THE
INVESTMENT
ASSOCIATION

Written evidence submitted by The Investment Association to the Work & Pensions Select Committee inquiry on Pension freedom guidance and advice

Summary

- The Investment Association represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5.5 trillion of assets in the UK on behalf of domestic and overseas investors.

- Investment managers play a key role in helping consumers save for their later life as well as helping them to manage their income needs through retirement and the industry therefore has a strong interest in working to achieve pensions policy outcomes that are good for the end consumer.

- In that spirit, The Investment Association has been a long-standing supporter of greater flexibility in the provision of retirement income, allowing pension savers access to the right product at the right time in their lives. We therefore welcome the decision to liberalise the retirement income market. However, we also recognise the delivery and support challenges and are committed to working with Government, regulators and other stakeholders to secure the successful long-term implementation of the reforms.

- Our submission makes five key points about the future landscape from a product design and distribution perspective:

  i. Role of asset managers in the new retirement income market. Investment managers are manufacturers of products for the retirement income market but are not generally the end providers of pensions and retirement products, instead being intermediated in various ways. In particular, it is insurance companies and trust-based schemes that are the central delivery mechanism for defined contribution (DC) pensions.

     As the new flexibilities have only recently become available, it will take some time before a full picture of consumer and scheme behaviour emerges, and before the product market develops accordingly.

  ii. The role of guidance and advice in supporting decision-making. Individual experiences are likely to be increasingly varied, both during and prior to retirement. Guidance and, where appropriate, advice, is unlikely be a 'one-off' process for individuals; instead it will be required before, on and through retirement. Furthermore, there needs to be much greater clarity about the boundaries between guidance and regulated advice. For most individuals, the dividing line will be extremely unclear. Product distributors and manufacturers would also like greater comfort in this area.

  iii. Delivery of value for money. At the heart of ensuring that the pension system is trusted lies the perception that the financial services industry is delivering value for money. We do not believe that value for money automatically equates to lowest cost, and do not believe that charge caps offer the best means to ensure quality. However, it is essential that the cost of delivery throughout the chain is expressed in an accessible, consistent and complete

manner. The asset management industry is undertaking significant work in this area and would like to see all parties working together to ensure that clients have access to better information.

iv. The nature of risk facing retirees. The debate about appropriate retirement income products is fundamentally about the management of a broad range of risks - principally investment, inflation and longevity - which cannot be mitigated without trade-offs. Both annuities and drawdown have significant risks attached, and one should not assume that there is any inherently 'low risk' approach which does not have an impact on anticipated return.

v. Individual behaviour and default arrangements. Behavioural economics has clearly indicated the challenge of ensuring that consumers behave in a manner that traditional economic theory might predict in financial services product markets. With respect to those unable or unwilling to make active choices for retirement, the debate about the potential role of default arrangements has further to run. While many pension schemes currently appear unsure about how they may offer retirement income options, some form of default standards may well be necessary with a possible extension of the kind of oversight mechanisms used for the accumulation stage default.

Role of asset managers in the new retirement income market

1. Investment managers are manufacturers of products for the retirement income market but are not generally the end providers of pensions and retirement products. In the workplace pensions environment, they are intermediated in various ways, with insurance companies and trust-based schemes the central delivery mechanism for defined contribution (DC) pensions. In the world of greater flexibility at retirement, pension savers should also be able to access investment funds through a wider range of distribution channels, such as platforms.

2. As the new flexibilities have only recently entered into force, it will take some time before a full picture of consumer and scheme behaviour emerges, and before the product market develops accordingly. The Investment Association notes evidence from pensions providers[1] that while the overall picture to date is mixed, there has been a tendency towards scheme members, notably those with small accounts, taking their pension savings as cash. This has focused immediate attention on a number of system readiness and accessibility issues. However, patterns of access are likely to evolve over time and a range of product design and wider support issues lie ahead. For pension schemes, it is still not clear how default arrangements may evolve, including extension into retirement. For individuals, there will be a wide range of preferences and individual circumstances.

3. With respect to the supply of new products, discussions with our members and our monitoring of the retirement income market suggests that there has been some innovation in terms of new products being launched to allow consumers to access the full range of freedoms – for example, options that allow members to access cash

[1] For example, BlackRock announced in early July that its workplace pension business has seen 83 per cent of eligible customers taking their savings as cash, representing total pension assets of £13.4 million. Legal and General announced in June that in the first six weeks of the new flexibilities, the vast majority of requests they had received were for cash, with around a quarter of these requests related to small pots. In contrast, Hargreaves Lansdown reported that after the first month of the freedoms, only around a quarter of customers planning to access their pensions this year were thinking of cashing them out (either all at once or in stages).

in stages or receive a steady income stream over a fixed period of time. In addition there are existing approaches that will function well for consumers, with some adaptation as appropriate, notably income funds.

4. Investment managers and insurers are also thinking about products that combine investment and insurance approaches, which complement each other in a good retirement income strategy. We set out the case for precisely these sorts of approaches in our response to the NEST consultation on the 'The future of retirement'[2] and are pleased to see that NEST has subsequently taken on board these ideas in its proposed approach[3] to providing retirement income. Over time we expect such combination products to emerge in the market.

5. However, it is still early days for the new retirement income market and we are likely to see more change in terms of the suite of products on offer over time. The characteristics of DC plan members who are currently availing themselves of the new freedoms are quite specific. This group have relatively small amounts of DC saving and may have access to DB pensions and other wealth, reflecting the immaturity of DC provision in the UK. The way they access their DC pensions will likely be very different from those future cohorts who are more reliant on DC pensions to provide them with a retirement income. It is therefore likely that products will adapt over time to better suit the circumstances of consumers in the market place.

6. The market is also being affected by regulatory uncertainty created by the possibility of a charge cap being imposed on retirement income products. As we discuss further below, we do not believe that charge caps are a substitute for a debate about what quality really constitutes. Furthermore, in the nascent retirement income market, with limited evidence on consumer behaviour and product pricing at this stage, it is not clear what the justification for any charge cap could be. Caps may also work against product innovation, ruling out certain features that members might otherwise value. They can also have unintended consequences as we are already seeing in the case of the default arrangement charge cap in the savings phase, in which members are being denied exposure to certain asset classes because the cap prices them out.

The role of guidance and advice in supporting decision-making

7. We set out in detail our views on guidance in our response to the 2014 Budget and the FCA's consultation[4] on the guidance guarantee. Our central observation is that guidance is not a 'one off' process, and that the complexity of choices many individuals will face means that developing the right framework is of significant importance. This involves supporting people before, on and through retirement.

8. We therefore support the Government's decision, announced in the July 2015 Budget, to extend access to Pension Wise to people aged 50 and above, and we suggest the Committee considers how Pension Wise could be used to further support individuals through both the accumulation and income phases of pension saving as well as at the moment of retirement. As an example, one option could involve giving people a set number of sessions with Pension Wise over their savings life-cycle e.g. in their 50s, on retirement and once or twice through the retirement period.

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[2] *'The future of retirement'*, NEST, November 2014.
[3] *'The future of retirement: A retirement income blueprint for NEST's members'*, NEST, June 2015.
[4] *'Retirement reforms and the guidance guarantee'*, FCA CP14/11, July 2014.

9. For most individuals, guidance will be an implicit feature of investment through the accumulation phase, given a widespread dependence on auto-enrolment and default strategies. Those strategies also need to make some assumption about retirement options, which may entail engagement by individuals some time before they access pension savings. Finally, accessing retirement savings will not, for many, take the form of a one-off product purchase and on-going support may be needed into retirement.

10. For example, an individual might choose to access some of their pension fund via cash withdrawal or a drawdown strategy in the first years of retirement, with a view to possibly annuitising the residual fund at a later stage. In such a strategy, individuals might need guidance on the sustainability of income withdrawals over time as well as the optimal age to annuitise and the kind of annuity to purchase. While it might be appropriate to seek regulated advice in such circumstances, individuals may not choose this route and such a scenario suggests that the assumption behind Pension Wise cannot be that retirement income is a once-and-done decision at a given moment in time.

11. For some individuals, financial advice is likely to be the most appropriate course of action. The cost of advice varies according to a number of factors, including how many DC schemes the investor has, at what point in the pension journey they are, and how much they have invested. But pension advice can seem expensive to those with smaller pots. Post-RDR changes to the advice regime, which cancelled out an implicit subsidy to smaller investors, have exacerbated this issue. The willingness of firms to step into the world of unregulated guidance is curtailed by the difficulty of distinguishing between what is guidance and what is advice, caused primarily by the concurrent impact of two advice regimes, under MiFID and the Regulated Activities Order (RAO). While the FCA sought in January to help clarify what is and what is not a personal recommendation, it served to highlight the confusion caused by having overlapping definitions, of "advising on investments" in the RAO and "investment advice" under MiFID. In particular, the RAO definition is so broad that it covers many possible scenarios (set out by the FCA) that would not constitute a personal recommendation under MiFID. If this regulatory confusion was addressed – in particular if the very broad definition of advising on investments under the RAO was revised – there would likely be more development of both guidance and simplified advice solutions by providers.

12. The distinction between guidance and regulated advice and the boundary between them is crucial from a consumer perspective as well as a regulatory one. For many individuals, guidance and advice will be seen to be the same thing – the distinction between them will not necessarily be appreciated. For all the reasons outlined above, we therefore welcome the recent launch of the Financial Advice Market Review.

Delivery of value for money

13. Policymakers and regulators are understandably concerned to ensure that individuals are not exposed to charges that are opaque and/or excessively high. Markets must operate in a cost-competitive way. However, as we note above, we do not believe

that low charges and a good outcome are necessarily the same thing, a view shared by The Pensions Regulator among others. However, we accept that the industry collectively must do more to ensure that value for money is better communicated and that this should start with improved transparency of charges and transaction cost disclosure. Improved transparency is not just about completeness of information, but about the provision of consistent and meaningful information.

14. The Investment Association has led the way with a number of initiatives in recent years, which have resulted in more consistent use of charge metrics and greater availability of transaction cost information. We have also made concrete proposals for disclosure to DC pension schemes, and believe that high standards of disclosure must be a core feature of the retirement income market. Individuals must have access to clear information about the costs and features of all aspects of the service: fund management, distribution and, as appropriate, advice.

The nature of risk facing retirees

15. While annuities may be suitable for many people at some stage of life, it should not be assumed that the dominant form of annuity (level payment) is low risk. It is subject to a number of significant risks, notably, 'one period' interest rate risk and inflation. In the same way, it should not automatically be assumed that taking an investment-based approach is inherently high risk in comparison: if managed correctly, drawdown can work successfully.

16. The biggest risk of poorly-informed individual decisions is that people end up with the wrong product, which could result in a range of consequences, from an inappropriate annuity contract to running out of money in a drawdown arrangement. The fundamental concern is to ensure that people have purchased the right product at the right time in their lives. For example, an individual may be better suited by going into income drawdown first before annuitising – but a decision to annuitise straightaway may leave them at risk of a sub-optimal outcome.

17. It is very likely that a combination of continued investment exposure and some form of income underpin will be required by many people, possibly sequentially rather than in parallel. Independent academic research from 2009 supports this conclusion.

18. Well-designed products are clearly critical and the impact of poorly informed decisions should not be seen solely through the lens of product costs. Alongside the overall appropriateness of a product, it is important to focus on quality and 'value for money'. This is subtly different to cost and a low cost product must not necessarily be seen as high quality and vice versa.

Individual behaviour and default arrangements

19. The issue of risk raises fundamental questions about individual decision-making and support. As discussed above clarifying the boundary between guidance and advice is likely to have a beneficial impact on the market for guidance and simplified advice, the cost of which may be more palatable for the auto enrolment demographic.

20. Beyond this, we believe that the role of a potential retirement income default should be further explored. As well as working with known behavioural biases, the use of a

default retirement income product would also circumvent the issues raised by a guidance/advice gap in a complicated retail market.

21. Our aforementioned response to the NEST consultation on 'The future of retirement' set out in detail the case, based on empirical evidence, for a default retirement income strategy based on a combination of investment and insurance approaches – the former to generate an income that keeps pace with inflation over time, the latter to provide longevity insurance.

22. For the majority of members, a default strategy that is based on using investment products through retirement, combined with a degree of annuitisation later in life may lead to the best outcomes. We recognise, however, that in the auto-enrolment market member expectations may focus on how the downside risk during the investment phase may be mitigated. This is likely to be a broader theme in the post-Budget retirement income debate.

23. We also recognise a number of significant practical challenges for the delivery of retirement income defaults that will need to be overcome. At the point of retirement, an individual may have a number of sources of income (e.g. multiple DC pension pots). A default would work best where an overall view could be taken. This might be challenging for the 'last' workplace pension scheme that an individual is a member of. Indeed, it is far from clear how many workplace schemes will wish to offer a default into retirement. The question then becomes whether a default takes a different form to that which will be seen in a workplace DC scheme.

24. In a retirement income strategy that is based heavily on the use of investment products through retirement, there is a significant role that defaults could play, with factors similar to the those in the accumulation stage:

- There is potential for economies of scale in delivery costs.

- They address behavioural biases, which may be particularly prevalent among inexperienced investors.

- They overcome the inertia bias that is prevalent amongst investors who may be initially engaged at the point of entering a strategy but subsequently become disengaged, leaving them at risk of being in a strategy which may no longer be suitable for them – for example because their circumstances or needs change over time.

25. A decumulation stage default strategy could also embed an appropriate drawdown rate thereby assisting members not to drawdown their funds too quickly in retirement. Member engagement could be focused on the more tangible issue about what outcomes might be from such a strategy.

Concluding remarks

26. We reiterate our support for the reforms, which now mean that consumers can purchase the most appropriate product for them at the right time in their lives. However, we also recognise the delivery and support challenges and are committed to working with Government, regulators and other stakeholders to secure the successful long-term implementation of the reforms.

The Investment Association, 27th August 2015.

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