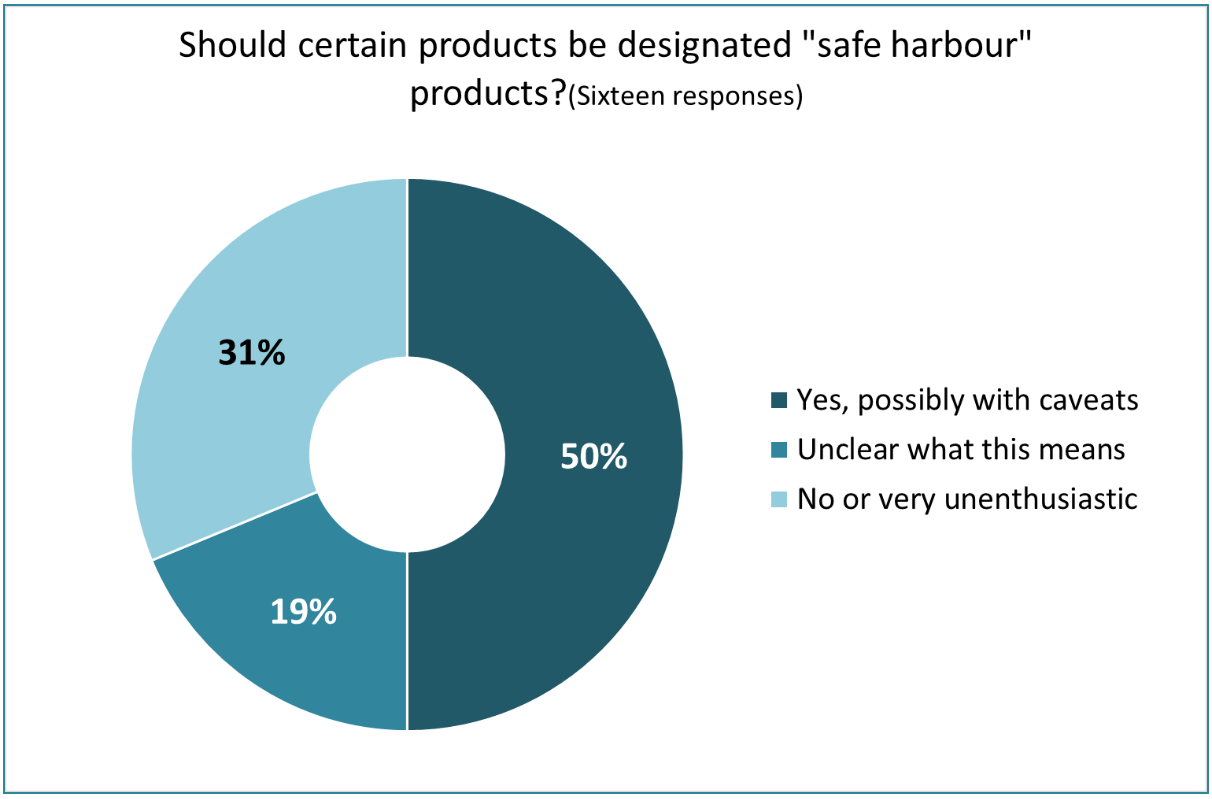
18. What other retirement products do you expect to become available? Please provide details if possible.

There were fifteen responses to this question. The range of products mentioned included: development of guaranteed drawdown products, term-certain annuities, flexible annuities and mixtures of products. All of these products have been mentioned at some point in this paper (usually in earlier questions).

Several responses were keen that a range of products should be purchased together rather than individuals having to buy different stand-alone products separately. One combination suggested was a drawdown product with ceiling and floor to payout combined with an (advanced-life) deferred annuity. There were several suggestions that products would combine with long-term care assurance, payment of which would be conditional on activities of daily living.

SUMMARY: A range of products were suggested, including new (flexible) annuity products and new (guaranteed) drawdown products. Products which combined more basic products were also suggested, such as those combining drawdown and annuities. Several responses suggested products involving long-term care assurance.

19. Is there a case for designating certain retirement products as 'safe harbour' products? Explain.



This question resulted in strong views on both sides. Of sixteen responses, 31 per cent argued "no" or were very unenthusiastic and half argued "yes". The remainder suggested that in practice it was not clear what was really meant by a safe harbour product or how to define it (especially if consumers misunderstood what was meant by "safe") and that it might inhibit market innovation.

One response felt that all products should be regulated equally. If a safe harbour product were inappropriate for many individuals who were defaulted into it, then it would make things worse. Some responses thought that all products should be subject to approval and that that was sufficient.

Three responses thought that the government might provide a basic product or that private firms might provide products defined by regulators or the government (to prevent claims of mis-selling). One response suggested that in an increasingly complicated world, having a safe harbour product would enable individuals who were confused to have a minimum.

> *"(Lawyer) No. It is, however, to be hoped that the Financial Conduct Authority's approach to applying behavioural finance theory and to look at the outturns from new financial services products on a thematic basis will lead to members not ending up with drawdown products which provide an ostensibly higher level of income but which carry the associated higher level of risk (e.g. 'precipice bonds')."*

> *"(Consultant) Yes, it might even make sense to have simple, low-cost government sponsored products (a public option) that the private providers would have to compete with."*

SUMMARY: There was a small majority of respondents in favour of designating retirement products as "safe harbour" products, but there were strong views both for and against.

20. Following the impact of the Budget 2014 tax changes on annuity providers, do you have any concerns about supply-side contraction or other developments in the annuity market that might make it less competitive?

Of the ten responses to this, there was unanimity that the market might get smaller and that this might result in less competition.

> *"(Consultant) It is essential that annuity products remain attractive commercially for providers otherwise it will spell the end of the offerings - what we need are products that are more balanced in terms of commercial attractiveness for providers and for savers with more being done for investors who do not understand the issues."*

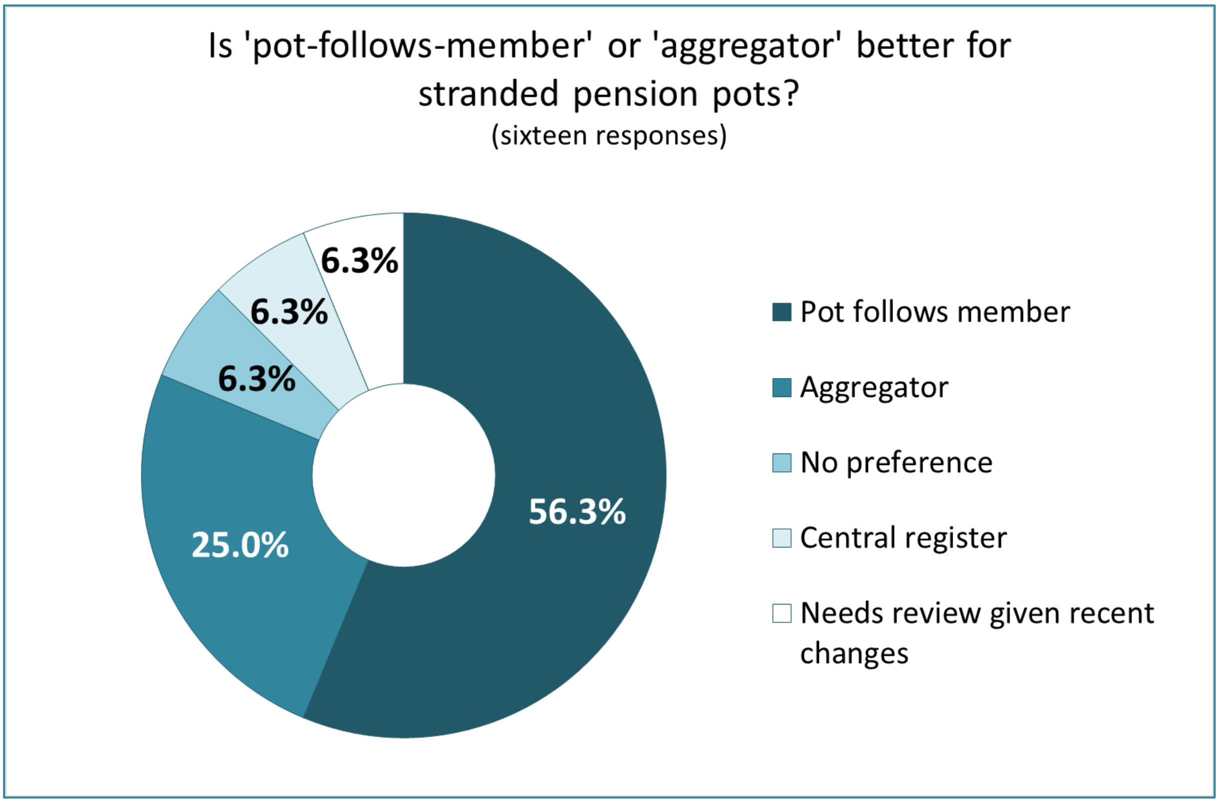
SUMMARY: Respondents were unanimous that the market would probably get smaller and less competitive as a result of the 2014 Budget changes.

21. (a) What is the best way to deal with stranded pots? Explain.
(b) Two approaches have been put forward to date: 'aggregator' and 'pot-follows-member'. Do you have preference for one over the other? Explain.
(c) Would 'scheme-follows-member' be feasible? Explain

Only two responses thought that "scheme-follows" member was feasible and even these thought that there would be costs to employers: the remainder thought that the issue of costs to employers was so great that it was infeasible. One response said that given the recent changes it is too late to be considering this.

Four responses preferred aggregation (with a limited number of aggregators), but the majority were in favour of "pot-follows-member". An alternative was a central clearing house or virtual or notional aggregation via a central database:

> *"(Consultant) A notional aggregator approach – through a central database – might be preferred by some parties, including members, although the actual pots do not move."*



Several responses said here and elsewhere that it is important to engage members (and avoid defaults) and that "pot-follows-member" encourages this:

> *"(Lawyer) The member can see in one place all of his retirement savings which, we would suggest, is likely to encourage a greater sense of awareness, ownership and involvement."*

> *"(NAPF) The proliferation of small, stranded pots is a problem that the NAPF recognises needs to be addressed over the short to medium term and which needs to be done in a way that protects members and keeps*

implementation and ongoing costs to a minimum. The NAPF has a number of strong concerns about whether the Government's policy of pot-follows-members automatic transfers does enough on either of these fronts. This policy was developed by Government three years ago, before the new charge cap, rules on transaction costs, before automatic enrolment had even begun and before the freedom and choice reforms were developed. These developments are changing the pensions landscape rapidly and alter the assumptions on which the policy is based – for instance that most people will want to consolidate pots to buy an annuity. Therefore the next Government should review the case for auto-transfers, and develop an approach that fits with the new reforms and the new landscape, which is likely to be dominated (particularly when considering smaller pots) by a small number of large-scale low-cost master trusts."

A final suggestion was to have a single clearing house for pension pots:

"(Insurance Company) An alternative approach may be that pensions are taken out of the workplace with each individual having their own pot. Employers would have the obligation to make contributions and collect contributions for their employees. This would then be fed into one clearing house which would then distribute the contributions to each individual's own scheme. This would be a particularly large infrastructure build and would move away form the potential to educate and engage people through their workplace."

"(Consultant) This is very difficult - I would argue scheme follows member could be a form of deferred membership depending on employer involvement - and the evidence suggests that deferreds become the 'forgotten members'. Pot follows member might result in assets being crystallised at entirely the wrong moment. On balance, I prefer the existence of centralised schemes for DC provision where the scheme is not employer dependent - i.e. the DC member in effect remains active throughout the accumulation period (like NEST up to a point). I think there needs to be statutory responsibility to deal with all ... stranded pots so that it should not matter where an asset has been left."

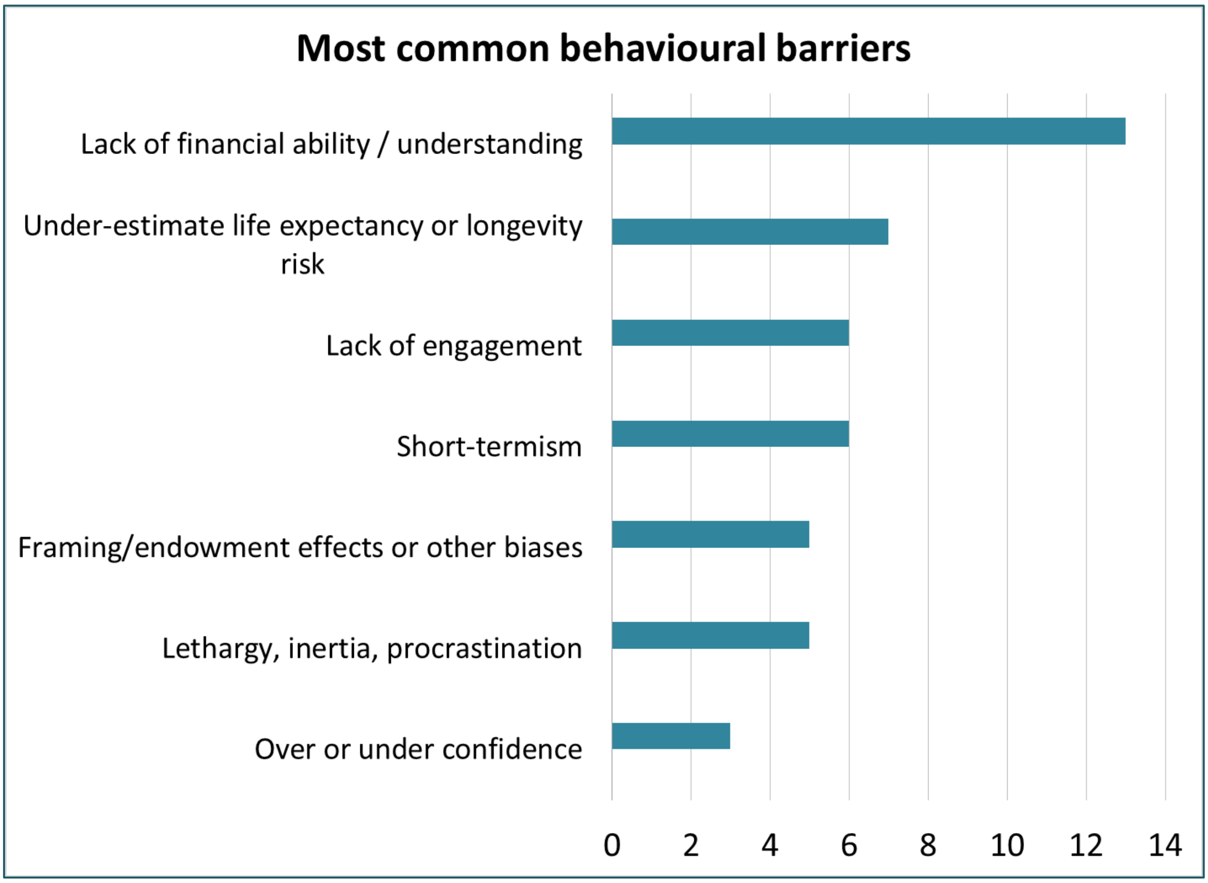
SUMMARY: The majority of responses were in favour of pot-follows-member to deal with stranded pots, although 25 per cent favoured aggregation (with a limited number of aggregators). An alternative was a central clearing house or virtual or notional aggregation via a central database. There was little support for "scheme-follows" member: a number of respondents said the issue of costs to employers was believed to be so great that it was considered infeasible, while another said that given the recent changes it is too late to be considering this.

2. Supporting savers to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment

This section of the consultation document investigated whether it is possible to design a good default option at retirement which will be suitable for most savers, in the same way that a good default investment strategy in the accumulation phase can be designed. The introduction to this section emphasised that savers exhibited greater heterogeneity in retirement than in the accumulation phase and asked how nudges or defaults (perhaps similar to auto-enrolment in the accumulation phase), combined with the "guidance guarantee" and other factors could help savers navigate through the complex decisions needed in the distribution phase.

22. It is now recognised that many people face a number of behavioural barriers which prevent them behaving optimally. When it comes to decumulation, what are the key barriers?

There were 22 responses to this question and many barriers were suggested. The term "behavioural" was interpreted both in the narrow sense used within academia (i.e., potentially irrational behaviour) and also to refer to problems that consumers might have accessing or processing information.



Not all responses were happy with the premise of the question as evidenced by the following comment:

"(Consultant) we are unsure that the use of terms such as "behavioural barriers" are helpful as they seem to blame consumers rather than identifying the imbalance of knowledge which makes it difficult for consumers to make informed decisions ... "

The frequency of the most commonly reported behavioural barriers is illustrated in the following figure:

The most common response related to consumers lacking understanding or the ability to make financial decisions. Many responses made clear that this was not due to the consumers alone but also the amount and complexity of information that consumers were given and the way in which it was presented. For example, one response suggested that the problem was down to

"(Consultant) Incomprehensible illustrations without any use of common language that the average member can easily understand, full of risk warnings that terrify most of the public."

There was disagreement about whether this problem could easily be resolved. On the more positive side there were responses such as

"(Insurance company) ... Both such risks can best be mitigated by clear advice and guidance prior and during decumulation so that savers choose the products that are most appropriate for them."

while on the other side it was suggested that

"(Consultant) The reforms announced in the 2014 Budget have been consistently framed in terms of 'freedom and choice', but if people do not have the skills and motivation to think about their money and make informed decisions about their retirement choices, then giving people information about their options will not suffice."

Employers also have significant concerns about employees' pension saving:

"(Insurance company) The CBI/Standard Life 2013 pensions survey illustrated that more than two-thirds (68%) of businesses report that they are either very concerned or concerned about employees either opting out or failing to take full advantage of their scheme. This is reinforced by data from the same survey that indicates only 36% of employees are currently taking advantage of their employer's highest contribution rate. Getting better outcomes for savers must encompass maximising what is available first and foremost, and this must take precedence over raising costs for employers."

SUMMARY: A wide range of behavioural barriers were mentioned by the different respondents. The barrier to optimal behaviour that was most commonly mentioned was the lack of financial literacy. Other behavioural barriers included poor understanding of longevity risk, lack of engagement, short termism, framing effects, procrastination and over/under confidence.

23. We need to recognise that retirees: have different expenditure needs during different phases of their retirement; need to pace their spending throughout retirement in order to optimise the use of their lifetime assets and income and their ability to make intended bequests; and need a choice architecture that reflects the market segment to which they belong.

(a) What is your understanding of the regulatory consumer market segmentation and is this appropriate in relation to the needs of DC retirees?

(b) What nudges and choice architecture do people need to deal with these issues and overcome the behavioural barriers they face?

There were eight responses to part (a) and most agreed with the three-fold division of (i) mass market; (ii) the mass affluent market; (iii) and the high net worth market. Only one response thought that it was important to have a more sophisticated model.

Of the twelve responses to part (b) only 25 per cent evinced any enthusiasm or confidence in defaults or nudges and one of these felt that defaults needed to be conditional on a much more detailed classification of consumers. However, in answers to other questions another four respondents suggested that defaults could play a role for at least part of the market (see comments on question 24), which in total suggests a substantial minority in favour.

The most common theme was the need to provide a better combination of information, guidance and advice, preferably in a way to encourage more engagement of consumers so that they could take their own decisions. However, several noted that this could not guarantee optimal outcomes, for example, the comment that

> *"(Insurance Company) the greater freedom that will soon be offered to retirees comes with greater responsibility. We believe that clear advice and guidance prior and during decumulation is the optimal way to encourage retirees to choose the products best suited to their needs.*

There was also a common theme that the process should not be unnecessarily complicated:

> *"(Consultant) People need simple options they can set up at retirement and then run with, without a lot of management needed after retirement."*

SUMMARY: There was general agreement on the characterisation of market segmentation into mass market, mass-affluent market and high net worth. A substantial minority of responses were enthusiastic about nudges, but more thought that it was more important to provide better information.

24. (a) What lessons from auto-enrolment in the accumulation phase can be brought to the decumulation phase?

There were fifteen responses to this question. Several noted the apparent contradiction between auto-enrolment in the accumulation phase (implying that individuals could not be trusted fully to take the correct decision) with freedom in the decumulation phase. Conversely, others thought the distinction useful because encouraging all individuals to save was appropriate (as nearly all individuals need to save), while heterogeneity in retirement meant that there was no "one-size-fits-all" solution for decumulation.

> *"(Pension provider) The need to save for later life is a certainty, the manner in which this saving is utilised is precisely the opposite."*

One possible way of combining the default principle with allowance for heterogeneity of pensioners was for a limited number of choices:

> *"(Lawyer) We think the better approach would be to offer the member a 'default menu' with a limited number of 'default choices'."*

There was widespread agreement that the experience of auto-enrolment suggested that inertia could be harnessed to encourage more saving. But not all responses saw this to be without disadvantages since

> *"(Consultant) Inertia is an effective tool to retain people in a given strategy; however it does not substantially increase member engagement."*

and many respondents thought that engagement was key to getting drawdown to work effectively. A further concern was that it would be inappropriate to default a consumer into a product such as an annuity, because the latter is irreversible and such decisions should be made consciously. There was also some disagreement over what a default is for. Several responses suggested that there should be a menu of defaults to allow for heterogeneity of consumers and some suggested explicitly that this was to prevent downside risk

> *"(Pension provider) The key role for defaults is to avoid the worst possible outcomes."*

But three responses thought that the purpose of defaults was to provide products for consumers who did not really want to engage with the process.

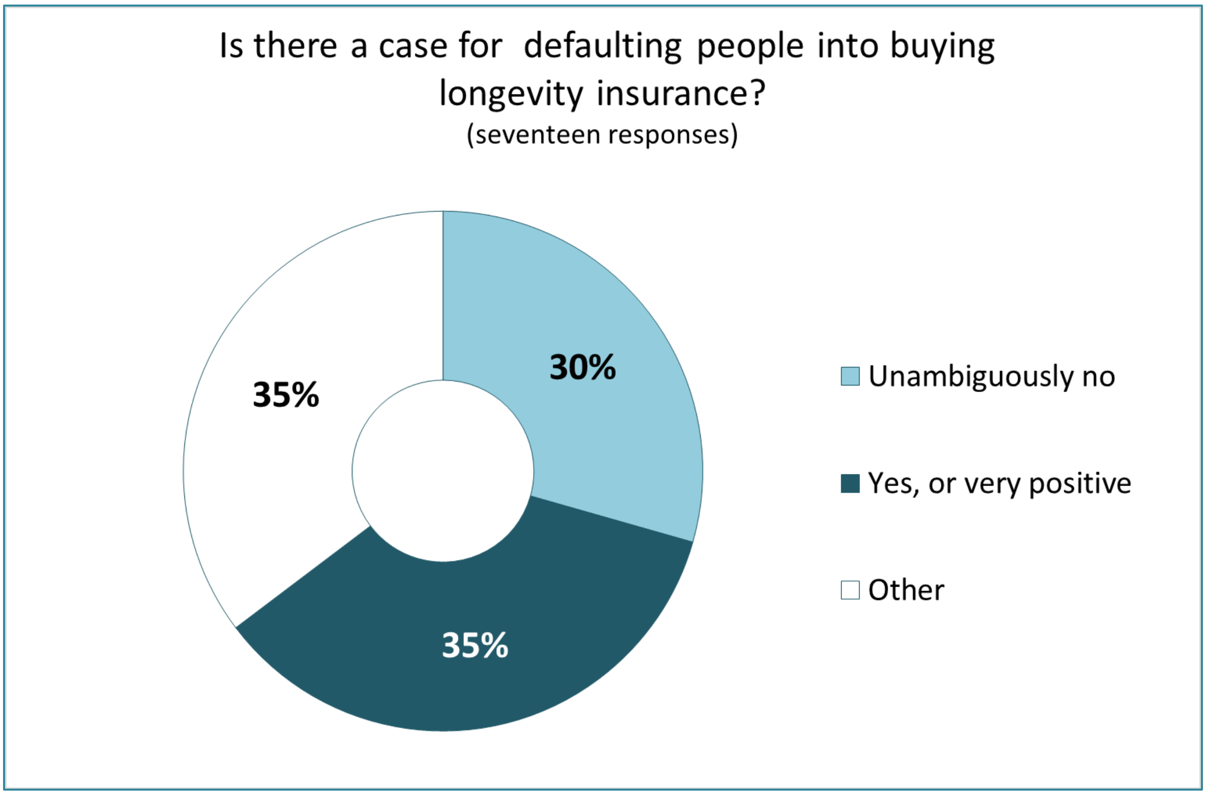
> *"(Consultant) Many people want to be told what to do and provided they see sense and it is pretty well done for them they will go along with it."*

> *"(Consultant) The success of the paternalistic approach in the accumulation period is clearly in contradiction with the new libertarian 'freedom' in the payout phase. The fact that around 10 million first-time savers may be included in the new system in a country so liberal and market-oriented as the UK seems to suggest that these very same people will need a lot of guidance at retirement – which raises even more complex questions than the accumulation period. Behavioural factors are being proven in the auto-enrolment exercise, and that implies that without properly designed default elements, the payout phase may bring ... suboptimal and/or expensive solutions to many customers. Just as saving is not mandatory (unlike in many other jurisdictions) but strongly motivated and supported, annuitisation – which is the most adequate tool leading to pensions – should at least be strongly proposed as the automatic way. The degree, timing and other details of annuitisation must be well designed, but some form should be a part of the default option."*

SUMMARY: Responses to this were very mixed. Respondents agreed that inertia had provided benefits in the accumulation phase of pension saving, but not all thought that this could be used in the decumulation phase: one reason for this was the greater diversity of needs in the decumulation phase, which makes it much harder to provide appropriate defaults. There were also differing views on whether defaults were needed to address the issue of inertia or whether they discouraged engagement with the process and made matters worse. Several responses suggested having a menu with a limited number of default choices.

24. (b) Given the importance of income security for the elderly and the existence of longevity risk, is there a case for defaulting people into buying longevity insurance via auto-enrolment (i.e., drawdown with longevity insurance becomes the default retirement strategy)? Consider the advantages and disadvantages of such a strategy.

There were seventeen responses to this question: 30 per cent were unambiguously against having such a default, at least in the short term, and 35 per cent were predominantly in favour.



While some felt that such a policy was inappropriate given the policy change to "freedom and choice", the greater concern was how to provide an appropriate range of options for heterogeneous pensioners with different needs.

> *"(CBI) ... creating default routes into an income product for savers at retirement should not be a priority for the next government. The saving positions of people at retirement will be vast as the result of auto-*

enrolment, and therefore there will be no one-size-fits-all route that will suit most individuals. A default income route risks putting an individual into a product that does not suit their circumstances ... "

Among those in favour, most suggested that the defaults should be contingent on at least some of the circumstances of the consumer

"(SPP) We would be cautious about making drawdown a default. We think drawdown works best when individuals are engaged and make conscious decisions about the specific aims, which they wish to meet through drawdown. For default options, it might be better to concentrate on paying the whole pot as a lump sum if it is below a certain level or simply buying an annuity if it is not."

A few of the suggestions for defaults were phrased within more detailed suggestions for the whole process. For example,

"(TUC) A system of limited – no more than three - retirement pathways would strike the balance between harnessing inertia and providing options for consumer to consider. These would provide a starting point for conversations with guidance advisers too. This reconciles the idea of freedom while making it more manageable for consumers than being presented with a blank sheet of paper and asked to plan for what could be several decades in retirement. Each broad retirement pathway could contain a default route plus some variations from it appropriate for different circumstances.

Given the importance of managing longevity risk, there is a strong case for longevity insurance being part of the key pathway offered to consumers."

Alternatively, the longevity insurance need not be a single-premium policy:

"(Lawyer) It would be helpful to establish whether there is any advantage in purchasing longevity insurance by instalments over the member's accumulation period as distinct from purchasing the longevity insurance with a lump sum at the time the member decides to start drawing-down his retirement savings.)

The most enthusiastic response to a default noted that people could always opt out:

"(Consultant) I do not see real disadvantages of such an 'auto-enrolment' strategy in the payout phase, if the most appropriate type of annuity (and the age of annuitisation) is well defined. Those who do not want it will opt out (and there will be enough communication to do exactly that by interested parties) and the solution would serve the interest of the majority in helping to manage longevity risk. Individual needs (e.g., debt repayment, requirement of an enhanced annuity, etc.) may be handled even in such a default environment – just as you do not have to save in the auto enrolment system or do not have to stay in the default portfolio. Reconciliation with the freedom of selecting a pension product is not a problem. Every retiree is free to select whatever product. They are just not left alone."

SUMMARY: Responses were equally divided on whether or not there should be defaults into longevity insurance. Opponents said that such a policy was inconsistent with "freedom and choice" and that it would be hard to select an appropriate range of options for heterogeneous pensioners with different needs. The most enthusiastic supporters said that people could always opt out.

24. (c) What would be the likely annualised cost of such products for individuals?

There were six responses to this part of the question and most noted that the cost depended on too many circumstances to be able to give an answer. Two responses suggested that a deferred annuity starting payment at age 85 would not cost much if purchased at age 60.

SUMMARY: Responses suggested that the cost of default longevity products depends on too many factors to provide a simple answer.

24. (d) How could the default principle, upon which the success of auto-enrolment is predicated, be best reconciled with the individual freedoms for DC decumulation introduced in the 2014 Budget?

There were ten explicit responses to this part of the question. The variety of views about defaults expressed earlier translated into different views on this question. Some felt that there was no problem:

> *"(Consultant) [regarding default or encouraged annuity option] Reconciliation with the freedom of selecting a pension product is not a problem. Every retiree is free to select whatever product. They are just not left alone."*

Others suggested that defaults could help consumers to start the process

> *"(Consultant) Defaults can be very helpful in eliminating confusion and setting participants on a good course if the right products are chosen."*

especially where consumers would be under-confident in making decisions:

> *"(Consultant) … lots of people who do want to engage but are not comfortable making extremely complex decisions about their retirement will simply want an answer to the question "What should I do?", and the guidance guarantee as currently constituted will not answer this. To accommodate people who fall into the above category and who are not catered for by the regulated financial advice market industry should develop a 'default recommendation' that is likely to be appropriate for most people in their general circumstances (for example health, family status, pot size). This could then be provided as part of the guidance guarantee."*

Alternatively it was suggested that individuals who wanted to take advantage of the new freedoms would need advice:

"(Consultant) If members wish to take full advantage of the individual freedoms they will have to make decisions from a wide range of options, which may include leaving the scheme(s) in which the DC pot accumulated. To do so effectively, they will need to engage with the process, and may need help.

They may feel that they are happy to make some of their own decisions (e.g. short-term ones) but are uncomfortable with, for example, assuming the full risk of getting things seriously wrong and running out of money.

For those retirees, a default strategy that sits below the full drawdown options and acts as a safety net, but uses a part only of the accrued DC pot to secure an income to supplement any earned income and/or state or other workplace pension, leaving the balance to be drawn down according to the retiree's discretion, can coexist with the Budget 2014 freedoms. This, of course, will require a DC pot and/or other discretionary income of sufficient size ... ."

Finally one respondent, already quoted above, suggested that the issue needed more analysis:

"(Consultant) The default nature of auto-enrolment (which recognises that individuals do not always make considered choices about their finances) is at odds with the individual freedoms for DC decumulation (which assumes that individuals are best able to make decisions about their money). We do not believe these are entirely irreconcilable, but far greater policy attention needs to be given to their interaction."

SUMMARY: Responses were very divided on whether or how defaults into longevity products could be reconciled with choice and there was no agreed position. Supporters of defaults thought there was no real problem of reconciliation: defaults were useful in eliminating confusion and helped those who wanted to be told what to do, while everyone was free to opt out. Opponents said individuals needed advice to take full advantage of the individual freedoms.

25. What are the implications of the Chancellor's announcement in September 2014 effectively ending the 55% tax rate on inherited pension pots?

A third of the fifteen responses thought that this would increase the attractiveness of savings and increase pension savings.

"(Insurance Company) The abolition of the 55% tax rate on inherited pension pots should encourage individuals to save, as it will allow them to pass on any retirement savings in their entirety to their loved ones.

A few responses thought that this made inheritance situation easier, although this depended on how the pension wealth was put into drawdown. Most of the remaining responses discussed the effect on post-retirement behaviour, realising that this might encourage more bequests, but that the issue was moot for consumers with small pots:

"(Consultant) In theory this could encourage more people to draw down less from their pots in early years, because they would be able to pass on any amounts remaining at their death to a relative, without it incurring punitive tax. ... In practice, however, this latter type of estate planning is likely to be rare, due to the small size of most pots – a factor which is unlikely to change significantly for many years, if at all."

Another response suggested that it might create another behavioural barrier:

"(Insurance company) The prospect of a tax free legacy may have another behavioural effect, in further undermining the purchase of an annuity. Prospective annuitants may be discouraged from securing a guaranteed income by underestimating both their income requirements and their longevity. As a result, they feel that they may be depriving beneficiaries of a lump sum, when the reality for many is that their fund will be extinguished in their lifetime."

As with the previous question, it was noted that the effect would depend on the position of the saver.

"(TUC) This risks having the twin effect of allowing very wealthy savers a route around inheritance tax, while leaving low and middle income people restricting their spending and quality of life in retirement because they feel an obligation to pass on some limited wealth to their beneficiaries."

Three responses were critical of the change, typical of which was:

"(Consultant) Pension saving tax rules should penalise bequest behaviour – bequests have no part in pension tax policy."

SUMMARY: A third of respondents thought that ending the 55 per cent tax rate on inherited pension pots would encourage more pension savings. Others thought people might feel obliged to use their pension pot for inheritance, rather than spend it during their own retirement. Most recognised that the issue was irrelevant for people with small pension pots.

26. What are your views on the guidance guarantee and how effective it will be?

Of the 21 responses, 19 per cent thought that it was too soon to say and some raised issues concerning costs and whether it would be able to meet its existing remit.

"(Consultant) It is too early to say. It seems that it will be more costly and complicated than what the first statements of the government indicated. It is still possible that the 400,000 retirees expected to need the guidance may receive an acceptable service, but even to monitor that process and handle complaints may turn out to be a gigantic job."

Four thought that it would be inadequate, although only one was sufficiently emphatic to say

> *"(Consultant) It sounds like an absolute disaster! People want to be told what to do, they don't want someone telling them, 'Here are a bunch of options to consider, but I can't tell you what you should do.' "*

Whether positive or negative, responses often worried that recipients of guidance would not be sure what they were getting:

> *"(Consultant) We believe that the guidance guarantee (now branded Pension Wise) will be of limited effectiveness. In our view, the distinction between "guidance" and "advice" is an entirely arbitrary one understood solely by the financial services industry, and completely alien to others. Consequently, lay people turning to Pension Wise for help will be disappointed that they are not given advice, or anything approaching it."*

The most common views were that it provided a floor to what consumers would receive and would, in the best case, help consumers decide whether or not they needed advice.

> *"(Consultant) For most individuals, this is unlikely to provide sufficient information to make the best decision, but may prevent some from making poor ones."*

> *"(Pension provider) We think Pension Wise has the potential to address some of the most significant shortfalls in the pensions market, including the weakness of the buyer side. However, it is impossible to know whether it will be effective until it is launched in April 2015."*

> *"(ACA) The guidance guarantee does not provide anything like all the help needed by consumers and will be too late to really affect outcomes for many people. It could also be difficult to provide the promised guidance if demand is high. That said, we welcome the guidance guarantee as a useful step in the right direction."*

> *"(Pension provider) The Pension Wise service provides a useful generic 'sense check' for investors approaching retirement."*

SUMMARY: Many responses thought that it was too soon to tell whether the guidance guarantee would be effective and many had concerns that it would be insufficient, especially for those who wanted to be told what to do.

27. (a) Will other forms of guidance and advice be needed?

There were nineteen responses to this question and 95 per cent of these said that more support would be needed by some or all parts of the market. The remaining response also felt that guidance would be inadequate, but the focus on advice was wrong:

> *"(TUC) The focus should be on providing robust income pathways rather than seeking to educate or advise consumers in the hope that they can become effective market actors in their own right. This latter aspect is, at best, a long-term aim."*

So, with this caveat, there was unanimity that the current guidance will be inadequate. There were various responses to the issue of advice. One provider felt it was essential

> *"(Insurance Company) given the complexity of the current market, [our company] does not accept business from individuals unless they have sought advice."*

A further suggestion, found by 26 per cent of responses, was that there needed to be a level of support between guidance and advice:

> *"(Insurance company) However, we also know that the price of advice is off-putting to some customers. [We] would like to see the development of a mass-market for advice. ... something between full advice and guidance, with a fixed fee. However the regulatory regime would need to be changed to enable this. [We] believe that the FCA's recent Finalised Guidance on Retail Investment Advice will not lead to a market for simplified advice as the regulator intends."*

SUMMARY: There was a very strong view that more support would be needed than the guidance guarantee alone. A quarter of responses thought that there needed to be a level of support between guidance and advice.

27. (b) For DC savers who prefer to make their own decisions, what is the best way to build on the guidance guarantee to help individuals avoid buying retail products that are inappropriate (e.g., in relation to risk) and/or poor value (e.g., in relation to price)?

Of the fifteen responses to this question, 27 per cent mentioned advice or guidance and one mentioned nudges. The most common response was to provide better information, frequently by making it more accessible and more comparable. One response noted that the guidance guarantee should explicitly explain the difference between regulated and non-regulated investments. Twenty per cent of responses suggested providing more online tools to help consumers:

> *"(Consultant) Risk rating questionnaires and cash flow modelling tools would help DIY DC savers to check for suitability. These are widely available to advisers but less so for individuals. Similarly, consumer comparison engines do not cater well for retirement income products."*

> *"(Lawyer) Just as independent advice must be obtained before a member transfers a defined benefit pension into a defined contribution retirement savings arrangement (leaving to one side amounts with a value of £30,000 or less), the same should apply to the decumulation of the member's retirement savings. If necessary, it could be made mandatory, for example, that the member's retirement savings should be created with an 'expense reserve' for the provision of independent advice built into it."*

SUMMARY: Most responses thought that better information needed to be provided to build on the guidance guarantee, possibly via online resources. Only a minority referred to advice or nudges.

28. (a) What specific risks should regulatory safeguards aim to address in relation to financial decisions made at retirement?

The fifteen responses to this question can be divided into three roughly equal groups. In the first group, respondents suggested that regulation should ensure that products should be approved, that consumers would be sold items with a suitable risk rating, and that basic questions should be asked to identify, for example, that married individuals had suitable products.

> *"(AGE UK) For example, developing minimum quality standards for products; looking into appropriate defaults; and ensuring that standards are in place to govern lenders' behaviour in relation to debtors' pension pots."*
>
> *"(Pension provider) It should also aim to identify vulnerable individuals who are unable to make an informed decision."*

The second group identified financial risks, such as investment risk, and longevity risk. The final group were concerned about scams and mis-selling.

Among the responses, some respondents raised the issue of risk to the state:

> *"(ACA) The most obvious key risk is deliberate deprivation - spending assets before falling back on the State. If consumers otherwise bear the consequences of their own decisions, then arguably this is the natural result of the Freedom and Choice reforms."*
>
> *"(Consultant) This depends on what policy decision is made on the nature of a floor for a saver where the capital for whatever reason has run out - is the state a provider of last resort? Should there, for example, be a NEST equivalent that introduces a form of DB provision in the form of certain floors and ceilings in the provision at decumulation stage based on accumulation history. There would be issues of State Aid to be resolved - particularly in relation to the EU 4% capital requirement and whether the government could fund that or be a guarantor for that on a pay as you go basis. There is a real case to consider a 'regulated own fund' type of provision - DB NEST - that would then drive the regulatory framework and protections that would be needed and would determine when the State would step in to look after an individual when the products designed for their needs 'fail'."*

SUMMARY: Respondents identified three main risks of decision-making at retirement that need to be addressed by regulation: the risk that individuals purchased inappropriate products (e.g., a married person buying a single life annuity); the investment risks faced by individuals; and the risk of scams and mis-selling.

28. (b) At what point does individual choice cease to be a regulatory concern/responsibility?

There were twelve responses to this question and 42 per cent noted that the point of the recent reforms was to provide choice and that this would inevitably mean that at some point consumers should be free to make mistakes and hence not the concern of the regulator:

> *"(Pension provider) Products should be approved, but the government has brought in legislation to provide complete flexibility to members and has stated that individuals should be trusted – responsibility for policing should therefore not be a burden on the industry who were not consulted over these changes."*

> *"(Insurance company) Providers cannot be responsible for the individual who, in full possession of the facts, makes a decision based upon something they want, rather than their needs."*

In some cases, there appeared to be cynicism about the government's view of this issue:

> *"(Consultant) Given the government's apparent nonchalance around the possibility of a retiree using up all their accrued DC pot before death and relying solely on the state basic pension, the risk of virtual penury from this route is unlikely to be the focus of regulatory concern."*

At the other extreme, one response suggested that individual choice does not cease to be a concern and this is for the protection of both the consumer and the industry:

> *"(AGE UK) At no point should people cease to be a regulatory concern. If these reforms are not successful, the impact on public trust in financial services and financial regulation will be severe. The regulatory safeguards should aim to minimise the risk of people taking poor decisions ..."*

Within this spectrum, several responses suggested that the point at which regulation ceased to be concerned was when an individual secured an income for life (many response pointing out that firms always had to act within regulatory requirements when selling or providing any product).

SUMMARY: Responses disagreed on when individual choice ceases to be a regulatory concern. On balance, responses suggested that it was when (or if) an individual secured an income for life. A significant minority (42 per cent) said that the point of the recent reforms was to provide choice and that this would inevitably mean that at some point consumers should be free to make mistakes and hence not the concern of the regulator.

29. Some DC customers might draw down all their pots in the early years of retirement, a decision they might subsequently regret. What is the most effective way of assisting DC customers to act in their best long-term interests?

There were eighteen responses to this question and they were quite varied, largely reiterating previous responses. Some returned to the issues of defaults, some to incentives to secure an income (at varying points in retirement); others advocated education and information.

> *"(Consultant) The most obvious way is having at least partial annuitisation, at least from the age 75 or so, as part of a default strategy."*

"(Pension provider) Education. This needs to be an on-going process which starts while in full time education and is continued, where possible, by the pension provider.

Unless you prevent individuals from making their own decisions, it is not possible to prevent any bad decisions being made."

Responses reiterated that it is impossible to prevent poor decisions and that, in some cases, it is not always clear what constitutes a poor decision. However, several recognised that poor decision making could result in large problems later.

"(AGE UK) We are concerned about the potential scale of this problem and that it will mean considerably worse outcomes for many people in later life. It is, of course, unknown at present exactly how many people will be affected, and it may not become clear for several years."

"(Consultant) It is also important – and ought to be an integral element of the new approach of 'freedom' – to make very clear that if the individual runs out of savings early due to lump sums and fast drawdown and the lack of proper longevity insurance, there is no specific state support in place.

If the libertarian approach is preferred to the paternalistic one, then a free lunch financed by other pensioners, or the taxpayer in general, may not be allowed. Such moral hazard must be ruled out upfront."

SUMMARY: Respondents were divided on how to assist DC customers to act in their best long-term interests and not make decisions that they subsequently regret. Some responses noted that the point of "freedom and choice" is to allow choice and that the possibility of bad choices must be accepted as part of that. The responses to this question on how to avoid bad choices were varied and included defaults, better education and incentives to secure an income (at varying points in retirement).

30. (a) What is the best way of ensuring that any DB-to-DC transferees only undertake such a transfer when it is in their best interests?

Of the fifteen responses to this question, 73 per cent said explicitly that consumers should be given advice (perhaps excepting small pots) and one response raised the possibility that transfers should be banned unless advice for the transfer was positive. Where responses mentioned guidance, it was agreed that this was inadequate. One response suggested that if individuals wanted to transfer out they should take advice at their own expense.

The other responses largely suggested discouraging transfers and discussed conflicts of interest.

"(Consultant) We would therefore not propose going further than has been proposed by the government in respect of individual cases, in requiring that the member takes (but has the freedom not to follow) independent financial advice. We would make one change to the government's

proposals however. The member should always be the party bearing the cost."

"(Consultant) Transfers should have some anti-avoidance provisions so that the transfer to DC is not seen simply as a way of accessing the pot of capital. There needs to be more regulatory thought in this area."

SUMMARY: The large majority of respondents thought that transfers from DB to DC should only be allowed after taking advice (with an exception for small pots). Many accepted that the advice could be ignored, although one suggested that transfers should be banned if the advice was negative. One response suggested that if individuals wanted to transfer out they should take advice at their own expense.

30. (b) What are your estimates of the number of DB-to-DC transferees (deferred and also active) and size of assets involved?

There were very few responses to part (b) of the question. Two responses suggested that the proportion transferring might be ten per cent.

"(ACA) Anecdotal evidence suggests that only 10% of transfer offers reviewed by an independent financial adviser result in a recommendation to transfer. There is however clearly scope for a massive transfer … the impact is likely to emerge gradually over the coming years as DB members reach retirement age."

SUMMARY: Very few responses provided estimates of the number of DB-to-DC transferees. Those that did thought that about ten per cent would transfer.

30. (c) Is the requirement for regulated independent advice for such transferees adequate?

SUMMARY: The few responses to this question believed that the requirement for regulated independent advice for DB-to-DC transferees was adequate.

30. (d) Can/will the guidance guarantee process cope with DB active/deferred members who seek help in considering their options?

As mentioned above, guidance was considered inadequate. One response noted that IFAs cannot advise on this issue without specialist qualifications and permission.

SUMMARY: Respondents thought that the guidance guarantee for DB members was inadequate.

31. Are there other ways of supporting pension savers to make the right choice at retirement for them and their family?

The twelve responses to this largely built on responses to previous questions, mentioning advice, nudges, incentives and information. Many noted that a combination of these would be necessary:

"(AGE UK) Automatic enrolment has proven inertia to be a powerful force, and this need to be harnessed in the decumulation phase too. Default products and pathways are likely to play a role in ensuring people spend their money appropriately, while advice and guidance will also be important."

Some responses also took a longer term view of the issue and discussed education and financial literacy more broadly.

"(Pension provider) Many people are reticent to talk about their finances. As a result, couples rarely communicate about either their retirement savings or their retirement plans. Therefore we believe that some behavioural work needs to be undertaken towards normalising conversation about later life savings."

"(ACA) Improved financial education from school and throughout working life will help consumers make better financial choices. In the short term, we hope employers and providers will give consumers guidance, information or even advice to supplement the basic guidance guarantee."

SUMMARY: Respondents suggested that a combination of approaches (including advice, nudges, incentives and information) would be needed to support pensioners to make the right choice at retirement. Some believed that better education and improved financial literacy were required in the longer term.

3. Helping savers to manage longevity risk

The consultation document discussed two issues in the introduction to this section: the idiosyncratic longevity risk faced by an individual member; and the systematic or aggregate longevity risk faced by a scheme. The issues then follow about how to manage these risks when faced with two constraints: the first might be poorly understood by members and the second cannot be hedged by schemes.

32. What evidence is there of individuals' ability to reliably estimate how long they are going to live?

33. How easy is it for individuals to quantify longevity risk? What evidence is available on this question?

There were twenty responses to question 32 and seventeen to question 33, but answers often overlapped.

Responses were unanimous in reporting that consumers were poor at estimating life expectancy and tended to under-estimate it.

In many cases, respondents implicitly or explicitly referred to a wider body of research than their own experience. Of course, this merely confirmed the claim on page 11 of the consultation document that "[r]esearch has found that most individuals underestimate how long they are going to live, often by many years".

One provider noted that its own experience was that consumers only under-estimated life expectancy a little and several noted that the problem got less severe as consumers approached retirement and started thinking about these issues.

Most responses noted explicitly that point estimates of life expectancy were largely irrelevant, since what mattered was the uncertainty

> *"(TUC) There is little evidence of [being able to estimate life expectancy]. We would also question the value of such knowledge. While a saver might know average life expectancy, they will never know whether their own lifespan is going to be longer than this – or whether they will fall under a bus on the way home from their guidance session."*

> *"(NAPF) A recent report supported by NAPF found that men aged 50–60 underestimate their life expectancy on average by around two years and women by four. Perhaps more significantly, people tend to make point estimates of their longevity and find it difficult to comprehend the range of possible outcomes."*

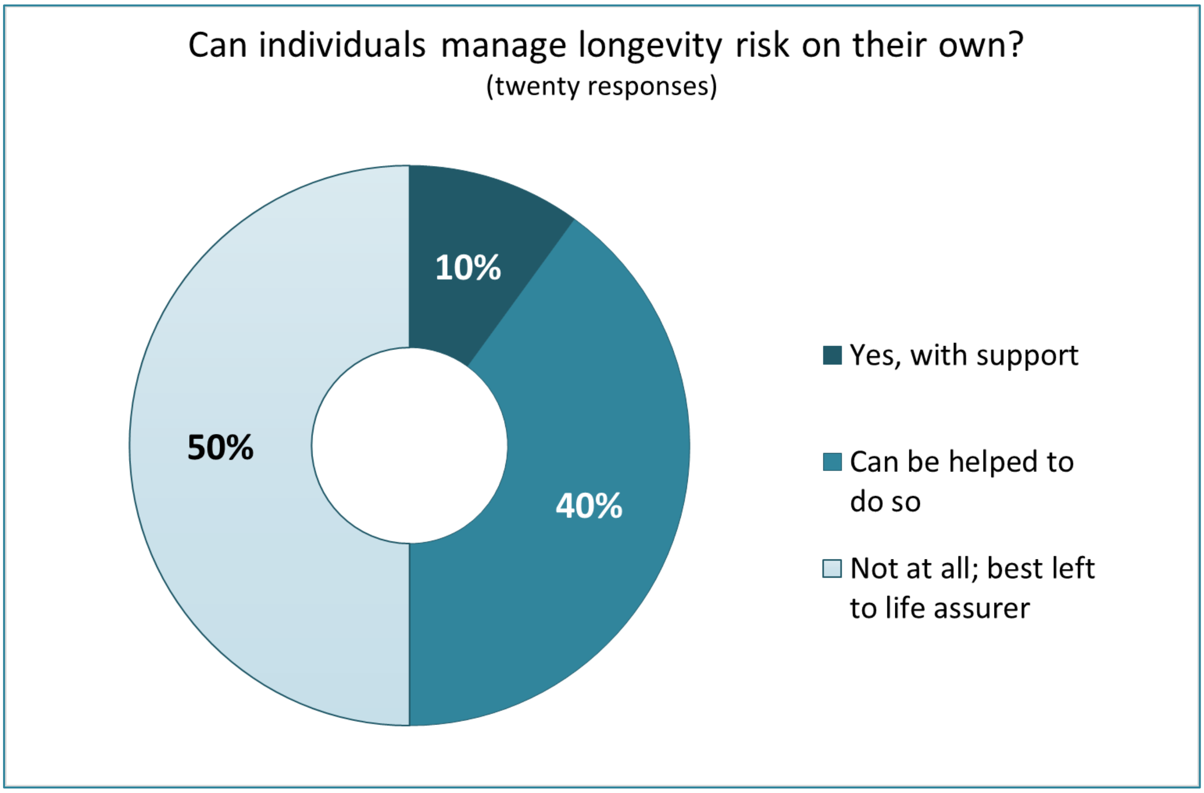
> *"(Insurance Company) It is almost impossible to accurately quantify longevity risk. While the new pension freedoms are to be welcomed, for those who choose not to buy a source of guaranteed income for life, it will mean that individuals will have to be a fortune teller, actuary and an investment manager."*

Several responses argued that once consumers had started to engage with the process, they were able to grasp the key issue of running out of money before death quite quickly: furthermore that online tools or appropriate graphs helped illustrate the scale of the problem.

SUMMARY: Respondents were unanimous that individuals had problems estimating both life expectancy – with a tendency to under-estimate it – and longevity risk. A minority thought that these problems could be overcome with education or engagement.

34. Is longevity risk a risk that individual savers are able – and should be expected – to manage themselves?

Of twenty responses, only two suggested that individuals could manage longevity risk satisfactorily and 50 per cent said "no" unambiguously.



However, some argued that the process could be managed, albeit not necessarily particularly well. For example

> *"(ACA) Savers will be able to manage longevity risk to some degree, especially if given the right help. However, given the complexity and high level of stochastic risk, we do not believe that the average consumer will be able to manage this optimally. This again highlights the benefits of longevity insurance/annuitisation."*

Several responses noted that this was a natural corollary of the recent reforms:

> *"(NAPF) On the one hand, Freedom & Choice, and indeed earlier changes to pension policy, have allowed people to take this risk. Removing those*

freedoms will be politically difficult. On the other hand, if the risks are not knowable simply informing people that they are now exposed to them may not prove adequate. The development of default pathways described above and that take account of other behavioural biases seems to strike a middle ground between extreme freedom and extreme paternalism."

Along the same lines, one argued that if consumers took their decisions carefully then it was impossible to gainsay their decision:

"(Pension provider) ... even fully informed individuals will behave differently to their own longevity risk. While some may choose annuity purchase, others may elect to eke out savings and still others may choose to spend their savings early on. Each of these routes may be appropriate for that individual, but it is only if they make an informed decision, having spoken to Pension Wise and/or having consulted an adviser ..."

One response emphasised the need for some form of longevity protection in the absence of annuity purchase:

"(Insurance company) ... We further believe that widespread movement from annuity schemes to income drawdown could have invidious long-term consequences. To guard against such consequences, individuals should be aware that hybrid products exist, such as guaranteed drawdown, which offer a degree of flexibility and access but also provide a guaranteed income for life."

SUMMARY: The majority of respondents thought that individuals could not manage longevity risk adequately, and pointed to solutions in the form of longevity insurance, annuities and guaranteed drawdown. A minority thought that individuals could manage longevity risk if they received some additional help.

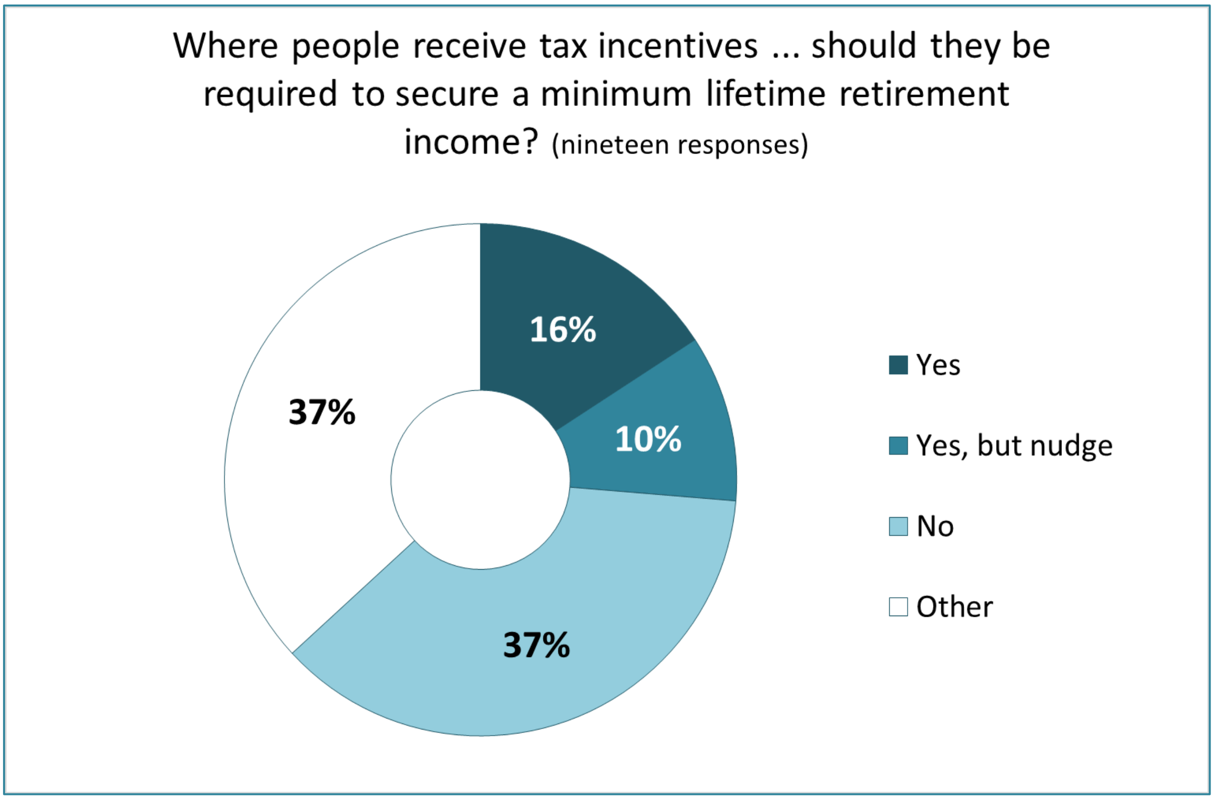
35. Where people receive tax incentives to save into pensions, should people be required to secure a minimum lifetime income in retirement?

There were nineteen responses to this and they represented a variety of positions.

Twenty-six per cent thought that a minimum income was a good idea, but some of these (ten per cent) believed that it should be achieved via a "nudge" rather than be compulsion. Most respondents noted the need for an exemption for small pots. The reason for compulsion was linked back to the original rationale for a pension in the first place:

"(Lawyer) It is unclear why future taxpayers should have to pay for those who have over consumed their retirement savings and fall back on the State for support."

"(Consultant) Yes, otherwise it may not really be pensions after all. People running out of savings early may have to rely on state support, which leads to costs paid twice by the taxpayer."



However, others argued that the policy would have been effective anyway, since resources had been saved for retirement:

> *"(ACA) The tax incentive encourages retirement saving overall and this saving need not be drawn as a regular income. The public policy objective can be achieved even if the funds are used irregularly after retirement."*

> *"(Consultant) I don't think you can expect them to secure a minimum lifetime income if the products are solely dependent on market risk - but a NEST Type DB fund that required a minimum amount of capital saved to provide a DB type benefit may be more realistic, with shortfalls being underwritten by the government on an insured or pay as you go basis. But as covered in question 2, this is where there may be a real case for a Pensions Commission so that these pots could not be dipped into by future governments."*

Three responses noted that a requirement to buy a lifetime income might be a cause of low saving to start with, for example:

> *"(Pension provider) This leads to the risk of individual inaction induced by the scale of challenge. For example, a twenty year old on £20,000 a year may need pension contributions of over 20% a year for almost fifty year to achieve a retirement income of two–thirds of their final salary. If this is perceived as, or actually is, unrealistic there will be a strong temptation to not save at all. It is therefore important that the message that individuals are not saving enough for their retirement does not prevent them from saving anything."*

Many responses did not provide an unambiguous "yes" or "no", but suggested that the whole issue needed to be considered within a re-evaluation of tax reliefs. For example, pensions saving could be combined with (or become a long-term savings vehicle):

> *"(Consultant) ... These changes, reinforced by the freedom and choice agenda, indicate a possible change of purpose for tax relief, effectively turning it instead into a long-term general savings incentive. If that is seen as a socially desirable objective, then the relief may survive. However, if it is not judged to be worth the expense, then continuation of pension tax relief is more doubtful – particularly in an age of austerity."*

Alternatively the tax incentives might be withdrawn or deployed elsewhere:

> *"(Insurance company) There could be potential to use tax incentives to incentivise in the decumulation phase instead. For example, awarding tax relief on longevity insurance premiums or applying a more favourable tax rate on the receipt of guaranteed income. This would provide incentives to secure income payments in retirement and would have the effect of boosting income payments."*

Finally, it was noted that the tax incentives failed to reach savers on low or modest incomes anyway and that this was a much more significant problem.

SUMMARY: Respondents were split on whether people who had received tax incentives should secure an income in retirement or not. Just over a quarter said "yes", while just over a third said "no". Others thought that tax relief could be used to encourage people to buy longevity insurance after retirement. Some thought that the use of tax relief in pensions should be reviewed, especially since it did not benefit those on low or modest incomes.

36. (a) Do you believe that the DC retirement income market could benefit from the introduction of a market in longevity bonds? Explain.
(b) Do you believe that a market in longevity bonds is viable (in the sense of having sufficient demand to justify its introduction)? Explain.

37. Do you have a preferred design for a longevity bond?

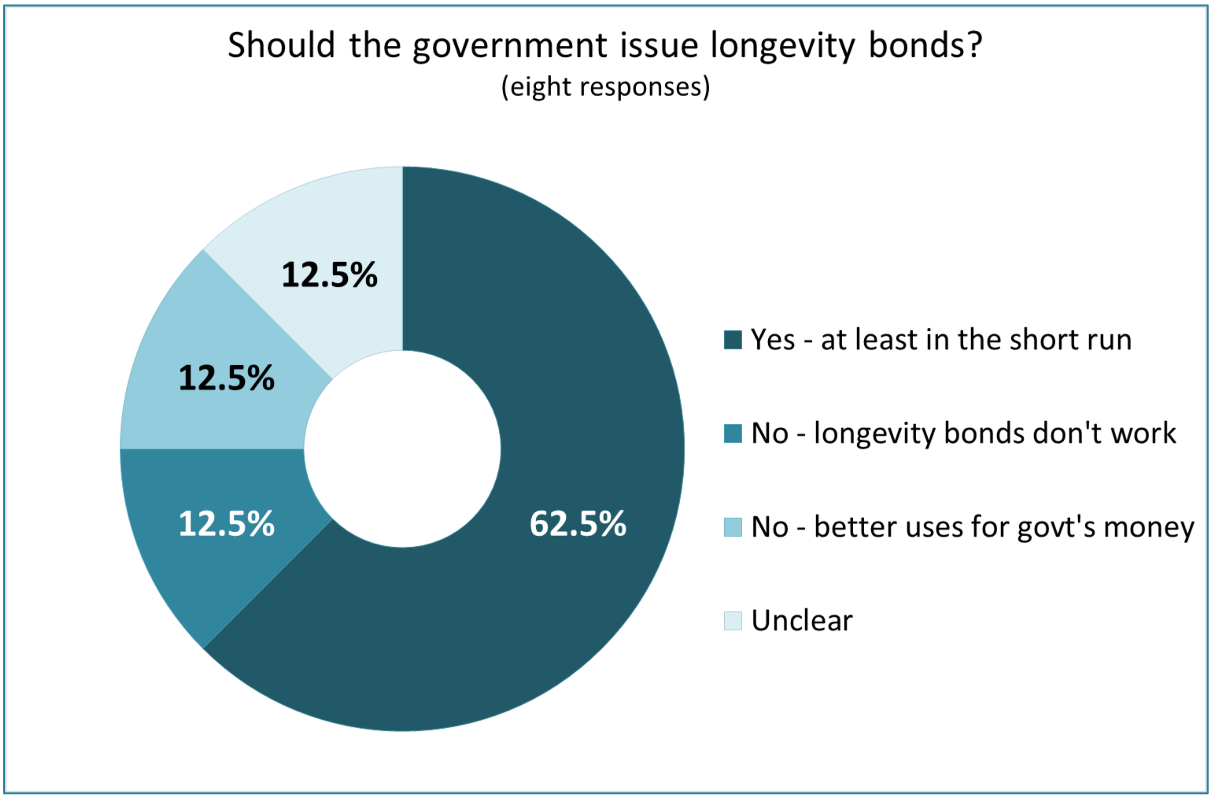
38. Is there a case for the government to issue longevity bonds? Explain.

These questions received between eleven and two responses, although not all respondents answered all questions. I consider these three questions together because the questions were interpreted in two quite different ways: some responses assumed longevity bonds referred to wholesale financial products sold to life assurers to allow them to hedge their longevity risk, while other responses interpreted longevity bonds to be retail products.

I start by considering the interpretation that a longevity bond is a product purchased by a life assurer to hedge cohort mortality risk. Some responses were negative, arguing that longevity bonds had been unsuccessful hitherto and such products would have to be supplied by the government. It was suggested that the government might use its resources better to support the state pension. Another response thought that they were very important to support life assurers.

> *"(Consultant) Longevity bonds – issued by the government – would be essential for insurance companies to hedge their risks when providing deferred annuities."*

A total of eight respondents interpreted a longevity bond in this way and 63 per cent thought that government should issue such products.



The alternative interpretation was that longevity bonds referred to retail products sold by the Post Office or National Savings, i.e. a form of deferred annuity. Several respondents thought this a good idea, for example:

> *"(Pension provider) As discussed above, we believe that there is a strong case for longevity bonds that pay regular income over a fixed or indefinite period, especially if tax free transfers from pension funds were permitted.*
>
> *The Government has been hesitant to issue longevity bonds, but NS&I holds less than one tenth of government debt and this option could be cheaper for the Government than issuing debt on the gilt markets."*
>
> *"(Consultant) A [deferred annuity] would be a very useful ingredient of a decumulation strategy as it has risk smoothing and other beneficial characteristics. However, unlike the US, the UK does not have these instruments which, given its dominant role in annuities globally, is an anomaly. One of the main reasons is exactly the lack of such longevity bonds.*

I expect that many stakeholders will realise that annuities should still be a basic element of a sound retirement strategy, but that more user-friendly versions have to be developed. Since deferred annuities are exactly one of those potential solutions, I think there would indeed be a demand for longevity bonds.

Yes, the government is best positioned to issue such instruments, due to scale, a need to finance government debt by identifying new buyers, and because the government may in fact have a natural hedge here."

One respondent went further than this and thought that there could be a secondary market in such products and that this would encourage purchase in the first place:

"(Consultant) If an individual purchased longevity protection in their SIPP & it's value increased the closer they got to vesting date and they could then choose to realise this value by selling it to someone else in the market who wanted to purchase it for a discount vs the new business purchase price, then it would encourage retirees to purchase the cover yet give them the comfort of knowing that if their situation changed they weren't loosing out on the purchase price."

SUMMARY: There were two interpretations of these questions on longevity bonds. Where longevity bonds were interpreted as products issued by the government to allow insurance companies to hedge mortality risk, a majority were in favour of government issuance, although a minority did not believe they would work. Where longevity bonds were interpreted as retail products (i.e., a form of deferred annuity) purchased by individuals (perhaps from the Post Office or National Savings and Investments), many respondents thought that this would be a good idea.

39. Are there alternatives to longevity bonds to hedge systematic longevity risk? Explain.

Where this question was interpreted as referring to wholesale products for life assurers to hedge their risk, there were only two answers. One said no, but the other was a little more positive:

"(Consultant) It should be possible to introduce hedging structures but the economics would need to be worked out and the options may be quite expensive."

SUMMARY: There were only two replies to whether there are alternatives to longevity bonds to hedge systematic longevity risk, one saying "no" and the other saying "yes, but it would probably be expensive."

40. Are there other ways of helping savers to manage longevity risk?

There were nine very varied responses to this question, several referring to previously mentioned products such as annuities or guaranteed drawdown. Most responses did not think that other products were available:

> *"(Consultant) Savers are not in a position to manage idiosyncratic longevity risk without longevity insurance (annuity) and providers can not perfectly handle systemic longevity risk in other ways than described above (longevity bonds or swaps)."*

Forty-four per cent of responses argued that more could be achieved with better education, communication and positive and encouraging engagement. For example,

> *"(SPP) We suggest that part of the means of helping savers to manage longevity risk is to place a more positive emphasis on the process. Individuals are perhaps more likely to respond to encouragement, say, to ensure that they have sufficient savings left to support possible long term care needs or to provide an inheritance for their survivors, than they are to specifically addressing longevity risk.*
>
> *We also would note here that work has been, and is being done, by the Pensions Policy Institute, using qualitative research methods, into how to develop default products and strategies for individuals approaching retirement ... and suggest that this material should be referenced in your analysis."*

The final response suggested the government provide an additional pension from age 85 or 90 to provide longevity insurance for the very old.

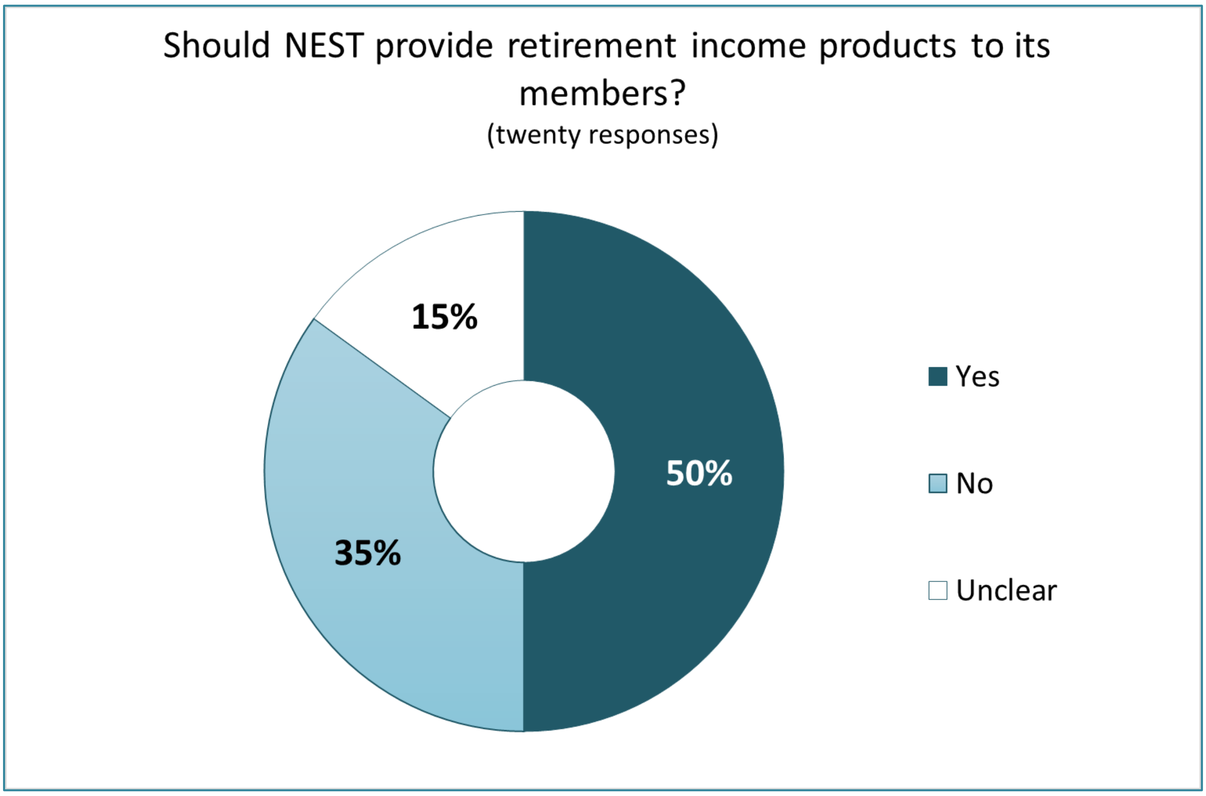
SUMMARY: Most responses thought that savers could not manage longevity risk without some form of annuity or guaranteed drawdown. A significant minority thought that better education and engagement would improve the chances of individuals dealing with longevity risk.

4. The role of the National Employment Savings Trust (NEST) in helping savers to access good quality retirement products

The consultation document noted that NEST has radically transformed the accumulation phase of DC pensions: thereafter, in the distribution phase, members have to purchase retail products on the open market. This section asks what institutional standards could be brought to the retirement income space and what role NEST could play.

41. Should NEST provide retirement income products to its members?

There were twenty responses to this question and fifty per cent thought this to be a good – or even excellent – idea.



Supporters emphasised the ability of NEST to use inertia, its economies of scale and the links between accumulation and decumulation.

> *"(Consultant) Yes. NEST's investment strategy should keep on connecting the accumulation and payout phases, and they are in the process of reconsidering their options without mandatory annuitisation. Decoupled accumulation and decumulation phases lead to suboptimal pensions. Given the success of the paternalistic approach in the savings phase, it is likely that an easy-to-use retirement product provider for the same customers would make sense. Scale, efficiency and comfort for clients support the idea of NEST providing (default) pension products. ATP's experience in Denmark could also be investigated in this regard.*
>
> *Alternatively, a strategic partnership with one, or more, reliable external provider(s) could be developed, where NEST's scale would achieve low cost*

and good value services from the partner(s) to NEST's customers. Judging the benefits and possible disadvantages of these two options requires more thinking."

"(Lawyer) NEST has shown that it is able to design good quality default and other options in a strong governance framework."

"(AGE UK) We are concerned that the mass market may fail to deliver high quality and good value products to consumers with smaller DC funds, and believe that NEST or a 'sister' organisation could play an important role in driving innovation and competition."

"(Consultant) It also holds the statutory duty of default provider in the event that an employer makes no active choice. Particularly in the new world of freedom and choice, where the distinction between work and retirement is blurred, it is advantageous for members with DC provision to have the opportunity of a holistic lifetime approach to retirement income provision. That is less likely to be achieved if there are enforced distinct and separate pre and post retirement phases, with the latter requiring the transfer of an accrued pot to another arrangement.

We do not consider that allowing NEST to extend its remit in this way presents an unfair threat to other providers that did not have the benefit of government-backed loans to finance their start up."

Another response suggested that it would promote competition:

"(Consultant) This would be an excellent idea—to set a public option standard that private companies would have to compete against."

However, some were concerned that this would divert attention from NEST's core mission, especially when it has not yet finished sorting out the issues of auto-enrolment.

"(CBI) It would also be premature to make changes to NEST's framework if there is no evidence that there is a gap in the market for it to fill. NEST has an important role to play, through its public service obligation, to underpin the workplace pensions market as part of the auto-enrolment regime. It should not seek to nationalise the private savings market by competing in more fields, unless there is logic behind government intervention. A lack of focus on its core goals is the biggest risk to NEST fulfilling its statutory duty to meet the needs of its target market."

Seven responses were against NEST being involved in providing retirement products. In some cases, this was because it was felt that there was no clear need or that the case for NEST being involved had not yet been made and required further debate. For example:

"(Insurance company) We consider it is premature to debate the relative merits of NEST as a potential decumulation provider. NEST was originally introduced as a result of an extensive piece of research and analysis by the Pensions Commission to address a very specific issue; namely, the apparent lack of availability / appetite for large-scale pension provision under

automatic enrolment. NEST's related Public Service Obligation very much reflects this.

It is too early to apply this rationale to the 'at retirement' market, when the new reforms have not even been introduced. We simply do not know at this stage exactly how consumers will behave in the new environment and how the market will respond to this. It therefore seems premature to conclude (a) that there is a market failure in the decumulation space and (b) that this should be addressed through creating a more prominent role for NEST."

Two felt that NEST should promote members to shop around and one of these explicitly worried that provision by NEST would reinforce an undesirable tendency for members not to engage with the process. One was concerned that the offer of a product by NEST might be interpreted as tacit support or advice.

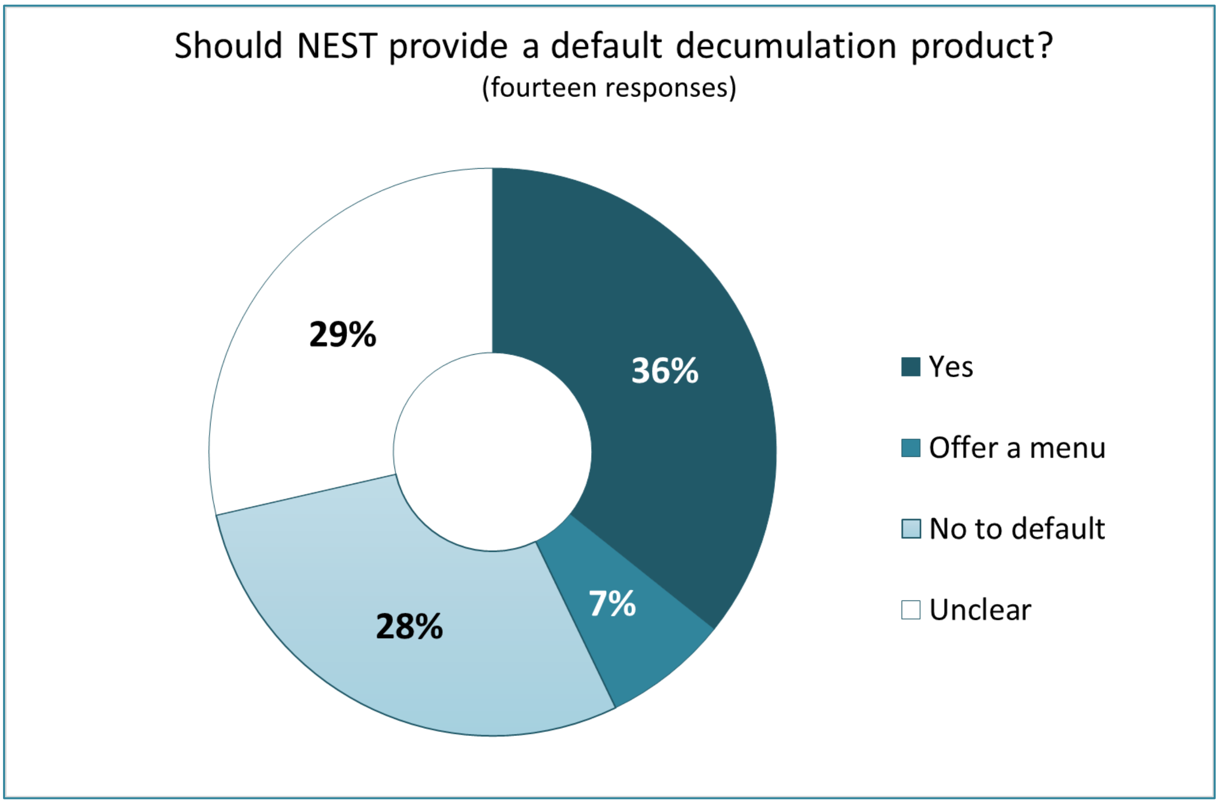
A quarter of responses felt that NEST was set up to be a retirement savings vehicle with a clear mandate to overcome a clearly identified market failure. This alone provided the justification for government support and enabled it to be set up within EU rules on state aid. The most explicit statement of this position is as follows:

"(Insurance company) NEST was put in place to deal with a recognised potential market failure attached to auto-enrolment, which is that some employers (particularly small and with low-paid, high-turnover workforces) would be unattractive or uneconomic for the private sector to serve for AE. Hence a 'provider of last resort' was needed to serve those parts of the market that the private sector was unlikely to reach – and it was on that basis that EU state aid approval for NEST was received. There can be no equivalent evidence that a market failure exists in the decumulation market, because that market has just been radically transformed by the new rules from the 2014 Budget (including the increase in triviality limits to £30,000, as well as the greater flexibility above that level). If it emerges over time that (for example) customers with small pots are not being well served by the new private market for decumulation, and that other regulatory intervention is not appropriate or sufficient, then there could possibly be a case for NEST to become involved in this market. However, until this evidence emerges we do not believe it would be appropriate for NEST to act in this way."

SUMMARY: Half of the respondents (a majority of those that had a clear view on the matter) thought that NEST should provide retirement income products, citing NEST's ability to use its economies of scale, the links between accumulation and decumulation, and pensioner inertia in seeking out good products. However, a significant minority – 35 per cent – were against the idea, mainly on the grounds that there was not yet any evidence of market failure in the provision of retirement income products and that this would also involve NEST operating beyond its original remit.

42. *(a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)? (b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?*

Excluding responses that had said that NEST should not provide retirement income products at all in the previous question, there were fourteen responses to this question.



A total of 43 per cent agreed with some sort of default, although in one case this would be a short menu of different default options rather than a single default. For example:

> *"(Consultant) NEST should provide a default decumulation solution. The basic ingredient of a default pension product could be an inflation-indexed annuity from the age of approximately 75, when a few years of 'free spending' by the member have already occurred, the tipping-point of good value purchase of an annuity has arrived but diminished old-age decision-making capability is not dominant yet. Such an annuity purchase may be phased-in, and/or combined with money-back or joint-life characteristics. As a rule of thumb, allocating the present 75% of savings for such an annuity seems reasonable, though more thought will have to be given to details."*

Many responses felt that it was not clear whether or not NEST should provide a default or, at least, that it was unclear at the moment.

> *"(Consultant) In my view they still need to sort out the accumulation products before moving to decumulation - but yes eventually that is what they should do and there should be quality standards around charges governance etc."*

The few respondents that answered the question about standards generally thought that existing quality standards would be appropriate, although one was against charge caps.

SUMMARY: Of the respondents who were happy for NEST to provide retirement income products, 43 per cent agreed that there should be a default or a menu of default opinions, 28 per cent were against, and the rest were unclear. Most thought existing quality standards would be appropriate.

43. Are there any other ways in which NEST can help savers to access good quality retirement products?

The eleven responses to this question focused on NEST being able to give better guidance or even advice and to signpost appropriate products. One response emphasised that engaging savers with pensions was a long on-going process and that lessons could be learned from successes abroad:

> *"(Consultant) Members need substantial, easy-to-understand, interactive communication from relatively young ages (30-35) and not only approaching retirement. If deferred annuities were made a part of the investment portfolio from the beginning, meaningful communication in fact should start immediately after joining. These are complex questions where customers require more than one simple letter. At the same time, customers do not read long and complex documents.*
>
> *NEST's way to communicate with members, its Golden Rules of communication, the vocabulary used and the Phrasebook provide a very good basis for further developing such a discussion with members. It should be simple (as simple as possible when discussing such complex subjects as annuities, and the link between optimising the accumulation and payout phases), interesting and interactive.*
>
> *Most of NEST's customers will not be able to afford costly advice, and the new regulations promise free guidance. NEST should be involved when developing the exact details, which should include easily understandable instructions that most likely prompt adequate action.*
>
> *While the context is somewhat different, the experience of the Chilean Supervisor (Superintendencia de Pensiones) in communicating with members in a user-friendly and interactive way and prompting them to make important decisions (such as saving more or working longer) may be useful to study. Similarly, TIAA-CREF's close and cost-efficient communication with its members may offer some ideas."*

One response suggested an annuity shopping service.

> *"(Consultant) Perhaps offering an annuity shopping service similar to Income Solutions(R) in the U.S."*

SUMMARY: Most respondents suggested that NEST could provide guidance, advice or something in between, and also signpost customers to appropriate products. One respondent suggested the importance of engaging with pension savers on an on-going basis. There was also a suggestion that NEST might provide an annuity shopping service.

44. In an aggregator model for stranded pots:
(a) Would it be desirable for NEST to act as one of the aggregators?
(b) Which other schemes could act as aggregators?

There were eleven responses to this question. Twenty-seven per cent said "no" and while the other 73 per cent said that NEST could be an aggregator, no one wanted NEST to be the only aggregator. To act as an aggregator, a scheme would need to be fairly large and have good governance and low charges.

SUMMARY: The vast majority – 73 per cent – of respondents thought that NEST could be an aggregator for stranded pots, but this did not imply that NEST should take on this role. A minority of respondents thought that it was inappropriate for NEST to be an aggregator. All respondents agreed that NEST should not be the only aggregator, but there were relatively few responses to the second part of the question.

45. Could NEST do more in decumulation for the self-employed and workers excluded from auto-enrolment?

There were eleven responses to this question. Only one was unambiguously positive and one unambiguously negative. Five responses doubted that it was something important for NEST or that the self employed needed (given that the self-employed could join NEST or pursue other options).

SUMMARY: The overwhelming majority of responses expressed no strong view on whether NEST could or should do more in decumulation for the self-employed and workers excluded from auto-enrolment.

46. (a) Could NEST become a collective pension scheme? Explain.
(b) Should NEST become a collective pension scheme? Explain.

There were only eight responses to this question, consistent with relatively few responses to all of the questions on CDC in the next section. Thirty-eight per cent were against, arguing that it was not the role of NEST to get involved (two of these thought that NEST should not be involved in any decumulation products). One rationale for this is that there is more heterogeneity among pensioners in the decumulation phase than in the accumulation phase

> *"(Insurance company) We do not believe that NEST should become a collective pension scheme. ... decumulation is complex and individuals have different needs in retirement. We believe these differing needs should be respected, so we would again advocate against a one-size-fits-all approach."*

A further issue is what changes would be needed to become a collective pension scheme:

> *"(Consultant) [NEST could not become a collective pension scheme] unless the rules surrounding participating employers changed or it converted to a Regulatory Own Fund. To us, a CDC scheme needs to be accessible to all and NEST is not such a scheme.*
>
> *There is no reason why NEST should not continue in its current role. We would guard against mission creep, even though this means that NEST does not pay back its loan any time soon. NEST should be used by those into which it auto-enrols as a DC scheme, it can have collective elements in retirement, but it needs to remain competitive with other DC schemes and not be accorded special status because of its special ownership (and special debt)."*

On the other hand 38 per cent of respondents thought that this would be a good idea for NEST, for example:

> *"(Consultant) A key issue for any CDC scheme is that members need to have trust that the scheme is operated in their interests. For NEST to run a CDC option successfully, it will need to retain the confidence of its members. As the national DC scheme, it seems ideally placed to be the trusted scheme of choice."*

SUMMARY: Respondents were equally divided on whether or not NEST should become a collective pension scheme, with strong views on both sides.

5. The role of collective pension schemes and how these could be introduced in the UK

The analysis of the risks outlined in the consultation document suggested that there might be a need for new types of risk pooling. Collective DC (CDC) pension schemes that pool and share risks were not allowed in the UK prior to the 2015 Pension Schemes Act. However, this is enabling legislation only, does not include the full regulatory details, and says nothing specific about CDC regulation. Good regulation for CDC schemes is essential because the property rights of members are less clearly defined. This section asks a series of questions about CDC schemes.

There were fewer responses to the questions in this section, with only sixteen respondents answering any of the questions.

47. What should 'collective' mean in the UK context (e.g., collective in terms of scale and governance, and collective in terms of risk-sharing)?

There were only ten responses to this question and they were unanimous in referring implicitly or explicitly to the importance of risk sharing for collective DC schemes (often referred to as risk pooling). However, as shall become apparent from the discussion below, there was disagreement about which groups were pooling risk (inter-generational or intra-generational). Of the ten or so respondents who did not answer this question but did answer other questions in this section, four seemed to suggest that risk sharing was not the primary purpose of collective schemes.

Five responses also referred to the additional benefit of economies of scale and two referred to issues of governance. One response suggested that these issues should not be confused:

> *"(Pension provider) We suggest that the use of terms should not be confused. In the current environment, 'collective' has come to refer to risk sharing. It does not, and should not, be confused with scale and governance."*

One more-detailed response referred to the Institute of Actuaries Sleepwalking into Retirement Working Party (2015) report "Why DC desperately needs actuaries". Starting from a position of DC pensions, this had suggested alternative interpretations of collective, including: (i) DC in a with-profits fund; (ii) deferred annuities; (iii) managed DC; (iv) DC with insured capital guarantees; (v) split retirement into term annuity plus (mutualised) later life annuity; or (vi) an employer smoothing fund.

SUMMARY: The vast majority of responses suggested that risk sharing of some form or another was the defining feature of a collective DC scheme. However, there was disagreement about which groups should be pooling risk.

48. What are the main benefits of CDC schemes over individual DC schemes?

There were nineteen responses to this question, displaying considerable variety due to respondents having different ideas of the aims of CDC schemes. Three responses thought that there were no real benefits of CDC over individual DC, for example:

> *"(Consultant) None. All the investment & risk sharing models available to CDC are already available to individuals via collective investments and longevity protection products."*

A further response used this question to raise the issue of whether CDC could really work:

> *"(Consultant) CDC in my view does not work because it is really no more than a smoothing mechanism in the same way that with profits products were and potentially open to the same sort of abuses that they suffered from. ... although I know the Dutch have been more successful on the face of it with this."*

(In responses to other questions, two other respondents raised the issue of the similarity of CDC to with-profits products.)

Five responses mentioned economies of scale. The other advantages on the investment side of a CDC product were the ability to invest in a wider range of illiquid long-term investments to obtain a liquidity premium (five responses) and the ability to avoid issues about linking the accumulation and decumulation phases of the pension via locking in to annuities (four responses).

> *"(Consultant) A CDC scheme has no need to buy annuities at retirement. The investment strategy post retirement is not constrained to investments of low return. The severe outcome volatility generated by annuity purchase is avoided. Managing a CDC scheme is mainly a matter of cash flow management, balancing contribution and asset income with benefit outgo, making market value volatility rather less important. Therefore a CDC scheme can be expected to deliver, on average, higher benefit outcomes (due to the unconstrained post retirement investment policy) with lower volatility (due to the absence of switching of investments into an annuity) than a money purchase DC scheme."*

Other responses carefully outlined the advantages of being in a CDC scheme compared with being in a DC scheme and having to buy an annuity:

> *"(Consultant) ... the Government Actuary's Department calculates that profit and reserving, (and perhaps adverse selection?) take 20-25% of an inflation linked annuity. Further, in order for annuities to be safe, they need fixed contractual terms, in turn underpinned by triple-A bonds. This conservative investment pattern also has a cost. Finally, there is a big timing risk since the annuity is purchased on a particular day. CDC addresses these problems, albeit that CDC needs a degree of flexibility, and therefore to achieve best value from CDC the precise nominal payment is more difficult to predict than with an annuity."*

"(ACA) Individual DC schemes must purchase annuities to give a reliable income for life, effectively requiring investment in cautious investments throughout the whole period of retirement. A CDC scheme has no such need to buy annuities at retirement and the investment strategy is therefore not constrained to low returning investments ..."

SUMMARY: There were a variety of responses and there was no dominant view on the main benefits of collective versus individual DC schemes. Twenty-one per cent of responses either did not think that collective DC schemes were better than individual DC schemes or did not think that they could work. Among those responses that were more positive, economies of scale were mentioned by 26 per cent of responses and risk sharing by another 26 per cent. On the investment side, it was mentioned that CDC – in contrast to an individual DC scheme – had the ability to invest in a wider range of illiquid long-term investments to obtain a liquidity premium as well as the ability to avoid the separation between the accumulation and decumulation phases.

49. What are the main disadvantages of CDC schemes over individual DC schemes?

There were seventeen responses to this question. Eleven of these referred to the problem of how to share returns between individual savers. Risk-sharing was seen to be potentially problematic. Several reasons were cited for this. First, individual members might struggle to understand risk sharing. One response referred to the

"(Insurance company) [c]hallenges of explaining to members how the scheme works and what this means to each of them. Most people find it hard to understand the theory of pooled risk, as has been shown in the annuity and with-profits markets.

Another noted the problem in managing expectations and distribution decisions:

"(Insurance company) History suggests that where pooling and risk sharing applies between individuals (e.g. with-profits), disputes over fairness and the need for transparency will lead to a continual regulatory intervention in how benefits are apportioned, a process that it is not possible to model effectively. The idea that future income is a target and not a guarantee could also potentially put trustees in a difficult position. We believe that it would be dangerous for CDC schemes to promote 'soft guarantees' to pension savers such as a target amount expressed in the form of a defined benefit. Confidence and trust will be rapidly eroded when the inevitable time comes when these 'targets' are not met."

Three responses also observed that the inter-generational risk sharing meant that it might be difficult to sustain a CDC scheme:

"(Insurance company) CDC schemes largely rely on continuous growth for their success. If a scheme is contracting at a time when investments are low it could get into serious difficulties."

"(Pension provider) ... a bad funded plan (high underfunding) may be unattractive for new entrants; also a fat funded plan (high overfunding)

may be attractive to be closed to divide surplus over participating members."

Five responses also cited reduced flexibility for members compared to DC. Finally, three responses noted that the income generated was itself uncertain (these respondents tending to be those who thought a pension should provide a stable income).

SUMMARY: Sixty-four per cent of respondents thought that the main disadvantage of CDC over individual DC schemes was how to share risks between individual savers, particularly in a contracting CDC scheme. Some thought that this made the long-term sustainability of CDC doubtful. Many raised the issue of explaining risk sharing to members who might struggle to understand it, especially the notion that the actual pension might be lower than the target pension. Twenty-nine per cent pointed to the reduced flexibility for members compared to individual DC.

50. CDC schemes may be able to generate incomes that are higher than individual DC schemes as the latter are currently operated.
(a) Are there reasons why an individual DC scheme could not follow the same investment or decumulation strategy as a CDC scheme?
(b) Would trustees of an individual CDC scheme be willing to accommodate the greater investment risk, given the need to enable members to transfer out and to take their pension pot with them?

There were fourteen responses to part (a). Four of these thought that CDC could not generate higher returns than DC. For example:

"(Consultant) There is no generic reason why a CDC would generate higher incomes than best practice individual DC schemes. Investment strategy, scale and fees may all be handled without CDC, and purchasing best value annuities does not require this new format either. It is true that smaller schemes might be disadvantaged, but that is not about CDC but consolidation. I have found declarations about collective schemes providing 30% better performance than individual DC schemes somewhat misleading."

Half of the respondents thought that CDC could out-perform individual DC, but different reasons were given for this. One referred to economies of scale

"(Insurance company) An individual DC scheme would not have the same economies of a scale as a CDC scheme, so it would be unable to follow exactly the same investment or decumulation strategy as a CDC scheme. However, CDC schemes, by their nature, offer a one-size-fits-all solution, so the group is being protected to the possible detriment of the individual. As we state above, research indicates that individuals broadly welcome the increased flexibility introduced by recent reforms in the retirement market so they may find the CDC approach revisionist."

Others mentioned that because risk could be reduced by sharing (within or between) generations, it was possible for the fund to invest in higher-risk, higher-return assets:

"(Pension provider) ... risk sharing can be set up between existing accrued pension capital and new pension capital to be accrued in the nearby future. This form of risk sharing cannot be replicated in an individual plan as this plan cannot share risk with some future individual or future accrual ..."

Another response noted that the purpose of CDC was to provide some degree of insurance and that this enabled investment in higher-risk and higher-return products:

"(Lawyer) In theory there is no reason why an individual DC scheme could not follow the same investment or decumulation strategy as a CDC scheme. Whether it would be sensible for the member to do so will depend on the member's ability to bear the increased volatility in the outturns without the smoothing that the pooling of risk, both intra-generation and across generation, enables."

Also noted was the fact that traditional DC schemes use a de-risking glide path and move towards less risky products as a member approaches retirement and this would not need to be the case in CDC:

"(TUC) Even with the pension income reforms, many traditional DC schemes are likely to de-risk as a member approaches state retirement age, thus reducing the likely investment returns."

There were eight responses to part (b). Several responses questioned whether the greater investment opportunities would be utilised by trustees in practice

"(IFoA) Trustees are likely to accept different levels of risk within their schemes. Risk appetite will determine a range of outcomes that will reflect the freedom within the overall legislative framework. Experience of with-profit funds should be considered when understanding the range of outcomes. It is worth noting that CDC schemes in the Netherlands do not take the degree of investment risk that some of the UK proponents of the design are recommending."

Two noted the problems for CDC schemes if transfers were allowed:

"(Consultant) It is difficult to see how a CDC scheme can be run effectively in respect of its attempts to invest to spread risk across a membership with diverse age and other characteristics, if any or all of a cohort of members may without notice effectively withdraw any or all of their accrued monies. Although this is, in effect, possible now pre-retirement, where the member wishes to exercise their statutory right to transfer their accrued funds to another scheme of their choosing, the facility to do so post-retirement is a new complication for those schemes that will offer drawdown, and it is also anticipated that the take-up rate of cash withdrawal will be greater than in the past."

"(Consultant) CDC also has an advantage of permanence, and hence ability to invest in illiquid projects. This advantage can be lessened in the event of ungated transfers in and out."

SUMMARY: Half of the respondents thought that CDC could out-perform individual DC, due to economies of scale, risk sharing (within or between) generations – enabling investment in higher-risk, higher-return assets – and the avoidance of a de-risking glide path which moves towards less risky products as a member approaches retirement. However, 30 per cent of respondents thought that CDC could not generate higher returns than individual DC and that the claims that they could were misleading. In terms of trustee attitudes, most respondents thought that trustees would be unwilling to take on greater investment risk due to the issues of transfers out of the scheme (such transfers were seen as problematic).

51. (a) Would a CDC scheme have any additional risk-sharing advantages over a large master trust DC scheme which followed the same investment and decumulation strategies where possible?
(b) Can the benefits from any additional sources of risk sharing available to CDC schemes be quantified?

There were ten responses to part (a). Forty per cent of these thought that a CDC might have no or few advantages over a large master trust DC scheme, although the respondents emphasised that this depended upon the size of the master trust and other assumptions. One response said that a CDC would have an advantage since it would be bigger. The remaining responses to part (a) emphasised the different investment strategies of CDC and DC schemes.

There were five responses to part (b), one saying that the advantage could not be quantified and the other four saying that it could, often referring to published research. For example:

> *"(Pension provider) de Haan, Lekniute and Ponds (2015)[8] sets up a level-playing-field framework for IDC and CDC plans. Within the used framework, the paper finds risk sharing between generations results in a better pension benefit. By constructing an equal median replacement rate, the downside risk of a contact with risk sharing is much lower: a collective contract with a smoothing period of 10-years time provides a 25% higher replacement rate for the downside scenario's."*

SUMMARY: Forty per cent of responses thought that CDC would not have any additional risk sharing advantages over a large master trust DC scheme, although other responses noted that the two types of scheme would follow different investment strategies. The small number of respondents who answered the second part of the question about quantifying the additional benefits thought that it was possible to do so through appropriate modelling.

[8] Pension contracts and risk sharing – a level playing field comparison, APG, Netherlands, February 2015.

52. (a) What is your preferred design for a CDC scheme, in terms of targeted benefits? (e.g., a CDC scheme that is intended to replace a DB scheme and hence would be earnings-related (specify accrual rate, earnings measure, pre-retirement indexation rule, post-retirement indexation rule); or a CDC scheme that is intended to replace an individual DC scheme and hence would be with-profit and a target return, unit-linked and a target return, etc.). (b) Explain why.

There were nine responses to part (a) this question, eliciting several possible designs: several respondents suggested that there were a range of possibilities and some were agnostic about the best solution.

> *"(ACA) We believe that the regulatory framework should allow for a range of possible designs, giving the industry flexibility to establish different schemes to fit differing needs and circumstances.*
>
> *In our view, CDC regulation needs to allow for different CDC schemes that are more similar to DC schemes (perhaps aggregating DC funds over a member's working life and/or as a decumulation vehicle, converting pots into benefits on a specific transaction date) and DB schemes (where the target benefits allow for a higher degree of cross subsidy, justified by the level of employer contributions such that all members can reasonably expect to get out more than they put in).*

Forty-four per cent of the responses suggested that there should be a target pension, for example:

> *"(TUC) CDC in the UK context is best seen as a means of improving DC provision. It is potentially a way of boosting outcomes for low and middle income savers without putting the sorts of additional burdens or risks on employers that would prevent such schemes being launched. This suggests that aiming for a target return would be most appropriate."*

One way to achieve this would be to have a system where members had explicit claims on variable annuities (whether deferred or in payment), but the precise returns would be smoothed across generations according to some pre-determined rule. One response referred to the paper by de Haan, Lekniute & Ponds (2015) which describes explicit smoothing rules as follows:

> *"(Pension provider) The valuation of new and already accrued annuities is based on fair valuation principles. The annuities all are risk bearing ('variable annuities') by means of an open contract by which any deviation of the funding ratio from a pivot funding ratio is smoothed out over a 10-year period. So a funding ratio of 110% and a pivot funding ratio of 100% leads to an adjustment of the annuities with +1%. The next year this process is repeated. In case the funding ratio falls to 95%, then the indexation that year will be - 0.5%."*

An alternative proposal suggested describing the pension asset in terms of income:

> *"(Lawyer) In each scheme year a contributing member will purchase a 'retirement income brick'. That brick will comprise:*
>
> > *(i) a nominal target retirement pension for life from a target retirement date,*
> >
> > *(ii) an allowance for inflation proofing in the period prior to the target retirement date, and*
> >
> > *(iii) an allowance for inflation proofing after the target retirement date.*
>
> *Note: None of these amounts would be guaranteed and would be subject to adjustment as necessary to make the "books balance" on an annual basis (more frequently in extreme circumstances).*

The main differences between the proposals were the differences in the degree of risk sharing across generations. Some responses thought that there should be little inter-generational risk sharing and one suggested that it would be easier to have inter-generational risk sharing if some of the contributions were explicitly from the employer rather than the employee. Three responses explicitly or implicitly pointed out that a CDC scheme with some employer support could be closer to a superior form of DC pension (DC-plus) or an inferior version of a DB pension (DB-minus). One response suggested that the DB-minus view of pensions was closer to what DB pensions used to look like before protections were added:

> *"(Consultant) CDC is, of course, a version of what the UK's old DB plans used to look like. The gold plating of DB made them unsustainable. DC gives flexibility but at a cost of poorer and/or less predictable pensions. There is room for all three."*

There were four responses to part (b). Two preferred DC-plus on the grounds that it was cheaper than DB-minus and hence likely to be more widely provided. One suggested that it would be better that there should be a range of options. Finally, the respondent who had suggested that CDC pensions be based on "bricks" of retirement income noted that it was better to describe the pension in terms of income because:

> *"(Lawyer) If the starting presumption is that what an individual is looking for in retirement is a relatively predictable form of retirement income, then expressing the target benefit in retirement income terms ties in with this aspiration. It also avoids the perception of mismatch between:*
>
> > *(i) what appears to be a 'small' amount of retirement income, and*
> >
> > *(ii) the 'perceived large' capital value of that target retirement income. In other words a member with what appears to be a substantial level of retirement savings in a DC 'pot' may misjudge the level of retirement income that can be provided from that DC pot."*

SUMMARY: There was considerable variety in the responses about the appropriate design of a CDC scheme and many respondents were agnostic or unsure themselves, suggesting that there is no consensus view on the target benefits. The most common response (by forty-four per cent of respondents) was that there should be some form of a target pension (essentially a DB-minus view of pensions). The main differences between the proposals were the differences in the acceptable degree of risk sharing across generations. Some said there should be little inter-generational risk sharing, with one suggesting that it would be easier to have inter-generational risk sharing if some of the contributions were explicitly from the employer. One response suggested that the DB-minus view of pensions was closer to what DB pensions used to look like before protections were added. Nevertheless, two respondents preferred DC-plus on the grounds that it was cheaper than DB-minus and hence likely to be more widely provided.

53. (a) What is the best estimate contribution rate to achieve the target benefit? (b) How should the contribution rate be shared between employer and member?

There were eight responses to this question. None of these provided explicit numerical figures to answer part (a), pointing out that this depended on a variety of factors and needed actuarial expertise. Three of the responses noted that the higher the share of the contribution from the employer the greater the scope for inter-generational risk sharing.

SUMMARY: Respondents did not provide numerical figures on the best estimate of the contribution rate because of the variety of factors needed to be taken into account. A number of respondents noted that the higher the share of the contribution from the employer the greater the scope for inter-generational risk sharing.

54. (a) Can a CDC scheme work with a planned contribution rate that is fixed independent of a member's age or is an age-dependent member contribution rate required? (b) If the latter, is a change to equality legislation required?

There were six responses to this question. One view was that either the contribution must vary to meet the target or *vice versa*. Subsidies across ages were perceived as problematic:

> *"(Lawyer) If you have higher employer contribution rates for older employees, the younger employees can claim that the older employees are being paid more for the same work. Conversely, if you have a uniform contribution rate, the younger employees can claim that the older employees are being provided with a more valuable target benefit than the younger employees."*

And, because of this, three of the respondents explicitly said that there needed to be employer contributions to allow cross-subsidy:

> *"(ACA) The contribution rate can be fixed independent of a member's age if there is an employer contribution that means the target benefit value is higher than the member's contribution for every age. If the CDC membership is unconnected, ... contributions should be converted into*

target benefits having regard to the characteristics of each individual (including age)."

Two respondents referred to existing legislation, one arguing for each type of contribution to be possible:

> *"(Consultant) [a fixed contribution rate works] for example at ATP in Denmark, which is covered by the same equality legislation as the UK.*
>
> *"(ACA) We believe that an age-dependent rate is already allowable."*

But one response suggested that it might be worth strengthening this:

> *"(Lawyer) Irrespective of how the contribution rate is set, …we would recommend an express exemption in the equality legislation … . What the employer will wish to avoid is a situation where its contribution rate ends up with an age discrimination claim."*

SUMMARY: Most respondents suggested that either the contribution rate or the target benefit had to be fixed but not both. However, it was recognised that, while it was possible to fix both, this would involve cross-generational subsidies, which really required (possibly variable) contributions from employers to be feasible. In the case where a scheme wishes to operate with age-related contributions, one respondent said that there should be an express exemption from equality legislation.

55. What investment strategy would be appropriate for CDC schemes: (a) in accumulation and (b) near retirement and (c) in decumulation?

There were six responses to this question and four noted that the investment strategy depended partly on the composition of the scheme membership:

> *"(Consultant) A CDC scheme would typically have a single investment strategy for all (like a DB plan), however, if it is started as an accumulation scheme and matures to decumulate over time, it would be sensible for the investment strategy to be dynamic moving from a growth to a more balanced fund over time."*

But the general principle was that a CDC scheme would not be constrained by its liabilities

> *"(Consultant) The short answer would be high expected return assets held in a well-diversified portfolio at all times. CDC schemes do not provide guaranteed liabilities requiring investments to be constrained to liability matching investments, there is not a guaranteed liability to match."*
>
> *"(Consultant) The question of appropriate investment for CDC is a long one; however it would probably look more like a DB scheme without costly ALM."*

SUMMARY: Respondents suggested that the investment strategy would not be constrained by its liabilities, but would probably look like a DB scheme without costly asset-liability management – consistent with the target pension view of what CDC was trying to achieve - although the optimal strategy would depend on the composition of scheme membership.

56. What are the main benefits of a CDC scheme in terms of intra-generational risk pooling?

There were five explicit responses to this question, and three said that the main benefit was the sharing of longevity risk within the pool (some respondents had implicitly addressed this issue in earlier questions). One response made the caveat that transfers in or out should be medically underwritten to preserve the risk sharing. In response to both this question and the next, one respondent noted that the redistribution would mean some people were worse off:

> *"(Insurance company) Some people, probably those who joined the scheme early, and continued to be a member until retirement, will do well out of the scheme. Others will do less well, depending on how the makeup of the scheme changed."*

SUMMARY: Respondents suggested that the main intra-generational benefit of a CDC scheme would be sharing of longevity risk within the pool. One response made the caveat that transfers in or out should be medically underwritten to preserve the risk sharing.

57. What are the main benefits of a CDC scheme in terms of inter-generational risk sharing?

There were seven explicit responses to this question, of which four noted that risk sharing across generations could lead to greater smoothing of investment returns, albeit with the caveat noted in the previous question.

> *"(IFoA) Intergenerational risk sharing can smooth volatility over many generations as the indexation on pensions is much smoother than the market returns and also highly correlated. This is a desirable feature in a pension system, as it will provide time for individuals to smooth their consumption levels. However, this should be balanced against the level of risk for younger and future generations and appropriate safeguards to mitigate this could be beneficial."*

One respondent – in line with responses to earlier questions – also suggested that this risk pooling increased the ability to invest in higher-risk assets and obtain a higher expected return. Alongside hedging investment return risk, only one response to this question referred explicitly to inflation risk and longevity risk. So most of the responses to question 56 (intra-generational) referred to longevity risk and most of the responses to question 57 (inter-generational) referred to investment risk: however, one cannot make too direct a comparison since not every respondent answered both questions.

The final point raised for this question was the fact that there was a wider social benefit of having intergenerational risk sharing as it increased the chances that people would have sufficient pensions to enable retirement and this might have labour-market benefits for younger generations.

SUMMARY: Most respondents suggested that the main inter-generational benefit of a CDC scheme would be smoothing of investment returns. One respondent also suggested that this risk pooling increased the ability to invest in higher-risk assets and obtain a higher expected return. Only one respondent referred explicitly to inflation risk and longevity risk.

58. (a) Over how many generations should risk be shared? (b) Explain why this is optimal.

There were six responses to this question, but one merely reiterated the belief that there should not be inter-generational risk sharing. Of the remaining five answers, the possibilities were: (i) all generations, including those not yet in the workforce; (ii) all generations in the scheme; (iii) for a long period, without a clear definition of "long"; and (iv) ten years (two responses). The most detailed comment was that:

> *"(Pension provider) The potential welfare-improvement is higher the longer the smoothing period, and hence the more future generations (age-cohorts) [that] are included. However, too long a smoothing period (for example 30 years) could imply periods with deep underfunding and high overfunding, which may cause the breaking up of the plan. So discontinuity risk puts limit on the length of the smoothing period. The discussion in the Netherlands tends to a smoothing period of 10 years."*

Where given, the rationale for this being optimal was that a long period was needed to get smoothing (one response to the previous question noted that investment returns were serially correlated). One response noted that some people would be better in an individual scheme:

> *"(Consultant) [inter-generational risk sharing] may be optimal for some (who like to see solidarity across generations); it may be sub-optimal for others (who don't). Those who don't like risk sharing would be better off in an individual arrangement.*

SUMMARY: There were relatively few responses to the issue of how many generations should share the risk in a CDC scheme, but, of those who did respond, there were widely divergent answers, ranging from risk-sharing between all generations (including those not even in the workforce) to risk sharing over a 10-year period (as in the Netherlands).

59. How should the risk-sharing rules in a CDC scheme be defined?

There were seven responses to this question and these all used language saying that rules should be clear and transparent (as with previous questions, one respondent was against risk sharing). Only one response came up with explicit rules, citing de Haan, Lekniute and Ponds (2015), which have already been reported in the response to question 52.

SUMMARY: All respondents suggested that the most important issue was that the risk-sharing rules be clear and transparent.

60. How much discretion should a CDC scheme's managers have when it comes to smoothing or adjusting benefits to target benefits, or should the rules be fully transparent?

Of the seven responses to this question: three argued for "wide" or "high" discretion; one for some discretion and three for virtually no discretion. An argument against discretion was as follows:

> *"(Lawyer) Virtually [no discretion]. There should be a clear policy explained at inception on a fully transparent basis as to how target benefits are to be adjusted.*
>
> *Otherwise, there will be inherent risk in the "good times" of over distributing to those whose pensions are in payment and in the "bad times" not reducing with sufficient speed the benefits which are in payment.*
>
> *In other words, this is where the inter-generational risk arises and where it must be managed to avoid the older generations benefiting at the expense of the younger generations.*
>
> *It is important to avoid the process of 'trust me I am an actuary' from determining how the adjustments should be determined."*

One respondent suggested that the rules should be set by the regulator. On the other hand, some respondents thought that there would always be need for discretion:

> *"(Consultant) A CDC scheme cannot have benefit guarantees (otherwise it would fall within defined benefit scheme regulation). Ultimately, the benefits must always be discretionary. While it is desirable for there to be a clear target benefit policy (note, I haven't used the possibly stronger word "rule") which in the normal course of events is followed, it is not possible to foresee all future events and it must be expected that extreme events will arise in which trustees may reasonably want to diverge from the target benefit policy."*

This point was made with the proviso that there should be a policy on how and when discretion should be used.

SUMMARY: With a relatively small number of responses to this question, there was an almost equal split between respondents arguing for CDC scheme managers having no discretion to them having very wide discretion. One respondent thought that there would always be need for discretion, while another respondent suggested that the rules should be set by the regulator.

61. (a) If the actual pension is above the target pension, when should adjustments be made?
(b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?

62. (a) If the actual pension is below the target pension, when should adjustments be made?
(b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?

There were only four responses to question 61 and six to question 62. One response to question 62 noted simply that members would be likely to resist cuts to benefits in payment:

> *"(SPP) Members would often find unacceptable a reduction to benefits once in payment. This is particularly so if the benefits are themselves low, which is likely to continue to be the case unless there is a significant increase in the level of contributions paid."*

There was agreement that benefits should be reviewed annually, although one response countenanced the possibility of more frequent reviews in exceptional circumstances.

> *(Consultant) Current deficits are generally adjusted through conditional indexation, then pension in payment, future liability by reducing expectations, or member payment. Retirement age can remain flexible.*

Respondents agreed that adjustments should be made first to indexation (sometimes ordering indexation of pensions not in payment before pensions in payment) and second to the level of the pension: this was the same for both increases and decreases. One response was explicit that contributions and investment strategies should not be altered.

SUMMARY: Among the relatively small number of responses to Questions 61 and 62, most thought that adjustments should be made annually and they agreed that adjustments should be made first to indexation and second to the level of the pension. One respondent was explicit in saying that contributions and investment strategies should not be altered.

63. What mechanisms are needed to ensure that no CDC scheme becomes insolvent? For example, a CDC scheme might try to use a high target return to attract more customers.

Of the seven responses to this question, three noted explicitly that a CDC scheme could not technically become insolvent. However, it was recognised that there needed to be rules in place to stop CDC schemes over-promising to attract customers:

> *"(Lawyer) There will need to be appropriate regulation to address those schemes which market themselves as offering higher target benefits for the same contribution rate relative to schemes offering lower target*

benefits at the same contribution rate. This is a variation on an old problem of actuaries going to finance directors and offering them ways of reducing pension costs by changing the assumptions made to calculate the contribution rates (if you go back sufficiently far in time).

This should come out of the Regulations under the Pension Schemes Act 2015 for collective benefit schemes, but the likely structure will be to have specified probability levels for achieving, on specified assumptions, particular levels of target benefits.

There will then be some variation in this area which will be a function of the investment strategy adopted. That, in turn, will require some element of "risk rating" or "volatility rating" to be given to the target benefit schemes to take account of the volatility of the investment strategy. This would have to be specified in regulation."

Four responses mentioned actuarial reviews and the other issues mentioned were regulation, transparent rules and good trusteeship. For example:

"(Consultant) A CDC scheme has no benefit guarantees and therefore there is no concept of insolvency. ... Is the question really trying to ask about the risk of deliberate overestimation of the likely return on the investments in the actuarial planning of the CDC scheme?

The trustees must be able to demonstrate that their target benefits can be realistically provided for by the assets and contributions. Their plans must be published for all members to see ... and lodged with a supervisory body (be it TPR, FCA or whoever), not to mention accessible to financial journalists and self-promoting consultants.

An actuarial plan which is over-optimistic will pay out too much initially until the plan is corrected. ... some members could be said to 'lose out' at the expense of others. ... this emphasises the need for good trusteeship ... the position of a trustee in a CDC scheme is far more onerous that in a pure money purchase scheme and perhaps even than in a DB scheme."

SUMMARY: Forty-three per cent of respondents noted that CDC schemes could not technically be insolvent, but that they could over-promise (and hence under-deliver) to their members. Mechanisms needed to be put in place to deal with this and suggestions included actuarial reviews, regulation, transparent rules and good trusteeship.

64. Is it necessary for a CDC scheme to start with or build up a reserve fund to give it credibility?

There were nine responses to this question and only two unambiguously stated that there was a need for a reserve fund. On the other hand, only one thought that there was no need at all. The intermediate positions were mostly based on setting up of a scheme: a reserve fund would cover set-up costs and provide scale and credibility at the beginning. Further on in the scheme, a small buffer to cover contingencies would be helpful and might enable a with-profits form of CDC fund. For example:

"(Consultant) Reserves in CDC are needed to ensure its long term continuation, but not beyond."

SUMMARY: Seventy-eight per cent of respondents thought that there was no need for a reserve fund, while the rest said that there was such a need. However, many responses thought that a reserve fund might be helpful, especially initially, to cover set-up costs and provide scale and credibility.

65. CDC schemes in other countries (e.g., Holland) have virtually no flexibility with respect to member choice (e.g. contribution rate, investment strategy, retirement date, form of decumulation (i.e., pension). Do the freedoms and flexibilities introduced by the 2014 Budget render CDC schemes unfeasible or more risky in the UK? Explain why not or, alternatively, how freedom and flexibility would need to be tailored in the context of CDC schemes?

One response to this question was that CDCs are incompatible with the new pension freedoms. Four responses suggested that too much flexibility would make it hard to run a CDC scheme and that such flexibility was inappropriate and not really wanted anyway (since pensioners who wanted more flexibility had other options). On the other hand two responses suggested that flexibility was possible, even if not desirable:

"(Consultant) It is perfectly possible, (though not always desirable) to introduce flexibility—so for example the Shell Pension in Holland gives DC-like statements during accumulation. Dutch pension funds allow transfer."

One of the responses envisaged that there would be the possibility of transfer, involving the possibility of transfer during the accumulation period and something like the Open Market Option at the point of retirement. However, for practical purposes and to prevent gaming, it was suggested that the transfer opportunity would only be available in a short window after the annual valuation.

SUMMARY: Responses were fairly equally divided on whether member choice was compatible with CDC schemes, some believing it was possible if not desirable, while most thought that too much flexibility would make it hard to run a CDC scheme, or that such flexibility was inappropriate and not really wanted anyway (since pensioners who wanted more flexibility had other options).

66. One of the biggest growth areas prior to the 2014 Budget was the medical underwriting of annuities and the growth of enhanced annuities. But in a standard CDC scheme, everyone gets the same pension irrespective of health status.
(a) Would it be feasible in a CDC scheme to medically underwrite the pension in retirement?
(b) Would it be desirable to do this?

Of the eight responses, five replied unambiguously that it would be feasible, although not necessarily desirable. One responses suggested that a competitive equilibrium would drive providers to do this:

"(ACA) The more underwriting there is in a market, the more the rest of the market needs to follow suit. It might limit this area of CDC scheme provision to providers with underwriting skills.

However, three responses noted that medical underwriting was not really feasible before the age of 50 and the need for medical underwriting was partly dependent on the aims of the scheme: an employer-sponsored scheme aiming to provide a pension to all employees could cross-subsidise and avoid adverse selection (which one respondent thought could be managed anyway).

SUMMARY: Sixty-three per cent of responses suggested that medical underwriting of the pension in retirement was feasible for a CDC scheme, although some noted that such underwriting was not really feasible before the age of 50.

67. How should a CDC scheme best be organised: (a) on a company-wide basis, (b) an industry-wide basis, or (c) a nation-wide basis?

There were seven responses to this. Two thought that it should be done on the largest scale possible, i.e. nationally and possibly via NEST. The remaining five thought it could be done on any of the three bases and some suggested that a variety would be optimal.

SUMMARY: Seventy-one per cent of responses thought that a CDC scheme could be operated on any of the three bases suggested, while a minority thought that it should be done on the largest scale possible.

68. What is the minimum number of members in a CDC scheme to make it viable? Explain this figure.

There were five very different responses to this question. One said forty (one per generation); two said a few hundred; one said 5,000 and the last said that it could be done with 1,000, but 10,000 would be optimal. One of the responses advocating a few hundred thought that there was a mis-perception in this area based on the issue of annuitisation:

"(Consultant) You should ignore the often repeated allegation that a CDC scheme needs to be large deriving from the work by GAD for the DWP.[9] GAD's modelling of a CDC scheme bought annuities on retirement and, in some closed-to-new-entrants scenarios, their model ran out of money. The DWP concluded from this that CDC schemes needed to be large and multi-employer so they would never close to new entrants and so never be at risk of running out of money. A model which runs out of money is a flawed

[9] Department for Work and Pensions (2009a) 'Collective Defined Contribution Schemes: An assessment of whether and how collective defined contribution schemes might operate in the UK', December (www.dwp.gov.uk/docs/collective-defined-contribution-schemes-dec09.pdf); Department for Work and Pensions (2009b) 'Modelling Collective Defined Contribution Schemes: A summary of The Government Actuary's Department modelling of collective defined contribution schemes', December (www.dwp.gov.uk/docs/modelling-collective-defined-contribution-schemes-dec09.pdf).

> *model. In the real world, a process of reviewing the funding plan (perhaps annually) and adjusting benefits to keep the scheme on track could not possibly run out of money."*

SUMMARY: There was no consensus answer to this question. The small number of responses gave widely differing views on the minimum number of members in a CDC scheme, ranging from forty (one per generation) to 10,000.

69. Effective regulation, governance and quality standards will be crucial, given the absence of member property rights (which apply in standard DC schemes) and also the absence of a sponsoring employer that guarantees benefits (which applies in DB).

(a) What regulation is required to protect members' benefits?

(b) What governance mechanisms and quality standards are needed in CDC schemes, especially to ensure inter-generational equity?

There were eight responses to this question and they tended to emphasise different issues. Three responses noted that CDCs created property rights, which might be based on contributions or with actuarially set surrender values. Two responses stressed that all member types (pensioners, actives, deferreds) should be treated equally. Two responses said that regulation should be under trust law resulting in strong trustees.

Nearly all responses to (b) agreed that valuation should be on a best-valuation basis to ensure inter-generational equity. However, one response suggested that a new Act would be needed with an independent adjudicator to ensure that CDC did not evolve towards DB.

SUMMARY: No clear conclusion emerged from the varied responses to the first part of the question concerning what regulation is needed to protect members' benefits: 38 per cent noted that CDCs did create property rights (which might be based on contributions or with actuarially set surrender values), some stressed that all member types (pensioners, actives, deferreds) should be treated equally, while some said that regulation should be under trust law resulting in strong trustees. The vast majority of responses to part (b) agreed that valuation should be on a best-valuation basis for CDC schemes to ensure inter-generational equity.

70. Could CDC schemes operate both on a trust basis and a contract basis? Explain.

There were seven responses to this question and at least three thought that either basis was possible. Two noted that they would be regulated differently, with contract-based schemes regulated as life assurers and trust-based schemes needing an employer sponsor (it was suggested that this could be amended in regulation). Six of the responses preferred a trust-based scheme:

> *"(TUC) It is very hard to envisage CDC working on a contract basis due to the lack of robust governance. ... Fiduciary duty is key but is absent from contract based arrangements.*

The introduction of independent governance committees may be a step forward for DC if not our ideal, but we cannot back them for CDC schemes where only trust-based fiduciary governance is good enough. An IGC would be insufficient due to the strong influence that providers have over appointments of committee members and the complete absence of powers the committee has to compel the provider to act in a certain way."

SUMMARY: Eighty-six per cent of responses preferred a trust-based scheme, although many thought that either a trust or contract basis would be possible.

71. Could a 'for profit' organisation run a CDC scheme? Explain.

The seven responses to this question gave very different views. Three thought that a 'for profit' organisation could run a CDC scheme, so long as it was appropriately capitalised, and one thought that the idea was worth exploring. However, two responses were concerned that governance issues meant a trust-based scheme would be better. One response was unambiguously negative:

"(TUC) The scandals around with-profits funds and endowment mortgages in the early years of this century show that the conflicts of interest are too stark at for-profit organisations for them to run CDC schemes."

SUMMARY: Responses were divided as to whether or not a CDC scheme could be run 'for profit': 43 per cent said "yes" so long as it was appropriately capitalised, 28 per cent thought a trust-based scheme would be better than a 'for profit' scheme, and one response was unambiguous that 'for profit' CDC schemes would be inappropriate.

72. What communication strategy would be appropriate for CDC schemes (a) in accumulation and (b) near retirement and (c) in decumulation?

There were five responses to this question. Four of these were very similar, saying that there should be an annual report which described the financial position clearly and helpfully and reminded members that they only had a target, not a guaranteed, pension. The fifth response thought that the communication strategy should be used to promote more member engagement and personal responsibility.

SUMMARY: Eighty per cent of responses thought the appropriate communication strategy for a CDC scheme would be an annual report.

73. What measures should the government take to make CDC attractive to: (a) potential sponsors, and (b) potential members?

There were four responses to this question. Two responses emphasised the fact that sponsors should not be providing a guaranteed pension and require appropriate regulation. It was also suggested that sponsors would fear being a first mover and that government involvement via NEST might help get things started. The two responses to part (b) reiterated that pensioners need alternative decumulation products to annuities and transparent information.

SUMMARY: The small number of responses emphasised that sponsors need appropriate regulation. Government involvement via NEST might also help things get started.

74. How should transfer values be treated in CDC schemes, both in and out?

There were five responses to this question. Two emphasised that the sum of (potential) transfer values had to equal the available assets and a further one suggested that this could be achieved by a points-based system. Such transfers should only be for bona fide reasons to avoid gaming. One respondent suggested that there should be medical underwriting and a limited period after the annual report for transfers (as in the response to question 65).

SUMMARY: Most respondents suggested that transfers in or out of CDC schemes had to be for bona fide reasons to avoid gaming.

75. Is it possible for a CDC scheme to work within a charge cap of 0.75%?

There were six responses to this question. All thought that 0.75 per cent was possible (one response also suggested a cap of 1 per cent). One response thought a cap undesirable. Another response thought that 0.75 per cent was possible but that there might be issues with set-up costs:

> *"(Lawyer) Leaving to one side to establishment costs and the initial period while the CDC scheme grows in membership and size, if the CDC scheme is to deliver the benefits promised, it will need to keep its running costs low and so, in practice, operate within a charge cap of 0.75%.*
>
> *... once the CDC scheme has become established, then it should be feasible for the charge cap to apply."*

SUMMARY: All respondents thought that a 0.75 per cent charge cap was feasible, although not all thought that it was necessarily desirable.

6. Other issues

76. With the remit in mind, please tell us if there is anything else you think we should be considering that is not covered in the sections and questions above.

There were eleven responses to this question, some of which raised issues about previous questions and are not discussed here.

Three of these responses emphasised that the most important thing was to let existing reforms bed in:

> *"(CBI) ... the best way to achieve good outcomes for savers is by the next government not regulating for every possible outcome but it giving the current wave of pension reforms a chance to succeed, keeping employers engaged in pensions by keeping costs manageable, and ensuring it pays to save ..."*

> *"(Insurance Company) Given the scale of [the recent] changes, it seems reasonable to advocate that a period of reflection and impact analysis is required before any further, radical policies are pursued.*
>
> *This would help ensure the reforms already underway are given time to 'bed down' and enable a proper assessment of their effectiveness to take place before determining what further changes, if any, are required to improve consumer outcomes."*

In one case, this was cited as a risk to employer involvement:

> *"(100 Group) We also believe that short-term political decision-making is not helping the stability of pensions provision. The frequency of change, and the accompanying costs of advice and implementation, are also factors affecting employers' willingness to provide DC schemes above the statutory minimum."*

One response noted that the distinction between long-run savings and pensions was now blurred. Another raised the concern that any new products could become "gold-plated" by either the UK or the EU in the way that DB pensions were and hence become too expensive to provide.

A final consideration is a point raised at the outset by one respondent about the independence of the review:

> *"(Insurance Company) We're uncertain whether the review is truly independent. Firstly as it's been commissioned by the Labour Party and it explores many of its policy views. And secondarily because the authors appear, based on public appearances, to have preconceived ideas on how pension policy should develop, for example, in respect of a default retirement income policy, rather than waiting on the outcome of the review."*

I have discussed some of the issues of independence in the Introduction.

Appendix A – The Consultation Paper

Independent Яeview of Retirement Income

Consultation Paper

David Blake and Debbie Harrison

24 November 2014

Independent Review of Retirement Income

Consultation Paper

Background

On 29 May 2014, Rachel Reeves MP, the Shadow Work and Pensions Secretary, launched an **Independent Review of Retirement Income** to look at how to boost defined contribution (DC) savers' retirement income. She invited Professor David Blake, Director of the Pensions Institute, to lead the review, with Professor Debbie Harrison of the Pensions Institute as a senior consultant.

The terms of reference are as follows. "The **Independent Review of Retirement Income** will consider how to support a pensions market that works for all, retaining flexibility and choice on how savings are accessed and drawn down, while ensuring all savers, including those on low and modest incomes, are able to secure a decent and reliable retirement income. Specifically, this will include:

- How to ensure that the workplace pension retirement products available to people are those best suited to ensure they have security and confidence in retirement
- The support savers need to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment
- How savers can be helped to manage longevity risk
- The role of the National Employment Savings Trust (NEST) in helping savers to access good quality retirement products
- The role of collective pension schemes and how these could be introduced in the UK"

The Review will consult widely, drawing on the advice and input of senior experts in relevant fields and is working closely with the CBI and the TUC to ensure that employers and employees are engaged and their perspectives represented.

The Review team are members of the Pensions Institute. The Pensions Institute is an independent academic research centre. We believe that the subject of this Review is crucial to the long-term success of auto-enrolment, a policy objective which has cross-party support. We are interested in generating good consumer outcomes in the face of the significant structural and social challenges facing people at retirement.

Consultation Process

As part of the consultation process, we have prepared a consultation paper (CP). In this CP, we raise a series of questions that will help us address the above remit. We welcome responses from all interested stakeholders, including practitioners in the market (e.g., scheme and product providers, advisers, consultants, lawyers, trustees, Independent Governance Committees), trade unions, employers, think-tanks, regulators, and consumer organisations. We stress that respondents should feel free to be selective in the questions chosen for comment. Key questions are in **bold**; the rest are intended principally for specialists. We also welcome responses from consumer research organisations (which have collected evidence on the issues we have raised) and from organisations from other countries (which are in a position to share international experience on the issues we have raised).

The CP is posted on the Pensions Institute website, together with a template for comments contained in a word document (www.pensions-institute.org). Please use only this template for replies which should be emailed to:

Marilyn Parris-Bell (Marilyn.Parris-Bell.1@city.ac.uk)
Secretary to the Independent Review of Retirement Income
106 Bunhill Row
London
United Kingdom
EC1Y 8TZ

If you have any queries about the CP please email them to Marilyn. The closing date for submissions is **20 February 2015**. The Review team will report in summer 2015.

Introduction

'Good' defined contribution (DC) pension schemes produce predictable, although not guaranteed, lifelong retirement incomes from members' contributions. Good DC pension schemes also provide value for money for every pound saved in the scheme.

The remit of the **Independent Review of Retirement Income (IRRI)** is to examine and evaluate the predictability and value for money of the lifelong retirement income produced for a given level of planned pension savings in DC pension schemes, the type of pension schemes that most workers in the private sector now have in the UK.[10]

We seek to answer the following questions:

(1) Can we design a pension system that produces lifelong retirement incomes that are more predictable than existing systems?, and

(2) Can we generate the best possible value for every pound saved?

If the answer to both these questions is 'yes', then there is a third question to answer:

(3) Can we ensure that the options that people are encouraged, nudged or defaulted into are both well designed and well regulated?

We believe the answers to these questions lie in understanding the risks involved in the generation of retirement income from pension savings and then finding the most efficient ways of dealing with those risks.

The most important risks are:

- Contribution risk – the risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts.
- Investment risk – the risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement.
- Inflation risk – the risk that inflation is higher than anticipated.

[10] Adequate pensions require high levels of pension savings over long periods. It is generally not possible – due to the risks involved – to achieve this objective from low levels of pension savings that rely on unrealistically high real rates of investment return being realised over extended periods. The IRRI has not been asked to address the question of the adequacy of pensions or the adequacy of pension savings (which many commentators have said are inadequate in the UK). Nor will it address long-term care and the interaction of this with DC decumulation.

- Interest rate risk – the risk that interest rates are low at the point of annuity purchase.
- Longevity risk – the risk that the individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk).
- Cost risk – the risk that the total costs of running the pension scheme during accumulation and decumulation are higher than expected or understood.
- Political risk – the risk that the government changes the rules in an adverse way (e.g., reduces the level of tax relief).
- Regulatory risk – the risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates).
- Demographic/cultural risk – the risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK).
- Market conduct risk – the risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members).
- Behavioural risk – the risk that scheme members behave in a way that is not considered to be rational (i.e., not in their long term interests, since they make short-term decisions that they subsequently regret); included here would be the risk that members fail to understand the risks they face.

There are a number of ways of dealing with such risks in general:

- The risks can be assumed or 'run' – this might be deliberate (e.g., in the case where a scheme member increases the level of investment risk in their pension fund in the hope of achieving a higher investment return and, hence, a higher pension) or unavoidable (e.g., in the case of contribution, political or regulatory risk).
- The risks can be regulated against – effective regulation can reduce cost and market conduct risk, for example.
- The risks can be educated against – by explaining behavioural biases and nudging people towards making optimal decisions.

- The risks can be reduced – by careful design of the scheme. For example, demographic risk can be reduced by ensuring inter-generational fairness, while by careful design of the investment strategy, investment risk can be reduced.
- The risks can be pooled amongst members of a given cohort (known as intra-generational risk pooling) – idiosyncratic longevity risk can be pooled and hence made more predictable, but this, in turn, requires scale (i.e., only large pension schemes can do this).
- The risks can be shared between members of different cohorts (known as inter-generational risk sharing) – investment returns can be smoothed across different cohorts using a smoothing fund.
- The risks can be hedged if there are suitable hedging instruments – inflation and interest rate risk can be hedged using inflation and interest rate derivatives, but systematic longevity risk cannot currently be hedged due to the absence of longevity bonds.
- The risks can be managed within a carefully designed default plan into which the members are auto-enrolled. When someone first starts work, this will be a default accumulation plan with a default contribution rate and investment strategy. When someone retires, this could be a default retirement expenditure plan.
- Finally and most worryingly, the risks can be ignored.

Question (3) above is probably the most difficult question to answer. It requires those saving in a pension scheme to understand that confronting and dealing with risks are unavoidable aspects of building up pension savings over a 40-year (or longer) working life and then running down those savings over a retirement period that could be 30 years or more. But if people can have confidence that those designing and regulating the pensions system have dealt with these risks in the most efficient and cost-effective ways possible, then it might be possible to nudge (or even default) savers into making the right choice at retirement for them and their family. To do this, we will need to build on the lessons of auto-enrolment and, in particular, the issue of having a well-designed default decumulation process at retirement.

Finally, we note the different classes of DC savers and decumulators:

1. Members of DC auto-enrolment schemes: active, deferred and pensioners.
2. Defined benefit (DB) scheme members who transfer to the DC regime. Those who take advantage of the DB-to-DC transfer rules might use the DC scheme offered by their employer, if this includes a drawdown facility. In many cases, they will already be members for accumulation.
3. The self-employed.
4. Workers with employment contracts that do not qualify them for auto-enrolment.

We will examine the characteristics and challenges presented by each group in relation to achieving good retirement outcomes. Our main emphasis will be on the first group, although we will consider how DB-to-DC transferees, the self-employed and those with employment contracts that do not qualify them for auto-enrolment can also be helped.

Consultation Questions

The IRRI's report will focus on five key areas and we would welcome your responses to the following questions listed under each of the section headings. We would like you to note that longevity risk is discussed in a number of these sections. This is unavoidable, since it is a key risk in retirement and cuts across products, the decisions savers make, savers' understanding of this risk, and providers' capacity to bear it.

1. How to ensure that savers can get the best products in retirement

Until now, most members of DC pension schemes were required to buy a lifetime annuity at retirement. The 2014 Budget has changed that requirement as well as opened up the possibility that new types of retirement products will become available. Not all of these will be suitable, especially if they can lead to people spending all their pension savings before they die. We will examine the new products to see which are most suitable, given the new pension flexibilities, and whether there is a case for extending the governance and quality standards developed for the accumulation stage into (some) of the decumulation options. We will also consider how 'longevity insurance' (e.g., a deferred or immediate lifetime annuity) can be combined with 'scheme drawdown' to provide a cost-effective retirement income product that allows for flexibility in spending during retirement while ensuring that savers do not run out of money before they die.

Consultation questions:

1. ***(a) What should be the primary aims of a 'good' DC scheme? Please explain.***
   (b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined?
   (c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?
2. *(a) Do you agree with the breakdown of risks listed in the Introduction?*
   (b) Are there any important risks we have not identified?
   (c) To deal with political risk, would it make sense to have an independent Pension Commission to set pension policy (similar to the independent Monetary Policy Committee)?
3. ***(a) Do you expect products with longevity insurance (e.g., a lifetime annuity) to remain an essential component of a well-designed retirement programme?***
   (b) How should those individuals who continue to buy lifetime annuities be assisted to obtain the best value products for their circumstances?
   (c) If individuals do not purchase lifetime annuities, how does an individual hedge their longevity risk in retirement?

4. ***(a) Where annuities are purchased later in retirement, what are the most effective and efficient products for providing income in the period between retirement and the age at which the longevity insurance comes into effect?***

   (b) Should such products have a maximum recommended level of income withdrawal?

   (c) If so, how should that level of income be determined?
5. ***What are the advantages and disadvantages of scheme drawdown (i.e., where the scheme provides an income to the retired member prior to the purchase of an annuity)?***
6. ***(a) Should decumulation default products provided by, say, large-scale master trusts, be subject to the same trustee-based governance and quality standards that apply to the accumulation default fund?***

   (b) Where decumulation products are offered by contract-based schemes, should they be included in the requirements for the new Independent Governance Committees to provide governance and quality standards and to assess value for money?
7. ***(a) What could be the typical total expense ratio (TER) for a default drawdown product provided by a large-scale master trust?***

   (b) How might this TER compare with individual drawdown products sold in the retail market?

   (c) Can you give any examples of TERs for retail drawdown products?
8. *(a) Should scheme default drawdown products be subject to the charge cap?*

   (b) Should this be the same as for accumulation (i.e. 0.75%) or is there a case for a higher cap? If higher please explain why and what the difference might be?
9. *Retail drawdown products will be sold via regulated advice and they will be purchased via non-advice (execution-only). Is there a case for:*

   (a) Higher quality controls and consumer protection in relation to risk and costs? Explain.

   (b) Making retail products subject to a charge cap? Explain.
10. *What is the optimal investment strategy in scheme drawdown prior to the introduction of longevity insurance?*
11. ***What are the advantages and disadvantages of institutional annuitisation (i.e., where annuities are provided on a bulk basis either by the scheme (self annuitisation) or by an insurance company, rather on a retail basis as currently)?***
12. *Could institutional annuitisation deal with the individual underwriting of annuities and still encourage competition from providers in the open market to maximise consumer outcomes (e.g. in the case where a retired member has a medical condition which reduces their life expectancy)?*
13. *(a) Would a market for advanced life deferred annuities be viable?*

    (b) What is the likely demand for advanced life deferred annuities?
14. *Is there likely to be demand for inflation protection?*

15. *What are your views on the proposals by HM Treasury to allow annuities to have more flexible payment terms by:*
    (a) allowing lifetime annuities to decrease
    (b) allowing lump sums to be taken from lifetime annuities
    (c) removing the ten-year guarantee period for guaranteed annuities
    (d) allowing payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000?
16. *What are your views on U-shaped or J-shaped annuities?*
17. *Should DC retirement products and decumulation strategies be linked to the single tier state pension? If so, how?*
18. *What other retirement products do you expect to become available? Please provide details if possible.*
19. *Is there a case for designating certain retirement products as 'safe harbour' products? Explain.*
20. *Following the impact of the Budget 2014 tax changes on annuity providers, do you have any concerns about supply-side contraction or other developments in the annuity market that might make it less competitive?*
21. *(a) What is the best way to deal with stranded pots? Explain.*
    (b) Two approaches have been put forward to date: 'aggregator' and 'pot-follows-member'. Do you have preference for one over the other? Explain.
    (c) Would 'scheme-follows-member' be feasible? Explain

2. Supporting savers to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment

It is generally agreed that the optimal drawing down of retirement assets is a considerably more complex activity than the initial task of accumulating those assets, in part, because people's circumstances differ. We will investigate whether it is possible to design a good default option at retirement which will be suitable for most savers, in the same way that a good default investment strategy in the accumulation phase can be designed. Even if this is possible, we accept that more people might opt for a different retirement income plan than the estimated 10% of people who reject the default accumulation fund. For example, some retirees might be in poor health and so might choose to access their funds in full at the date of retirement – or over as short a period as possible (staggered to avoid paying unnecessary income tax). Given the complexities of retirement expenditure decision making, we will examine the support that savers need to make the right choices for them and their family. Building on the lessons of auto-enrolment, we will examine what nudges or defaults would be useful to move people towards making optimal decisions.

The 2014 Budget and subsequent consultation on the part of HM Treasury[11] introduces a new tax regime for decumulation, which takes effect in April 2015 and which confers greater freedom in the way DC savers draw their retirement income.[12] As a result, from April 2015, it is expected that DC decumulation at the point of retirement in many cases will take the form of cash and income withdrawal, with annuity purchase deferred until later life.

While the tax reform legislation has been broadly welcomed, in terms of the greater freedom it confers on DC savers at retirement, it has also raised concerns that the new regime will be more complicated, costly and risky, in terms of the wider product choice and tax planning, for example. To help DC savers avoid making poor decisions, the government has also introduced the guidance guarantee, a new service that will be free and impartial and which aims to will help individuals consider their options and make informed choices. [13]

Consultation questions:

22. ***It is now recognised that many people face a number of behavioural barriers which prevent them behaving optimally. When it comes to decumulation, what are the key barriers?***
23. ***We need to recognise that retirees: have different expenditure needs during different phases of their retirement; need to pace their spending throughout retirement in order to optimise the use of their lifetime assets and income and their ability to make intended bequests; and need a choice architecture that reflects the market segment to which they belong.***
    (a) What is your understanding of the regulatory consumer market segmentation and is this appropriate in relation to the needs of DC retirees?[14]
    (b) What nudges and choice architecture do people need to deal with these issues and overcome the behavioural barriers they face?
24. ***(a) What lessons from auto-enrolment in the accumulation phase can be brought to the decumulation phase?***
    (b) Given the importance of income security for the elderly and the existence of longevity risk, is there a case for defaulting people into buying longevity insurance via auto-enrolment (i.e., drawdown with longevity insurance becomes the default

[11] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/294795/freedom_and_choice_in_pensions_web_210314.pdf and the consultation response in https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332714/pensions_response_online.pdf

[12] https://www.gov.uk/government/publications/draft-legislation-the-taxation-of-pensions-bill

[13] https://www.gov.uk/government/news/millions-guaranteed-the-right-to-free-and-impartial-guidance-on-their-new-pensions-choices

[14] Traditionally, the UK market was segmented into the mass market, the mass affluent market and the high net worth market, but this is changing.

retirement strategy)? Consider the advantages and disadvantages of such a strategy.

(c) What would be the likely annualised cost of such products for individuals?

(d) How could the default principle, upon which the success of auto-enrolment is predicated, be best reconciled with the individual freedoms for DC decumulation introduced in the 2014 Budget?

25. *What are the implications of the Chancellor's announcement in September 2014 effectively ending the 55% tax rate on inherited pension pots?*
26. *What are your views on the guidance guarantee and how effective it will be?*
27. *(a) Will other forms of guidance and advice be needed?*

    (b) For DC savers who prefer to make their own decisions, what is the best way to build on the guidance guarantee to help individuals avoid buying retail products that are inappropriate (e.g., in relation to risk) and/or poor value (e.g., in relation to price)?
28. *(a) What specific risks should regulatory safeguards aim to address in relation to financial decisions made at retirement?*

    (b) At what point does individual choice cease to be a regulatory concern/responsibility?
29. *Some DC customers might draw down all their pots in the early years of retirement, a decision they might subsequently regret. What is the most effective way of assisting DC customers to act in their best long-term interests?*
30. *(a) What is the best way of ensuring that any DB-to-DC transferees only undertake such a transfer when it is in their best interests?*

    (b) What are your estimates of the number of DB-to-DC transferees (deferred and also active) and size of assets involved?

    (c) Is the requirement for regulated independent advice for such transferees adequate?

    (d) Can/will the guidance guarantee process cope with DB active/deferred members who seek help in considering their options?
31. *Are there other ways of supporting pension savers to make the right choice at retirement for them and their family?*

3. Helping savers to manage longevity risk

A particularly important issue in retirement income provision is longevity risk. There are two components to longevity risk. The first is the uncertainty over how long any particular scheme member is going to live after retirement. This is known as idiosyncratic longevity risk. The second is uncertainty over how long members of a particular age cohort are going to live after retirement. This is known as systematic or aggregate longevity risk.

Research has found that most individuals underestimate how long they are going to live, often by many years.[15] This is hardly surprising, given the complexity of quantifying longevity risk: even official agencies, like the Office for National Statistics, whose job is to forecast life expectancy in the UK, systematically underestimate how long people are going to live.[16] What all this means is that longevity risk is a risk that the majority of individual savers will not realistically be able – and therefore should not be expected – to manage themselves. To protect them from outliving their resources, most savers are likely to need longevity insurance at some stage in retirement – the possible exceptions being those with very significant wealth or those with a serious life-shortening medical condition but without dependants, for example.

Idiosyncratic longevity risk can be reduced by pooling and taking advantage of the law of large numbers. Systematic longevity risk, however, cannot be reduced in this way. It is a trend risk and can only be hedged with a hedging instrument such as a longevity bond. We will consider the role that longevity bonds might play in helping pension scheme providers hedge the systematic longevity risk they face when they provide longevity insurance.

Consultation questions:

32. ***What evidence is there of individuals' ability to reliably estimate how long they are going to live?***
33. ***How easy is it for individuals to quantify longevity risk? What evidence is available on this question?***
34. ***Is longevity risk a risk that individual savers are able – and should be expected – to manage themselves?***
35. ***Where people receive tax incentives to save into pensions, should people be required to secure a minimum lifetime income in retirement?***
36. ***(a) Do you believe that the DC retirement income market could benefit from the introduction of a market in longevity bonds? Explain.***
    (b) Do you believe that a market in longevity bonds is viable (in the sense of having sufficient demand to justify its introduction)? Explain.
37. *Do you have a preferred design for a longevity bond?*
38. *Is there a case for the government to issue longevity bonds? Explain.*

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[15] Chris O'Brien, Paul Fenn, and Steve Diacon (2005) How long do people expect to live? Results and implications, Centre for Risk and Insurance Studies, Nottingham University Business School, CRIS Research Report 2005-1.

[16] David Blake (2014) The consequences of not having to buy an annuity, Pensions Institute, June (www.pensions-institute.org/workingpapers/wp1409.pdf).

39. Are there alternatives to longevity bonds to hedge systematic longevity risk? Explain.
40. Are there other ways of helping savers to manage longevity risk?

4. The role of the National Employment Savings Trust (NEST) in helping savers to access good quality retirement products

The introduction of NEST has been a game changer for the provision of good-value, well designed and governed pension schemes for low- and medium-income savers in small and medium-sized companies. It has brought institutional standards – in terms of low charges, good governance and a well-designed default investment fund – to the formerly high-cost, poor-value world of retail customers.[17] It has also encouraged the entry of new multi-employer trust-based schemes, such as Now: Pensions and The People's Pension.[18] However, under current legislation, once members of these and other auto-enrolment schemes retire, they have to go to the retail market to buy annuities on an individual basis. Even under the proposed new decumulation regime for April 2015, those who do not wish to buy an annuity might end up buying a retail income drawdown product, which at present can be very expensive and suffer from both poor investment strategy and poor governance. Could institutional standards – in terms of charges, governance and design – be brought to the retirement income space and what role could NEST plays in achieving this?

Consultation questions:

41. Should NEST provide retirement income products to its members?
42. (a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)?
(b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?
43. Are there any other ways in which NEST can help savers to access good quality retirement products?
44. In an aggregator model for stranded pots:
(a) Would it be desirable for NEST to act as one of the aggregators?
(b) Which other schemes could act as aggregators?
45. Could NEST do more in decumulation for the self-employed and workers excluded from auto-enrolment?

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[17] In July 2014, the government announced that in 2017, it would remove the contribution cap and lift the transfer ban imposed on NEST.
[18] Debbie Harrison, David Blake and Kevin Dowd (2012) Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware, Pensions Institute, October (www.pensions-institute.org/reports/caveatvenditor.pdf) and Debbie Harrison, David Blake and Kevin Dowd (2014) VfM: Assessing value for money in defined contribution default funds, Pensions Institute, January (www.pensions-institute.org/reports/ValueForMoney.pdf).

46. (a) Could NEST become a collective pension scheme? Explain.
(b) Should NEST become a collective pension scheme? Explain.

5. The role of collective pension schemes and how these could be introduced in the UK

The analysis of the risks outlined in the Introduction suggests that these might be more effectively managed if they (or at least those that can be) are pooled and shared. This requires scale and, at present in the UK, DC pension schemes are treated as individual accounts. While the contributions of scheme members can be invested in a common investment fund, so that all members with the same length of membership in the same fund get the same return, there is no pooling or sharing of risks.

Collective DC (CDC) pension schemes that pool and share risks are not currently allowed in the UK. However, in the 2014 Pension Schemes Bill, the government is introducing legislation that is expected to change the traditional UK DC system in several important ways. The Bill includes provisions for new risk-sharing strategies for DC schemes that aim to improve the predictability of the retirement income. This is enabling legislation only; it does not include the full regulatory details. Effective regulation will be crucial, as the following extract from an article published in the Financial Times notes:[19]

> Regulation is especially important because, unlike DC pots, individual CDC members have no clearly defined property rights. And unlike DB pensions, there is no sponsoring employer standing behind it, so target pensions can only be paid from a CDC's own assets. For members to judge the likelihood of their target pensions actually being paid, it is crucial that they can understand the scheme's overall funding position easily.
>
> The current bill, however, says nothing specific about CDC regulation. In particular, CDC trustees, advised by actuaries, are left to decide for themselves how target pensions for all members should be valued, so overall funding can be measured against the market value of assets.
>
> This "DIY" approach means there is no objective and consistent benchmark for CDC members to judge the likelihood of their target pensions being paid. "Trust me, I'm an actuary" is not good enough as the basis for a wholly new and untested type of pension.

[19] John Ralfe, CDC pensions will work only if strictly regulated, FT 16 November 2014, http://www.ft.com/cms/s/0/d34f4288-69b8-11e4-8f4f-00144feabdc0.html?siteedition=uk#axzz3JEGVI3Nk

We will examine overseas examples of collective schemes that pool and share risks and hence make incomes in retirement more predictable (at least in principle).[20] Broadly speaking, there are two types of CDC scheme in existence: one that is a form of DB replacement and one that is a form of DC replacement. Because collective schemes claim to have economies of scale that are additional to those of individual-account-based DC schemes, we will examine whether this model for 'collective' schemes can also boost incomes in retirement or at least make such incomes more stable across different cohorts of members. We will investigate how their performance might compare with standard DC schemes. We will also consider how the ability of the member to transfer out and also the greater flexibility in drawing on the pot in retirement can operate in tandem with a CDC pension.

Consultation questions:

47. ***What should 'collective' mean in the UK context (e.g., collective in terms of scale and governance, and collective in terms of risk-sharing)?***
48. ***What are the main benefits of CDC schemes over individual DC schemes?***
49. ***What are the main disadvantages of CDC schemes over individual DC schemes?***
50. ***CDC schemes may be able to generate incomes that are higher than individual DC schemes as the latter are currently operated.***
    (a) Are there reasons why an individual DC scheme could not follow the same investment or decumulation strategy as a CDC scheme?
    (b) Would trustees of an individual DC scheme be willing to accommodate the greater investment risk, given the need to enable members to transfer out and to take their pension pot with them?
51. *(a) Would a CDC scheme have any additional risk-sharing advantages over a large master trust DC scheme which followed the same investment and decumulation strategies where possible?*
    (b) Can the benefits from any additional sources of risk sharing available to CDC schemes be quantified?
52. ***(a) What is your preferred design for a CDC scheme, in terms of targeted benefits? (e.g., a CDC scheme that is intended to replace a DB scheme and hence would be earnings-related (specify accrual rate, earnings measure, pre-retirement indexation rule, post-retirement indexation rule); or a CDC scheme that is intended to replace an individual DC scheme and hence would be with-profit and a target return, unit-linked and a target return, etc).***
    (b) Explain why

[20] CDC schemes are common in Netherlands, Denmark and Canada.

53. ***(a) What is the best estimate contribution rate to achieve the target benefit?***
    (b) How should the contribution rate be shared between employer and member?
54. *(a) Can a CDC scheme work with a planned contribution rate that is fixed independent of a member's age or is an age-dependent member contribution rate required?*
    (b) If the latter, is a change to equality legislation required?
55. ***What investment strategy would be appropriate for CDC schemes: (a) in accumulation and (b) near retirement and (c) in decumulation?***
56. *What are the main benefits of a CDC scheme in terms of intra-generational risk pooling?*
57. *What are the main benefits of a CDC scheme in terms of inter-generational risk sharing?*
58. *(a) Over how many generations should risk be shared?*
    (b) Explain why this is optimal
59. ***How should the risk-sharing rules in a CDC scheme be defined?***
60. ***How much discretion should a CDC scheme's managers have when it comes to smoothing or adjusting benefits to target benefits, or should the rules be fully transparent?***
61. ***(a) If the actual pension is above the target pension, when should adjustments be made?***
    (b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?
62. *(a) If the actual pension is below the target pension, when should adjustments be made?*
    (b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?
63. ***What mechanisms are needed to ensure that no CDC scheme becomes insolvent? For example, a CDC scheme might try to use a high target return to attract more customers.***
64. *Is it necessary for a CDC scheme to start with or build up a reserve fund to give it credibility?*
65. ***CDC schemes in other countries (e.g., Holland) have virtually no flexibility with respect to member choice (e.g. contribution rate, investment strategy, retirement date, form of decumulation (i.e., pension). Do the freedoms and flexibilities introduced by the 2014 Budget render CDC schemes unfeasible or more risky in the UK? Explain why not or, alternatively, how freedom and flexibility would need to be tailored in the context of CDC schemes?***

66. *One of the biggest growth areas prior to the 2014 Budget was the medical underwriting of annuities and the growth of enhanced annuities. But in a standard CDC scheme, everyone gets the same pension irrespective of health status.*
    (a) Would it be feasible in a CDC scheme to medically underwrite the pension in retirement?
    (b) Would it be desirable to do this?
67. *How should a CDC scheme best be organised: (a) on a company-wide basis, (b) an industry-wide basis, or (c) a nation-wide basis?*
68. ***What is the minimum number of members in a CDC scheme to make it viable? Explain this figure.***
69. ***Effective regulation, governance and quality standards will be crucial, given the absence of member property rights (which apply in standard DC schemes) and also the absence of a sponsoring employer that guarantees benefits (which applies in DB).***
    (a) What regulation is required to protect members' benefits?
    (b) What governance mechanisms and quality standards are needed in CDC schemes, especially to ensure inter-generational equity?
70. *Could CDC schemes operate both on a trust basis and a contract basis? Explain.*
71. *Could a 'for profit' organisation run a CDC scheme? Explain.*
72. *What communication strategy would be appropriate for CDC schemes (a) in accumulation and (b) near retirement and (c) in decumulation?*
73. *What measures should the government take to make CDC attractive to: (a) potential sponsors, and (b) potential members?*
74. *How should transfer values be treated in CDC schemes, both in and out?*
75. ***Is it possible for a CDC scheme to work within a charge cap of 0.75%?***

6. Other issues

The five sections above reflect our initial expectation of the areas that would need to be covered, and the issues that would need to be addressed, in our response to the remit set out the beginning of this document. However there may be other issues you would like to raise or areas you think we should be looking at.

76. *With the remit in mind, please tell us if there is anything else you think we should be considering that is not covered in the sections and questions above.*