

## **PPI Submission to the Financial Advice Market Review (FAMR) – Call for input**

Please find attached the Pensions Policy Institute's response to the Financial Advice Market Review (FAMR) Consultation, made up of this paper and 3 attachments.

*PPI Report: Transitions to Retirement Series: How complex are the decisions that pension savers need to make at retirement?*

*PPI Report: Myths and Rules of Thumb in Retirement Income*

*PPI Briefing Note<sup>76</sup>: Financial education and retirement: International examples.*

As some of the findings from this submission are relevant to the HMT consultation on Public Financial Guidance, this paper is also being submitted to the HMT consultation.

The PPI will also be working with LV= in the coming weeks to consider the different needs of individuals coming to retirement (in particular those identified by the PPI at being at most risk of poor outcomes in the system as it currently stands) and potential ways to improve outcomes. We will keep the Review team aware of findings as they emerge.

### **Summary**

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and older age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.
2. This submission does not address specific question in the consultation, rather the response sets out key evidence from PPI research that is relevant to the questions asked.
3. This paper consists of 3 sections, the first discussing the PPI report: *How complex are the decisions that pension savers need to make at retirement?*, the second discussing the PPI Report: *Myths and Rules of Thumb in Retirement Income*, and the third discussing the PPI Briefing Note: *Financial education and retirement: International examples*.

**Section 1: Transitions to Retirement Series: How complex are the decisions that pension savers need to make at retirement?**

4. With the popularity of DC savings increasing, and the pension flexibilities that were introduced in April 2015, pension savers are faced with a new range of choices. These choices are required throughout saving stages in regards to accumulation, at retirement and decumulation, particularly with the introduction of the secondary annuity market.

**Pension and retirement transitions have become more staged and gradual**

5. Over the past few decades, the Defined Contribution (DC) model has become more popular with employers, creating more variation in the pension and retirement landscape. DC pension savings involve more choice by the consumer than DB pensions, as to the structure of the income stream and the age at which to commence.
6. This change, considered alongside other changes such as rises to State Pension Age, and some Normal Pension Ages, the removal of the Default Retirement Age, increases in longevity, and economic challenges, have all resulted in changes to the way that people approach retirement and pension transitions. What was traditionally a single event (leaving work and taking a pension) has for many people become more staged and gradual as people work longer, and often more flexibly, as opportunities for taking pensions in stages have become more readily available.

**There are a range of options potentially facing people at and during retirement**

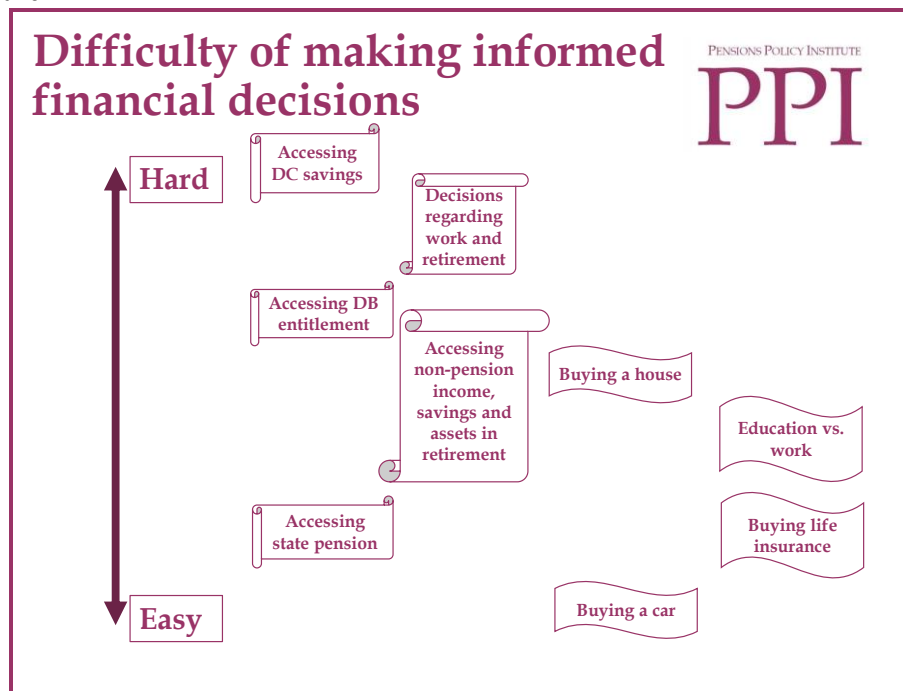
7. All of the changes within pensions mean that now, and particularly going forward, people contemplating a work or pensions transition can in some cases face an array of options such as when, how and whether to retire; when and how to take state and private pensions; and when and how to access non-pension savings and assets. Each transition has several options within it and there are myriad ways to combine them. However many work and pension transitions are involuntary, such as those triggered by ill-health or redundancy. Not everyone has a range of assets and savings to depend on in retirement and for many there may be strong defaults dictating how they retire.

**Decisions about accessing DC pensions are considered the most challenging of pension and retirement decisions and other major financial decisions from across the life course**

8. PPI research supports the idea that making informed decisions about accessing DC savings was the most difficult of both pensions and retirement and other financial decisions (Chart 1). The factors considered necessary to make informed decisions about DC savings involve knowledge about the economy and market-risks, numerical skills and

knowledge about the potential impact of unknown factors. Making informed decisions regarding work and retirement were ranked as the second most difficult as these all involved a high degree of uncertainty.

Chart 1



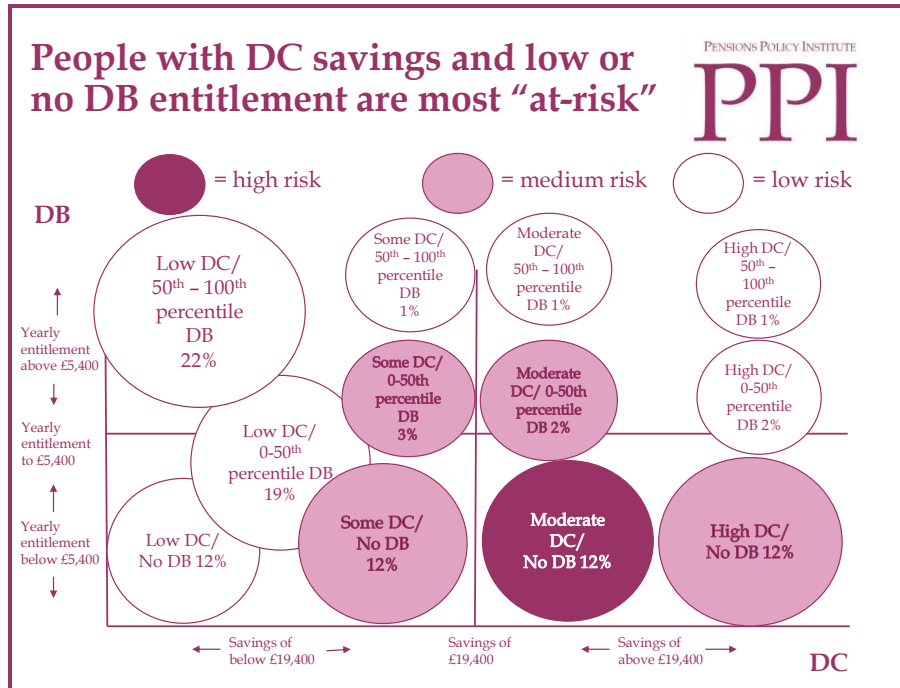
9. These were re-ranked by the level of impact they might have on people's future financial outcomes. The considered opinion was that decisions about accessing DC savings, the most difficult to make an informed decision on, were also near the top of the ranking of financial impact level. The areas that were considered most difficult to make an informed decision about and were also likely to have a high financial impact were those about accessing DC savings, and decisions about work and retirement.

### Those who are judged to be very dependent on DC savings have higher levels of risk

10. Risk level can be mitigated by other factors such as whether people have substantial enough DC savings to afford the risk, whether they were more likely to use independent advice, and whether they were likely to have higher numerical ability, or score well on proxy indicators of financial skill and engagement
11. The group identified as being exposed to the highest risk was those with £19,400 to £51,300 of DC savings and no DB entitlement (Chart 2). This group constituted 694,000 people, 12% of people aged 50 to SPA in 2014, aged to their individual SPAs. The people in this group are likely to rely

mainly on the state pension or state benefits, but have moderate DC savings which could be used to support retirement through a combination of paying off debts, spending on necessary items, or as a source of retirement income.

Chart 2



However, this group scores low on proxy indicators of financial skill and knowledge and are less likely than people in some other groups to use independent advice which might aid in determining the best use for their DC savings.

12. For some people this may be because regulated financial advice appears unaffordable, though many people may be unaware that there is commission attached to the sale of products that are non-advised. If they make a poor decision about their DC savings they have little other income sources than the state or housing assets to fall back on.

**After April 2015, decisions about accessing DC pension savings became more complex**

13. In order to make an informed decision about accessing DC savings and structuring income in retirement people need to be able to understand economic factors such as inflation, market-based risks and longevity risk. Therefore, people may struggle more with complex decisions regarding using DC savings to support themselves in retirement.

14. Levels of numeracy in particular have been found to have correlations with ability to understand pension arrangements. However, having DC savings and no DB entitlement is associated with lower levels of numeracy. People with DC savings and no DB entitlement will also be more dependent on using their DC savings to provide themselves with an income in retirement than those who have some DB entitlement to fall back on but may also have more difficulty making a fully informed decision about accessing their DC savings.
15. Though many people with DC savings (between 70%-80%) reported receiving information from their scheme or provider, people report finding scheme communications confusing and difficult to understand. Natural tendencies towards inertia can be further exacerbated by complexity, uncertainty and a lack of understanding.<sup>1</sup> Therefore, scheme communications, without significant redesign, are unlikely to fill the gap in knowledge or provide the support that people with DC savings might need to make complex decisions, particularly once people over the minimum pension age are allowed complete flexibility to access DC pension savings.
16. Decisions about accessing DC savings are likely to be very difficult for people to make without assistance. However, regulated financial advice has an upfront cost attached to it which might make it appear inaccessible to people with small amounts of DC savings. Regulated advice may not be unaffordable in practice in comparison to the sale of non-advised products which often have a commission attached. But use of regulated financial advice was very low on average among all the segments, ranging between 4%-9% engaged from each segment excepting for those with the highest levels of DC saving and no DB savings, 14% of whom had used an IFA.

**Guidance will need to be able to fill the gaps in advice and information required by people with DC pension savings**

17. It will, therefore, be imperative that the guidance services are particularly able to engage with people with DC savings and no or low levels of DB entitlement who might be in danger of making decisions which are detrimental to their outcomes in retirement due to low levels of numeracy or cognitive or behavioural barriers.
18. For those who do engage with guidance, they may need ongoing support, not just around decisions at retirement, but decisions later on in retirement as income needs or sources might change for people several times during

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<sup>1</sup> Department for Work and Pensions (DWP) (2012). Extending Working Life: behaviour change interventions. DWP, p. 23

retirement because of changes of health, household makeup, and increases or decreases in available income. It might be worth investigating whether people would benefit from the offer of several targeted guidance sessions throughout retirement. It may also be worth investigating whether the guidance should be offered to people of working-age who are still making decisions about saving in a pension.

19. It should also be taken into account that people who do not act on advice or guidance immediately after receiving it may be less likely to make a decision or to make a decision with positive outcomes. Those who are more impulsive or more prone to inertia are the least likely to act on advice or information right away. These tendencies could be considered in the design of advice. There are ways of helping people to take action, for example giving them easy, practical steps to follow, or by including the action as part of the advice or guidance session. However it may be more difficult to give people these options through guidance than through regulated advice.
20. Those designing the delivery of guidance and communications with eligible customers may want to look at focussing on how to engage with people who have DC savings. If there are behavioural barriers, such as a lack of trust, the communications might want to look at ways of addressing these. Research on people's engagement styles indicate that the framing of messages impacts people's responses; people engage more readily when an option is framed as a "gain" rather than a "loss".<sup>2</sup> People also find making decisions with short-term, tangible consequences easier.<sup>3</sup> Guidance communications could explore ways of incorporating positive messages and perhaps framing potential outcomes as more "tangible" in order to encourage engagement.
21. It should also be recognised that there is likely to be a group of individuals who will always find it difficult, or simply will not engage with, guidance or advice. For these groups, and even for those who do eventually engage, the design of processes and defaults (or paths of least resistance) needs to be very carefully considered to make it as easy as possible for individuals to achieve good outcomes. This need not be the best possible outcome, but it should ensure that potentially catastrophic outcomes are avoided. More informal forms of guidance, such as rules of thumb, may be helpful.

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<sup>2</sup> Department for Work and Pensions (DWP) (2012). Extending Working Life: behaviour change interventions DWP, p. 23 p. 30-31

<sup>3</sup> Department for Work and Pensions (DWP) (2012) Household financial decision making: Qualitative research with couples. DWP. p. 35 Figure 4.2

22. Many different mixtures of income and assets will exist, across many different income and asset levels (Chart 2). It is highly unlikely that one type of advice, engagement or guidance will be suitable for every individual. Rather, a coherent framework will be needed.

## **Section 2: Myths and Rules of Thumb in Retirement income. Rules of thumb could help individuals manage their DC pension pots**

23. In the absence of defaults or financial advice there is the risk that, by following what others say or what they perceive to be accepted wisdom, individuals will not always act in their best interests (although they may think they are). In such situations, rules of thumb could be used as a guide (or as a target).
24. Rules of thumb are not necessarily a way to achieve the optimum outcome for a particular individual. They are not intended to replace financial advice or guidance. What they are, however, is a course of action that is broadly appropriate for most people in a particular group. The central question around the use of rules of thumb is whether, for the group who use them, outcomes are better than if the rule of thumb were not used.
25. There needs to be a clear distinction between a rule of thumb, which offers an appropriate course of action for many people and a received wisdom, which generally does not.

### **Received wisdom may be true, but not in every case**

26. The two received wisdoms considered in the report ('purchase a buy-to-let property' or 'withdrawing my pension pot to find somewhere better / safer to invest') may be the best course of action for some. However, there are many instances when it will not be the right course.

### **Rules of thumb need to be carefully phrased and the language needs to make them easy to understand**

27. Round table participants shared the belief that if financial rules of thumb are to be as successful as '*five a day*' these need to be conveyed using language that is both accurate and easy to understand, and financial education and literacy are essential.
28. Previous PPI research<sup>4</sup> identified a group of 694,000 individuals with low levels of financial education at high risk of using their DC savings in a

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<sup>4</sup> PPI (2014) *How complex are the decisions that pension savers need to make at retirement?*

way that is misaligned with their circumstances.<sup>5</sup> This supports the need for clear language that individuals with low levels of financial education or literacy understand.

### **Certain rules of thumb could be helpful to UK individuals under the new pension flexibilities**

29. The two rules of thumb considered in the report ('4% rule' and 'secure a basic income') are considered to be generally in the best interests of an individual.
30. The '4% rule' is where an individual could withdraw this amount of their DC pension pot in the first year and, in subsequent years, the same amount indexed by inflation. The rationale behind this rule is that using it should make the fund last their lifetime. This specific rule of thumb could be helpful in the UK, as it addresses a general lack of understanding around life expectancy and awareness of the probability of living until age 90 or 100. Its strength also lies in the fact that it can be used as a guide or as a target. Even if it is not followed to the letter, it provides a reasonable basis for most people in terms of managing their expectations of income from their pension pot.
31. The 'secure a basic income to meet essential needs' rule could also be helpful in the UK as it addresses the risk that UK individuals will be at risk of drawing down their pensions too quickly. In terms of language, it is relatively easy to understand and it can be used as a guide or a target.

## **Section 3: Briefing note 76. Financial education and retirement: International examples**

### **Resources available to UK individuals**

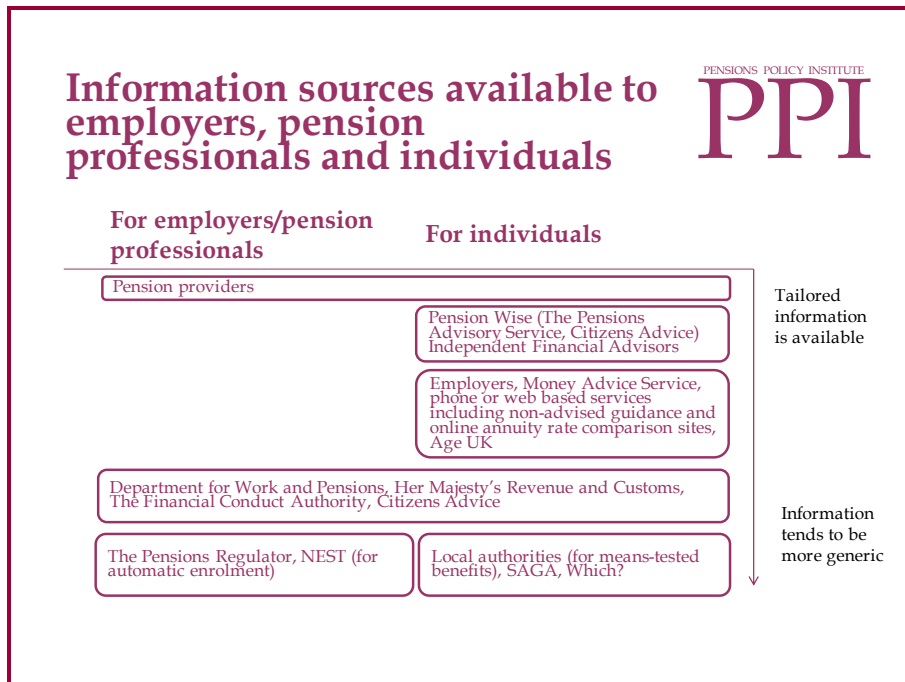
32. An overview of resources available to a UK pension saver is shown in Chart 3. The written form (letters, pamphlets, analysis, etc.) about both the pension system in general and about their own pension provision, has generally been the medium used to convey information. However, there is a growing appreciation that this is not sufficient.

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<sup>5</sup> These were individuals projected to have between £19,400 and £51,300 of DC savings and no DB entitlement at State Pension Age – financial literacy is not generally that high amongst this group of individuals who are likely to depend to a large extent on their DC savings in retirement.



Chart 3



33. There are different models of engagement and education used internationally. These can take the form of web-based communication or general awareness raising. However, those that are most successful appear to be designed to fit with a generally accepted culture of retirement saving, and often are a result of a partnership between Government, industry, employers and individuals.

#### Financial education during accumulation – Denmark

34. Information around pensions is available on the same website as information around other financial issues; which may bring the topic of pensions to the attention of someone initially looking for information on another subject.
35. There is an emphasis on both practical arrangements and adequacy of savings during the accumulation phase, e.g., what to do when changing jobs or evaluating savings against desired retirement income.
36. As with some of the other countries considered, it is possible for individuals to see consolidated information about their own pension entitlements, including state, occupational and private pensions.

**Pensions Dashboard – Sweden**

37. The dashboard enables individuals to see all of their pension entitlements, including state, private and occupational pensions, regardless of whether these are DB or DC pensions.
38. The information is updated on a near real-time basis for most pension funds. The service's reach is wide—over 2 million individuals of a 9.5 million population are registered.<sup>6</sup>
39. The 'Minpension' portal is owned by a subsidiary of Swedish Insurance (the Swedish insurance trade association), is run and funded jointly by the state and pensions industry.

**Sorted website – New Zealand**

40. It provides guidance to help people make financial decisions, e.g. it provides individuals with a list of questions that they might ask.
41. It provides advice around lifetime financial planning rather than focusing on pensions. It is user-friendly, trusted and personalises information. The website is complemented by other approaches.

**Pensionedriedaagse – Netherlands**

42. Three days every October 'Pensionedriedaagse' (Three Pensions Days) occurs. Pension providers, employers and advisors work together to inform the public around their pensions.
43. The Pensionedriedaagse can act as a trigger for people to consider their pension arrangements.
44. Information is provided to individuals in a layered way, meaning that relatively straightforward information is provided in the first instance and, should they wish, individuals can access more complex and detailed information.
45. Individuals are encouraged to consider changes in their circumstances and the ways in which these affect their pension position.
46. Pension providers of workplace pensions play a large role in the provision of information to members.

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<sup>6</sup> <http://www.ftadviser.com/2015/03/11/pensions/personal-pensions/report-calls-for-swedish-style-pension-income-dashboard-y8nZbbuThY8Ozr1bQT0VSL/article.html>

Chart 4

**Overview of approaches to communication taken by a selection of countries**

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Country	Approach taken to communication	Outcome
Denmark	Provision of information such as statements that includes less text and jargon following the recommendations of the Money and Pensions Panel	An evaluation round the provision of information by the Danish Insurance Association found that 74% and 66% of respondents were satisfied with the amount of information that they received about their personal pension and occupational pension respectively
Netherlands	Three Pensions Days every October alongside the provision of information in a layered way	No specific evaluation: Netherlands scores highly (89.4 compared to an average of 71.9) on the integrity index (that includes quality of communications) for the Mercer Global Pension Index
Sweden	Pensions Dashboard that enables individuals to see all of their pension entitlements together	No specific evaluation: Sweden scores 81.6 on the integrity index for the Mercer Global Pension Index
New Zealand	Sorted website, with a familiar tone, that covers pensions alongside other issues	Reported saving rates in 2005 were at the highest level since 1995 with 72% of people surveyed saying that they (or someone else on their behalf) were saving for retirement (though this may not due to the Sorted website only)
United States	Auto-escalation: Save More Tomorrow initiative in which individuals sign up to increase their pension contributions in future years	In one US 401k (DC) scheme with SMarT features, employees increased their pension contributions from 3.5% to 13.6% of salary over a four and a half year period. Take-up has tended to be higher where individuals are provided with financial advice

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How complex are  
the decisions that  
pension savers  
need to make at  
retirement?



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A Research Report by Daniela Silcock, John Adams and Mel Duffield

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## How complex are the decisions that pension savers need to make at retirement?

Introduction	1
Executive Summary	3
1. What are the main pension and retirement decisions that people have to make at and during retirement?	17
2. What factors influence the choices people make in retirement?	33
3. How complex are the choices that people have to make at and during retirement?	42
4. How complex are the decisions facing people retiring within the next ten to fifteen years?	54
Appendices	77
Acknowledgements and contact details	97
References	98

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## Introduction

With automatic enrolment now well under way and around 9 million employees expected to be newly saving or saving more in pension schemes by 2018, there has been increasing focus on the design and quality of Defined Contribution (DC) schemes. So far the focus has mainly been on the accrual stage, employer contribution levels, the design of default investment strategies, and the level and transparency of charges. However with existing DC pension schemes now maturing, and the first auto-enrolees due to retire over the next few years, attention is turning also to the retirement phase and how best to help DC members to achieve better outcomes and greater security in retirement.

The pensions landscape is undergoing many changes alongside automatic enrolment. Changes announced in Budget 2014 mean that, from April 2015, people with Defined Contribution savings will be allowed greater levels of flexibility when they come to access their pension savings after the minimum pension age (currently age 55). A number of factors have increased the costs of providing DB pension schemes and, as a consequence, over 85% of DB schemes in the private sector are now closed either to new members or to both new members and new accruals. Due to a combination of automatic enrolment and DB closures, the UK private sector workplace pensions landscape is likely to be dominated by DC schemes in the future.

PPI has undertaken research projects on income needs and the use of income and assets in retirement before; however rising longevity, the growing complexity of retirement behaviour, and regulatory changes introducing more flexible access to DC savings, have all generated new challenges and opportunities and increased the appetite for a debate on policy responses and industry solutions to enable better retirement outcomes.

Therefore the PPI is embarking on a series of three major research reports exploring developments in how people access pension savings. These reports should serve as a timely, invaluable and independent assessment of how well equipped the UK pensions landscape is to support good member outcomes in retirement.

This, the first report in the series, explores the range of potential decisions people have approaching, at the point of, and after retirement. It sets out the likely income and savings portfolios people might reach retirement with now and over the next ten to fifteen years, and sets these against the behavioural and psychological factors that affect the decisions people could make at and during retirement. The research investigates implications for the retirement income product industry, employers, trustees, providers, consultants and services which provide advice and guidance.

The research methodology includes using the PPI's dynamic model and data from Wave 5 of the English Longitudinal Study of Ageing to make estimates of

future levels of savings portfolios as well as exploring the attributes of what different savings portfolios and attributes might mean for outcomes in retirement. The research also involved a workshop conducted by the PPI with experts on the behaviour and psychology of pensions and retirement decisions.<sup>1</sup> The workshop explored the range of options facing people in the lead up to and at retirement, then explored the knowledge and skills that people need in order to make informed decisions about these options. The research also makes use of managerial information provided by The Pensions Advisory Service on public enquiries regarding pensions issues.

Chapter one sets out the decisions that people face in the run up to, at and during retirement and looks at some of the available information on current trends in these areas.

Chapter two sets out the internal and external factors which influence the decisions that people make in retirement and examines retirement and pension transitions which are involuntary.

Chapter three sets out the skills and knowledge that people need in order to make informed decisions about pensions, retirement and other financial decisions from across the life course and ranks these decisions by difficulty and overall financial impact on people's lives.

Chapter four sets out the portfolios of pension saving and entitlement that people will be reaching State Pension Age with today and over the next ten to fifteen years. It defines different segments within this population and looks at which segments are faced with the most complex decisions at and during retirement and how these correlate with financial skills and knowledge. This chapter explores the implications of the segmentation for the provision of advice and guidance.

<sup>1</sup> The workshop was attended by: Christopher Brooks, Senior Policy Manager (Age UK), Alev Sen, Policy Researcher (CAB), Dr Paul Cox, (CHASM), Alan Higham, Retirement Director, (Fidelity), Janette Weir, Director (Ignition House), Anthony Tomei, Visiting Professor (King's College), Melinda Riley, Head of Policy, (TPAS), Rebecca Fearnley, Chief Adviser, (Which)

## Executive Summary

### **Pension and retirement transitions have become more staged and gradual**

Pension provision in the UK has historically been provided through a combination of a Defined Benefit (DB) model, sponsored by employers, and the state pension or state benefits. The DB and state pension models, coupled with a Default Retirement Age have all encouraged people to take their pension at the same time that they retire, as a single “taking a private and/or state pension and leaving work” event, whether this be at Normal Pension Age or at State Pension Age.

Over the past few decades, the Defined Contribution (DC) model has become more popular with employers, creating more variation in the pension and retirement landscape. DC pension savings, generally converted into an annuity, involve more choice by the consumer than DB pensions, as to the structure of the income stream and the age at which to commence.

This change, considered alongside other changes such as rises to State Pension Age, and some Normal Pension Ages (the expected age at which to take a DB pension as income), the removal of the Default Retirement Age (the age at which an employer was legally allowed to terminate employment on the basis of age), increases in longevity, and economic challenges, have all resulted in changes to the way that people approach retirement and pension transitions. What was traditionally a single event (leaving work and taking a pension) has for many people become more staged and gradual as people work longer, and often more flexibly, and as opportunities for taking pensions in stages have become more readily available.

### **The number of people saving in DC pension schemes is rising**

The introduction of auto-enrolment in 2012 also means that many more people are being brought into pension saving, particularly into private sector DC pension schemes, as many private sector DB schemes are closing to new members. Changes announced in Budget 2014 also mean that, from April 2015, people with DC savings will be allowed greater levels of flexibility when they come to access their pension savings after the minimum pension age (currently age 55). There is already evidence that people are interested in the new flexibilities and feel that they need assistance in making decisions about their DC savings in light of the announcement. The number of calls to The Pensions Advisory Service regarding at-retirement decisions increased after the Budget announcement that further flexibilities would be introduced. In the first few weeks after the announcement, the proportion of helpline calls received by TPAS about at-retirement decisions rose from 15% of calls to 45%.

### **There are a range of options potentially facing people at and during retirement**

All of these changes mean that now, and particularly going forward, people contemplating a work or pensions transition can in some cases face an array of options such as when, how and whether to retire; when and how to take state and private pensions; and when and how to access non-pension savings and assets. Each transition has several options within it and there are myriad ways to combine them. However many work and pension transitions are involuntary, such as those triggered by ill-health or redundancy. Not everyone has a range of assets and savings to depend on in retirement and for many there may be strong defaults dictating how they retire.

The PPI conducted a workshop with experts on the behaviour and psychology of pensions and retirement decisions.<sup>2</sup> The workshop explored the range of options facing people in the lead up to and at retirement, then explored the knowledge and skills that people need in order to make informed decisions about these options. The workshop also explored the knowledge and skills that people need in order to make informed decisions about other major financial decisions from across the life course.

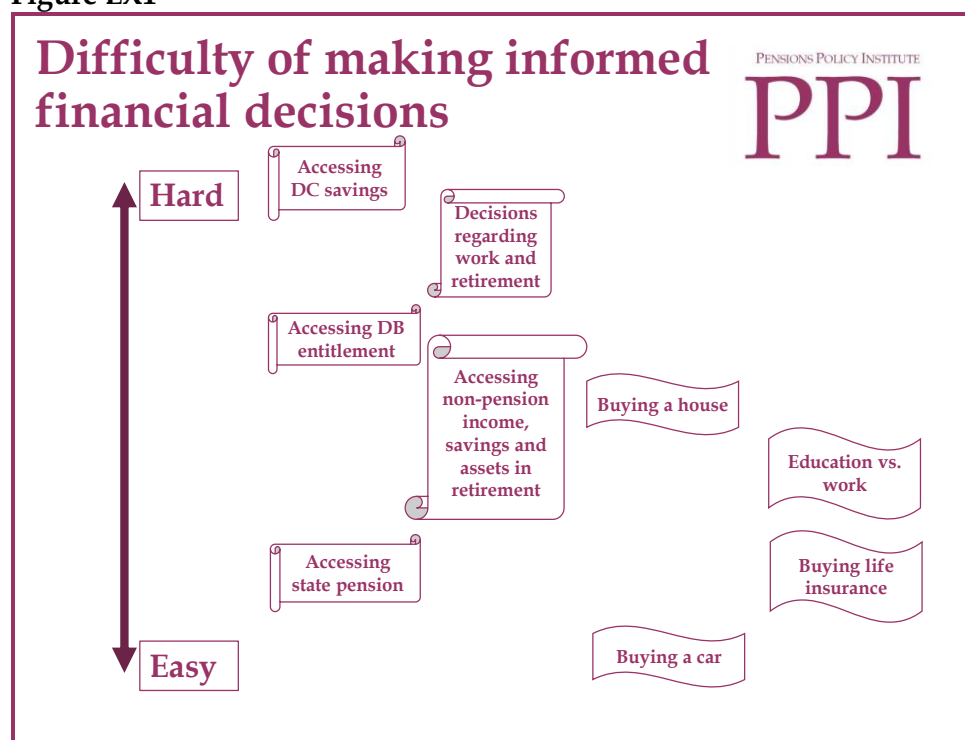
The workshop participants ranked decisions related to pensions and retirement, and other major financial decisions from across the life course by the difficulty of making an *informed financial decision* on each.

### **Decisions about accessing DC pensions are considered the most challenging of pension and retirement decisions and other major financial decisions from across the life course**

The workshop's considered opinion was that making informed decisions about accessing DC savings was the most difficult of both pensions and retirement and other financial decisions (Figure EX1). The factors considered necessary to make informed decisions about DC savings involve knowledge about the economy and market-risks, numerical skills and knowledge about the potential impact of unknown factors. Making informed decisions regarding work and retirement were ranked as the second most difficult as these all involved a high degree of uncertainty.

Making informed decisions about accessing DB entitlement were considered the third most challenging, just above making informed decisions regarding accessing other income and assets, buying a house or choosing between further education and work. Making an informed decision about accessing state pension entitlement, purchasing life insurance or purchasing a car were ranked the easiest, as the outcomes of these decisions were relatively simple to understand and there are strong defaults attached to some of these options.

<sup>2</sup> The workshop was attended by: Christopher Brooks, Senior Policy Manager (Age UK), Alev Sen, Policy Researcher (CAB), Dr Paul Cox, (CHASM), Alan Higham, Retirement Director, (Fidelity), Janette Weir, Director (Ignition House), Anthony Tomei, Visiting Professor (King's College), Melinda Riley, Head of Policy, (TPAS), Rebecca Fearnley, Chief Adviser, (Which)

Figure EX1<sup>3</sup>

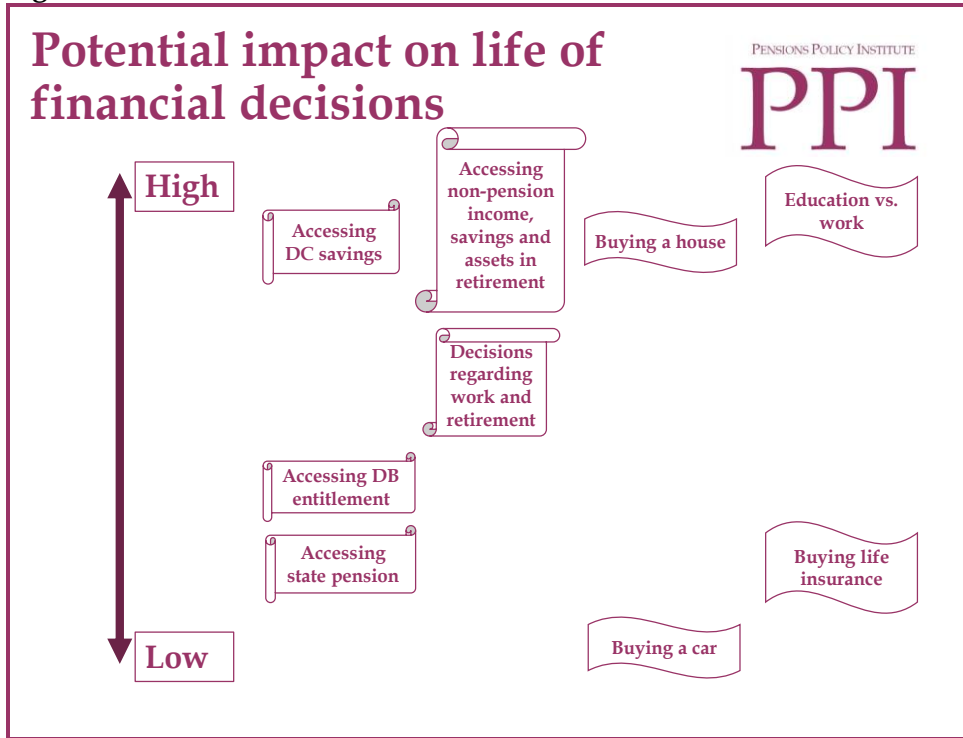
The decisions were re-ranked by the level of impact they might have on people's future financial outcomes.

The level of financial impact that decisions about accessing pension or non-pension savings and assets will have on an individual is dependent foremost on the levels of savings or entitlement that the individual has accrued of a particular type. If the level of savings or entitlement of one type is small, and the individual has substantial levels of savings or entitlement of other types, then the decision may have less of an impact. If the individual has accrued a large level of savings and entitlement of one type, such as DC savings, and has very little other types of savings or entitlements, then the impact of any decision made might be more profound. Those with small levels of savings or entitlement may also experience a relatively greater impact from decisions about access if they have very little other savings, entitlements or assets to fall back on.

The workshops considered opinion was that decisions about accessing DC savings, the most difficult to make an informed decision on, were also near the top of the ranking of financial impact level. Decisions about further education versus work, buying a house and accessing other income and assets in retirement were also ranked as having the highest potential for financial impact during the lifetime (Figure EX2). The areas that were considered most difficult to make an informed decision about and were also likely to have a high financial impact were those about accessing DC savings, and decisions about work and retirement.

<sup>3</sup> Rankings agreed by working group of experts including representatives from: Age UK, CAB, CHASM, Fidelity, Ignition House, King's College, TPAS, Which

Figure EX2<sup>4</sup>

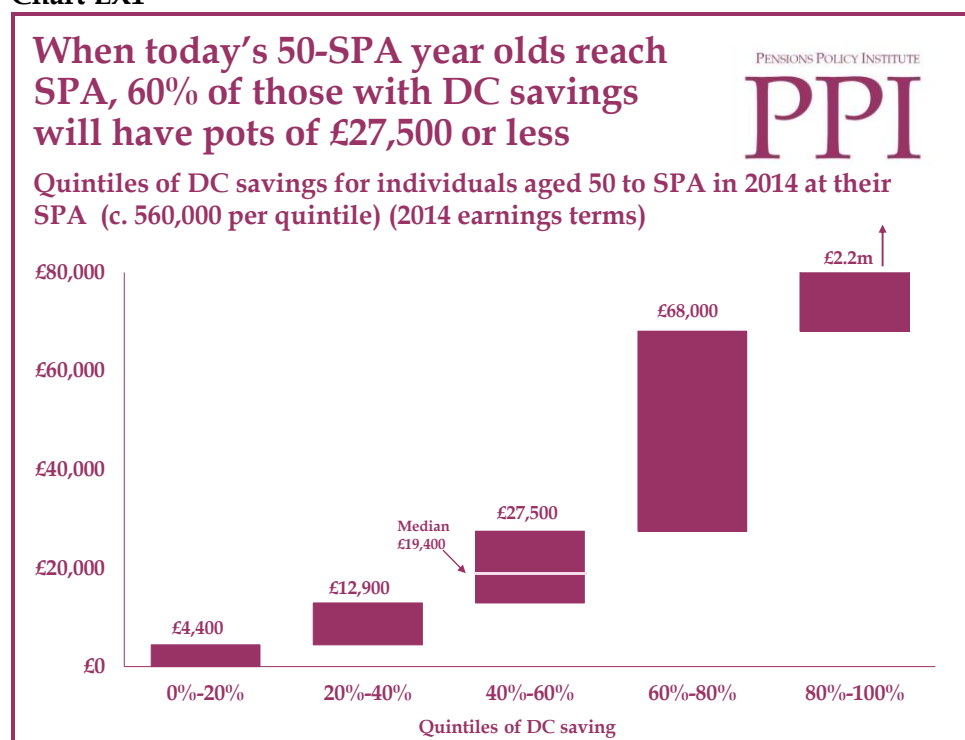


**There are varying saving and asset groups within the over 50 population, and these have different characteristics attached to them**

This report explores the portfolios of pension saving and entitlement that people will be reaching State Pension Age with today and over the next ten to fifteen years. It defines different segments within this group and looks at which segments are faced with the highest risks and most complex decisions at and during retirement and how these correlate with financial skill and engagement. The segment groups are separated by level (25<sup>th</sup> percentiles) of DC savings, then further divided by level of DB entitlement (those with less than the 50<sup>th</sup> percentile of DB entitlement - £5,444 per year - and those with more than the 50<sup>th</sup> percentile) to create 12 separate segments.

The DC portfolios of groups approaching retirement over the next ten to fifteen years are of special interest, as it is people with this type of savings who will be most impacted by the Budget changes introducing further flexibility of access to DC savings. Simulating ageing for all of today's 50 to SPA year olds with DC savings till they reached their own individual SPA and considering them as one population, then 60% of them are modelled as having pots of £27,500 or less (2014 earnings terms) (Chart EX1).

<sup>4</sup> Rankings agreed by working group of experts including representatives from: Age UK, CAB, CHASM, Fidelity, Ignition House, King's College, TPAS, Which

Chart EX1<sup>5</sup>

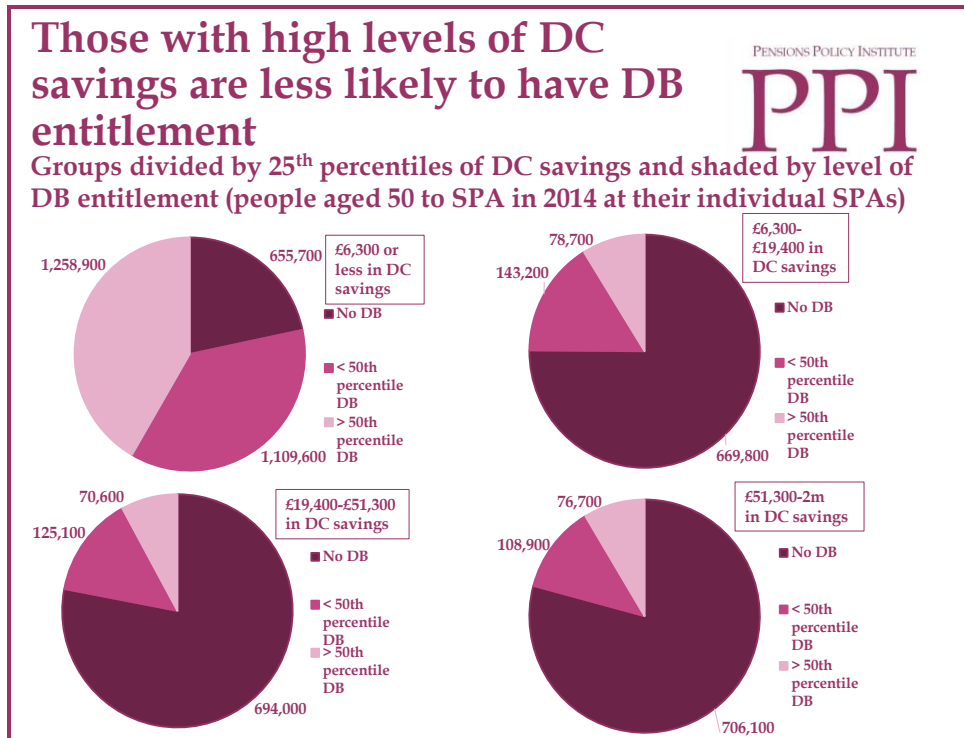
**Half of people currently aged between 50 and SPA with pension savings will have £6,300 (2014 earnings terms) or less in DC savings by the time they reach their SPA – including some with no DC savings**

Around 5.7 million people currently (2014) aged between 50 and SPA will have some private pension savings or entitlement at their SPA. Around half of these people will have DC pots of £6,300 or less, including those who will have no DC savings. Around three quarters of this group will have DB entitlement. Half of this group will have DC pots of £6,300 or more and around a quarter of these will have DB entitlement (Chart EX2).

<sup>5</sup> PPI Dynamic Model



Chart EX2<sup>6</sup>



The segment groups have been assigned risk labels reflecting indicators such as degree of dependence on DC, whether they had DB entitlement to fall back on, and their likely ability to make “good” DC decisions based on their levels of financial skill and engagement.

Those who are judged to be very dependent on DC savings are determined to have higher levels of risk. Risk level can be mitigated by other factors such as whether people have substantial enough DC savings to afford the risk, whether they were more likely to use independent advice, and whether they were likely to have higher numerical ability, or score well on proxy indicators of financial skill and engagement (Chart EX2, Table EX1).

**The highest risk group was those with £19,400 to £51,300 (the 50<sup>th</sup> to 75<sup>th</sup> percentiles of DC saving within the sample group) of DC savings and no DB entitlement**

The group identified as being exposed to the highest risk was those with £19,400 to £51,300 of DC savings and no DB entitlement. This group constituted 694,000 people, 12% of people aged 50 to SPA in 2014, aged to their individual SPAs. The people in this group are likely to rely mainly on the state pension or state benefits, but have moderate DC savings which could be used to support retirement through a combination of paying off debts, spending on necessary items (such as home repairs) or as a source of retirement income. However, this group scores low on proxy indicators of financial skill and knowledge and are

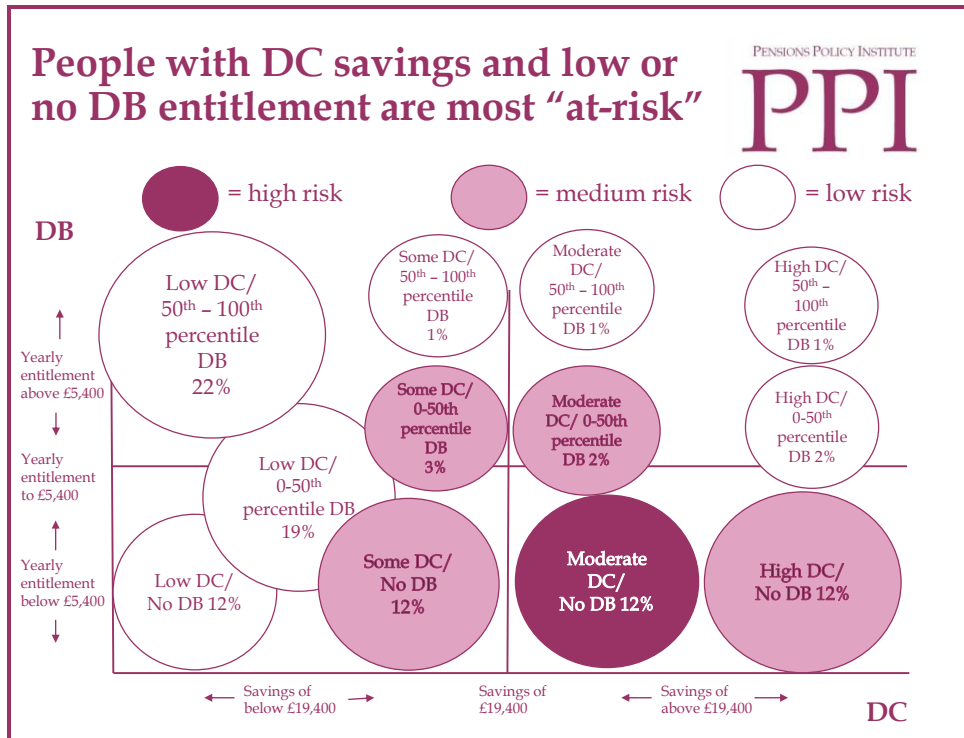
<sup>6</sup> PPI Dynamic Model

less likely than people in some other groups to use independent advice which might aid in determining the best use for their DC savings. For some people this may be because regulated financial advice appears unaffordable, though many people may be unaware that there is commission attached to the sale of products that are non-advised. If they make a poor decision about their DC savings they have little other income sources than the state or housing assets to fall back on. Prior to the transitional arrangements introduced in 2014, many of the people in this group would have had to purchase a lifetime annuity or invest in Capped Drawdown with their DC savings because they would have been above the trivial commutation limit of £18,000. After April 2015 all of these people will be able to flexibly take their DC pension savings after the minimum pension age and therefore they will face an array of decisions that they would have had to if they were purchasing a lifetime annuity or Capped Drawdown.

Around 29%, or 1.6 million, of people aged 50 to SPA in 2014, aged to their individual SPAs, are classified as having a medium risk level, because they will be dependent to some degree on the income from their DC savings in retirement, have little other savings and assets to fall back on and have low levels of financial skill and engagement. They were not classified as high risk either because they are relatively less dependent on their DC savings (due to other savings or entitlement or because they have low levels of DC savings) or because they have enough DC savings to be reasonably expected to use advice, or not suffer the same proportionate loss from making poor decisions.

Those labelled as “low-risk,” because of high levels of DB entitlement, constitute around 25% of the population analysed. The majority of these people have low levels of DC savings and either have high levels of DB savings, or will be dependent mainly on the state pension and, possibly, state benefits (Chart EX3).

Chart EX3<sup>7</sup>



**This report looks at different indicators and how they correlate with pension and non-pension savings portfolios**

It is useful to explore how different indicators correlate with pension and non-pension saving portfolios because they can provide information about the likely needs and characteristics of different groups. For example, profession based socio-economic class can give indications about education, income level and the likelihood of people being able to work longer or more flexibly. For example, those in lower profession based socio-economic classes are less likely to have flexible working options available to them and are more likely to have to leave work for involuntary reasons such as health problems.

The level of non-pension savings and assets held by people gives an indication of how dependent they might be on one source of pension savings or on the state. Proxy indicators of financial skill and engagement can allow judgements to be made regarding people’s likely ability to make complex decisions about accessing pension savings without assistance. The following table sets out the segment groups and indicates whether they scored high, medium or low in each of these indicators.

<sup>7</sup> PPI Dynamic Model

Table EX1<sup>8</sup>

Group average scores on different indicators - colour-coded by risk level High = ✓ Medium = ~ Low = X  DC - total savings DB - yearly entitlement in 2014 earnings terms	Socio-economic class	Non-pension savings and assets	Proxy indicators of financial skills and engagement
Low DC/No DB (£6,300 or less (DC), No (DB))	X	X	X
Low DC/0-50th percentile DB (£6,300 or less (DC), £5,400pa or less (DB))	X	~	X
Low DC/50th-100th percentile DB (£6,300 or less (DC), £5,400-£300,400pa (DB))	~	~	~
Some DC/No DB (£6,300-£19,400 (DC), No DB)	X	X	X
Some DC/0-50th percentile DB (£6,300-£19,400 (DC), £5,400pa or less (DB))	~	~	~
Some DC/50th-100th percentile DB (£6,300-£19,400 (DC), £5,400-£300,400pa (DB))	✓	✓	~
Moderate DC/No DB (£19,400-£51,300 (DC), No DB)	~	~	X
Moderate DC/0-50th percentile DB (£19,400-£51,300 (DC), £5,400pa or less (DB))	~	~	~
Moderate DC/50th-100th percentile DB (£19,400-£51,300 (DC), £5,400-£300,400pa (DB))	✓	✓	✓
High DC/No DB (£51,300- 2m (DC), No DB)	✓	~	~
High DC/0-50th percentile DB (£51,300-2m (DC), £5,400pa or less (DB))	✓	✓	✓
High DC/50th-100th percentile DB (£51,300-2m (DC), £5,400-£300,400pa (DB))	✓	✓	✓

<sup>8</sup> PPI Dynamic Model

**After April 2015, decisions about accessing DC pension savings will become more complex**

In order to make an informed decision about accessing DC savings and structuring income in retirement people need to be able to understand economic factors such as inflation, market-based risks and longevity risk. Therefore, people may struggle more with complex decisions regarding using DC savings to support themselves in retirement than those with DB savings who can make an informed decision based on a more limited understanding (as scheme rules generally protect members against inflation, market based risks and longevity risk).

Decisions about accessing DC savings will become more complex after April 2015 when people will no longer be required to use a recognised retirement income product. Retirement income products such as annuities and income drawdown previously had some safeguards against market-based and longevity risks built into them, and many, such as lifetime annuities, will continue to do so after April 2015. However, people who choose not to purchase a retirement income product which protects against risk with some or all of their DC saving after April 2015 will have to make decisions about how to protect themselves against risks, many of which are not predictable (such as inflation risk and longevity risk). The 56% reduction in annuity purchases observed in Q3 of 2014 (in comparison to Q3 of 2013) indicates that far fewer annuities will be purchased by people with DC savings in future, and that their funds may therefore be exposed to these greater levels of risk.

Levels of numeracy in particular have been found to have correlations with ability to understand pension arrangements. However, having DC savings and no DB entitlement is associated with lower levels of numeracy. People with DC savings and no DB entitlement will also be more dependent on using their DC savings to provide themselves with an income in retirement than those who have some DB entitlement to fall back on but may also have more difficulty making a fully informed decision about accessing their DC savings.

Though many people with DC savings (between 70%-80%) reported receiving information from their scheme or provider, people report finding scheme communications confusing and difficult to understand. Natural tendencies towards inertia can be further exacerbated by complexity, uncertainty and a lack of understanding.<sup>9</sup> Therefore, scheme communications, without significant redesign, are unlikely to fill the gap in knowledge or provide the support that people with DC savings might need to make complex decisions, particularly once people over the minimum pension age are allowed complete flexibility to access DC pension savings.

Decisions about accessing DC savings are likely to be very difficult for people to make without assistance. However, regulated financial advice has an upfront cost attached to it which might make it appear inaccessible to people with small

<sup>9</sup> DWP (2012a) p. 23

amounts of DC savings. Regulated advice may not be unaffordable in practice in comparison to the sale of non-advised products which often have a commission attached. But use of regulated financial advice was very low on average among all the segments, ranging between 4%-9% engaged from each segment excepting for those with the highest levels of DC saving and no DB savings, 14% of whom had used an IFA.

### **The Guidance Guarantee will need to be able to fill the gaps in advice and information required by people with DC pension savings**

It will, therefore, be imperative that the new Guaranteed Guidance service is particularly able to engage with people with DC savings and no or low levels of DB entitlement who might be in danger of making decisions which are detrimental to their outcomes in retirement due to low levels of numeracy or cognitive or behavioural barriers.

During a pensions guidance pilot on at-retirement decisions, only 2.5% of customers were reported to have taken up the offered guidance.<sup>10</sup> This suggests that, as with the accumulation stage, there may be a substantial group of individuals who do not wish to engage in decision-making around their retirement provision. Recent PPI research analysing findings from a consumer survey found that individuals' intentions around their DC pensions are characterised by a high degree of uncertainty around both when they might retire and how they will access their pension savings. Even 12 months ahead of their expected retirement dates, only around 50% of DC savers say they know what they expect to do with their pension pot at retirement. So, even if engagement can be achieved, it is unlikely that savers will have clear or definitive views on their expectations and preferences in retirement. It is more likely that gradually raising their awareness ahead of retirement around the choices and trade-offs they will face will help them to become comfortable with any default options they are offered by their schemes or providers, or will prompt them into exploring where they can find further help, beyond any initial guidance service.

For those who do engage with the guidance, they may need ongoing support, not just around decisions at retirement, but decisions later on in retirement as income needs or sources might change for people several times during retirement because of changes of health, household makeup, and increases or decreases in available income. It is not yet clear whether people will be only allowed to use the Guidance service once, in the lead up to retirement, or will be allowed to have multiple sessions. It might be worth investigating whether people would benefit from the offer of several targeted guidance sessions throughout retirement. It may also be worth investigating whether the guidance should be offered to people of working-age who are still making decisions about saving in a pension.

<sup>10</sup> [www.moneymarketing.co.uk/2015140.article?cmpid=pmalert\\_590745](http://www.moneymarketing.co.uk/2015140.article?cmpid=pmalert_590745)

It should also be taken into account that people who do not act on advice or guidance immediately after receiving it may be less likely to make a decision or to make a decision with positive outcomes. Those who are more impulsive or more prone to inertia are the least likely to act on advice or information right away. These tendencies could be considered in the design of advice. There are ways of helping people to take action, for example giving them easy, practical steps to follow, or by including the action as part of the advice or guidance session. However it may be more difficult to give people these options through guidance than through regulated advice.

Those designing the delivery of guidance and communications with eligible customers may want to look at focussing on how to engage with people who have DC savings. If there are behavioural barriers, such as a lack of trust, the communications might want to look at ways of addressing these. Research on people's engagement styles indicate that the framing of messages impacts people's responses; people engage more readily when an option is framed as a "gain" rather than a "loss".<sup>11</sup> People also find making decisions with short-term, tangible consequences easier.<sup>12</sup> Guidance communications could explore ways of incorporating positive messages and perhaps framing potential outcomes as more "tangible" in order to encourage engagement.

Delivery partners must be aware that when customers do engage, they are likely to have varying levels of numeracy and therefore potentially varied abilities to understand and engage with decision-making or to understand the implications of different options. Delivery partners should explore ways of ensuring that those with lower levels of numeracy are provided with information and guidance that they can understand and use to make informed decisions about using DC savings to provide an income in retirement.

### **Summary of conclusions**

Decisions about accessing DC pensions are difficult for people to make as they often require understanding of complex and uncertain economic and market concepts such as inflation, investment risk and longevity risk. Changes announced in Budget 2014 mean that, from April 2015, many people with Defined Contribution savings will be allowed far greater levels of flexibility when they come to access their pension savings. This will further complicate the decisions that DC savers must make as it will increase the number of available options, push the burden of managing risk further onto pension savers, and, in some cases, extend the need for ongoing decision making into retirement.

The people reaching SPA over the next ten to fifteen years vary considerably in their pension and non-pension savings and asset portfolios. Within this population, there are segments who will require greater support than others as a result of reaching retirement more reliant on their DC savings to secure an adequate income, with riskier portfolios and potentially lower levels of ability

<sup>11</sup> DWP (2012a) p. 30-31

<sup>12</sup> DWP (2012b) p. 35 Figure 4.2

to make financial decisions. The challenges for these segments will be compounded over the next few years as the industry is still responding to the reforms and adjusting to a new type of pension saver who will be allowed to access their savings more flexibly. The defaults in place for these groups may either be actively developed in response to the reforms (for example, new drawdown strategies offered directly by a pension scheme or provider) or may be the “path of least resistance options” made available to them (for example, taking the DC pension as cash, or buying an annuity from their current provider). At this early stage it is unclear which options will be most popular.

PPI segmentation based on key characteristics of people currently aged 50-SPA in England indicate that around 12% of the population analysed (694,000 people) will be at “high-risk” of making poor decisions when they reach SPA if they are not offered support through either guidance and advice or suitable defaults. These are groups with between £19,400 and £51,300 in DC savings and little or no additional DB pension to fall back on). A further 29% (or 1.6 million) people aged 50-SPA in 2014 of people aged 50 to SPA in 2014 will be at “medium risk” of making poor decisions. These are groups with anywhere from £6,300 to above £51,300 in DC savings and little or no additional DB. This means that around 4 in 10 retirees will need significant support over the next ten to fifteen years because they will be dependent to a significant degree on the income from their DC savings in retirement to supplement their state pension, have little other savings and assets to fall back on, have low levels of financial skill and engagement, and are less likely to already use a financial adviser or be actively targeted by financial advisers in the current market given the size of their pension pots.

There is a particular correlation between having low levels of numeracy and low or no DB savings to supplement their DC savings. Those with low levels of numeracy will find decisions about accessing pension savings particularly challenging but they are also unable to fall back on a secure source of private pension income in the form of an indexed DB pension.

The Guidance Guarantee, which will offer the provision of free impartial guidance to those reaching retirement with DC savings will be operational from April 2015, however there are significant concerns regarding what the take-up of the guidance may be, whether the guidance will be able to meet the level of need and the complexity of the different individual and household circumstances, and the likelihood that individuals will follow up on the guidance they receive with timely and appropriate actions. There are intrinsic issues with engaging with people around pension decision-making that are impacted both by their own high levels of uncertainty around their retirement planning and by behavioural barriers which can lead to inertia and a reluctance to actively engage and take decisions. There were already concerns in place about the availability and quality of guidance and support offered to pension savers prior to Budget 2014 and the announcement of the new flexibilities. It is clear that a large number of people will require even more support and assistance once these new flexibilities are in place.



This research has identified around 40%, 2.3 million, people approaching retirement in England with private pension savings over the next ten to fifteen years who will be most in need of assistance and for whom access to these services will be particularly critical if they are to make the most of their available DC savings to support their retirements.

The number of people retiring with DC pots is expected to grow as more people are brought into pension saving through auto-enrolment, but average pot sizes are likely to remain relatively low over the next few years, with the median DC pot size, for those age 50 to SPA, in 2015 at £13,800 and growing to £23,800 by 2024. It will be critical that the people reaching retirement with DC savings over the next few years are given support. Independent and trusted guidance and advice services, beyond the Guidance Guarantee, will need to be made available to people in these medium to high risk groups. The people in these groups will need special targeted support to engage with and act on advice and guidance or they will be at risk of accepting defaults or making decisions that could adversely impact their retirement incomes.

## Chapter 1: What are the main pension and retirement decisions that people have to make at and during retirement?

This chapter sets out the decisions that people face in the run up to, at and during retirement and looks at some of the available information on current trends in these areas.

### **Pension and retirement transitions have become more gradual**

Pension provision in the UK has historically (for the last 100 years) been provided through a combination of a Defined Benefit (DB) model, sponsored by employers, and the state pension or state benefits. The DB and state pension models, coupled with a Default Retirement Age have all encouraged people to take their main (state and/or private) pension at the same time that they retire, as a single event.

Over the past few decades, the Defined Contribution (DC) model has become more popular with employers, creating more variation in the pension and retirement landscape. DC pension savings, generally converted into an annuity, involve more choice by the consumer than DB pensions, as to the structure of the income stream and the age at which to commence.

This change, considered alongside other changes such as: rises to State Pension Age, and some Normal Pension Ages (the expected age at which to take a DB pension as income); the removal of the Default Retirement Age; increases in longevity; and, economic problems, have all resulted in changes to the way that people approach retirement and pension transitions. What was traditionally a single event (leaving work and taking a pension) has become more staged and gradual as people work longer, but more flexibly, and opportunities for taking pensions in stages have become more readily available.

People contemplating a work or pensions transition may face a greater array of choices such as when, how and whether to retire; when and how to take state and private pensions; and when and how to access non-pension savings and assets. Each transition has several options within it and there are myriad ways to combine them.

The main pension and retirement transitions can be grouped under the following five headings:

- **Work and retirement transitions**
- **Accessing state pension**
- **Accessing DB pension entitlement**
- **Accessing DC savings**
- **Accessing other income and assets**

### Work and retirement transitions

For those contemplating a work transition there are several options, though the accessibility of each option will be affected by the availability of appropriate employment. Some people may have greater levels of autonomy than others over how, and when, they leave work. The self-employed in particular may have more control over working hours and how to transition out of work. On the other hand, especially for employed people, some work transitions are involuntary, though the removal of the Default Retirement Age should have made it easier for some people to stay in work for longer (Box 1).

#### Box 1: options for work transitions

- Remaining in current work arrangement
- Leaving work altogether
- Moving from employment to self-employment (or vice versa)
- “Sliding” into retirement: this can take many forms, including:
  - Moving from full-time work to part-time work
  - Working “flexibly” – flexible working can take many forms within three broad sub-headings:<sup>13</sup>
    - ❖ *Flexible working hours*: such as part-time working, compressing hours or zero-hour contracts
    - ❖ *Flexible working space*: such as working from home some or all of the time
    - ❖ *Flexible work*: such as shifting to work which is less physically or mentally demanding
- The age at which to affect a work transition is a pre-cursory decision for each of the above

Involuntary transitions can be prompted by the following:

- Leaving work due to:
  - redundancy
  - expectation by scheme or employer (due to age)
  - ill-health
  - caring needs
- Working part time because:
  - no full time work is available
  - caring responsibilities
  - need the income despite wanting to retire
  - psychological factors: for example, fear of retirement; family relationships
- relationship breakdown – signalling return to work

#### Default options:

- There is no single default for those leaving work:
  - people with an occupational pension may have normal pension ages which can be a strong trigger for leaving work.
  - reaching the State Pension Age can be a trigger to leave work.

<sup>13</sup> PPI (2012), DWP (2009), Age UK (2012)

- people may be compelled to leave work due to ill-health or because they are no longer able to fulfil their duties.
- people may be compelled to leave work because of redundancy and/or lack of available or alternative employment.
- people may work flexibly or part-time as a transition out of work because they wish to or because flexible or part-time work may be the only employment available.
- people may be compelled to remain in work despite wanting to leave, because they cannot afford to leave

**The average age of leaving work in 2010 was between 61-65 for men and between 56 and 60 for women**

The average age of leaving work increased between 2002 and 2010 for both men and women. The average age of leaving work in 2010 was between 61 and 65 for men and between 56 and 60 for women, though the proportion of women leaving work later has increased more quickly than it has for men. (Table 1)

**Table 1:<sup>14</sup> the proportion of people leaving work (in 3 year time periods) in each age group for men and women**

Time period	Ages (men)				Ages (women)			
	51-55	56-60	61-65	66-70	51-55	56-60	61-65	66-70
2002-2004	12%	27%	31%	18%	15%	38%	25%	11%
2004-2006	11%	20%	38%	19%	11%	42%	23%	15%
2006-2008	9%	23%	40%	14%	14%	40%	30%	8%
2008-2010	8%	25%	40%	16%	9%	36%	33%	12%

The proportion of people in full time work transitioning to part-time work and the age at which they did so both increased between 2002 and 2010 suggesting that more people are using part-time work as part of a transition out of work. Some of these people may be doing so because full-time work is not available to them (Table 2).

<sup>14</sup> PPI analysis of ELSA data, Waves 2-5

**Table 2:<sup>15</sup> Proportion of people who transitioned from full time work to part-time work between time periods, by age**

Time period	Ages (men and women combined)			
	51-55	56-60	61-65	66-70
2002-2004	29%	33%	20%	7%
2004-2006	26%	45%	15%	6%
2006-2008	25%	34%	25%	6%
2008-2010	22%	43%	24%	5%

**Accessing state pension**

People with state pension entitlement (arising from contributions or credits) can currently claim a state pension income at any time from State Pension Age (SPA). SPA is currently age 65 for men and rising for women from age 60 in 2010 to age 65 in 2018. Further SPA rises are scheduled for both men and women to reach age 66 by 2020 and age 67 by 2028. The timetable for a rise to age 68 is currently under review.<sup>16</sup>

People can either take a state pension income at SPA or defer. Both Basic State Pension and additional state pension (S2P, SERPS, GRB) can be deferred. People who have already started to receive their state pension income can also choose to stop receiving income and defer. Under current rules people who defer can receive either a higher state pension income or a lump-sum in return (Box 2).

Those who do defer have the following options:

- **Income:** For every five weeks of deferral, people can receive a 1% enhancement to state pension income. This is equivalent to 10.4% increase for each year people defer.
- **Lump sum:** Benefit that has been deferred for 12 consecutive months from April 2005 can be taken as a one-off lump sum payment, rather than as an increase in future pension payments. The lump sum accrues interest at 2% above the Bank of England Base Interest Rate, and the whole of the resulting lump sum is taxable at an individual's marginal tax rate.

**Box 2: options for accessing state pension**

- Take state pension income from SPA till death
- Defer at SPA or defer after receiving state pension for a period of time
  - Choose how long to defer for
  - Choose between a lump sum or enhanced pension income (after April 2016, only the enhanced income option will be available)
- Top up (buy back NI contributions)

**Default option:**

<sup>15</sup> PPI analysis of ELSA data, Waves 2-5

<sup>16</sup> PPI (2014b) p. 26

- The default option (resulting from taking no decision) for those with state pension entitlement is to take their state pension as an income at SPA, and continue receiving payments until death

The Government currently estimates that between 10,000 and 25,000 people defer their state pension each year.<sup>17</sup> Based on ELSA data, between 2008 and 2010, around 1% of people reaching SPA deferred their state pension. Of those who had deferred at the time of questioning, 30% were going to opt for or had received a lump sum, 26% had opted for or received higher weekly state pension payments and 44% had not yet decided how to take their deferred pension (based on a small sample size).<sup>18</sup>

### **After the New State Pension is introduced, the rules for deferring state pension will change**

After the introduction of the New State Pension (previously known as the Single-Tier Pension) in 2016, those deferring their state pension will receive a 1% increase in their state pension income for every nine weeks of deferral. This is equivalent to an increase of around 5.8% for each year people defer. After the introduction of the New State Pension, those deferring will no longer be eligible to receive lump sums.<sup>19</sup>

### **Accessing DB pension entitlement**

People with entitlement to Defined Benefit (DB) pensions<sup>20</sup> have a Normal Pension Age (NPA), at which they are expected to begin taking a pension. NPAs generally range between age 60 and age 65.

People with DB pensions in both the private and public sector (though not, after 2015, in “unfunded” public sector schemes) are allowed to transfer the “value” of their DB entitlement out of their DB scheme and into a Defined Contribution scheme. The value calculation is known as the Cash Equivalent Transfer Value (CETV). DC schemes allow savings to be accessed in a different way from DB schemes. The way that DC savings can be accessed will be covered in the next section.

People who wish to take their DB pension earlier than the NPA can usually do so though the level of pension income they receive will generally be lower than the level promised at NPA. People can defer their DB pension as well and take it later than their NPA with some enhancement or lump sum given in return. Around 60% of pensioners in 2013 received some income from Occupational Pensions (the majority of which are DB).<sup>21</sup> Those with DB entitlement have several options when they come to take their DB pension (Box 3).

<sup>17</sup> DWP (2013) p. 22 para 90b

<sup>18</sup> PPI analysis of ELSA data, Wave 5

<sup>19</sup> [www.gov.uk/deferring-state-pension/what-you-may-get](http://www.gov.uk/deferring-state-pension/what-you-may-get)

<sup>20</sup> trust-based pension schemes provided by employers which guarantee a proportion of average or final salary as income in retirement

<sup>21</sup> DWP (2014a) p. 44 table 3.7

**Box 3: options for accessing DB pension entitlement**

- Take pension income at Normal Pension Age (NPA)
- Take lump sum – generally 3/80<sup>th</sup> of salary – or enhanced pension income
  - Take the lump sum early as a way of bridging the gap till the pension is taken
- Transfer DB value (CETV) to a DC scheme
- Take pension income early: reduced pension income
- Take pension income late: enhanced pension income
- Take reduced pension income in order to supplement spousal pension

**Default option:**

- The default option (for those who do not wish to make a decision) for those with DB entitlement is to take their entitlement as an income from their NPA, with or without taking a tax-free cash lump sum

**Accessing DC savings**

The options that people with Defined Contribution (DC), or money-purchase, savings have at retirement will change after April 2015. Transitional arrangements are currently in place (between April 2014 and April 2015). However, one aspect that will remain the same is the imposition of a minimum pension age at which people can access their DC pension savings. This is enforced through tax rules; most people who access their DC savings before the minimum age are classified as making an “unauthorised withdrawal” and their withdrawal is subject to a tax charge of 55%. The minimum pension age is currently 55 (it rose from 50 in 2010). The Government plans to raise the minimum pension age to 57 in 2028.<sup>22</sup>

Under current rules, people accessing their DC savings after the minimum pension age have several options (Box 4).

**Box 4: Options for accessing DC savings under the current system****Tax-free lump sum**

- Take 25% of savings as a tax-free lump sum
  - What to do with lump sum – re-invest vs. spend
  - What age to take it (any age after 55, subject to scheme rules)

**Pots below £30,000**

- These are currently under transitional regulations: those with total pension savings of £30,000 (prior to 2014 this applied to total savings of £18,000) or less can take the total as a lump sum, 25% tax free and 75% taxed at their marginal income tax rate. This is known as Trivial Commutation and can be executed at any time after the age of 60 rather than the minimum pension age of 55.
- In addition to access to a pot of £30,000, a further three pots of £10,000 (prior to 2014 this applied to two pots of £2,000 or less) or less can be taken as a lump sum, after the age of 60.

<sup>22</sup> HMT (2014a) p. 11

**For those with a guaranteed minimum annual income of £12,000**

- Those who can provide themselves with a guaranteed lifetime income of £12,000 per year from state and private pensions (DB or DC) can purchase an income drawdown product which allows withdrawals of income in unlimited amounts. This product is called Flexible Drawdown.

**Pots above £30,000 but without a guaranteed minimum income of £12,000**

- People who have DC savings pots of over £30,000 but are not able to secure a minimum income of £12,000 per year are required to use a product which provides a secure retirement income, if they wish to access their savings (excepting the 25% tax-free lump sum). They can do this in one of two ways:
  - Purchasing an annuity, which provides a guaranteed income for life, or
  - Purchasing an income drawdown product, which allows investment and fund growth, and limits income withdrawals to 150% of an equivalent annuity based on rates set by the Government Actuary's Department. This product is called Capped Drawdown.

**Default option:**

- Under the current system, the default option for those above the trivial commutation limit (and some below) has been to take a 25% tax-free cash lump sum and use the remaining fund to purchase a lifetime annuity. (Those wishing to trivially commute can do so from age 60.)
- Some DC schemes have a default annuity option included in the pension contract and some have guaranteed annuity rates (guaranteed rates might be higher than market rates) attached. Many schemes market their own annuities to the fund-holders in their schemes.

In March 2014, the Government announced that all people with DC savings over the minimum pension age would, from April 2015, no longer be required to purchase an annuity or a drawdown product in order to access their DC savings, and would be allowed to withdraw their DC savings in unlimited amounts, taxed at an individual's marginal rate (with 25% of the amount withdrawn tax-free) (Table 3).

Historically, people who wanted to access their DC savings were required to secure a retirement income. The Government's justification for this regulation was that it provided tax relief for pension savings in order that people would use their pension savings to provide themselves with an income in retirement. The Government did not wish to encourage "moral hazard", defined in this case as the risk that people spend down all of their pension savings and then fall back on the state for support in retirement.<sup>23</sup> However, the Government believes that the annuity market has not been "operating in the best interests of consumers" and that the introduction of the New State Pension will help reduce the risk of moral hazard, by giving people on lower incomes a higher state pension income

<sup>23</sup> HMT (2006)



and reducing the number of people eligible for Pension Credit at the Guarantee Credit level (Savings Credit will be abolished for those retiring after the introduction of the New State Pension). Therefore the Government has felt that it is appropriate to introduce more flexible access to DC savings at this time.<sup>24</sup>

**Table 3: New tax rules apply to pensions after April 2015<sup>25</sup>**

Prior to April 2015	After April 2015
<p><b>Annual/lifetime allowance:</b></p> <ul style="list-style-type: none"> <li>• Pension contributions are tax-free up to the amount of £40,000 per year, £1.25m per lifetime (between 2011 and 2014, the annual allowance was £50,000. In 2010-2011 it was £255,000)<sup>26</sup></li> </ul> <p><b>After age 55:</b></p> <ul style="list-style-type: none"> <li>• 25% of DC pension pots can be taken as a tax-free lump sum</li> <li>• Those who have DC savings above the trivial commutation limit<sup>27</sup> but who are not able to meet the Minimum Income Requirement<sup>28</sup> must purchase a product which will provide a secure retirement income (an annuity or capped drawdown product) in order to access their savings and have income from these products taxed at marginal rate.</li> <li>• Any other withdrawal is taxed at 55%</li> </ul> <p><b>Bequest</b></p> <ul style="list-style-type: none"> <li>• Inherited pensions (with the exception of lifetime annuities without capital guarantees) are tax-free if: <ul style="list-style-type: none"> <li>➢ The fund-holder dies under the age of 75 without taking any savings out through access to a lump-sum and/or income drawdown</li> </ul> </li> <li>• Inherited pensions are taxed at marginal rate of the beneficiary if: <ul style="list-style-type: none"> <li>➢ The fund-holder dies over the age of 75 <i>and</i> the beneficiary is a spouse or a child under the age of 23</li> </ul> </li> <li>• Inherited pensions are taxed at 55% if: <ul style="list-style-type: none"> <li>➢ The fund-holder dies under the age of 75 but has taken money out of the pot <i>or</i> the fund-holder dies</li> </ul> </li> </ul>	<p><b>Annual/lifetime allowance:</b></p> <ul style="list-style-type: none"> <li>• Pension contributions are tax-free up to the amount of £40,000 per year, £1.25m per lifetime</li> </ul> <p><b>After age 55:</b></p> <ul style="list-style-type: none"> <li>• 25% of DC pension pots can be taken as a tax-free lump sum</li> <li>• All other withdrawals are taxed at an individual's marginal rate</li> <li>• People will still be able to purchase a lifetime annuity, a flexible annuity, a flexible drawdown product or withdraw lump sums from uncrystallised pension funds (25% of each withdrawal tax-free and the remaining 75% taxed at an individual's marginal rate)</li> <li>• The age of access, 55, will rise to 57 in 2028 when State Pension Age (SPA) rises to 67 for men and women. After that the minimum age of access will rise so that it remains ten years below SPA.</li> </ul> <p><b>Bequest</b></p> <ul style="list-style-type: none"> <li>• Inherited pensions (with the exception of lifetime annuities without capital guarantees) are tax-free if: <ul style="list-style-type: none"> <li>➢ The fund-holder dies under the age of 75 with uncrystallised funds or funds in a drawdown account</li> </ul> </li> <li>• Inherited pensions are taxed at marginal rate if: <ul style="list-style-type: none"> <li>➢ The fund-holder dies over the age of 75 with uncrystallised funds or funds in a drawdown account</li> </ul> </li> <li>• Inherited pensions are taxed at 45% if:</li> </ul>

<sup>24</sup> HMT (2014a)

<sup>25</sup> [www.gov.uk/government/news/chancellor-abolishes-55-tax-on-pension-funds-at-death](http://www.gov.uk/government/news/chancellor-abolishes-55-tax-on-pension-funds-at-death); DWP (2014b)

<sup>26</sup> [www.gov.uk/tax-on-your-private-pension/annual-allowance](http://www.gov.uk/tax-on-your-private-pension/annual-allowance)

<sup>27</sup> £18,000 prior to April 2014 plus up to two more pots of £2,000 or less; £30,000 between April 2014 and April 2015 plus up to three more pots of £10,000 or less

<sup>28</sup> £20,000 prior to April 2014, £12,000 between April 2014 and April 2015

<p>over the age of 75 but leaves their fund to someone other than their spouse or child under the age of 23</p>	<p>➤ The fund-holder dies over the age of 75 <i>and</i> the beneficiary takes it as a lump sum (from 2016-17, those taking a lump sum in these circumstances will be taxed at their marginal rate)</p> <p><b>Further measures</b></p> <ul style="list-style-type: none"> <li>• In order to avoid people over age 55 (rising to age 57) diverting their salary through their pension fund and avoiding paying tax, the following rules apply: <ul style="list-style-type: none"> <li>➤ People who withdraw more than 25% from a DC pension fund, where the fund value is above £10,000 will have their annual allowance of tax-free contributions for DC savings reduced to £10,000 per year</li> </ul> </li> </ul>
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Box 5 shows what the new rules mean for those accessing DC savings after April 2015.

#### **Box 5: Options for accessing DC savings after April 2015**

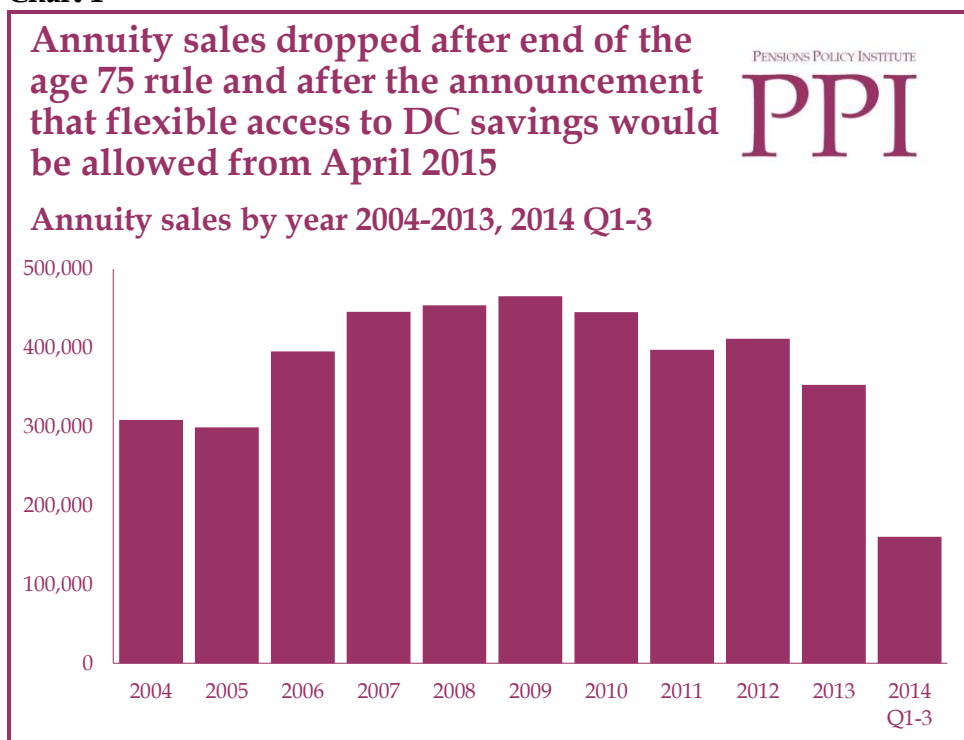
<ul style="list-style-type: none"> <li>• Take 25% of savings as a tax-free lump sum <ul style="list-style-type: none"> <li>➤ What to do with lump sum – re-invest vs. spend</li> <li>➤ What age to take it (any age after 55)</li> </ul> </li> <li>• The remainder can be withdrawn in unlimited amounts, taxed at the individual’s marginal rate. People can also do one or a combination of the following: <ul style="list-style-type: none"> <li>➤ People will still be able to purchase an annuity or a drawdown product but should be able to choose between several varieties of these</li> <li>➤ People may also be able to leave their fund with their pension provider and withdraw directly from their pension fund, “uncrystallised funds pension lump sums”.</li> <li>➤ Those who withdraw their total fund can choose whether to spend or re-invest the lump sum</li> </ul> </li> </ul> <p><b>Default option:</b></p> <ul style="list-style-type: none"> <li>• It is not yet clear what the default option will be under the new system. Default options will depend on how scheme members and schemes and providers respond to the changes. Some schemes may not expand access and withdrawal options for members. Defaults for those with complete access could either be withdrawing pension lump sums directly from a pension fund or provider or investing in Flexible Drawdown.</li> </ul>
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**Annuity purchase behaviour has changed since the changes were announced**

Until recently, the majority, around 75%, of people with DC savings generally purchased an annuity, or an income drawdown product if they had large pots.<sup>29</sup> In 2013, there were 6 million annuities in payment, and half a million income drawdown products held.<sup>30</sup> The number of annuities purchased each year from 2004 to 2013 ranged between 300,000 and 400,000 (Chart 1). The number of drawdown products purchased from Association of British Insurers’ members each year varied, by 2013 there were almost 600,000 income drawdown products in force (Chart 1). However, the data on drawdown does not include some large providers of drawdown who are not ABI members.

Annuity sales dropped slightly in 2011, when the rule requiring people to purchase an annuity at age 75 was lifted. It was at this time that Capped and Flexible Drawdown were introduced, though income drawdown has existed in different formats since the mid-90s.<sup>31</sup> In effect, this change meant that those people who purchased drawdown products could remain invested in them for the entirety of their retirements, when previously they would have been required to convert to an annuity at age 75. Therefore, annuity sales saw a slight decrease after 2011 (Chart 1). However, at that time, drawdown products were still considered by most providers of these products to be appropriate only for those with large DC pots (e.g., £100,000 or more) (Chart 2).

**Chart 1**<sup>32</sup>

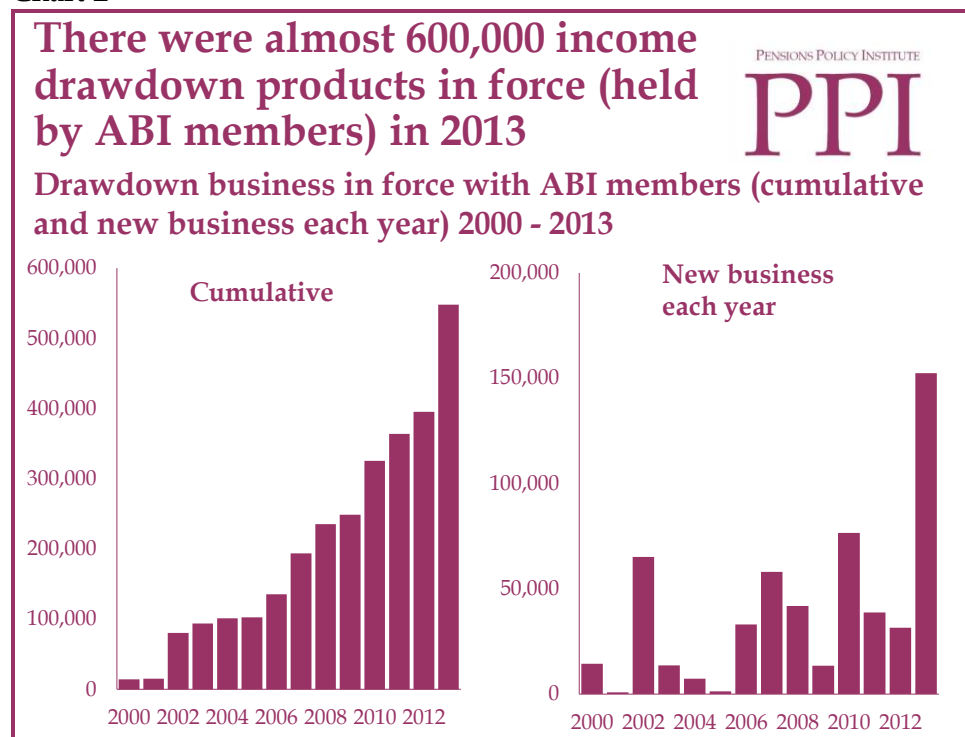


<sup>29</sup> HMT (2014b)

<sup>30</sup> ABI stats, Business in Force – Pensions and Retirement Income 2013

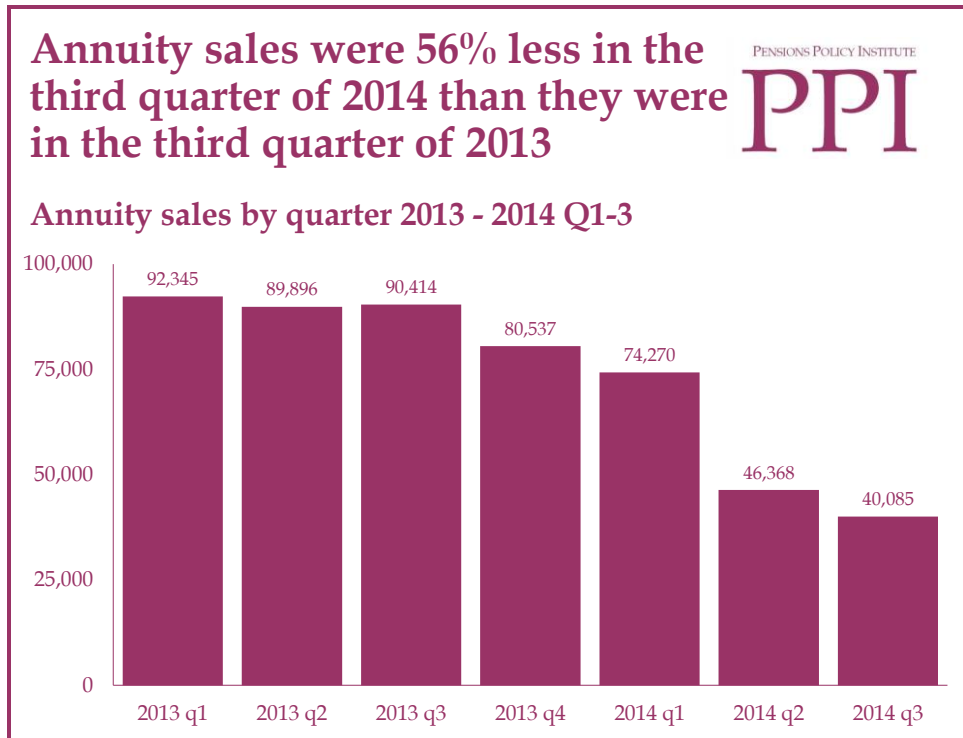
<sup>31</sup> [www.sharingpensions.co.uk/income\\_drawdown.htm](http://www.sharingpensions.co.uk/income_drawdown.htm)

<sup>32</sup> ABI stats

Chart 2<sup>33</sup>

After the announcement in April 2014 that trivial commutation limits would be raised to £30,000, with immediate effect and that from April 2015 people aged over age 55 with DC pots would be able to flexibly access their savings, annuity sales dropped considerably. Annuity sales in the third quarter of 2014 were around 56% less than sales in the third quarter of 2013 (Chart 3).

<sup>33</sup> ABI stats – includes only drawdown provided by ABI members, not the whole drawdown market

Chart 3<sup>34</sup>

### One of the decisions outlined above is the age at which to take a private pension

Private pensions are any non-state pension in which membership is voluntary. They can be *personal pensions*, which involve a contract between an individual and a pension provider (such as an insurance company) who manages a DC fund on the individual's behalf and then returns the fund to the individual in retirement or *occupational pensions* (DB or DC) which involve a contract between the employer and their employee and in which the employer is responsible for paying the pension once it becomes due.

People are most likely to start drawing *occupational pensions* at around age 60 (generally the normal pension age for these schemes).

The age at which people first access *personal pension* savings on average varies by gender; men are more likely to access personal pensions at age 65 (SPA) whereas women are more likely to access personal pensions around age 60 (women's SPA until 2010).<sup>35</sup> These figures indicate that SPA is a trigger for accessing personal pensions. The minimum pension age of 55 is also a trigger, shown by a small peak of people purchasing annuities at age 55, 7% of annuities purchased in 2013 were by 55 year olds.<sup>36</sup>

<sup>34</sup> ABI stats

<sup>35</sup> IFS (2012a) p. 23-24

<sup>36</sup> PPI (2014c), ABI stats

The below tables show that the age that people access personal and occupational pension savings has increased on average between 2004 and 2010, with more people, predominantly women, waiting until their 60s to access their pension savings and entitlement. (It is worth noting that in 2010, the minimum age of access to private pensions was raised from age 50 to age 55.)

**Table 4:<sup>37</sup> Proportion of men accessing their *personal pension* for the first time by age group in different years**

Age	2004-2006	2006-2008	2008-2010
51-55	7%	13%	5%
56-60	17%	26%	20%
61-65	41%	47%	66%

**Table 5:<sup>38</sup> Proportion of men accessing their *occupational pension* for the first time by age group in different years**

age	2004-2006	2006-2008	2008-2010
51-55	9%	5%	3%
56-60	41%	49%	53%
61-65	41%	42%	42%

**Table 6:<sup>39</sup> Proportion of women accessing their *personal pension* for the first time by age group in different years**

Age	2004-2006	2006-2008	2008-2010
51-55	16%	3%	9%
56-60	42%	51%	43%
61-65	32%	32%	39%

**Table 7:<sup>40</sup> Proportion of women accessing their *occupational pension* for the first time by age group in different years**

age	2004-2006	2006-2008	2008-2010
51-55	7%	9%	10%
56-60	61%	74%	58%
61-65	21%	16%	28%

### **The relationship between leaving work and taking a private pension**

Accessing a private pension is not always associated with leaving work. Some people who access their private pension savings do not necessarily leave work right away, and others may already be out of work when they come to access pension savings.

Among people aged 50 and over (between 2004-2011), just under 70% were in work immediately prior to drawing their private pension. Of those in work,

<sup>37</sup> PPI analysis of ELSA data, Waves 2, 3, 4 and 5

<sup>38</sup> PPI analysis of ELSA data, Waves 2, 3, 4 and 5

<sup>39</sup> PPI analysis of ELSA data, Waves 2, 3, 4 and 5

<sup>40</sup> PPI analysis of ELSA data, Waves 2, 3, 4 and 5

around 55% remained in work after beginning to draw their pension.<sup>41</sup> However, it is unusual for people out of work to *return* to work once they have started drawing a personal pension. The majority of those who were not in work remained not working after beginning to draw their private pension, with just under 3% entering work after drawing their private pension.<sup>42</sup>

### **The proportion of people choosing to take a private pension while still in work is increasing**

The proportion of people aged 60-64 in work and also receiving a private pension income has increased between 2002/03 and 2010/11 by 13% for men and 8% for women. Those who continue to work after drawing their private pension are likely to work fewer hours; around 9 hours fewer a week on average in 2010/11 (men).<sup>43</sup>

Of those aged 50 and over, women and people over the age of 55 are more likely to leave work after starting to draw their private pension than men and people aged 50-54.<sup>44</sup>

### **Pensioners can use non-pension income, savings and assets to support retirement**

People can use non-pension income, savings and assets to support themselves in retirement, for example: state benefits, housing, non-pension savings and assets, earnings and investment income.

#### *28% of pensioners receive income from state benefits*

Many pensioners will be eligible for state benefits in retirement. In 2013, 28% of pensioners received income from income-related benefits (such as Housing Benefit or Pension Credit). Those who are eligible for income-related benefits will generally have fewer choices to make regarding retirement income than those with higher incomes and private savings and assets.<sup>45</sup>

#### *In the first half of 2014, around £642m was released through equity release*

One major source of non-pension income in retirement is housing. People can access income from their house through an equity release product, downsizing, or taking in lodgers. In 2011, 76% of households (England and Wales) with the head of household<sup>46</sup> aged 65-74 and 73% with head of household aged 75 or over, were owner-occupiers<sup>47</sup> who could potentially use housing as a source of income. In the first half of 2014, around £642m was released through equity release. The average age for accessing equity release is 69.<sup>48</sup> Owning housing

<sup>41</sup> This is 31% of all those who began drawing a private pension regardless of whether they were in work or not

<sup>42</sup> IFS (2012a) p. 25, table 2.1

<sup>43</sup> IFS (2012a) p. 26, 29, table 2.3

<sup>44</sup> IFS (2012a) p. 25, table 2.1

<sup>45</sup> DWP (2014a) p. 40, Table 3.4

<sup>46</sup> Household Reference Person – defined as “the oldest full-time worker in most households or a person chosen from the household based on their age and economic activity status”

<sup>47</sup> ONS (2011)

<sup>48</sup> KRS (2014) p.8

(without a mortgage) in retirement can also reduce living costs (in comparison to paying rent) by around 30% for a single person and by around 40% for a married couple.<sup>49</sup>

***17% of pensioner households receive earnings income, 62% receive investment income***

Pensioners can also use income from earnings and other savings and assets (such as ISAs) in retirement. In 2013 17% of pensioner households received income from earnings and 62% received income from investments.<sup>50</sup> People can access non-pension savings and assets with fewer restrictions than they can pension savings. For example, there is no minimum age for using earnings or investment income to support oneself. Though individuals must be aged 55 or older to use equity release (Box 6).

**Box 6: Options for accessing non-pension income, savings and assets**

- Using own or others earnings as income
- Releasing housing equity
  - For example: Downsizing; equity release (lump sums or drawdown); lodgers; buy-to-let homes
- Accessing savings and/or investments
- Using expectation or receipt of inheritance as a source of income
- Selling one's business as a source of income
- Applying for state benefits

**Default options:**

- Non-pension income, savings and assets which can be used to support retirement are not regulated in the same way as pension savings and there is no single default. Those who do not wish to make a decision could leave their savings and assets invested and, if they are not needed during retirement, leave them as a bequest. Another option would be to spend down other savings and assets while leaving pensions invested in a tax favoured vehicle, the tax treatment of pension savings and bequests is becoming more beneficial after April 2015.

**The amount of debt owed by a household will impact the way they use non-pension income, savings and assets**

It is worth noting that the amount of debt people have accrued when they reach retirement is likely to impact the way they manage both their pension savings and other savings and assets. People who have accrued debt (or have an outstanding mortgage) alongside savings and assets in retirement may have less income in retirement than expected if a large portion of the savings and assets accrued must be used to pay off debt.

<sup>49</sup> PPI (2009) p.2

<sup>50</sup> DWP (2014) p. 34, figure 3.2



### **Summary**

People contemplating a work or pensions transition may have an array of decisions to make regarding when, how and whether to retire as well as when and how to take state and private pensions and/or access any non-pension savings or assets they have. Because each of these areas has several options within it, there are a myriad of different ways that these options can be combined. The accessibility of each option will be affected by the availability of appropriate employment. Some people may have greater levels of autonomy than others over how they work and when they leave work. The self-employed in particular may have more control over hours and when and how to transition out of work. On the other hand, especially for employed people, some work transitions are involuntary such as those triggered by redundancy or ill-health.

The proportions of people in full time work transitioning to part-time work at older ages increased between 2002 and 2010 showing that more people are using part-time work as part of a transition out of work, though some of these people may be doing so because full-time work is no longer available to them.

The options that people with Defined Contribution (DC), or money-purchase, savings have at retirement will change after April 2015.

Historically, people with DC savings above and below certain levels were required to secure a retirement income in order to access them. These people generally purchased an annuity, or an income drawdown product if they had large pots. The number of annuities purchased each year from 2004 to 2013 ranged between 300,000 and 400,000. The number of drawdown products purchased each year varied. By 2013 there were almost 600,000 income drawdown products in force.

After the announcement in April 2014 that trivial commutation limits would be raised to £30,000 (with immediate effect) and that from April 2015 people aged over 55 with DC pots would be able to flexibly access these, annuity sales have dropped considerably. Annuity sales in the third quarter of 2014 are around 56% lower than in the same quarter of 2013.

## Chapter 2: What factors influence the choices people make in retirement?

This chapter sets out the internal and external factors which influence the decisions that people make in retirement and examines retirement and pension transitions which are involuntary.

The key factors which influence retirement decisions and transitions (and other financial decisions) can be organised into five general groups.<sup>51</sup>

- **Cognitive factors**
- **Affective (emotional/feeling) factors**
- **Behavioural factors**
- **Attitudes towards external stakeholders**
- **Structural factors**<sup>52</sup>

### Cognitive factors

Cognitive factors encompass knowledge, awareness and beliefs. Knowledge, in this sense, applies both to financial capability (e.g., numeracy, maths or economics skills) as well as awareness and understanding of the available options and key risks people face before and during retirement. People are particularly likely to lack knowledge about the more uncertain aspects of retirement such as their life expectancy and healthy life expectancy, future job prospects, and the impacts of inflation and investment returns.<sup>53</sup>

### **Many people believe they don't have sufficient knowledge or skills to make decisions about pensions**

Many people feel that they lack the necessary tools and knowledge to make pension decisions. People commonly report worrying that they will be “short-changed”, and this fear can inhibit active decision-making. A general lack of trust in the sustainability of the state pension and in the providers of private pensions reinforces fears and uncertainty, though trust in employer-sponsored pensions is higher than it is for third-party run pensions.<sup>54</sup>

On the whole, people in the UK have low understanding of how state, employer and private pensions work. There are “notable gaps and misunderstandings”,<sup>55</sup> irrespective of education level, both because people are not equipped to make accurate calculations of pension values and retirement income and because many future factors (such as investment returns) are unknown. Knowledge about how the tax and benefit systems work are also low and hampered by frequent policy changes.<sup>56</sup>

<sup>51</sup> DWP (2012a) p. 22 figure 3.3

<sup>52</sup> DWP (2012a) p. 22 figure 3.3

<sup>53</sup> DWP (2012a) p. 22

<sup>54</sup> DWP (2012a) p. 25

<sup>55</sup> DWP (2012a) p. 15

<sup>56</sup> DWP (2012a) p. 25

Levels of numeracy in particular have been found to have correlations with people's ability to understand pension arrangements.<sup>57</sup>

In the UK levels of numeracy among adults are low. In 1999, around 20% of adults (around seven million) were found to have more or less severe problems with basic skills, in particular with what is generally called 'functional literacy' and 'functional numeracy'.<sup>58</sup> In 2011, 43% of adults were found to have literacy skills below a GCSE "C" grade and 78% with numeracy skills below a GCSE "C" grade. This implies that levels of literacy and numeracy may be decreasing within the population.<sup>59</sup>

Around 4 in 5 adults have a low level of numeracy (below GCSE grade C level).<sup>60</sup> This means that nearly one in five people cannot correctly identify the balance in a bank statement, while only around one person in ten has the ability to calculate compound interest.<sup>61</sup>

### **Affective factors**

Affective (or emotional/feeling) factors encompass feelings or attitudes towards retirement, pensions and work. They include whether people trust or mistrust government policies and agendas around pensions and retirement. They include perceptions of injustice, for example, some people may feel that rises to State Pension Age are unjust and this may affect attitudes to work and retirement.<sup>62</sup>

Attitudes are often affected by the past experiences of individuals or their friends and families in making financial decisions. Those with negative past experiences may be more cautious about subsequent financial decisions, whereas those with positive experience may be more confident. The experiences of family members also play a significant role in shaping attitudes.<sup>63</sup>

Changes to households, such as the birth of children, which cause a shift in priorities have also been shown to impact on people's attitudes and approach to financial decision making, as do economic changes, such as recessions.<sup>64</sup>

Attitudes to risks will also affect engagement, for example in relation to investment decisions. Those who are risk averse may be likelier to follow default options with lower potential for reward but less potential for volatility. Those with high-risk aptitudes are more likely to take financial risks in the hopes of a better return. The majority of people are fairly risk-averse, though men on average are less risk-averse than women.<sup>65</sup>

<sup>57</sup> BIS (2013) p. 58

<sup>58</sup> DFEE (1999)

<sup>59</sup> [www.nationalnumeracy.org.uk/what-the-research-says/index.html](http://www.nationalnumeracy.org.uk/what-the-research-says/index.html)

<sup>60</sup> [www.nationalnumeracy.org.uk/what-the-research-says/index.html](http://www.nationalnumeracy.org.uk/what-the-research-says/index.html)

<sup>61</sup> MAS (2013) p 15

<sup>62</sup> DWP (2012a) p. 23

<sup>63</sup> DWP (2012b) p. 11, para 2.1.1

<sup>64</sup> DWP (2012b) p. 11, para 2.1.1

<sup>65</sup> DWP (2012b) p. 5, para 1.1 p. 11, para 2.1

**Behavioural factors**

Behavioural factors or “intention” are influenced by both cognitive and affective factors. Many people display a natural tendency towards inertia which impacts pension decisions by manifesting as a reluctance to seek information or make active decisions. Natural tendencies towards inertia are further exacerbated by the complexity and uncertainty surrounding decisions about pensions and retirement.<sup>66</sup>

The following quotes from TPAS’s enquiry database indicate some of the confusion and complexity people experience when dealing with pensions decisions.

*“I am currently on benefits and cannot afford to pay for advice on company pension policies I hold. I have received details on my options, but they are a mass of figures that are difficult to understand. Can you help me?”*

*“Hello, I am wanting to begin contributions towards a pension scheme. I am employed and my employer will contribute X% towards a scheme of my choice. However, I am feeling overwhelmed by the range of pensions on offer and what would make financial sense. Can you help me?”<sup>67</sup>*

This tendency towards inertia can result in a mismatch between stated intentions and actual behaviour, evidenced by the lack of saving among those who report that they recognise the need to save for retirement.<sup>68</sup>

Inertia can also arise from competing priorities taking precedent, a lack of funds making people feel that there is no point trying to make decisions, or intimidation at the prospect of making decisions. Interestingly, the tendency towards inertia decreases just before retirement, when most people have more motivation to make a decision, but can increase again afterwards. Inertia arising from intimidation about pensions decisions tends to disappear during retirement, after which many retirement decisions might have already been faced or taken, but inertia arising from other factors can remain throughout retirement.<sup>69</sup>

**Attitudes towards external stakeholders**

Attitudes towards external stakeholders encompass attitudes towards government and other key stakeholders who play a role in pensions and retirement decisions, such as pension providers. This involves both awareness of the existence and roles of these organisations and whether they are trusted as organisations (rather than trust or lack of trust in an agenda or policy as in affective factors). The level of trust people have in organisations will impact on their willingness to engage with them or take their advice.<sup>70</sup> Those who have

<sup>66</sup> DWP (2012a) p. 23

<sup>67</sup> Sample of enquiries received by The Pensions Advisory Service on the issues raised by online enquiry customers: September 2014

<sup>68</sup> DWP (2012a) p. 23

<sup>69</sup> DWP (2012b) Pp. 36-37

<sup>70</sup> DWP (2012a) p. 23

been with a provider for a long time may also be subject to the influence of brand loyalty, choosing options offered by this provider even if they are not the best offers on the market. There is strong evidence that brand loyalty is a major factor in DC pension decisions.<sup>71</sup>

Trust plays a particularly vital role in pensions decisions. Many people, especially those making decisions about accessing private pensions, are dependent on assistance from external agencies such as advisers or scheme providers because most individuals are not equipped with the skills and knowledge needed to make informed decisions without assistance.<sup>72</sup> People do not always know whether they can trust particular agencies or not, illustrated by this quote from TPAS's enquiry database:

*"I will be taking my pension at the end of September when I leave work and am looking at providers. I have been given a quote from a company called \*\*\*\*\*. It was the best I have received but I am not sure if they are as safe as the main annuity providers such as \*\*\*\*\*, \*\*\*\*\* etc. Are you aware of this company and are they known for their pension service?"<sup>73</sup>*

### **Structural factors**

Structural factors include both external factors and individual factors which may or may not be under the control of the individual. External factors include:

- Benefit and tax system
- State pension system
- The economy

Individual factors include:

- Employment status<sup>74</sup>
- Socio-economic class
- Household structure
- Levels of pension saving
- Health

### **Employment status affects people's work and retirement options**

Pension decisions are affected by decisions about work. People who remain in work as part of their retirement transition will be less dependent on pension income and will therefore have more options regarding when and how to take their pension savings. Conversely, those who leave work, or who are already out of work, when they take their private pension may experience more restricted pension options.

People can use phased retirement alongside taking their private pension; working flexibly or part-time while taking a supplementary income from their

<sup>71</sup> ABI (2012)

<sup>72</sup> DWP (2012c) Pp. 3-5

<sup>73</sup> Sample of enquiries received by The Pensions Advisory Service on the issues raised by online enquiry customers: September 2014 (quote edited for clarity)

<sup>74</sup> DWP (2012a) p. 22 figure 3.3 & p. 23

private pension. This option is not available to all workers who may not be aware of or may not have flexible working options available to them. People in low-skilled or manual jobs in particular may be prevented from making active choices regarding retiring in a flexible way because they are forced to leave work due to health problems or because of a lack of flexible employment options.<sup>75</sup>

Affective factors also impact decisions about working for longer, for example many people feel that it is unjust that they should have to work longer than previous generations and this might affect decisions that people make about remaining in work. However, changes in employer practices, removal of the Default Retirement Age, the shift from DB pensions to DC pensions and a normalisation of working longer could all contribute to attitudes to working longer changing among younger generations in future.<sup>76</sup>

### **Socio-economic class affects people's susceptibility to external intervention**

Profession-based proxy classifications for socio-economic class can be correlated with responsiveness to external triggers<sup>77</sup> regarding extending working life and pension decisions, and allow for consideration of what extent the use of information and advice might affect pension and retirement decisions. External triggers include interventions by external stakeholders such as Government, providers and charities.

- **Professional/managerial:** people in this group require “least attention” from external stakeholders. They are likely to have high levels of personal wealth and greater freedom and choice over working and pension decisions.
- **Middle strata:** This group is the most likely to be in stable employment and have access to flexible working arrangements, as well as being more likely to have occupational pension entitlement and/or DC pension savings. People in this group are more likely to be in a position to enhance the retirement income potential of their savings by deferring or making additional contributions. The flexibility available to this group in terms of both work and retirement income provision mean they have a higher variety of options available to them, but may benefit from assistance or intervention.
- **Low/unskilled:** This group is generally less able to respond to external triggers because their options tend to be more restricted in terms of employment and flexibility. People in this group are also more likely to have to leave work early as a result of ill-health or redundancy. Their retirement income arrangements tend to be “modest” which also limits options at retirement.<sup>78</sup>

### **Household structure**

Couples in a household tend to take financial decisions together, or at least discuss them before acting. This implies that the thoughts and attitudes of the other members of a household could impact on the financial decision making of

<sup>75</sup> DWP (2012a) p. 24

<sup>76</sup> DWP (2012a) p. 24

<sup>77</sup> Particularly policy interventions

<sup>78</sup> DWP (2012a) p. 11

individuals.<sup>79</sup> Whether an individual is the main financial decision-maker in a household will also impact the way that they make decisions. Main financial decision-makers tend to be more confident and more long-term in their thinking, while those who take a more passive role within the household tend to have shorter-term thinking and be more likely to spend than save.<sup>80</sup>

Gender and gender roles within a household can impact pension decisions. Women are likely have accrued lower levels of pension savings during working life, as many tend to prioritise family and children in financial decision making. Therefore women and men can reach retirement with very different pensions and savings portfolios. Even at retirement, decisions might be gendered as women's small amounts of savings and assets may be used to meet immediate financial needs for the family while men's savings, which may be more substantial, could be funnelled into an income for the family. In cases where there is an unequal distribution of income or relationship breakdown this could potentially result in inequality. The trend for many partnered men to purchase single-life annuities is reflective of the way that pension income is often unequally distributed within households.<sup>81</sup>

#### **The different factors which influence behaviour affect each other and some have a greater impact than others**

Each of the above factors interrelates with the others to create a host of influences at play in pension and retirement transitions. Obviously, some factors will carry more weight than others. For example structural factors which mean that people are forced into a transition, such as leaving work due to ill health, will play a greater role than attitudinal factors which might allow for detailed consideration of options and flexibility of choice.

People with limited employment prospects or low levels of saving, who are more likely to be in the low/unskilled socio-economic class, will generally have fewer options available to them and their choices will be subsequently restrained.

#### **Active financial decision-making is often prompted by life events**

Active financial decision-making is often prompted by life events such as getting married or having children, or financial triggers which involve changes to the income of a household. Significant life events such as births, deaths or illnesses are powerful triggers for making financial decisions, for example, purchasing life insurance. However, purely financial triggers, such as a reduction in income or a receipt of inheritance, do not seem to have as strong an impact on financial decision-making.<sup>82</sup>

Looking at the enquiries received by TPAS gives an indication of some of the triggers that cause people to seek help. The need to make retirement decisions

<sup>79</sup> DWP (2012b) p. 13, para 2.1.2

<sup>80</sup> DWP (2012b) p. 15, para 2.3.1

<sup>81</sup> DWP (2005)

<sup>82</sup> DWP (2012b) p. 12, para 2.2.1

was the main reason for calls (Table 8). The number of calls regarding at-retirement decisions increased after the Budget announcement that further flexibilities would be introduced. In the first few weeks after the announcement, the proportion of helpline calls received by TPAS about at-retirement decisions rose from 15% of calls to 45%.<sup>83</sup>

**Table 8: Distribution of a random sample of calls to TPAS helpline in 2013/14<sup>84</sup>**

Reason for call	Numbers calling	Proportion of total
<b>Retirement and planning decisions</b>	7515	30%
<b>Trivial commutation</b>	2879	11%
<b>Automatic enrolment</b>	2688	11%
<b>Pre-retirement pension saving guidance</b>	2206	9%
<b>Trying to find pension</b>	2199	9%
<b>Pension contract terms</b>	2126	8%
<b>Mistakes</b>	1763	7%
<b>Pension transfers</b>	1709	7%
<b>Tax relief</b>	1677	7%
<b>Delays</b>	707	3%
<b>TOTAL</b>	25469	100%

### **People find it easier to make simple, short-term decisions with tangible outcomes**

People are more inclined to make decisions that are administratively simple and have shorter term consequences. There is a reluctance to make decisions with longer term consequences, such as saving in a pension scheme. People are also more likely to make “poor” choices (leading to unintended or undesirable outcomes) when the consequences are delayed, such as inadvertently purchasing an annuity which does not provide an income for a spouse or dependents.<sup>85</sup>

Financial decisions with less tangible outcomes are more difficult for people to make than tangible decisions such as purchasing houses, cars or holidays. Outcomes from pension saving are not just intangible, but also uncertain as they are affected by investment growth, inflation, total contributions, time of receipt, length of life in retirement etc. These uncertainties and the lack of tangibility make decision-making about pensions during working life and at retirement very difficult.<sup>86</sup>

### **Timing affects decision-making**

The timing of a decision can impact outcomes. People who do not act on advice or guidance immediately after receiving it may also be less likely to make a

<sup>83</sup> Data provided by TPAS

<sup>84</sup> TPAS (2014) p. 16

<sup>85</sup> DWP (2012b) p. 33

<sup>86</sup> DWP (2012b) p. 35 Figure 4.2



decision or to make a decision with positive outcomes. Those who are more impulsive or more prone to inertia are the least likely to act on advice or information right away.

There are ways of helping people to take action, for example giving them easy, practical steps to follow, or by including the action as part of the advice or guidance session. However it may be more difficult to give people these options through guidance than through regulated advice.<sup>87</sup>

### **Pension decisions are particularly affected by inhibiting factors**

Inhibiting factors such as fearfulness or competing priorities, appear to have a greater impact on decisions about pensions (saving in) than on other financial decisions. People tend to put off decisions about the accumulation phase of pensions more readily than other decisions.<sup>88</sup>

### **The framing of communications affects decision-making about pensions**

The framing of external messages and communication (from schemes or advice agencies) impacts the way people react to them. The biggest impact seems to arise from whether an option is framed as a “gain” or a “loss”. Options framed as gains are considered more attractive. People’s position in their life course also makes them more sensitive to the framing of particular factors, such as healthy life expectancy for older people. However, framing that is crafted too deliberately can also make people feel that attempts are being made to manipulate them. Research concludes that while framing has an impact on behaviour, it is not the major factor.<sup>89</sup>

General information is not as useful in terms of influencing behaviour as interventions at critical times dealing with key decisions. Though educational material is seen to be effective for those actively seeking information.<sup>90</sup>

### **Summary**

Decisions people make at retirement are affected by both internal (behavioural and cognitive) factors and external (structural) factors.

On the whole, people report lacking the necessary tools and knowledge to make pension decisions. A general lack of trust in the sustainability of the state pension and in the providers of private pensions reinforces fears and uncertainty, though trust in employer-sponsored pensions is higher than it is for third-party run pensions.

Levels of numeracy in particular have been found to have correlations with people’s ability to understand pension arrangements. In the UK levels of numeracy among adults are low. Around 4 in 5 adults have a low level of numeracy (below GCSE grade C level).

<sup>87</sup> AXA, University of Warwick (2007a), AXA, University of Warwick (2007b)

<sup>88</sup> DWP (2012b) p. 32

<sup>89</sup> DWP (2012a) p. 30-31

<sup>90</sup> DWP (2012a) p. 15

Many people display a natural tendency towards inertia which impacts pension decisions by manifesting as a reluctance to seek information or make active decisions. Natural tendencies towards inertia are further exacerbated by the complexity and uncertainty surrounding decisions about pensions and retirement.

Financial decisions with less tangible outcomes are more difficult for people to make than tangible decisions such as purchasing houses, cars or holidays. Outcomes from pension saving are not just intangible, but also uncertain as they are affected by investment growth, inflation, total contributions, time of receipt, length of life in retirement etc. These uncertainties and the lack of tangibility make decision-making about pensions during working life and at retirement very difficult.

Each of the above factors interrelates with the others to create a host of influences at play in pension and retirement transitions. Obviously, some factors will carry more weight than others. For example structural factors which mean that people are forced into a transition, such as leaving work due to ill health, will play a greater role than attitudinal factors which might allow for detailed consideration of options and flexibility of choice.

Many people may need or seek advice or guidance for help with their decision-making around pensions. People who do not act on advice or guidance immediately after receiving it may be less likely to make a decision or to make a decision with positive outcomes. Those who are more impulsive or more prone to inertia are the least likely to act on advice or information right away. These tendencies could be considered in the design of advice. There are ways of helping people to take action, for example giving them easy, practical steps to follow, or by including the action as part of the advice or guidance session. However it may be more difficult to give people these options through guidance than through regulated advice.

People with limited employment prospects or low levels of saving, who are more likely to be in the low/unskilled socio-economic class, will generally have fewer options available to them and their choices will be subsequently restrained.

## Chapter 3: How complex are the choices that people have to make at and during retirement?

This Chapter sets out the skills and knowledge that people need in order to make informed decisions about pensions, retirement and other financial decisions from across the life course and ranks these decisions by difficulty and overall financial impact on people's lives.

The PPI conducted a workshop with experts on the behaviour and psychology of pensions and retirement decisions.<sup>91</sup> The workshop explored the range of options facing people in the lead up to and at retirement, then explored the knowledge and skills that people need in order to make informed decisions about these options.

For some of these areas, it is not possible to make a fully informed decision. That is because uncertain factors such as economic changes, inflation, and longevity can affect outcomes. However, in order to make an informed decision, people would benefit from some understanding of the potential ranges these factors may operate within and how changes could affect retirement outcomes.

### **Work and retirement**

For those in work and contemplating a transition, options range from staying in work to working flexibly or leaving work altogether. Though some people may have very few options if they are constrained by internal or external factors such as ill-health or lack of appropriate employment.

However, for those who have available options, the following knowledge is necessary, at a minimum, in order to make an *informed decision* about work and retirement:

### **Box 7: Skills and knowledge necessary to make an informed decision about transitions out of work and into retirement<sup>92</sup>**

- **How much income will people need in retirement?** – people must have some understanding of the level of income they might need or want in retirement. They will need to know whether the income they will receive from pensions (and/or other sources) will be sufficient without further contributions to their pot or giving their pot further time to mature.
- **What income is available?** – people will need to understand what income is available from pensions and other (non-pension) savings and assets. Specifically, they will need to have some idea what the yearly income might be from these sources once accessed, how certain it is, whether it will change over time and whether it is time limited.

<sup>91</sup> The workshop was attended by: Christopher Brooks, Senior Policy Manager (Age UK), Alev Sen, Policy Researcher (CAB), Dr Paul Cox, (CHASM), Alan Higham, Retirement Director, (Fidelity), Janette Weir, Director (Ignition House), Anthony Tomei, Visiting Professor (King's College), Melinda Riley, Head of Policy, (TPAS), Rebecca Fearnley, Chief Adviser, (Which)

<sup>92</sup> As agreed by workshop

- **How might income needs change in future?** – People will need to know what effect changes in health or household circumstances could have on their income needs and whether they will have sufficient income to support themselves or a partner if they develop care needs. They will need to know whether their work plans could be impacted by changes in health; whether a longer than expected life could impact their need for saving and income from work; and, how their death or the death of their partner could impact the income of the household.

### State pension

People with state pension entitlement are faced with two main choices: whether to defer or take their state pension at State Pension Age (SPA). Those who defer have supplementary choices such as how long to defer for and how to take their increase. Those who choose to take their state pension at SPA can, at a later date, choose to defer.

The following knowledge is necessary, at a minimum, in order to make an *informed decision* about accessing state pensions:

### Box 8: Skills and knowledge necessary to make an informed decision about accessing state pensions<sup>93</sup>

- **What options are available** – people will need to know that they have a choice between taking at SPA or deferring and the options available to those deferring.
- **The comparative value of different options** – people must have some understanding of what the different options will mean for overall income in retirement. In order to understand this, people will need to have some knowledge about what their life expectancy may be and what the impact of living for much longer than expected might be.

### DB pension entitlement

People with DB pension entitlement have a range of options for taking pension income, though there are several defaults built in to the system and those who do not wish to make a choice can take a tax-free lump sum and the rest as income from their Normal Pension Age.

Some people with DB pension entitlement may transfer the value of their entitlement as a lump sum into a DC pension saving scheme.

The following knowledge is necessary, at a minimum, in order to make an *informed decision* about accessing DB entitlement:

<sup>93</sup> As agreed by workshop

**Box 9: Skills and knowledge necessary to make an informed decision about accessing DB pension entitlement<sup>94</sup>**

- **What options are available** – people will need to know that they can choose to take their pension early or defer; take their lump sum in different ways; take partial income while staying in work; and, leave an income for dependents.
- **The comparative value of different options** – as is the case for state pensions, people must have some understanding of what the different options will mean for overall income in retirement. In order to understand this people will need to have some knowledge about their own life expectancies and the potential for health problems in retirement.

**DC pension savings**

Those with DC pension savings face the greatest array of complex choices as well as the greatest uncertainty in outcomes. DC pension decisions are more complex than others as they require knowledge about the economy and market risks as well as some numerical ability. Ahead of automatic enrolment, around a quarter of people had more than one DC pension pot, which adds complexity in terms of tracking down and consolidating pots within the DC regulations.<sup>95</sup> Many outcomes, particularly after April 2015, will depend on unknown factors such as longevity, inflation and changes in income needs. Purchasing a lifetime annuity can reduce some uncertainty, however, annuities do not always protect against inflation or changes in income needs.

The following quote from TPAS's enquiry database illustrates some of the complications involved in making decisions about accessing DC pension savings:

*"I took out a stakeholder pension. It was part unit-linked and part with-profit [...]. \*\*\*\*\* have now [taken] it over in the last 3-4 years I think. I need advice on what I should be doing with it. When it got transferred I was made aware that \*\*\*\*\* had been using the wrong unit price or scale. \*\*\*\*\* told me this and adjusted my pension. So I need someone to have a good look at it to make sure I'm getting the best deal for the future."*<sup>96</sup>

The following knowledge is necessary, at a minimum, in order to make an informed decision about accessing DC savings:

**Box 10: Skills and knowledge necessary to make an informed decision about accessing DC savings<sup>97</sup>**

- **What options are available** – people with DC savings have a range of products they can use to access their savings. Those with incomes below a certain level or anyone with DC savings accessing their savings after

<sup>94</sup> As agreed by workshop

<sup>95</sup> IFS (2012b) p. 32

<sup>96</sup> Sample of enquiries received by The Pensions Advisory Service on the issues raised by online enquiry customers: September 2014 (quote edited for clarity)

<sup>97</sup> As agreed by workshop

2015 can take lump sums in unlimited amounts (from age 55 and taxed at an individual's marginal rate).

- **Economic factors** – people using a financial product (for example, income drawdown, an annuity, a savings account) will need to understand how economic factors might affect their fund value and the availability of income over time:
  - **Inflation** – people will need to understand how inflation could impact both their investments and their need for income in retirement
  - **Market risks and returns** – people using products which invest savings and allow for income withdrawal will need to understand how investment returns and market risks could impact available income and the potential for savings to support them throughout retirement.
  - For those considering whether to take their DC savings or to delay in order to contribute for longer, an understanding of **compound interest** might be necessary in order to make an estimate of what their pot may be worth when they come to take it
  - **Longevity risk** – People will need to consider what their life expectancy might be and correspondingly how long they might need to support themselves for and what the impact of living for longer than expected may be on their need for income in retirement. They will need to understand how and when they might become eligible for means-tested benefits.

### Non-pension income, savings and assets

Access to non-pension savings and assets is generally less restricted than it is for pension savings and these can be used as flexible sources of income during periods of greater need or during later retirement.

The following knowledge is necessary, at a minimum, in order to make an *informed decision* about accessing other income and assets in retirement:

#### Box 11: Skills and knowledge necessary to make an informed decision about accessing non-pension income, savings and assets<sup>98</sup>

- **Available options** – as with the other sources of retirement income it is necessary to have an understanding of what options are available in order to make an informed choice between them. People will need some understanding of how eligibility for means-tested benefits operates.
- **Costs associated with options** – sources of income in retirement often have associated costs, such as accessing income from housing through equity release, costs attached to purchasing financial advice, or the tax costs associated with receiving or leaving an inheritance. People will need to be able to factor these in when calculating how much income can be sourced from particular assets.
- **Uncertain future factors** – people might need to have some idea of how long they are expected to live and what the impact of factors such as an

<sup>98</sup> As agreed by workshop

extended life, changes in health or unexpected inflation may have on their need for income or availability of income.

The workshop participants elected certain core skills or knowledge that people might need to make financial decisions on any and all of the above areas.

In order to make *informed decisions* about work, retirement, pensions (state, DB and DC) and non-pension savings and assets, people will need the following skills and knowledge, at a minimum:

**Box 12: Skills and knowledge necessary to make an informed decision about work, retirement, pensions and non-pension savings and assets<sup>99</sup>**

- **Tax/National Insurance/state benefit entitlement** – people will need to have an understanding about how savings and income are taxed in retirement and how they interact with state benefits alongside a recognition that these regulations are subject to change.
- **Basic maths and literacy skills** – people will need these to be able to understand their different options and compare values
- **Sufficient knowledge to recognise pensions scams and other financial scams** – people will need to have some understanding of what constitutes legitimate offers or approaches and be able to recognise the hallmarks of fraudulent approaches
- **Understanding of defaults** – people will need to know what might happen if they do not make a decision

**How do the complexities of pensions and retirement decisions compare to other major financial decisions?**

The workshop participants also reflected on the skills and knowledge which people would require in order to make other major financial decisions that people might take during their life course, in order to allow for comparison between pensions and retirement decisions and other financial decisions (Box 13).

**Box 13: skills and knowledge necessary to make major non-retirement financial decisions<sup>100</sup>**

**Further education vs. entering work**

- Salary post-education vs. salary without further education
- Potential “opportunity costs” of spending time out of the labour market
- Likelihood of course leading to employment vs. other training/internships etc.
- Current climate of job market
- Structure of student loans, likely future burden of repayments
- Other costs associated with attending education

<sup>99</sup> As agreed by workshop

<sup>100</sup> As agreed by workshop

**Buying a car**

- Residual costs
- Ongoing costs: running costs, repairs/maintenance, tax, insurance, warranty

**Buying a house**

- Cost and affordability of mortgage
  - Value of different types of mortgages
- Future earnings risk
- Interest rate risk
- Upkeep costs and other ongoing costs

**Life insurance**

- Comparative value of different products
- Income needs of dependents
- Do terms & conditions allow for potential refusal to pay?

**It is more difficult to make informed decisions about accessing DC savings than it is to make other decisions**

The workshop participants ranked pension, retirement and other major financial decisions by the difficulty of making an *informed financial decision* on each. Their considered view was that making informed decisions about accessing DC savings were the most difficult. The factors considered necessary to make informed decisions about DC savings involve knowledge about the economy and market-risks, numerical skills and knowledge about the potential impact of unknown factors.

Citizens Advice interviewed Citizens Advice Bureaux (CAB) clients and volunteers in their fifties and sixties with private pensions. Many find choices about what to do with DC pension savings especially challenging because of the difficulty in determining what different options would mean in practice for retirement income and because of the difficulties involved in understanding the impact of taxation and the potential impact of market factors such as investment returns.<sup>101</sup>

The following quote from TPAS's enquiry database illustrates some of the complications involved in making decisions about accessing DC savings through a DB conversion, and highlights the potential impact of less predictable factors involving health, life expectancy, the need for a dependent's income and how options have changed in light of the increased flexibilities being introduced from April 2015.

*"My question is about transferring and managing my workplace pension. I have a good final salary pension, but the problem is that I have an incurable lymphoma and have now developed a secondary cancer, my life expectancy is not clear, but obviously not brilliant.*

<sup>101</sup> Forthcoming Citizens Advice research paper 'How people think about older age and pensions: finding a way through the maze'

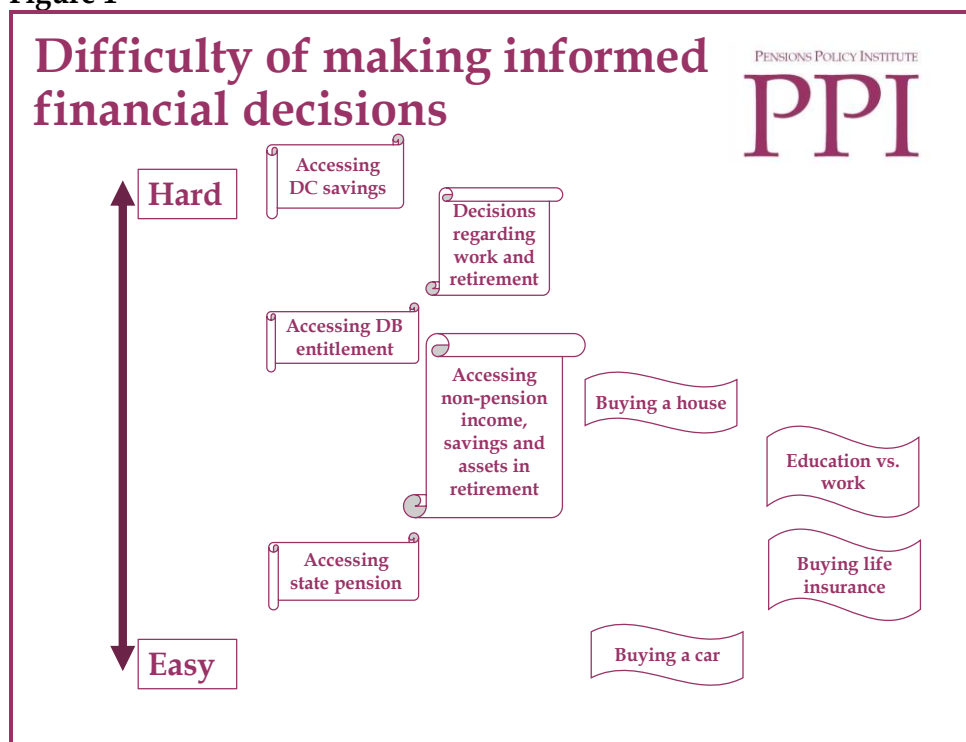


*The present pension goes to half its value for my wife on my death, which means she ends up on a small pension when she is still young. With the pension changes it seems to make sense for me to take the “pension” pot from my company pension and manage it myself so that it can then be transferred to my wife on my death and she then has no reduction in pension?”<sup>102</sup>*

Making informed decisions regarding work and retirement were ranked as the second most difficult as these all involved a high degree of uncertainty.

Making informed decisions about accessing DB entitlement were considered the third most challenging, just above making informed decisions regarding accessing other income and assets, buying a house or choosing between further education and work. Making an informed decision about accessing state pension entitlement, purchasing life insurance or purchasing a car were ranked the easiest as the outcomes of these decisions were relatively simple to understand and had strong defaults attached to each option (Figure 1).

**Figure 1**<sup>103</sup>



The decisions were re-ranked by the level of impact they might have on people’s future financial outcomes.

The level of financial impact that decisions about accessing pension or non-pension savings and assets will have on an individual is dependent foremost on

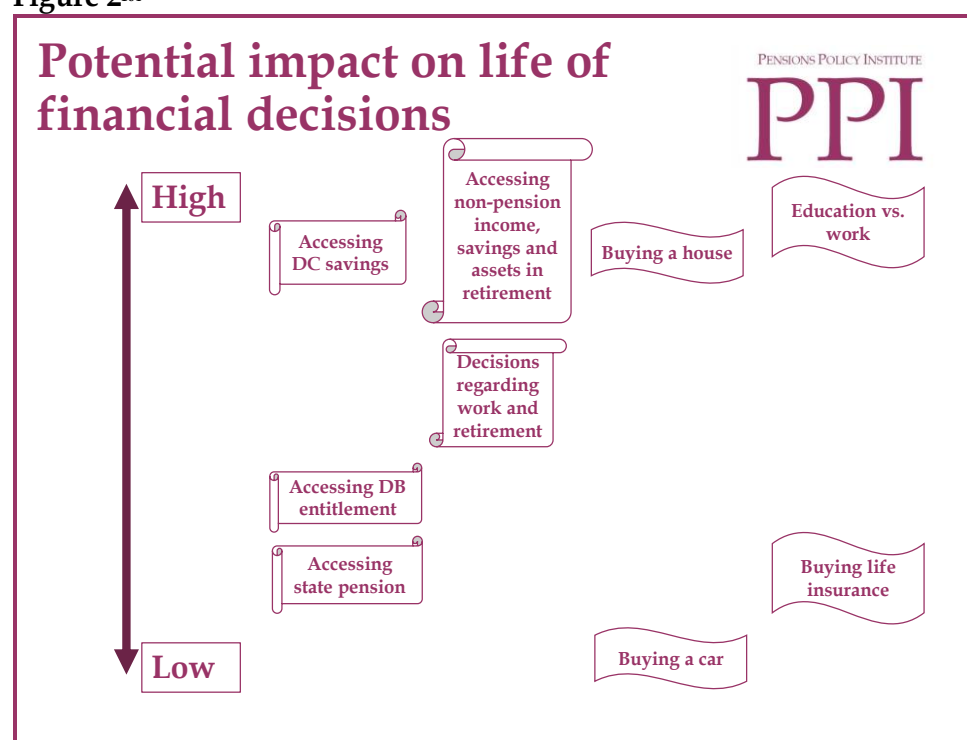
<sup>102</sup> Sample of enquiries received by The Pensions Advisory Service on the issues raised by online enquiry customers: September 2014

<sup>103</sup> Rankings agreed by working group of experts including representatives from: Age UK, CAB, CHASM, Fidelity, Ignition House, King’s College, TPAS, Which

the levels of savings or entitlement that the individual has accrued of a particular type. If the level of savings or entitlement accrued in one type is minimal, and the individual has substantial levels of savings or entitlement of other types, then the decision may have less of an impact. If the individual has accrued a large level of savings and entitlement of one type, such as DC savings, and has very little other types of savings or entitlements, then the impact of any decision made might be more profound. Those with small levels of savings or entitlement may also experience a relatively greater impact from decisions about access if they have very little other savings, entitlements or assets to fall back on.

The workshop participants found that decisions about accessing DC savings, the most difficult to make an informed decision on, were also near the top of the ranking of financial impact level. Decisions about further education vs. work, buying a house and accessing other income and assets in retirement were also ranked as having the highest potential for financial impact during the lifetime (Figure 2).

Figure 2<sup>104</sup>



### The Government is guaranteeing the availability of face-to-face guidance for everyone approaching retirement from April 2015

Making decisions about accessing DC savings involves complexity. As a result of the further flexibilities in accessing DC savings being introduced from April 2015, the decisions people make about accessing DC savings at retirement will

<sup>104</sup> Rankings agreed by working group of experts including representatives from: Age UK, CAB, CHASM, Fidelity, Ignition House, King's College, TPAS, Which

become more complex and involve more options and greater risk of financial detriment.

This is because, unlike DB pensions and state pensions which pay out a certain amount of income (generally rising in line with an inflationary index) until the death of the individual, DC savings can, after 2015, be accessed flexibly. Under the current system, people with savings above the trivial commutation limit are required either to prove that they have a secure income of £12,000 per year (£20,000 until April 2014) or to purchase a product which provides a “secure” retirement income; either an annuity or a Capped Drawdown product.

Lifetime annuity and Capped Drawdown products remove some of the differences between DC pensions and DB pensions because there is either no or reduced risk of the fund being depleted before the death of the annuitant (though drawdown holders faced some market-based risks which could reduce their funds). After full flexibility is allowed, from April 2015, people with DC savings who do not purchase a secure income product will run greater risk of running out of funds before their death. Other risks arise as a result of the new system, because people with DC savings might be faced with choosing between inaction or several complicated retirement income products. They will have to make choices based on imperfect knowledge as many of the factors which affect needs in retirement are surrounded by uncertainty, particularly changes in health, longevity and economic changes such as inflation.

Those who do not purchase an annuity may also be required to make decisions throughout retirement on changing funds or retirement income products as needs, circumstances, or economic factors change. However, cognitive functioning has been shown to decline throughout old age and could impair people’s ability to make decisions as they get older.<sup>105</sup>

This is why options for accessing DC savings were ranked as the most complicated to make informed decisions on.

The Government recognises that the new flexibilities will result in DC savers (or those who transfer entitlement from DB to DC) having to make more difficult decisions at retirement than under the old system. Therefore it has committed to providing availability to people with DC savings, approaching retirement, with “free and impartial guidance on their options”. The Government has guaranteed that the guidance will be impartial and provided face-to-face, online or over the phone according to the needs and preferences of the person accessing the guidance.<sup>106</sup>

However, while the guidance will be offered to people approaching retirement, there will be no obligation on people to take the offer up before making a decision about accessing their DC savings. Some people may choose not to

<sup>105</sup> IFS (2004) p. 255

<sup>106</sup> FCA (2014)

engage with the guidance, for example because of behavioural biases, such as the tendency towards inertia some people display, which results in a reluctance to engage with decision making in retirement. Around 92% of people indicated that they would “probably or definitely” use the guidance service once it became available,<sup>107</sup> however, in a TPAS and Legal and General pilot of pensions guidance on at-retirement decisions, conducted with 9,000 customers between April and May, only 2.5% of customers took up the offer.<sup>108</sup>

A recent PPI Briefing Note analysing findings from a consumer survey found that individuals’ intentions around their DC pensions are characterised by a high degree of uncertainty around both when they might retire and how they will access their pension savings.<sup>109</sup> Even 12 months ahead of their expected retirement dates, only around 50% of DC savers said they knew what they expected to do with their pension pot in retirement. So, even if engagement can be achieved, it is unlikely that savers will have clear or definitive views on their expectations and preferences in retirement. It is more likely that gradually raising their awareness ahead of retirement around the choices and trade-offs they will face will help them to become comfortable with any default options they are offered by their schemes or providers, or will prompt them into exploring where they can find further help, beyond any initial guidance service.

For those who do engage with the guidance, they may need ongoing support, not just around decisions at retirement, but decisions later on in retirement as income needs or sources might change for people several times during retirement because of changes of health, household makeup, increases or decreases in available income. It is not yet clear whether people will be only allowed to use the Guidance service once, in the lead up to retirement, or will be allowed to have multiple sessions. The guidance will be funded by a levy on providers and financial service organisations and the level of provision will depend to some extent on available budget. It might be worth investigating whether people would benefit from the offer of several guidance sessions throughout retirement. If the guidance is effective, it may also be worth investigating whether the guidance should be offered to people of working-age who are still making decisions about saving in a pension.

It should also be taken into account that people who do not act on advice or guidance immediately after receiving it may be less likely to make a decision or to make a decision with positive outcomes. Those who are more impulsive or more prone to inertia are the least likely to act on advice or information right away. These tendencies could be considered in the design of advice. There are ways of helping people to take action, for example giving them easy, practical steps to follow, or by including the action as part of the advice or guidance

<sup>107</sup> [www.cii.co.uk/knowledge/policy-and-public-affairs/articles/cii-report-guaranteed-guidance-what-consumers-want/32081](http://www.cii.co.uk/knowledge/policy-and-public-affairs/articles/cii-report-guaranteed-guidance-what-consumers-want/32081)

<sup>108</sup> Pilot sponsored TPAS and Legal and General, [www.moneymarketing.co.uk/2015140.article?cmpid=palert\\_590745](http://www.moneymarketing.co.uk/2015140.article?cmpid=palert_590745)

<sup>109</sup> PPI (2014d)

session. However it may be more difficult to give people these options through guidance than through regulated advice.<sup>110</sup>

The Treasury will hold overall responsibility for the guidance but it will be monitored by the Financial Conduct Authority (FCA). The guidance for members of contract-based (third-party) DC schemes will be funded by a levy on these providers and on other financial services organisations. Trust-based schemes, run by a board of trustees with a fiduciary duty to members, will be obligated under the legislation to signpost to guidance; this will be monitored by The Pensions Regulator.

The telephony and internet-based elements of the guidance service will be provided by The Pensions Advisory Service (TPAS), an independent organisation who already has an established telephone and internet based guidance service. The face-to-face element will be provided through Citizens Advice Bureaux across England, Scotland, Wales and Northern Ireland.<sup>111</sup>

### Summary

Making decisions about accessing DC savings involves complexity. As a result of the further flexibilities in accessing DC savings being introduced from April 2015, the decisions people make about accessing DC savings at retirement will become more complex and involve more options and potentially greater risk of financial detriment. Those who do not purchase an annuity at the beginning of retirement may also be required to make decisions throughout retirement on changing funds or retirement income products as needs, circumstances, or economic factors change. Though some people may purchase an annuity in later retirement and reduce the need for subsequent decision making about that portion of their DC savings.

PPI workshop participants ranked pension, retirement and other major financial decisions by the difficulty of making an *informed financial decision* on each. Making informed decisions about accessing DC savings were ranked as the most difficult. The factors considered necessary to make informed decisions about DC savings involve knowledge about the economy and market-risks, numerical skills and knowledge about the potential impact of unknown factors. Making informed decisions regarding work and retirement were ranked as the second most difficult as these all involved a high degree of uncertainty.

Making informed decisions about accessing DB entitlement were considered the third most challenging, just above making informed decisions regarding accessing other income and assets, buying a house or choosing between further education and work. Making an informed decision about accessing state pension entitlement, purchasing life insurance or purchasing a car were ranked

<sup>110</sup> AXA, University of Warwick (2007a), AXA, University of Warwick (2007b)

<sup>111</sup> FT Adviser, 01 October 2014, "*Treasury chooses Tpas for remote pensions guidance*", [www.gov.uk/government/news/pensions-guidance-providers-unveiled](http://www.gov.uk/government/news/pensions-guidance-providers-unveiled)

the easiest as the outcomes of these decisions were relatively simple to understand and there are strong defaults attached to each option.

The level of financial impact that decisions about accessing pension or non-pension savings and assets will have on an individual is dependent foremost on the levels of savings or entitlement that the individual has accrued of a particular type. If the level of savings or entitlement accrued of one type is minimal, and the individual has substantial levels of savings or entitlement of other types, then the decision may have less of an impact. If the individual has accrued a large level of savings and entitlement of one type, such as DC savings, and has very little other types of savings or entitlements, then the impact of any decision made might be more profound. Those with small levels of savings or entitlement may also experience a relatively greater impact from decisions about access if they have very little other savings, entitlements or assets to fall back on.

The workshop participants found that decisions about accessing DC savings, the most difficult to make an informed decision on, were also near the top of the ranking of financial impact level. Decisions about further education vs. work, buying a house and accessing other income and assets in retirement were also ranked as having the highest potential for financial impact during the lifetime. The decisions that were considered most difficult to make an informed decision about and were also likely to have a high financial impact were those about accessing DC savings, and decisions about work and retirement.

The Government recognises that the new flexibilities will result in DC savers (or those who transfer entitlement from DB to DC) having to make more difficult decisions at retirement than under the old system. Therefore it has committed to offering people with DC savings, approaching retirement, access to “free and impartial guidance on their options”.

## Chapter 4: How complex are the decisions facing people retiring within the next ten to fifteen years?

This chapter sets out the portfolios of pension saving and entitlement that people will be reaching State Pension Age with today and over the next ten to fifteen years. It defines different segments within this population and looks at which segments are faced with the most complex decisions at and during retirement and how these correlate with financial skills and knowledge. This chapter explores the implications of the segmentation for the provision of advice and guidance.

### **This report explores pension saving among individuals aged 50 to SPA in 2014**

This report uses PPI modelling on the distribution of DC, DB and other pension wealth for older workers at a household and an individual level.

The modelling uses data from Wave 5 (2010/11) of the English Longitudinal Study of Ageing (ELSA) on benefit units with at least one individual aged between 50 and SPA. The modelling projects forward assumptions about continued earning and saving among people aged 50 to SPA and assumes that anyone eligible for auto-enrolment is auto-enrolled, does not opt-out, makes pension contributions along with their employer and receives tax relief. Those already in a pension scheme are assumed to continue contributing at their current percentage.

The PPI's Dynamic Model<sup>112</sup> uses data collected on over 10,000 respondents (selected to be representative of the English population aged 50 and over) and assesses their earnings and existing pension arrangements. As this is a relatively large sample, any analysis based on the whole sample is likely to be robust and, as a result, it is possible to generalise from these findings to the population of individuals in England aged over 50. However, more detailed analysis on smaller groups (e.g. by individual age bands) should only be treated as illustrative of how outcomes might differ between individuals and households, and the variation in household circumstances that might be observed.

The analysis uses short-term economic assumptions for RPI, CPI and annual earnings growth in line with Office for Budget Responsibility projections. It has also assumed expected investment returns of 6% in nominal terms, before charges, corresponding to a mixed equity/bond fund in the ratio of 60% equities, 40% bonds. However, this could overstate investment returns if the older workers are placed in more bond heavy, lower risk funds as they approach retirement.

<sup>112</sup> see Annex 1 for more detail

### Assumptions about changes to DB

The modelling makes certain assumptions about the rate and impact of DB scheme closure in the private sector.

A number of factors have increased the costs of providing DB pension schemes<sup>113</sup> and, as a consequence, over 85% of DB schemes in the private sector are now closed either to new members or to both new members and new accruals (from existing members).<sup>114</sup> 41% of private and “other public sector” schemes that are still open are planning to close their schemes to new members over the next 5 years, and a quarter of open schemes are planning to close to new and existing members over the next five years.<sup>115</sup> Therefore, a large majority of those automatically enrolled are likely to be placed in DC pension schemes.

In the future the UK private sector workplace pension landscape is likely to be dominated by DC schemes, although the Government is currently consulting on ways of enabling employers to set up more hybrid schemes (which sit between DB and DC) and schemes which share risk between employees collectively.

Previous PPI analysis indicates that if an average of 15% of all people opt-out of being auto-enrolled automatic enrolment throughout the programme and beyond (and given certain economic and labour assumptions) the value of total private sector workplace DC assets in the UK could become greater than the total value of private sector workplace DB assets in around 2036 at £540 billion.<sup>116</sup>

Since 2010 active membership of private sector defined benefit pension schemes has fallen from 2.1 million members in 2010 to 1.6 million members in 2013, whereas active membership of public sector pension schemes has remained steady at 5.3 million in both 2010 and 2013.<sup>117</sup>

The analysis in this report assumes that people who are currently active members of DB pension schemes remain so and continue to accrue DP pension up until their retirement. That assumptions may overstate the amount of DB pension held by individuals at retirement. However if we were to make the assumption that people in this age group experience an end of their defined benefit accrual at the average rate of scheme closure then we have two problems to overcome; we must arbitrarily choose people whose DB accrual ceases, and we may be overstating the closure for this particular age group, which may be more likely to remain active in schemes that are closed to new entrants but still offer accrual for existing members. For these reasons the assumption made is that employees currently in DB pension schemes continue to accrue pension in their existing scheme.

<sup>113</sup> Such as increased longevity and market-based risks

<sup>114</sup> TPR (2014)

<sup>115</sup> NAPF (2013) p. 18

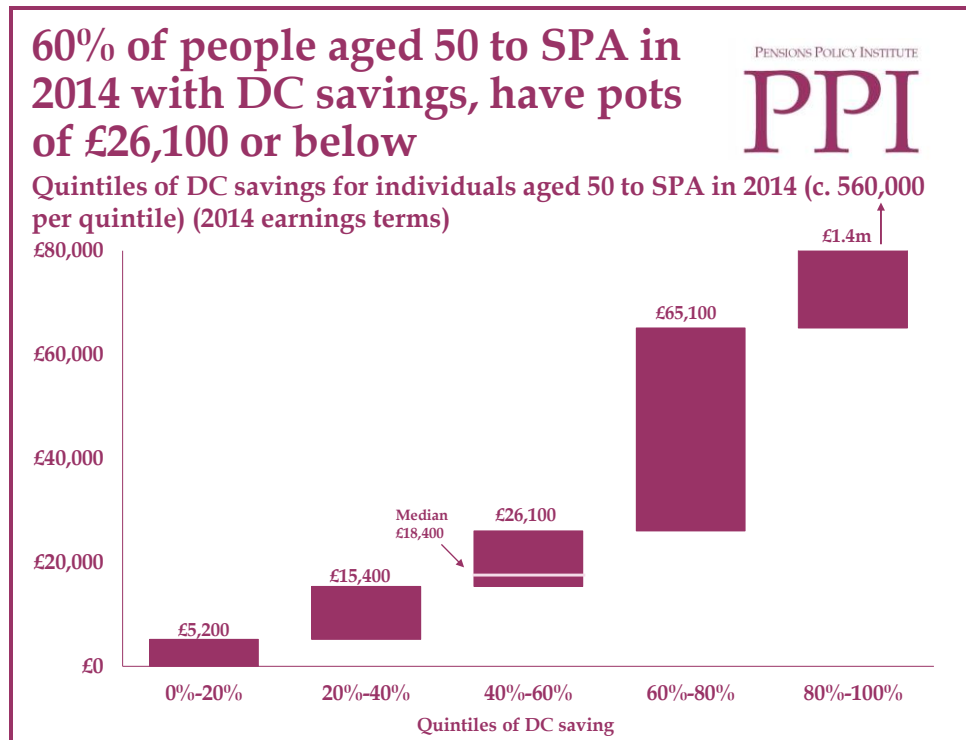
<sup>116</sup> PPI (2014a)

<sup>117</sup> ONS Occupational Pension Schemes Survey 2013



**The majority of DC savers over age 50 have low levels of DC pension savings** 60% of people aged between 50 and their State Pension Age (SPA) in 2014 with DC savings have pots of £26,100 or less (2014 earnings terms) (Chart 4). A pot of this size or less is unlikely to help provide a substantial level of income through retirement, though it could make a significant difference for someone on a relatively low income. A pot of £26,100 could purchase an income from a level annuity of around £110 to £125 per month.<sup>118</sup> Level annuity income does not rise in line with an inflationary index, but remains constant in nominal (cash) terms.

**Chart 4**<sup>119</sup>



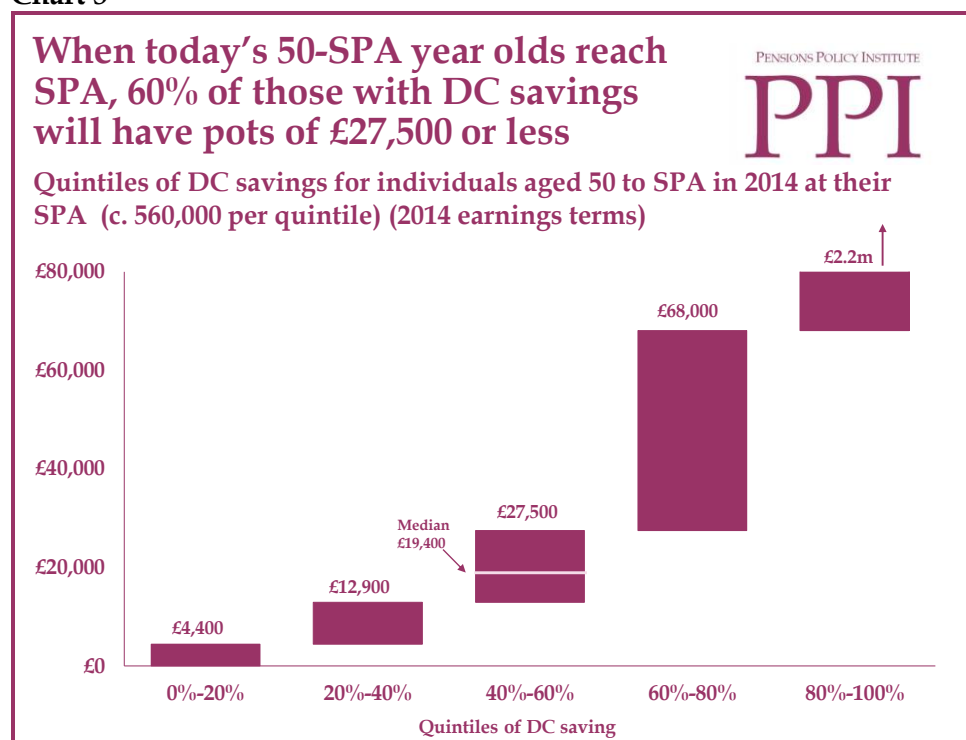
<sup>118</sup> Money advice service annuity comparison tables for a 65 year old, non-smoking single man living in London, assuming no tax-free lump sum is taken. Calculated 20 October, 2014.

<sup>119</sup> PPI Dynamic Model

**By SPA the value of DC savings that people currently aged 50 to SPA with DC savings have will increase**

If you simulated ageing for all of today's 50 to SPA year olds with DC savings till they reached their own individual SPA, assuming they continue to save and contribute at their current levels, and then considered them as one population, then 60% of them would have pots of £27,500 or less (2014 earnings terms) (Chart 5).

**Chart 5**<sup>120</sup>

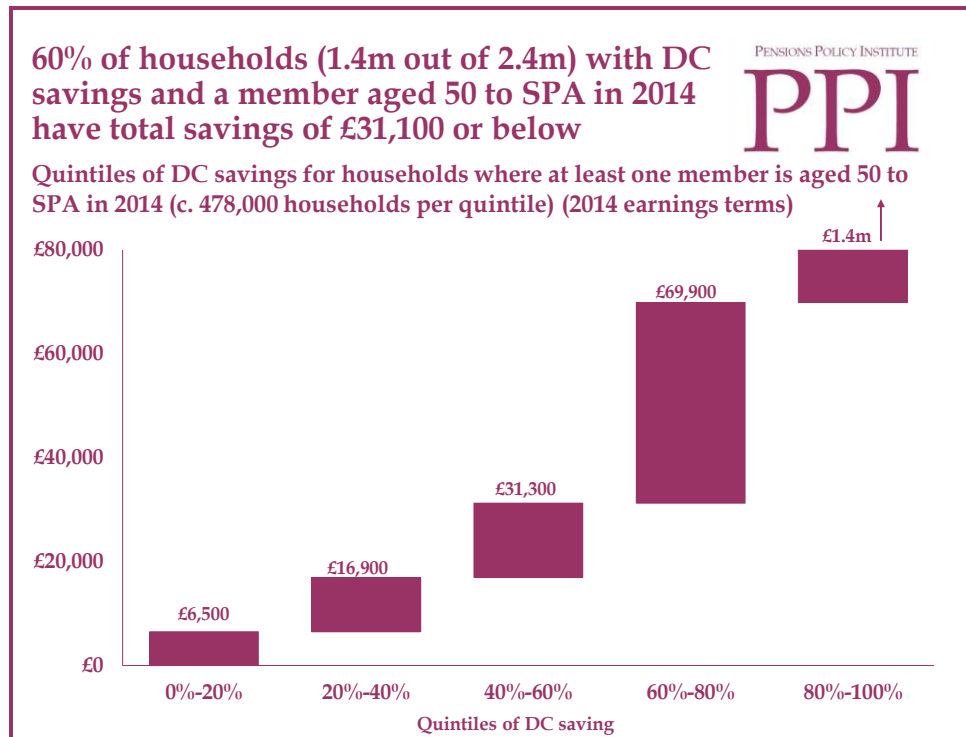


<sup>120</sup> PPI Dynamic Model

**The value of household DC savings do not differ substantially from those on an individual level**

Households have higher levels of DC wealth than individuals, as household analysis includes all the savings and assets belonging to a couple. On a household basis, 60%, (or around 1.4 million) of households with DC savings have total DC savings of £31,300 or below, compared to £26,100 or below for individuals (Chart 6). However, the value of household DC savings do not differ substantially from those on an individual level, indicating that in many households, the majority of DC wealth is held by one person.

**Chart 6**<sup>121</sup>



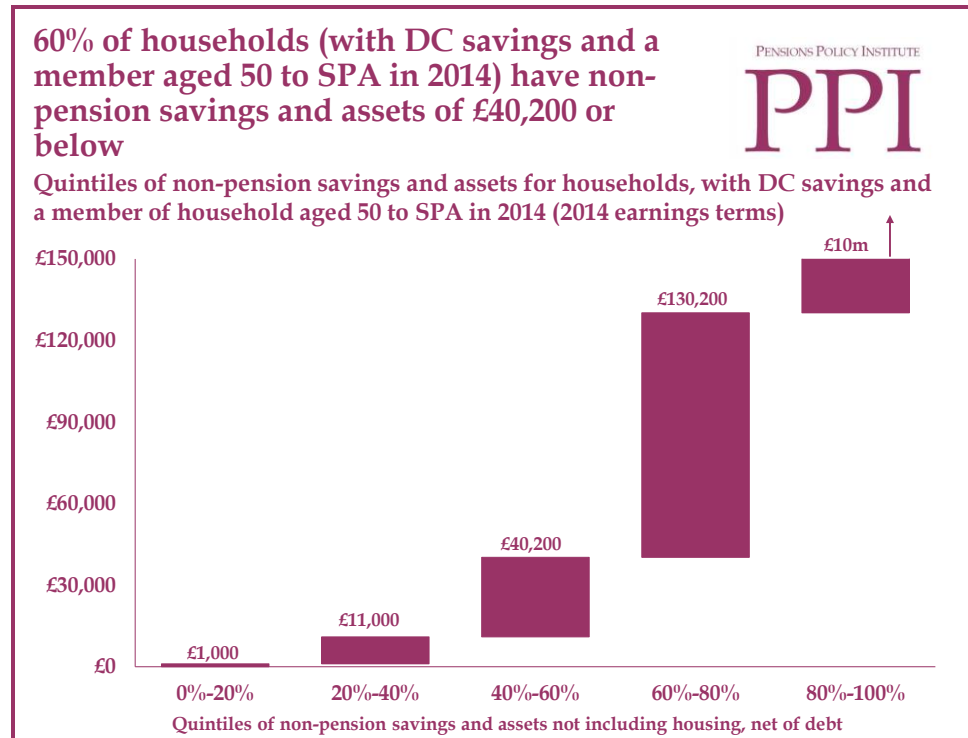
**60% of people aged over 50 with DC savings have non-pension savings and assets of £40,200 or more**

Many households will be able to use other, non-pension wealth<sup>122</sup> to supplement pension income and support themselves in retirement. Of those with DC savings, around 1.3 million households (out of 2.4 million) have non-pension savings and assets of £40,200 or more (Chart 7).

<sup>121</sup> PPI Dynamic Model

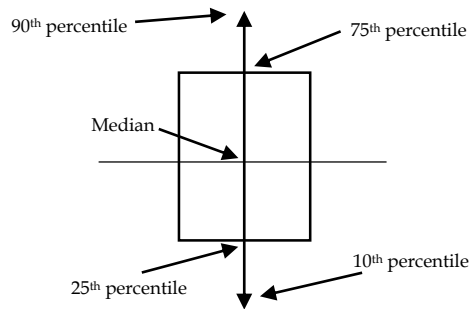
<sup>122</sup> Non-pension savings and assets include: savings (bank accounts, ISAs, TESSAs); investments (Premium Bonds, National Savings, PEPs, shares, trusts, bonds, ISAs, elements of life insurance) minus debts. It also includes physical wealth: second homes, farms or business property, other business wealth, other land, assets such as jewellery, art or antiques.

Chart 7<sup>123</sup>



**Box plots**

The next two charts in the report are **box plots**. Box plots allow graphic representation of a distribution of outcomes. The rectangle represents the 25<sup>th</sup> to 75<sup>th</sup> percentiles of the distribution while the end of the vertical line represent the 10<sup>th</sup> and 90<sup>th</sup> percentiles. The horizontal line through the box represents the median.



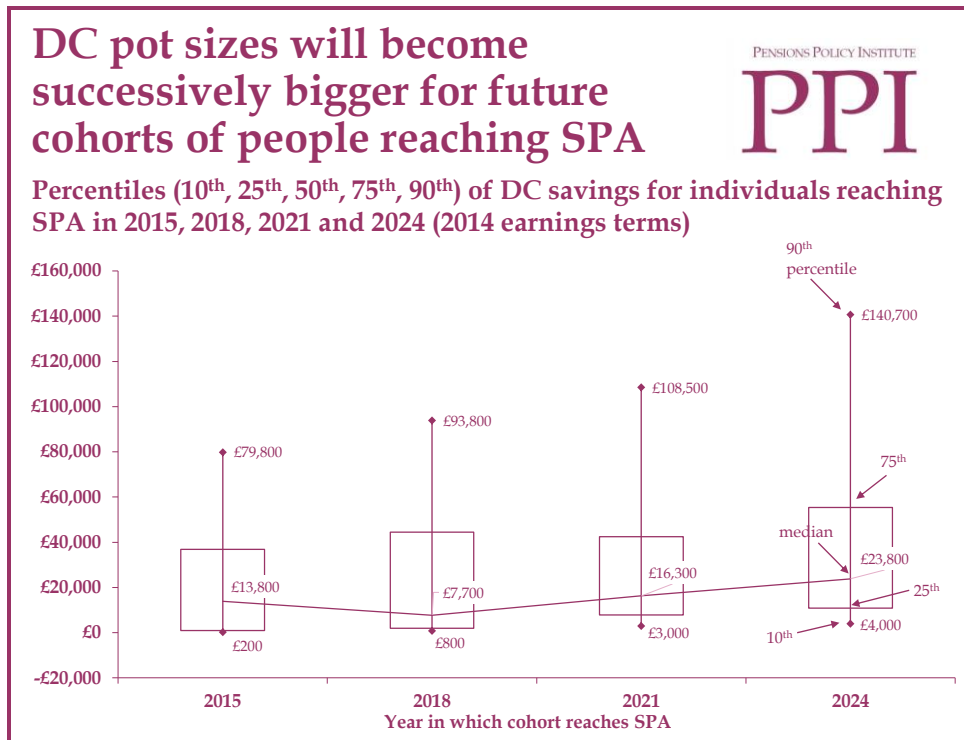
<sup>123</sup> PPI Dynamic Model

**Over the next decade, cohorts of people reaching SPA should have successively greater amounts of DC savings**

The following **box plot chart** shows percentiles of saving for those reaching SPA in 2015, 2018, 2021 and 2024. For each cohort, the box shows the median level of DC pension savings, (horizontal line through the boxes) as well as the 25<sup>th</sup> and 75<sup>th</sup> percentile (either end of the boxes) and the 10<sup>th</sup> and 90<sup>th</sup> percentiles, at either end of the vertical line through each box.

Between 2015 and 2024, the median level of DC savings for those reaching SPA with DC savings will rise from £13,800 to £23,800 and the 90<sup>th</sup> percentile will increase by around 75%<sup>124</sup> from £79,800 to £140,700 (2014 earnings terms) (Chart 8). Between 2015 and 2018, the median value of pot sizes decreases. This is due to the impact of auto-enrolment leading to more people saving in total, but smaller average pot sizes as the pots of people who have been auto-enrolled have only had a few years in which to grow.

**Chart 8**<sup>125</sup>



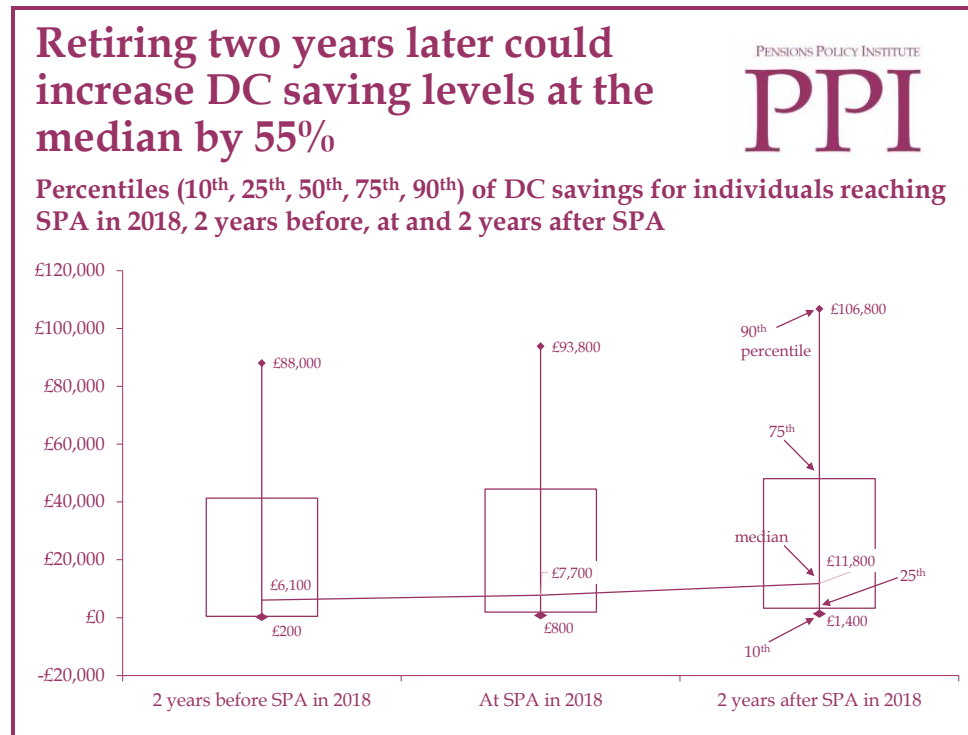
<sup>124</sup> Rounded to nearest 5%

<sup>125</sup> PPI Dynamic Model

**Continuing to save beyond SPA could also increase the median value of DC savings by around 55%**

If it is assumed that the cohort reaching SPA in 2018 with DC savings continues to save into their DC pension funds for an additional 2 years after SPA (without taking any money out) then the median value of DC pension savings could increase by around 55%, from £7,700 to £11,800, due to the value of compound interest operating on mature pots.<sup>126</sup> If, conversely, people in that cohort are all assumed to access their DC pension savings pots 2 years prior to SPA, then the median value of DC savings could be reduced by around 20%<sup>127</sup> (Chart 9).

**Chart 9**<sup>128</sup>



<sup>126</sup> Rounded to nearest 5%

<sup>127</sup> Rounded to nearest 5%

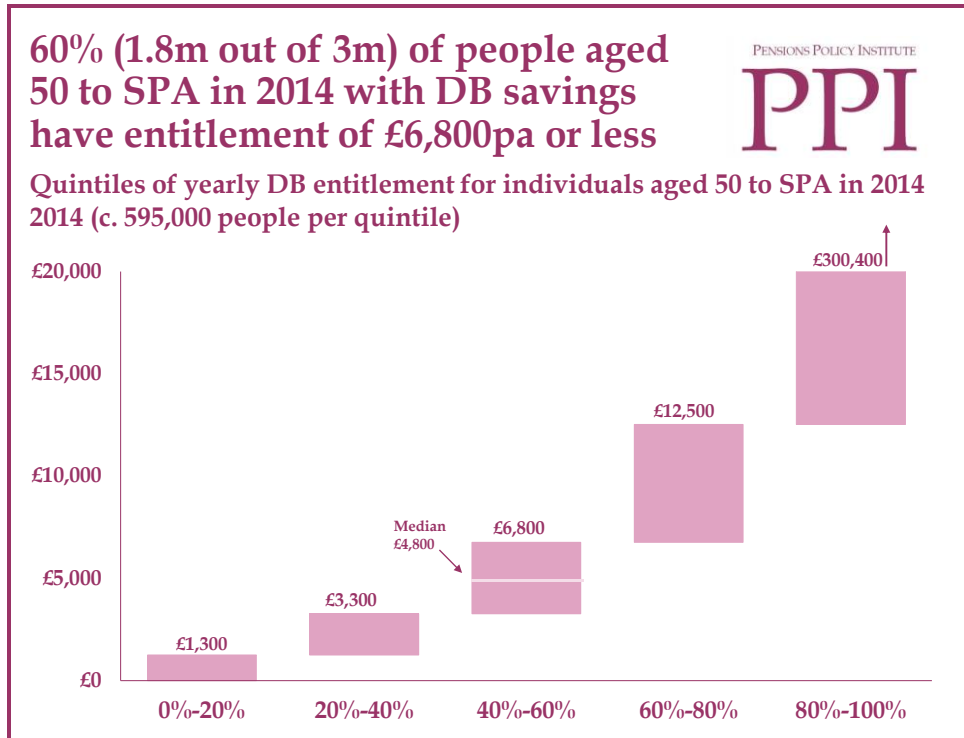
<sup>128</sup> PPI Dynamic Model

**People aged 50 and over in 2014 have higher average levels of DB entitlement than DC savings**

Current average levels of DB entitlement for those aged 50 to SPA would provide a higher income than the average levels of DC savings could provide. 60% of people aged between 50 and their State Pension Age (SPA) in 2014 with DC savings have pots of £26,100 or less (2014 earnings terms), which could purchase an annual level annuity income of around £110 to £125 per month, which does not escalate (i.e., remains the same in nominal terms year on year).

However, 60% of people aged 50 to SPA in 2014 with DB entitlement have entitlement of £6,800 per year or less, equivalent to £565 per month (2014 earnings terms), which should escalate each year in line with a pre-agreed index (e.g., CPI) (Chart 10). The escalating element of the DB pension increases its value relative to a level income, as the escalation ensures that the DB income is not as vulnerable to losing relative value (purchasing power) in real terms.

**Chart 10**<sup>129</sup>

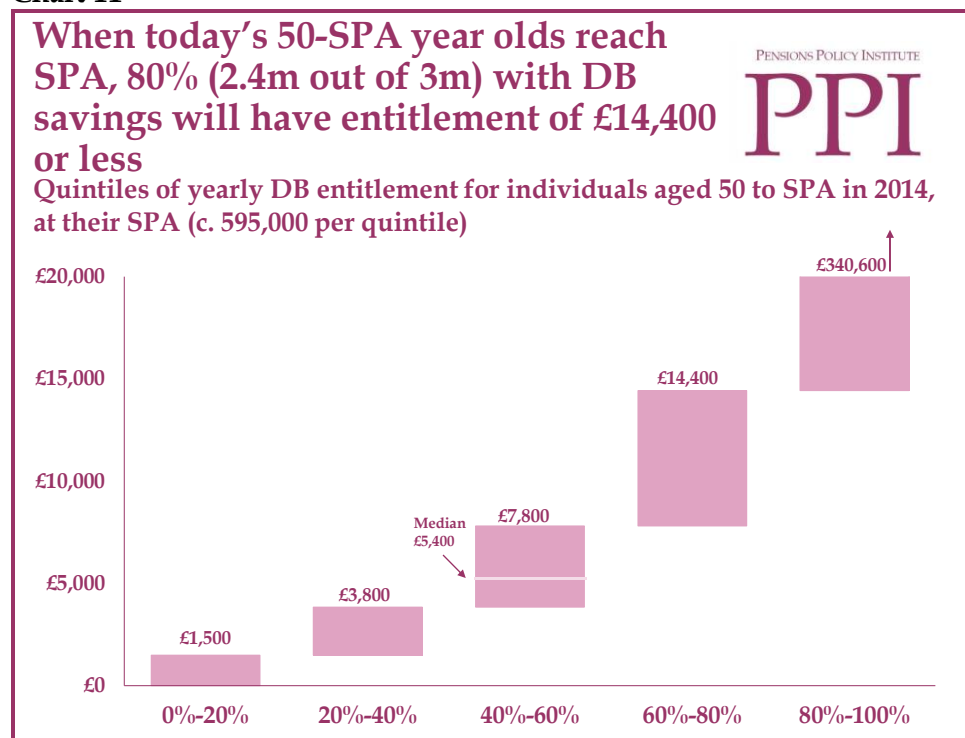


<sup>129</sup> PPI Dynamic Model

### By SPA the value of DB entitlement that people currently aged 50 to SPA with DB entitlement have will increase

If it is assumed that all people with DB entitlement currently in schemes remain in their schemes contributing until SPA, then the value of DB entitlement will increase. If you took a snapshot of all of today's 50 to SPA year olds with DB entitlement at their SPA and looked at them as one cohort, then 60% of them would have DB entitlement of £7,800 or less (2014 earnings terms) (Chart 11).

Chart 11<sup>130</sup>



Many DB schemes in the private sector are closing to new members and most employers are offering DC schemes for automatic-enrolment. In the future, more people are likely to reach SPA with DC savings and the average levels of DC saving are likely to increase, while the number of people with DB entitlement will decrease.

The rest of this chapter uses PPI's dynamic model and data from the English Longitudinal Study of Ageing to explore the portfolios of pension saving and entitlement that people will be reaching SPA with today and over the next ten to fifteen years. These people, aged 50 to SPA are aged to their individual SPAs and then their pension and other saving portfolios are considered. This chapter defines different segments within this group and looks at which segments are faced with the most complex decisions at and during retirement and how these correlate with financial skill and engagement. The segment groups are

<sup>130</sup> PPI Dynamic Model



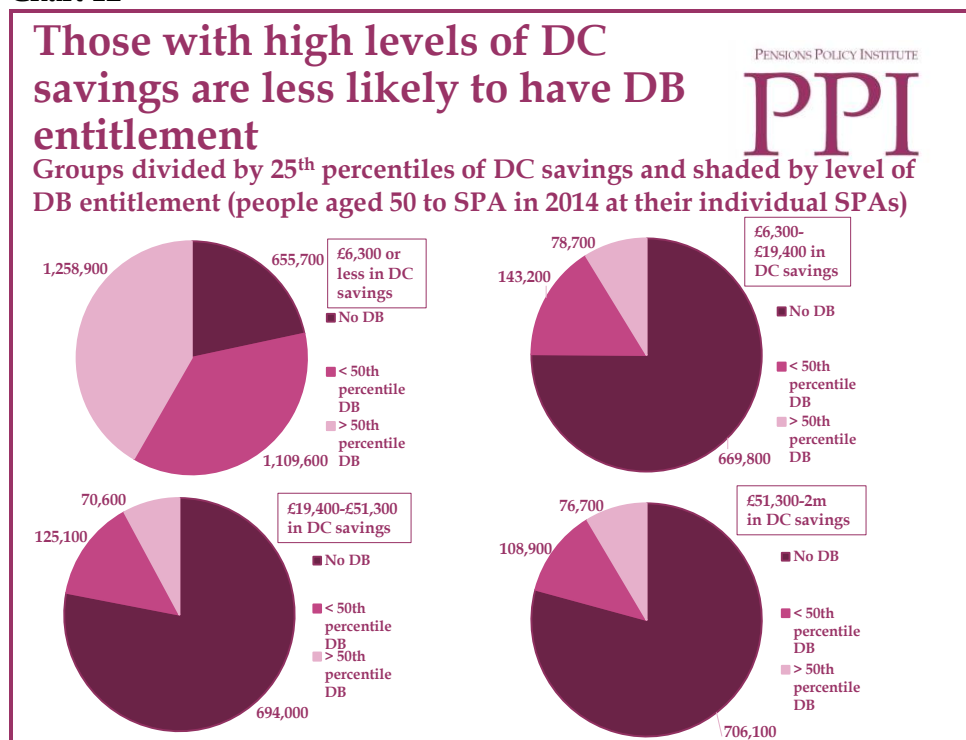
separated by level (25<sup>th</sup> percentiles) of DC savings, then further divided by level of DB entitlement to create 12 separate segments.

The characteristics of each group is explored. The DC portfolios of groups approaching retirement over the next ten to fifteen years are of particular interest, as it is people with this type of savings which will be most impacted by the budget changes introducing further flexibility of access.

**Half of people currently aged between 50 and SPA with pension savings will have £6,300 or less in DC savings by the time they reach their SPA - including some with no DC savings**

In England, around 5.7 million people currently (2014) aged between 50 and SPA will have some private pension savings or entitlement at their SPA. Around half of these people will have DC pots of £6,300 or less, including those who will have no DC savings. Around three quarters of this group will have DB entitlement. Half of this group will have DC pots of £6,300 or more and around a quarter of this half will have DB entitlement (Chart 12).

Chart 12<sup>131</sup>



**The segments were assigned labels indicating the level of risk that they are exposed to**

It is useful to explore how different indicators correlate with pension and non-pension saving portfolios because they can provide information about the likely needs and characteristics of different groups. For example, profession based

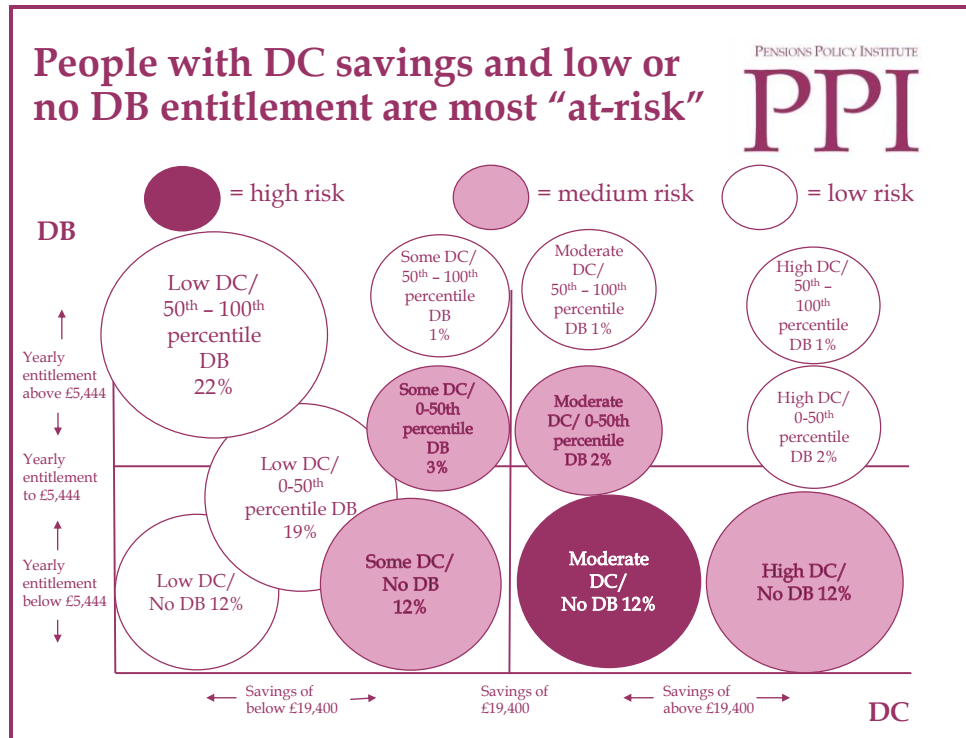
<sup>131</sup> PPI Dynamic Model

socio-economic class can give indications about education, income level and the likelihood of people being able to work longer or more flexibly. For example, those in lower profession based socio-economic classes are less likely to have flexible working options available to them and are more likely to have to leave work for involuntary reasons such as health problems.

The level of non-pension savings and assets held by people gives an indication of how dependent they might be on one source of pension savings or on the state. Proxy indicators of financial skill and engagement can allow judgements to be made regarding people's likely ability to make complex decisions about accessing pension savings without assistance.

The segment groups were assigned risk labels reflecting indicators such as degree of dependence on DC, whether they had DB entitlement to fall back on, and their ability to make "good" DC decisions based on their levels of financial skill and engagement. Those who were judged to be very dependent on DC savings, (which it has been established are difficult to make a fully informed decision about and the viability of which can be subject to unpredictable factors such as economic changes, inflation or living for longer than expected) were determined to have higher levels of risk. Risk level was mitigated by other factors such as whether they had substantial enough DC savings to afford the risk, whether they were more likely to use independent advice, and whether they were likely to have higher numerical ability, or score well on proxy indicators of financial skill and engagement (Chart 13).

Chart 13<sup>132</sup>



**£6,300 or less of DC savings – the Low DC group**

**People with Low levels of DC (655,700 people 12%), and 50<sup>th</sup> percentile or less of DB entitlement (1,109,600 people 19%)**

- Are more likely to be in lower socio-economic classes and the middle three overall income quintiles; have lower levels of non-pension savings and assets than other groups; scored low on proxy indicators of financial skill and engagement. These groups are classified as “low-risk” because they are likely to rely mainly on the state pension and state benefits or a combination of state and DB entitlement for their income in retirement. These are fairly low-risk sources of income which escalate to protect against inflation.

**People with low levels of DC but 50<sup>th</sup> percentile or more of DB entitlement (1,258,900 people 22%):**

- Are more likely than those with low levels of DB entitlement to be in a high socio-economic class and have reasonable levels of non-pension savings and assets. They scored around medium in the range of segments on proxy indicators of financial skill and knowledge. This group is classified as “low-risk” because they are likely to rely mainly on a combination of the state pension and DB entitlement for their income in retirement. These are fairly low-risk sources of income which escalate to protect against inflation.

**£6,300 to £19,400 of DC savings – the Some DC group**

For people with some DC, the level of DB entitlement makes a substantial difference to outcomes:

<sup>132</sup> PPI Dynamic Model

- **(No DB, 669,800 people, 12%)** Those with no DB tend to be in the bottom third of the range for social class, non-pension savings and assets and to score low on proxy indicators of financial skill and knowledge. This group is classified as “medium-risk”. They are likely to rely mainly on the state pension or state benefits, but have some DC savings which could be used to support retirement by paying off debts, for a single purchase or as a small source of income. This group scores low on proxy indicators of financial skill and knowledge; but is unlikely to have enough funds to purchase independent advice which might aid in determining the best use for their DC savings.
- **(<50<sup>th</sup> percentile DB, 143,200 people, 3%)** Those with up to 50<sup>th</sup> percentile DB entitlement were middle of the range for likelihood of being in a high socio-economic class and having high levels of non-pension savings and assets. They scored mid-range on proxy indicators of financial skill and knowledge. This group is classified as “medium-risk” for the same reasons as the previous group.
- **(>50<sup>th</sup> percentile DB, 78,700 people, 1%)** Those with 50<sup>th</sup> percentile or more of DB entitlement were quite likely to be in the highest or second highest socio-economic group and non-pension savings quintiles. They scored mid-range on proxy indicators of financial skill and knowledge. This group is classified as “low-risk” because they are likely to rely mainly on a combination of the state pension and DB entitlement for their income in retirement. These are fairly low-risk sources of income which escalate to protect against inflation. They have some small portion of DC savings, however the decisions they make about these are unlikely to impact heavily on their overall income in retirement.

#### **£19,400 to £51,300 of DC savings - the Moderate DC group**

People in the moderate DC group scored better on most indicators than the people with lower levels of DC savings, despite DB entitlement, though those with high levels of DB entitlement scored better than those with low or no levels.

- **(No DB, 694,000 people, 12%)** Those with no DB tend to be fairly evenly distributed across the range of socio-economic class and non-pension savings quintiles. They scored low on proxy measures of financial skill and engagement. This group is classified as “high-risk”. They are likely to rely mainly on the state pension or state benefits, but have moderate DC savings which could be used to pay off a significant debt or supplement retirement income. However, this group scores low on proxy indicators of financial skill and knowledge; but is unlikely to have enough funds to purchase independent advice which might aid in determining the best use for their DC savings. If they make a poor decision about their DC savings they have little other income sources than the state or housing assets to fall back on. Prior to the transitional arrangements introduced in 2014, many of the people in this group would have had to purchase a lifetime annuity or invest in Capped Drawdown with their DC savings because they would have been above the trivial commutation limit of £18,000. After April 2015 all of these people will be able to flexibly take their DC pension savings after the

minimum pension age and therefore they will face an array of decisions that they would have had to if they were purchasing a lifetime annuity or Capped Drawdown.

- (**<50<sup>th</sup> percentile DB, 125,100 people, 2%**) Those with up to the 50<sup>th</sup> percentile of DB entitlement are about mid-way up the range of likelihood of being in the highest socio-economic class, and are clustered around the top two non-pension savings quintiles. They scored medium on proxy measures of financial skill and engagement. This group is classified as “medium-risk”. They are likely to rely mainly on a combination of state and DB pensions, but have some DC savings which could be used to support retirement by paying off debts, for a single purchase or as a small source of income. If accessed in a way which suits their circumstances, their DC savings could be used in a way which impacts their retirement income by paying off a significant debt or supplementing income. However, this group scores low on proxy indicators of financial skill and knowledge; but is unlikely to have enough funds to purchase independent advice which might aid in determining the best use for their DC savings. If they make a poor decision about their DC savings they have some other DB entitlement to fall back on, which mitigates their risk down to medium rather than high.
- (**>50<sup>th</sup> percentile DB, 70,600 people, 1%**) Those with 50<sup>th</sup> percentile or more of DB entitlement are second most likely to be in the highest socio-economic class and the second highest non-pension savings quintile. This group scored high on proxy indicators of financial skill and engagement. This group is classified as “low-risk” because they are likely to rely mainly on a combination of the state pension and DB entitlement for their income in retirement. These are fairly low-risk sources of income which escalate to protect against inflation. They have a moderate portion of DC savings, but they also score high on indicators of financial skill and engagement and are therefore less at risk of making a poor decision. Those who do make a poor decision have other income sources to fall back on.

#### **£51,300 to £2,199,800 of DC savings - the high DC group**

Those with high levels of DC savings were more likely to score high on the indicators than other groups

- (**No DB, 706,100 people, 12%**) Those with no DB tend to be in the highest socio-economic class, mostly in the top three of the non-pensions savings quintiles, and scored middle of the range on proxy indicators of financial skill and capability. This group is classified as “medium-risk”. They have high levels of DC savings and are likely to rely on a combination of state pension, DC savings and non-pension savings and assets to support themselves in retirement. Having DC savings as a main source of retirement income is riskier than other sources because decisions about DC savings are more difficult to make and DC funds are more subject to unpredictable factors. However, this group scored medium on levels of financial skill and capability and are the group most likely to use independent financial advice for assistance in making pensions decisions.

- (**<50<sup>th</sup> percentile DB, 108,900 people, 2%**), (**>50<sup>th</sup> percentile DB, 76,700 people, 1%**) Those with any DB entitlement at all were quite or very likely to be in the highest socio-economic class, and non-pension savings and assets quintiles. They scored well on proxy indicators of financial engagement. These groups are classified as “low-risk”. They have a diverse portfolio of sources to depend on in retirement including state pension, DB entitlement, DC savings and other savings and assets. They score high on proxy indicators of financial skill and knowledge and are also more likely to be able to afford financial advice. Those who do make a poor decision about DC savings have other income sources to fall back on.

### **The next section explores the correlations between variables**

#### **Being in a high socio-economic class is associated with having higher levels of DB entitlement**

Those with DB entitlement of 50<sup>th</sup> percentile or more are more likely to be in the highest socio-economic class. However, the likelihood of being in a higher socio-economic class, once someone had DB entitlement of 50<sup>th</sup> percentile or more, increased in correlation with the level of DC savings; 89% of people with DB entitlement of 50<sup>th</sup> percentile or more and DC savings of 75<sup>th</sup> to 100<sup>th</sup> percentile were in the highest socio-economic class. Those with no or very little pension savings and entitlement were most likely to be in the lowest socio-economic class.

#### **Having DB entitlement of 50<sup>th</sup> percentile or more is most strongly associated with being in the highest quintile of non-pension savings and assets**

Having DB entitlement at the 50<sup>th</sup> percentile or higher is most strongly associated with being in the highest quintile of non-pension savings and assets, however, having higher levels of DC saving is also associated. 45% of those with 50<sup>th</sup> percentile or higher of DB entitlement and 75<sup>th</sup> to 100<sup>th</sup> percentile of DC are in the top quintile of other savings and assets, while 43% of those with 50<sup>th</sup> percentile or higher of DB entitlement but very low levels of DC (25<sup>th</sup> percentile or less) are in the top quintile. Only 20% of those with No DB and 25<sup>th</sup> percentile or less of DC savings are in the top quintile.

#### **Performing well on proxy indicators of financial skill and knowledge was associated with higher levels of DB entitlement, especially for education and numeracy**

There is no direct measure of financial capability. This report uses indirect proxy indicators, (though flawed as sole indicators because each indicator such as education or numeracy can be correlated with many other measures) to measure financial skill and engagement. Seen as a group, these indicators can give some insight as to the levels of financial skill and engagement that people with different levels of pension saving and entitlement have. This report uses four proxy indicators: financial engagement, access to information, education level and numeracy.

### **High education and high levels of numeracy are associated with higher levels of DB entitlement**

Those with DB entitlement of 50<sup>th</sup> percentile or higher were far more likely to have a degree and score 6/6 on a numeracy test, correctly answering the question about compound interest (the numeracy test questions are set out in the appendix). Higher levels of DC, with some DB entitlement, were also correlated with high levels of education and numeracy. 68% of people with DB entitlement of 50<sup>th</sup> percentile or more and DC savings of 75<sup>th</sup> to 100<sup>th</sup> percentile had a degree and 51% scored 6/6 on a numeracy test, correctly answering a question on compound interest. Having no DB entitlement at all was correlated with being less likely to have a degree or score well on a numeracy test, even when the individual had high DC entitlement.

Those with low levels of DC (50<sup>th</sup> percentile or less) and no DB are the most likely to have no qualifications at all.

### **All segments favoured their pension scheme and employer as a source of information on pensions**

The majority of people in most segments used their scheme and/or their employer as a source of information on pensions. Having DB entitlement was correlated with being more likely to use a pension scheme as a source of pensions information. Those with the highest levels of DB entitlement (50<sup>th</sup> percentile or higher) were less likely to use their employer as a source of information than those with moderate levels of DB entitlement (50<sup>th</sup> percentile or lower). However, the survey data is from before automatic enrolment. As a result of automatic enrolment, more people will be receiving pensions information from their employer and or provider if they remain opted in. The DWP are also conducting a high profile information campaign about automatic enrolment and workplace pensions over television, radio, press coverage and other forms of media and advertising in public places.

Experience of using ISAs, PEPs and TESSAs and experience of direct market investment was fairly evenly distributed, however, those with higher levels of DC were far more likely to have direct investment experience.

Having DB or higher levels of DB entitlement was correlated negatively with using an IFA. Having DC and no DB entitlement was positively correlated with using an IFA. The group most likely to use an IFA (14% were those with 75<sup>th</sup> to 100<sup>th</sup> percentile of DC savings and no DB entitlement).

**The following boxes and tables explore the data in more depth**

#### **The Low DC group (0<sup>th</sup> - 25<sup>th</sup> percentile DC savings)**

##### **£6,300 or less of DC savings – the Low DC group**

This group has very low levels of DC savings and are likely to depend more on DB savings, other, non-pension savings and assets or the state in retirement.

**Low DC/No DB** (*£6,300 or less of DC savings*)

The people in this group are:

- More likely than the people in any of the other segments to be in the lowest socio-economic class,
- More likely than the people in the other segments to be in the lowest quintile of non-pension savings and assets. A quarter of this group (26%) has £1,000 or less in other savings and assets,
- This group scored lower than any of the others on proxy measures of financial skill and engagement, though 5% have used an IFA and 1% have used an accountant for pensions advice.

**Low DC/0-50<sup>th</sup> percentile DB** (*£6,300 or less of DC savings, yearly DB entitlement of £5,444 or less*)

The people in this group are:

- In the bottom three for social class, a third (33%) are in the highest class and a third (32%) in the lowest,
- Fairly evenly distributed across quintiles of other savings and assets, with around a quarter (24%) in the top quintile,
- In the bottom three for education and numeracy, had low to medium levels of engagement and very little experience of using IFAs or accountants as a source of pensions information.

**Low DC/50<sup>th</sup>-100<sup>th</sup> percentile DB** (*£6,300 or less of DC savings, yearly DB entitlement of £5,444 to £300,400*)

The people in this group are:

- In the top five for socio-economic class, with 57% in managerial and professional occupations,
- In the top four for other savings and assets with 43% in the top quintile and 27% in the second highest,
- Scored medium for financial skill and engagement, with 39% having a degree, 34% scoring 6/6 on a numeracy test, answering the compound interest question correctly; 38% having direct investment experience, though very little experience of using IFAs or accountants as a source of pensions information and most using pension scheme and/or employer as a source of information.

**The Some DC group (25<sup>th</sup> to 50<sup>th</sup> percentile DC savings)****£6,300 to £19,400 of DC savings - the Some DC group**

This group has quite low levels of DC savings. They may have sufficient to pay off debts, or a mortgage but are likely to depend more on DB savings, other, non-pension savings and assets or the state for a regular income in retirement.

**Some DC/No DB** (*£6,300 to £19,400 of DC savings, No DB entitlement*)

The people in this group are:

- In the bottom three for social class: a third in the highest socio-economic class and a third in the lowest,



- This group is unlikely to have much other savings and assets with 21% in the top quintile, and a quarter (25%) with other savings and assets of £1,000 or less,
- Scored low for financial skill and knowledge: 20% have a degree, 18% scored 6/6 on a numeracy test, answering the compound interest question correctly; only 24% have direct investment experience and 52% have used an ISA, PEP or TESSA. However, 6% have used an IFA.

**Some DC/0-50<sup>th</sup> percentile DB** (£6,300 to £19,400 of DC savings, yearly DB entitlement of £5,444 or less)

The people in this group are:

- In the middle range for socio-economic class with 44% in the highest class, 18% in the second highest, but 27% in the lowest,
- More likely than any other group to be in the middle quintile of other savings and assets (30%), a quarter (25%) are in the second highest, only 15% are in the highest,
- Scored medium for financial skill and knowledge: 30% have a degree, 34% scored 6/6 on a numeracy test, answering the compound interest question correctly, 36% have direct investment experience and 67% have used an ISA, PEP or TESSA. 4% have used an IFA.

**Some DC/50<sup>th</sup>-100<sup>th</sup> percentile DB** (£6,300 to £19,400 of DC savings, yearly DB entitlement of £5,444 to £300,400)

The people in this group are:

- More likely than other groups to be in the second highest socio-economic class, 21%. 44% of the group are in the highest class,
- Scored high for other income and assets, with 46% in the top quintile and 26% in the second highest,
- Had medium levels of financial skill and engagement with 38% having a degree; 35% scoring 6/6 on numeracy and 54% scoring 5/6; 41% have direct investment experience and 49% have used an ISA, PEP or TESSA. 4% have used an IFA.

### **The Moderate DC group (50<sup>th</sup> to 75<sup>th</sup> percentile)**

#### **£19,400 to £51,300 of DC savings - the Moderate DC group**

This group has moderate levels of DC savings. They may have sufficient to pay off debts, or a mortgage or might be able to use their DC savings to provide an income for some portion of their retirement, they are likely to still depend partially on DB savings, other, non-pension savings and assets or the state for a regular income in retirement.

#### **Moderate DC/No DB** (£19,400 to £51,300 of DC savings, No DB entitlement)

The people in this group are:

- Less likely than those in most other groups to be in the highest socio-economic class, but they are more evenly spread across class groupings than those in other groups, with 39% in the highest class, 12% in the second, 15% in the third, then 12% and 22% in the lowest class,

- Fairly evenly distributed across other savings and assets quintiles, with 25% in the second highest and 21% in the highest,
- Scored low on proxy measures of financial skill and engagement with 23% with a degree, 25% scoring 6/6 on numeracy, answering the compound interest question correctly; 27% with direct investment experience. Many use their scheme (75%) and/or employer (28%) as a source of pension information. 5% have used an IFA.

**Moderate DC/0-50<sup>th</sup> percentile DB** (£19,400 to £51,300 of DC savings, yearly DB entitlement of £5,444 or less)

The people in this group are:

- About mid-way up the range of likelihood of being in the highest socio-economic class with around 53%,
- About mid-way up the range of likelihood of being in the highest quintile for other savings and assets with 31% in the highest and 32% in the second highest,
- Scored medium on proxy indicators of financial skill and engagement with 34% with a degree, 33% scoring 6/6 on numeracy, answering the compound interest question correctly; 26% with direct investment experience. Many use their scheme (89%) and/or employer (31%) as a source of pension information. 8% have used an IFA.

**Moderate DC/50<sup>th</sup>-100<sup>th</sup> percentile DB** (£19,400 to £51,300 of DC savings, yearly DB entitlement of £5,444 to £300,400)

The people in this group are:

- The people in this group are second most likely to be in the highest socio-economic class (74%). 17% are in the lowest socio-economic class.
- People in this group are more likely than any other (37%) to be in the second highest quintile for other savings and assets, 34% are in the highest quintile for other savings and assets,
- This group scored high on proxy indicators of financial skill and engagement. Half of the people in this group have a degree (49%); 47% scored 6/6 on a numeracy test, answering the compound interest question correctly; 64% have used an ISA, PEP or TESSA and 33% have direct investment experience. Many use their scheme (83%) and/or employer (23%) as a source of pension information. 6% have used an IFA.

**The High DC group (75<sup>th</sup> to 100<sup>th</sup> percentile)**

**£51,300 to £2m of DC savings - the high DC group**

This group has high levels of DC savings. Those near the bottom of the scale should have sufficient savings to pay off debts, or a mortgage and might be able to use their DC savings to provide an income for some portion of their retirement. Those higher up the scale might be able to use their DC savings to provide the majority of their income in retirement, supplemented by state pension, any DB entitlement and other savings and assets.

**High DC/No DB** (£51,300 to £2m of DC savings, No DB entitlement)

The people in this group are:

- Quite likely to be in the highest levels of socio-economic class: 60% of the people in this group are in the top socio-economic group, the remainder are fairly evenly spread through the other groups with only 18% in the bottom two,
- This group scored in the top five for other savings and assets with 39% of this group in the top quintile of other savings and assets and 24% second from the top, the remainder (36%) are fairly evenly distributed across the bottom three,
- This group scored middle of the range for proxy indicators of financial skill and engagement. 37% of the people in this group have a degree; 35% of the people in this group scored 6/6 on a numeracy test, answering the compound interest question correctly and a further 35% scored 5/6; 59% have used an ISA, PEP or TESSA and 37% have direct investment experience. 75% use their scheme as a source of info and 20% use their employer. The people in this group are the most likely of those in any group to use an IFA (14%).

**High DC/0-50<sup>th</sup> percentile DB** (£51,300 to £2m of DC savings, yearly DB entitlement of £5,444 or less)

The people in this group are:

- Quite likely to be in the highest socio-economic class 61%. Only 13% are in the lowest socio-economic class,
- Quite likely to be in the top quintile of other savings and assets (44%); 28% are in the second highest quintile, the remaining 27% is distributed evenly,
- Scored high on proxy indicators of financial skill and engagement with 41% of the people in this group having a degree; 44% of the people in this group scored 6/6 on a numeracy test; 50% have used an ISA, PEP or TESSA and 46%, more than any other group, have direct investment experience. 80% use their scheme as a source of info and 33% use their employer. 9% have used an IFA.

**High DC/50<sup>th</sup>-100<sup>th</sup> percentile DB** (£51,300 to £2m of DC savings, yearly DB entitlement of £5,444 to £300,400)

The people in this group are:

- Much more likely than those in the other groups to be in the highest socio-economic class (89%); less than 1% are in the lowest socio-economic class,
- Second most likely to be in the top quintile of other savings and assets (45%), 32% are in the second highest quintile, and only 11% in the bottom two,
- Scored high on proxy indicators of financial skill and knowledge. People in this group are more likely than those in other of the groups to have a degree (68%), 16% have further education below degree level and only 3% have no qualifications; the people in this group are most likely to score highly on numeracy, 51% scored 6/6, correctly answering the compound interest question; 55% of the people in this group have used an ISA/PEP or TESSA and 37% have directly invested in the stock market; 92% use their scheme as a source of info, 21% use their employer, 8% have used an IFA.

### Summary of conclusions

Decisions about accessing DC pensions are difficult for people to make as they often require understanding of complex and uncertain economic and market concepts such as inflation, investment risk and longevity risk. Changes announced in Budget 2014 mean that, from April 2015, many people with Defined Contribution savings will be allowed far greater levels of flexibility when they come to access their pension savings. This will further complicate the decisions that DC savers must make as it will increase the number of available options, push the burden of managing risk further onto pension savers, and, in some cases, extend the need for ongoing decision making into retirement.

The people reaching SPA over the next ten to fifteen years vary considerably in their pension and non-pension savings and asset portfolios. Within this population, there are segments who will require greater support than others as a result of reaching retirement more reliant on their DC savings to secure an adequate income, with riskier portfolios and potentially lower levels of ability to make financial decisions. The challenges for these segments will be compounded over the next few years as the industry is still responding to the reforms and adjusting to a new type of pension saver who will be allowed to access their savings more flexibly. The defaults in place for these groups may either be actively developed in response to the reforms (for example, new drawdown strategies offered directly by a pension scheme or provider) or may be the “path of least resistance options” made available to them (for example, taking the DC pension as cash, or buying an annuity from their current provider). At this early stage it is unclear which options will be most popular.

PPI segmentation based on key characteristics of people currently aged 50-SPA in England indicate that around 12% of the population analysed (694,000 people) will be at “high-risk” of making poor decisions when they reach SPA if they are not offered support through either guidance and advice or suitable defaults. These are groups with between £19,400 and £51,300 in DC savings and little or no additional DB pension to fall back on). A further 29% (or 1.6 million) people aged 50-SPA in 2014 of people aged 50 to SPA in 2014 will be at “medium risk” of making poor decisions. These are groups with anywhere from £6,300 to above £51,300 in DC savings and little or no additional DB. This means that around 4 in 10 retirees will need significant support over the next ten to fifteen years because they will be dependent to a significant degree on the income from their DC savings in retirement to supplement their state pension, have little other savings and assets to fall back on, have low levels of financial skill and engagement, and are less likely to already use a financial adviser or be actively targeted by financial advisers in the current market given the size of their pension pots.

There is a particular correlation between having low levels of numeracy and low or no DB savings to supplement their DC savings. Those with low levels of numeracy will find decisions about accessing pension savings particularly challenging but they are also unable to fall back on a secure source of private pension income in the form of an indexed DB pension.

The Guidance Guarantee, which will offer the provision of free impartial guidance to those reaching retirement with DC savings will be operational from April 2015, however there are significant concerns regarding what the take-up of the guidance may be, whether the guidance will be able to meet the level of need and the complexity of the different individual and household circumstances, and the likelihood that individuals will follow up on the guidance they receive with timely and appropriate actions. There are intrinsic issues with engaging with people around pension decision-making that are impacted both by their own high levels of uncertainty around their retirement planning and by behavioural barriers which can lead to inertia and a reluctance to actively engage and take decisions. There were already concerns in place about the availability and quality of guidance and support offered to pension savers prior to Budget 2014 and the announcement of the new flexibilities. It is clear that a large number of people will require even more support and assistance once these new flexibilities are in place.

This research has identified around 40%, 2.3 million, people approaching retirement in England with private pension savings over the next ten to fifteen years who will be most in need of assistance and for whom access to these services will be particularly critical if they are to make the most of their available DC savings to support their retirements.

The number of people retiring with DC pots is expected to grow as more people are brought into pension saving through auto-enrolment, but average pot sizes are likely to remain relatively low over the next few years, with the median DC pot size, for those age 50 to SPA, in 2015 at £13,800 and growing to £23,800 by 2024. It will be critical that the people reaching retirement with DC savings over the next few years are given support. Independent and trusted guidance and advice services, beyond the Guidance Guarantee, will need to be made available to people in these medium to high risk groups. The people in these groups will need special targeted support to engage with and act on advice and guidance or they will be at risk of accepting defaults or making decisions that could adversely impact their retirement incomes.

## Appendix: Technical Annex

This appendix describes the assumptions and methodology for the modelling in this report. The modelling presented in this report used the PPI's Dynamic Model which uses projects the possible earnings and pension savings of a data population in order to illustrate the potential outcomes at retirement for that population. The Dynamic Model was developed with a grant from the Nuffield Foundation.

### **The PPI Dynamic Model**

The Dynamic Model is a dynamic micro-simulation model. This means that an initial population of individuals are projected forward from the base year, with each individual being modelled independently by increasing their age, uprating their earnings, modelling the growth in their pension savings as they progress toward retirement.

### **Assumptions**

#### *General assumptions*

The following assumptions are based on standard PPI assumptions setting principles which are the result of consultation with the PPI's external modelling review board. The modelling review board consists of a number of experts in the field of financial modelling.

- Long-term increases in the retail prices index (RPI) of 3.3%
- Long-term increases in the consumer prices index (CPI) of 2%
- Long-term annual earnings growth of 4.4% in nominal terms
- Short-term economic assumptions for RPI, CPI and annual earnings growth in line with Office for Budget Responsibility projections<sup>133</sup>
- Expected investment returns of 6% in nominal terms, before charges, corresponding to a mixed equity/bond fund
- Band salary is the amount of salary on which auto-enrolment minimum contributions must be made. In 2014/15 the band salary is on earnings between £5,772 and £41,865. These are assumed to remain in line with the Lower Earnings Limit and the Upper Earnings Limit
- When auto-enrolled, individuals and their employers are assumed to contribute at the minimum levels required under automatic enrolment legislation (phased in from a combined contribution of 2% of band salary in 2012, rising to 8% of band salary in 2018 in accordance with existing regulations)
- All DC schemes are assumed to levy charges equivalent to a 0.5% annual management charge

<sup>133</sup> OBR (2014)

***Project specific assumptions***

There are further assumptions required, specific to the dynamic model in this exercise:

- Individuals currently in work are able to continue working and saving into a pension scheme until their SPA.
- People who are currently saving in a pension scheme continue to save in that scheme at the same level of contributions or accrual until they retire. This means that it is assumed that people who are members of DB schemes in the base year continue to be members of DB schemes.
- Individuals not currently contributing to a pension, but who will be eligible for auto-enrolment, are auto enrolled into a DC pension in 2014 at the minimum contribution rates (including phasing) required under existing regulations.<sup>134</sup>
- Individuals do not access their private pension savings until their SPA (except in scenarios that explicitly assume otherwise).
- People who are not in employment in the dataset are assumed to remain out of work.

Since 2010 active membership of private sector DB pension schemes has fallen from 2.1 million members in 2010 to 1.6 million members in 2013, whereas active membership of public sector DB pension schemes has remained steady at 5.3 million in both 2010 and 2013.<sup>135</sup> The assumption that members of DB pension schemes continue to accrue DB pensions until SPA, particularly in the private sector, may overstate the amount of DB pension held by individuals at retirement. However if we were to make the assumption that people in this age group experience an end of their DB accrual at the average rate of scheme closure then we have two problems to overcome; we must arbitrarily choose people whose DB accrual ceases, and we may be overstating the closure for this particular age group, which may be more likely to remain active in schemes that are closed to new entrants but still offer accrual for existing members. For these reasons the assumption made is that employees currently in DB pension schemes continue to accrue pension in their existing scheme, recognising that there will be some overestimation of DB entitlement.

**Data**

This project uses individuals in the English Longitudinal Study of Ageing (ELSA) as the dataset from which the individuals modelled are taken. ELSA is an on-going longitudinal study of a range of socio-economic and demographic indicators of households with an individual aged over 50 in England. The results in this report present aggregated analysis of deterministic projections based on current earnings and savings levels in the ELSA Wave 5 dataset (2010) updated to the baseline year of 2014.

<sup>134</sup> Contributions are phased in between 2012 and 2019 to reach 8% minimum total contributions on band earnings by 2019 - between £5,715 and £38,185 (2010/11 earnings terms)

<sup>135</sup> ONS Occupational Pension Schemes Survey 2013

This analysis is based upon data and a set of assumptions regarding future behaviour that may not be fully representative (such as the assumption of remaining with an employer until retirement, or of staying in a DB pension scheme). **As a result of this, the results of the modelling should not be taken as forecasts of future levels of retirement savings but are illustrative of the range of household outcomes and broad sizes of different segments.**

The data used in the model consists of two types of variables; those that are required to describe individuals' earning and pension saving circumstances for projections, and data that is used for making comparisons based on characteristics.

The most important variables considered for the purposes of projecting each individual concern:

- Earnings
- Age
- Pension contributions
- Current and deferred pension entitlement

The required data is not always available, as ELSA contains incomplete data on the level of deferred pension entitlement. In order to estimate this, broad assumptions on average contribution levels, investment returns and accrual rates were used in conjunction with available data on pension type, dates of scheme membership and current gross salary. Where scheme membership and salary data were unavailable, values were randomly assigned using a 'hot-decking' procedure based on the financial wealth quintile of the individual. This method is the approach used by the IFS in their paper *Estimating Pension wealth of ELSA Respondents*.<sup>136</sup>

### **Variables used for the purpose of making comparisons**

The analysis in this report uses other variables from ELSA to consider the distribution of individuals and couples by certain characteristics. The following data variables were taken from the ELSA dataset for this purpose.

- Benefit unit income quintile - This variable is based on the ranking of benefit units (either a couple or a single person) by their equivalised incomes from earnings, state benefits, investments, pensions in payment. It uses the income distribution of all the respondent households in ELSA, so includes those in retirement.
- Socio economic class (NS-SEC5) - This measure of socio-economic group is based on employment occupation, split into 5 categories in accordance with the Office for National Statistics groupings.
- Numeracy - In Wave 4 of ELSA the respondents were asked a series of numerical questions of progressive difficulty and awarded a score based on their performance. The question was not repeated in Wave 5 of the questionnaire so, by taking advantage of the longitudinal nature

<sup>136</sup> Banks, Emmerson, Tetlow (2005)



of ELSA, only individuals who had previously answered numeracy questions in wave 4 were included in numeracy analysis.

The numeracy questions consisted of three initial questions:

1. A sofa costs £300. How much would it cost in a half-price sale?
2. How many of 1000 people would be expected to get a disease if the chance is 10%?
3. A car is on sale at £6000, two-thirds of the cost new. What was the cost new?

The results of these first three questions then decided which route the numeracy test would take.

If the first three questions were answered incorrectly question 4 was asked, then the numeracy test was over:

4. How much change would you get from buying an 85p drink with a £1 coin?

If at least one of the first three questions was answered correctly, following question was asked:

5. How much would 5 people get with winning lottery numbers and a prize of £2m?

If at least one of questions 2, 3 or 5 was answered correctly the following question was asked:

6. How much would you have in an account from £200 after 2 years if the account pays 10% interest a year?

The respondent is then allocated a score. Credit for question 4 was given to those who were asked questions 5 and 6.

- Educational qualification - highest level of educational qualification achieved.
- Investments held - The ELSA data contains information about the assets held by respondents. The report does not distinguish between the amounts of the assets held as it is being used as a measure of familiarity, whereas amount is more likely correlated with opportunity. These investments were grouped into the categories used in the report as follows.
  1. Bank account - bank current account
  2. Basic savings - Savings account, Premium bonds, National Savings products
  3. More advanced savings - ISAs, TESSAs and PEPs
  4. Direct market investment - holdings in equities, bonds/gilts, unit/investment trust, share clubs and also included were any share reward schemes from their employer.
- Pension scheme information sources - respondents to ELSA were asked to identify the sources of information that they had used when making decisions about their pension savings.

### *Methodology*

This section provides a brief description of the method used in this modelling.

The individuals considered in the modelling work are those in the 2010 ELSA Wave 5 dataset, aged between 50 and SPA, belonging to a Benefit Unit<sup>137</sup> that has at least one member still in work, who is either currently a member of a pension scheme, has some pension savings or who is in employment and would be eligible to be auto enrolled. This sample consists of approximately 2,800 individuals aged 50-SPA who fitted the criteria to be included.

Automatic enrolment is assumed to occur in 2014 for all employees, however in reality there is staging of the automatic enrolment process between 2012 and 2017 for existing employers, based on the size of the employer's workforce. The ELSA data does not include information on the size of the workforce of an individual's employer. In the interest of simplicity and to include as many of the individuals in the data as possible, it was decided that a midpoint date, slightly biased to the earlier larger employers, of 2014 would be assumed as the automatic enrolment date for all relevant employees in the dataset. The use of this assumption is supported also supported by the rate at which employees have so far been auto-enrolled into pension schemes. The DWP projects a target number of auto-enrolled employees of 10 million employees, so far, up to October 2014, just under 5 million employees have been auto-enrolled suggesting that the median employee will be automatically enrolled by the end of 2014, or in early 2015.

The financial data has been adjusted to make it consistent with 2014 earnings levels, which is taken as the base year for the model. In subsequent years of the projection, individuals are aged and their earnings increased in line with average earnings growth.

In each year of the projection, potential retirement funds or incomes for each individual are calculated, based upon the projected level of current and deferred private pension entitlement. These are then converted into Benefit Unit incomes, by matching individuals with their partners.

Having calculated the level of individuals' pension savings in defined contribution pension schemes and/or any accrual they have in defined benefit pension schemes, the individuals were assigned into quintiles based on their savings separately for each type of saving they have. The individuals were then cross tabulated with each of the comparison variables above to produce the results set out in the report.

<sup>137</sup> In this analysis, a benefit unit is considered to consist of either a single adult or a couple living in the same household.

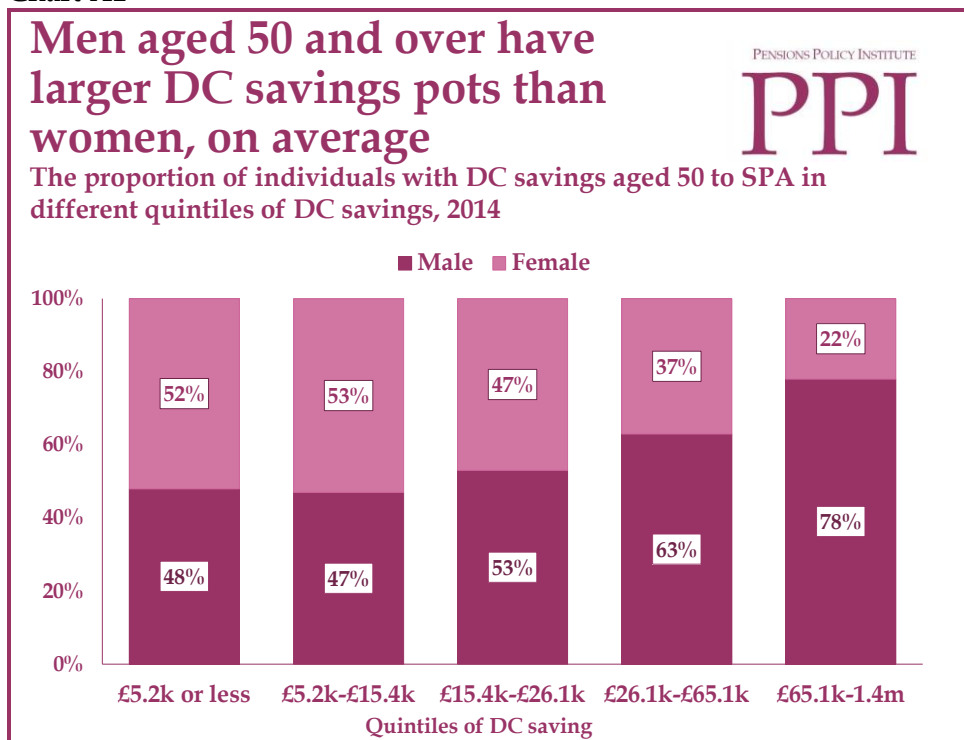
## Appendix 2:

The following charts and tables investigate the data in more detail

### Levels of DB and DC saving are not evenly distributed between men and women

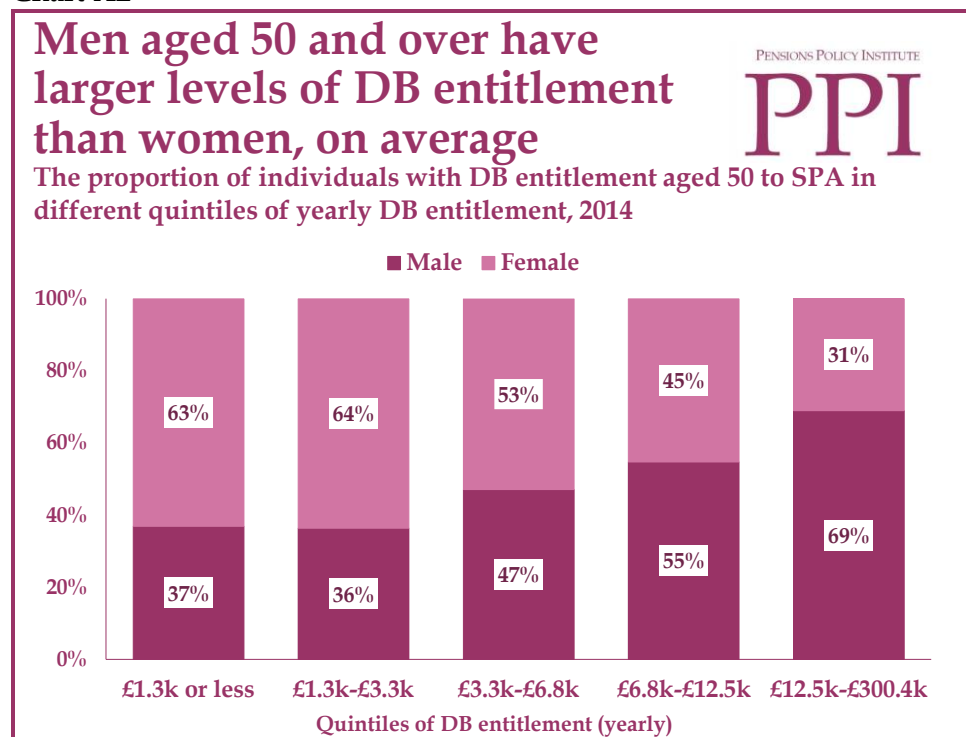
Women with DC savings or DB entitlement are more likely to be in the lower quintiles of savings than men. In 2014, among men and women aged 50 to SPA with DC savings, women disproportionately dominated the lower quintiles, with the lowest quintile being made up of 52% women and the highest quintile being made up of only around a quarter women. Women were also more highly represented in the lower quintiles of DB entitlement with the lowest quintile constituting 63% women and the highest quintile containing 31% women (Chart A1, A2). Though women were more likely to be represented in the higher quintiles of DB entitlement than in the higher quintiles of DC savings, perhaps because public sector jobs contain more women than men.

Chart A1<sup>138</sup>



<sup>138</sup> PPI Dynamic Model

Chart A2<sup>139</sup>

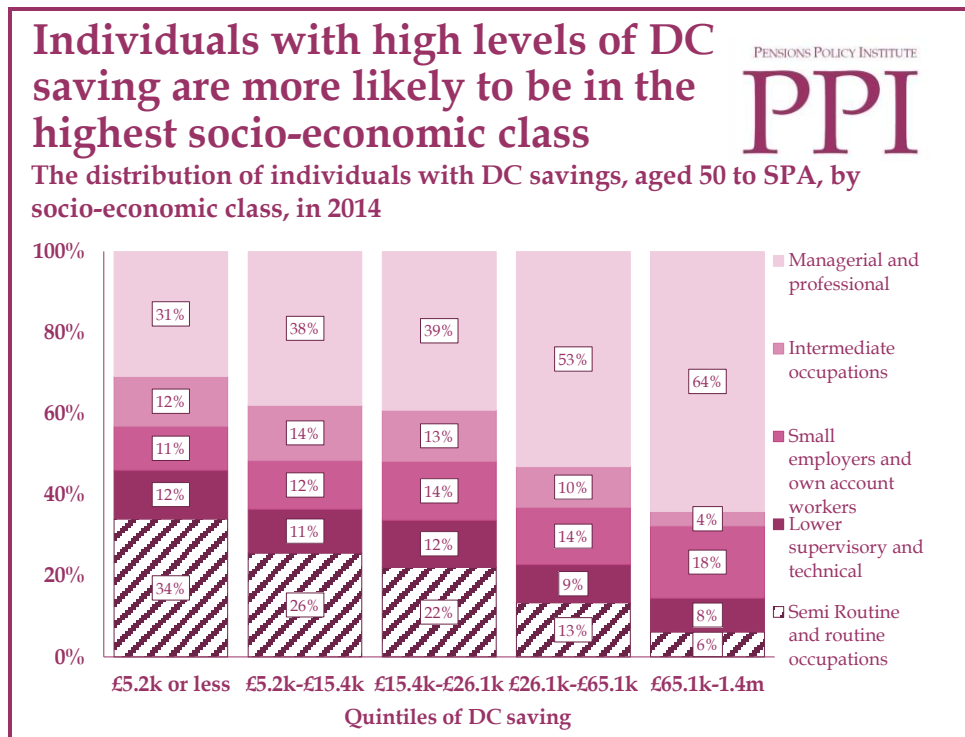


<sup>139</sup> PPI Dynamic Model

**People in higher socio-economic classes are more likely to be represented in higher quintiles of DC savings**

Socio-economic class is also associated with higher levels of DC pension savings. People in the highest socio-economic class (using occupation as a proxy measure) represented around 64% of those in the highest quintile of DC savings and only around 31% of those in the lowest quintile. The lowest socio-economic class represented around 34% of those in the lowest quintile of DC savings and only around 6% of the highest quintile (Chart A3).

**Chart A3**<sup>140</sup>



**This report uses several indicators to measure financial skill and engagement**

There is no direct measure of financial capability. This report uses indirect proxy indicators, (though flawed as sole indicators because each indicator such as education or numeracy can be correlated with many other measures) to measure financial skill and engagement. Seen as a group, these indicators can give some insight as to the levels of financial skill and knowledge that people with different levels of pension saving and entitlement have. This report uses four proxy indicators: financial engagement, access to information, education level and numeracy.

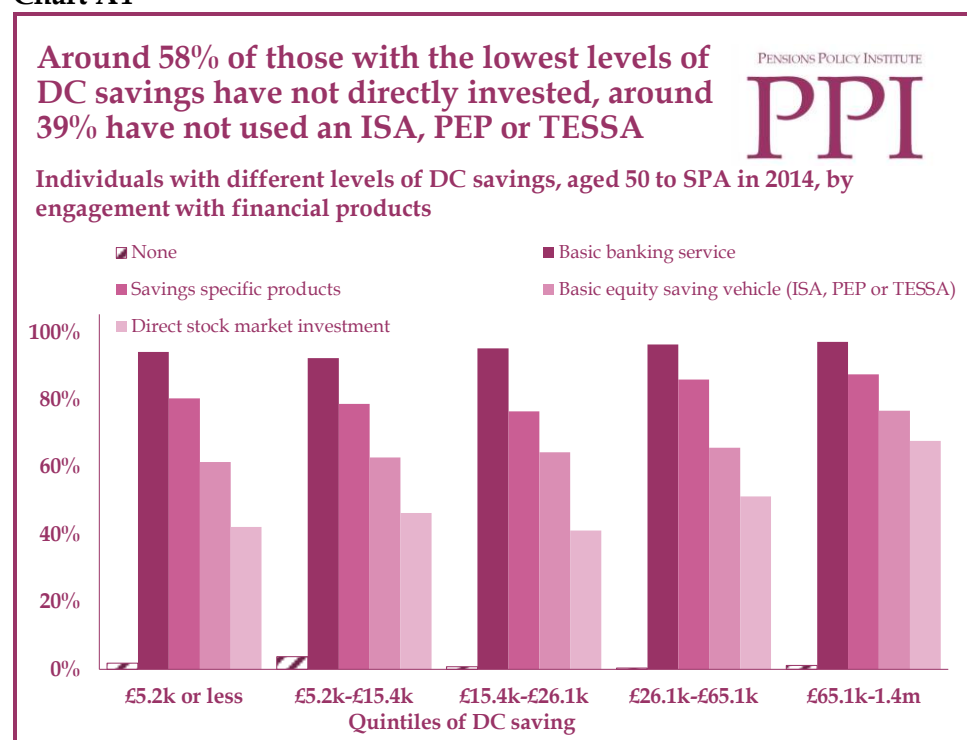
**Around 58% of those with the lowest levels of DC savings have not directly invested, around 39% have not used an ISA, PEP or TESSA**

Engaging with financial products can indicate the level of experience and knowledge people have of the market. People with direct experience of investing

<sup>140</sup> PPI Dynamic Model

are likely to have a more sophisticated understanding of how the market works than those only with no experience or only experience of a basic bank account. People with lower levels of DC savings are less likely to have direct engagement with a range of financial products. Among those with the lowest levels of DC saving, only around 42% have had experience of direct market investment and only around 61% have used a basic equity saving vehicle such as an ISA, PEP or TESSA. While around 68% of those with the highest levels of DC saving have direct investment experience (Chart A4).

**Chart A4**<sup>141</sup>



### **Around 80% of people get information on pensions from their scheme**

Advice and information may help support those making decisions in retirement, though not all sources will give equally tailored advice. Independent Financial Advice, which is regulated and must be paid for, will involve personal, tailored advice on the best course of action for an individual. Because of the cost attached, however, Independent Financial Advice is not accessible for all people. Advice or information from people or organisations who are not necessarily experts on pensions may be less helpful than advice from an adviser or accountant, or information or advice from a scheme or a guidance service such as The Pensions Advisory Service.

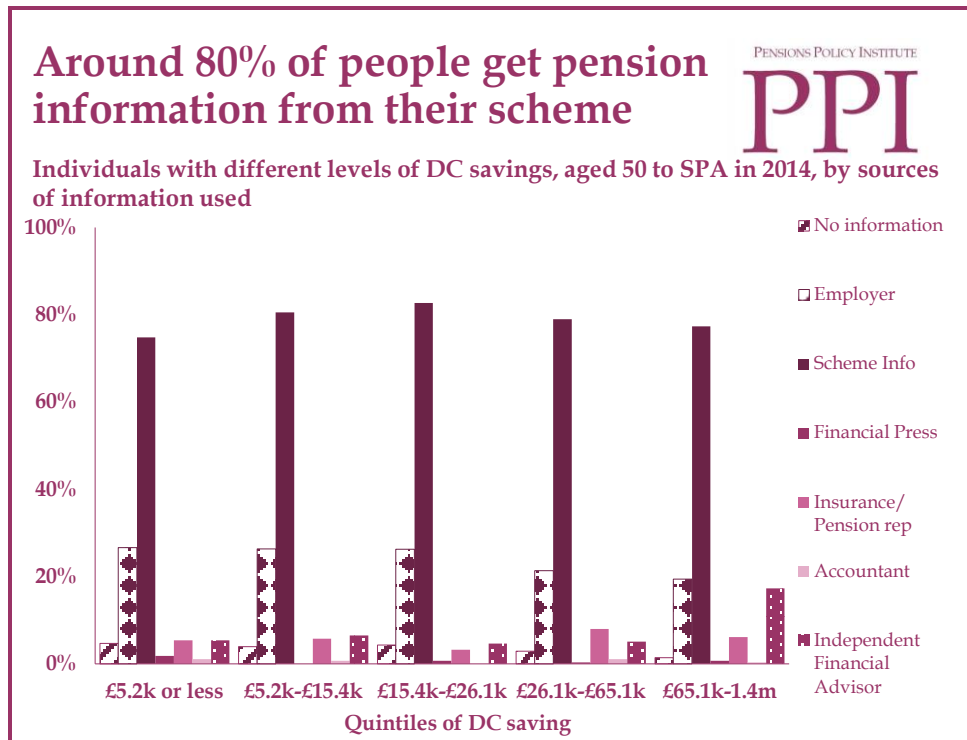
Around 80% of people in all DC saving quintiles used their scheme as a source of information and between 20% to 30% of people in each category of DC savings used their employer as a source of information. Those with lower levels of DC

<sup>141</sup> PPI Dynamic Model

pension saving were more likely to use their employer as a source of information than those with higher levels but less likely to use their scheme.

Those in the highest quintile of DC savings were most likely to report using an Independent Financial Adviser, but this was still a low level at just under 20%. Other sources of information such as the financial press, insurance representatives and accountants were not used very much by any group. Those with the lowest quintile of DC savings were most likely to report receiving no information on pensions (Chart A5).

Chart A5<sup>142</sup>

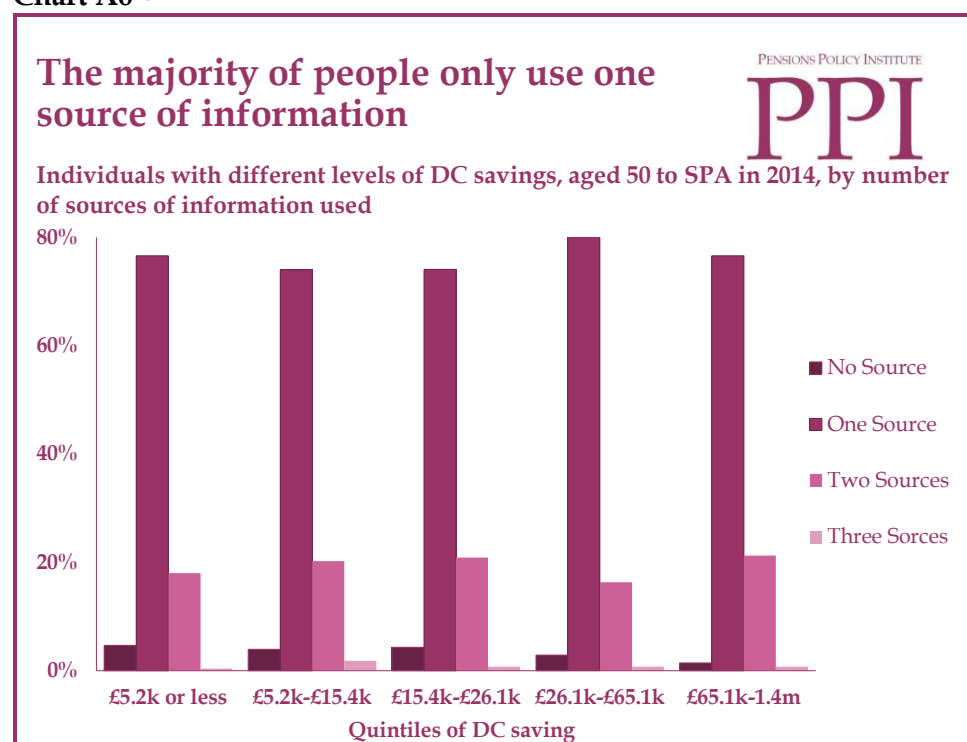


<sup>142</sup> PPI Dynamic Model

### The majority of people only use one source of information for pensions

Around 80% of people in most quintiles of DC savings only use one source of information for pensions; this is most likely to be their pension scheme. Around 20% of people in all quintiles of savings used two sources of information (Chart A6). It was very uncommon for people to use more than two sources of information on pensions. As pension schemes and employers were the most used sources of information, these are likely to be the two sources that most people used.

Chart A6<sup>143</sup>

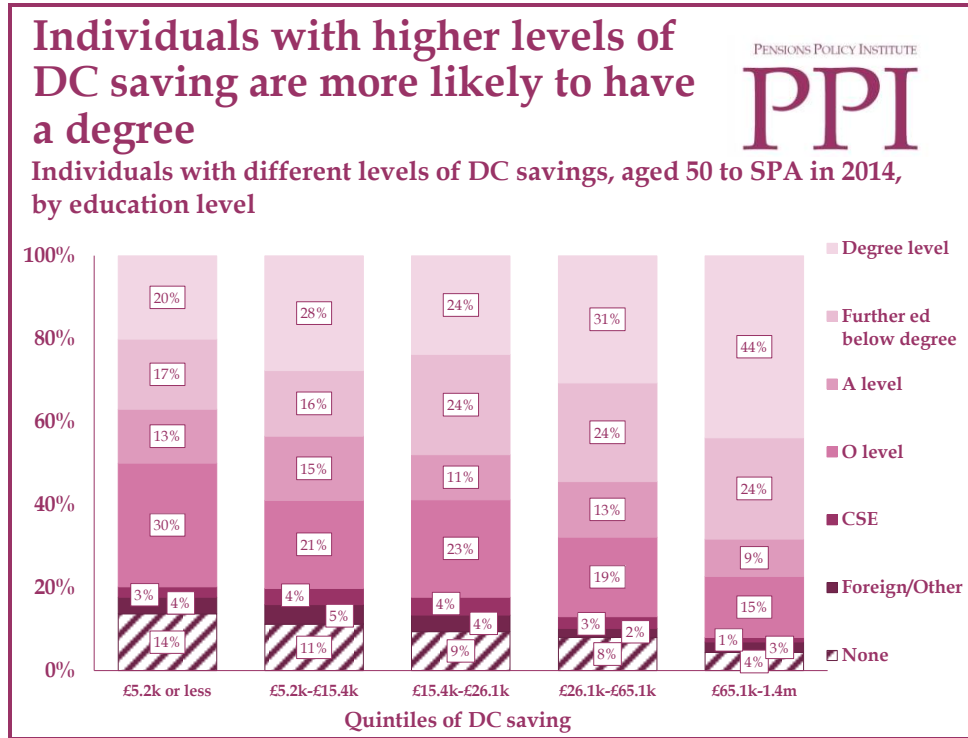


Levels of education may impact on people's ability to understand and engage with pension saving and decisions on accessing pensions in retirement. Basic skills in literacy and maths are necessary for understanding some of the complex issues involved in accessing DC pension savings. People with higher levels of DC saving are more likely to have a degree than people in the lower quintiles of DC saving. Around 44% of those in the top quintile of DC saving have a degree while only 20% of the lowest quintile have a degree. Around 68% of those in the top quintile of DC saving have further education of some description, compared to around 37% in the bottom quintile (Chart A7).

<sup>143</sup> PPI Dynamic Model



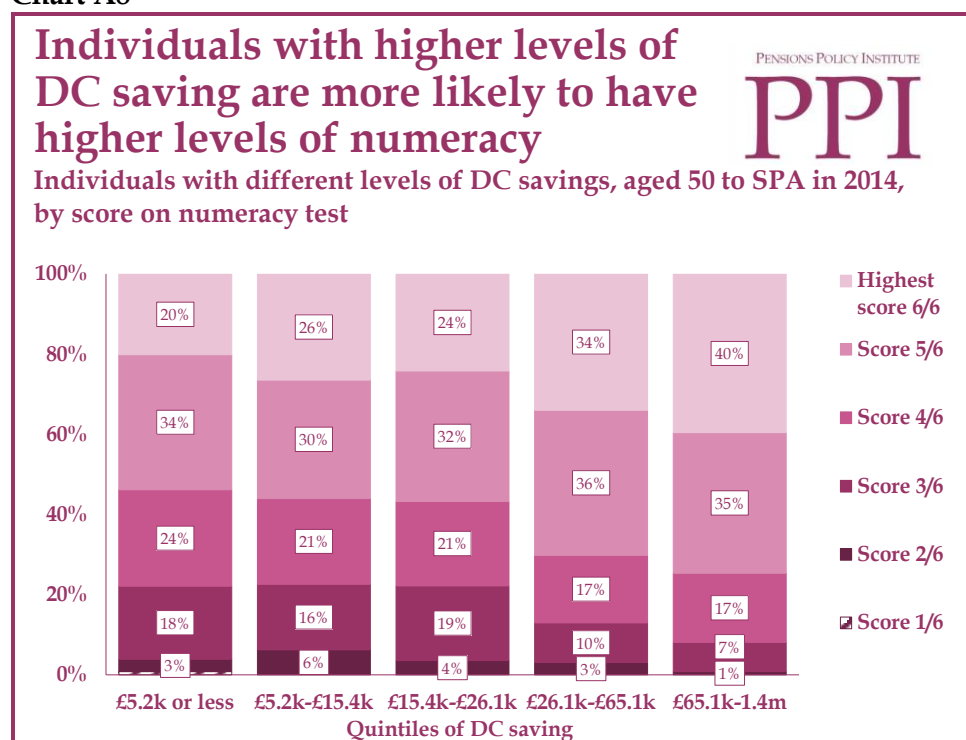
Chart A7<sup>144</sup>



<sup>144</sup> PPI Dynamic Model

Levels of numeracy in particular have been found to have correlations with ability to understand pension arrangements.<sup>145</sup> Those with higher levels of DC saving are more likely to score well on tests of numeracy. 40% of those with the highest quintiles of DC saving answered a question correctly which tested understanding of compound interest. Only around 20% of those with the lowest level of DC savings answered this question correctly (Chart A8).

Chart A8<sup>146</sup>



<sup>145</sup> BIS (2013) p. 58

<sup>146</sup> PPI Dynamic Model

Table A1

Individual savings portfolios	Socio-economic class		Non-pension savings and assets	
<i>People aged 50 to SPA in 2014 with some DC or DB savings -aged to their individual pension age (5.7m people)</i>				
<b>25<sup>th</sup> percentile or less of DC savings + No DB savings</b>  (655,700 people, 12% of total)	Managerial/professional	22%	£130,200 to £10,223,500	20%
	Intermediate	13%	£40,200 to £130,200	23%
	Small employers	5%	£11,000 to £40,200	14%
	Lower supervisory/technical	13%	£1,000 to £11,000	17%
	Semi routine/routine	46%	less than £1000	26%
<b>25<sup>th</sup> percentile or less of DC savings + 50<sup>th</sup> percentile or less of DB entitlement</b>  (1,109,600 people, 19% of total)	Managerial/professional	33%	£130,200 to £10,223,500	24%
	Intermediate	19%	£40,200 to £130,200	22%
	Small employers	8%	£11,000 to £40,200	19%
	Lower supervisory/technical	7%	£1,000 to £11,000	16%
	Semi routine/routine	32%	less than £1000	19%
<b>25<sup>th</sup> percentile or less of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  (1,258,900 people, 22% of total)	Managerial/professional	57%	£130,200 to £10,223,500	43%
	Intermediate	14%	£40,200 to £130,200	27%
	Small employers	7%	£11,000 to £40,200	16%
	Lower supervisory/technical	8%	£1,000 to £11,000	8%
	Semi routine/routine	14%	less than £1000	7%
<b>25<sup>th</sup> to 50<sup>th</sup> percentile of DC savings + No DB savings</b>  (669,800 people, 12% of total)	Managerial/professional	33%	£130,200 to £10,223,500	21%
	Intermediate	14%	£40,200 to £130,200	21%
	Small employers	10%	£11,000 to £40,200	18%
	Lower supervisory/technical	10%	£1,000 to £11,000	15%
	Semi routine/routine	33%	less than £1000	25%
<b>25<sup>th</sup> to 50<sup>th</sup> percentile of DC savings +</b>	Managerial/professional	44%	£130,200 to £10,223,500	15%
	Intermediate	18%	£40,200 to £130,200	25%

<b>50<sup>th</sup> percentile or less of DB entitlement</b>  <b>(143,200 people, 3% of total)</b>	Small employers	1%	£11,000 to £40,200	30%
	Lower supervisory/ technical	10%	£1,000 to £11,000	8%
	Semi routine/ routine	27%	less than £1000	21%
<b>Individual savings portfolios</b>	<b>Socio-economic class</b>		<b>Non-pension savings and assets</b>	
<b>25<sup>th</sup> to 50<sup>th</sup> percentile of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  <b>(78,700 people, 1% of total)</b>	Managerial/ professional	44%	£130,200 to £10,223,500	46%
	Intermediate	21%	£40,200 to £130,200	26%
	Small employers	8%	£11,000 to £40,200	13%
	Lower supervisory/ technical	13%	£1,000 to £11,000	8%
	Semi routine/ routine	15%	less than £1000	8%
<b>50<sup>th</sup> to 75<sup>th</sup> percentile of less of DC savings + No DB savings</b>  <b>(694,000 people, 12% of total)</b>	Managerial/ professional	39%	£130,200 to £10,223,500	21%
	Intermediate	12%	£40,200 to £130,200	25%
	Small employers	15%	£11,000 to £40,200	22%
	Lower supervisory/ technical	12%	£1,000 to £11,000	17%
	Semi routine/ routine	22%	less than £1000	16%
<b>50<sup>th</sup> to 75<sup>th</sup> percentile of DC savings + 50<sup>th</sup> percentile or less of DB entitlement</b>  <b>(125,100 people, 2% of total)</b>	Managerial/ professional	53%	£130,200 to £10,223,500	31%
	Intermediate	16%	£40,200 to £130,200	32%
	Small employers	6%	£11,000 to £40,200	15%
	Lower supervisory/ technical	8%	£1,000 to £11,000	10%
	Semi routine/ routine	16%	less than £1000	13%
<b>50<sup>th</sup> to 75<sup>th</sup> percentile of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  <b>(70,600 people, 1% of total)</b>	Managerial/ professional	74%	£130,200 to £10,223,500	34%
	Intermediate	3%	£40,200 to £130,200	37%
	Small employers	3%	£11,000 to £40,200	20%
	Lower supervisory/ technical	3%	£1,000 to £11,000	3%
	Semi routine/ routine	17%	less than £1000	6%

Individual savings portfolios	Socio-economic class		Non-pension savings and assets	
	75 <sup>th</sup> to 100 <sup>th</sup> percentile of DC savings + No DB savings  (706,100 people, 12% of total)	Managerial/professional	60%	£130,200 to £10,223,500
Intermediate		7%	£40,200 to £130,200	24%
Small employers		15%	£11,000 to £40,200	13%
Lower supervisory/technical		10%	£1,000 to £11,000	12%
Semi routine/routine		8%	less than £1000	11%
75 <sup>th</sup> to 100 <sup>th</sup> percentile of DC savings + 50 <sup>th</sup> percentile or less of DB entitlement  (108,900 people, 2% of total)	Managerial/professional	61%	£130,200 to £10,223,500	44%
	Intermediate	9%	£40,200 to £130,200	28%
	Small employers	9%	£11,000 to £40,200	9%
	Lower supervisory/technical	7%	£1,000 to £11,000	9%
	Semi routine/routine	13%	less than £1000	9%
75 <sup>th</sup> to 100 <sup>th</sup> percentile of DC savings + 50 <sup>th</sup> to 100 <sup>th</sup> percentile of DB entitlement  (76,700 people, 1% of total)	Managerial/professional	89%	£130,200 to £10,223,500	45%
	Intermediate	3%	£40,200 to £130,200	32%
	Small employers	3%	£11,000 to £40,200	13%
	Lower supervisory/Technical	5%	£1,000 to £11,000	8%
	Semi routine/routine	0%	less than £1000	3%

Table A2

Individual savings portfolios	Education levels		Score on numeracy test		Experience with financial products		Information source	
	<i>People aged 50 to SPA in 2014 with some DC or DB savings -aged to their individual pension age (5.7m people)</i>							
25 <sup>th</sup> percentile or less of DC savings + No DB savings  (655,700 people, 12% of total)	Degree level	16%	6/6	16%	Direct stock market investment	21%	IFA	5%
	Further education below degree	13%	5/6	30%	ISA, PEP or TESSA	55%	Accountant	1%
	A level	14%	4/6	26%	Savings specific product	47%	Insurance representative	4%
	O level	29%	3/6	20%	Basic banking	92%	Financial press	2%

	CSE	4%	2/6	7%	none		Scheme information	68%
	Foreign/Other	6%	1/6	0%			Employer	24%
	None	18%	0/6	0%		3%	Co-worker	0%
							None	8%
<b>Individual savings portfolios</b>	<b>Education levels</b>		<b>Score on numeracy test</b>		<b>Experience with financial products</b>		<b>Information source</b>	
<b>25<sup>th</sup> percentile or less of DC savings + 50<sup>th</sup> percentile or less of DB entitlement</b>  <b>(1,109,600 people, 19% of total)</b>	Degree level	21%	6/6	20%	Direct stock market investment	29%	IFA	1%
	Further education below degree	15%	5/6	32%	ISA, PEP or TESSA	58%	Accountant	0%
	A level	14%	4/6	23%	Savings specific product	47%	Insurance representative	3%
	O level	25%	3/6	19%	Basic banking	94%	Financial press	1%
	CSE	3%	2/6	6%	none	2%	Scheme information	66%
	Foreign/Other	7%	1/6	0%			Employer	32%
	None	15%	0/6	0%			Co-worker	0%
						None	11%	
<b>25<sup>th</sup> percentile or less of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  <b>(1,258,900 people, 22% of total)</b>	Degree level	39%	6/6	34%	Direct stock market investment	38%	IFA	1%
	Further education below degree	22%	5/6	39%	ISA, PEP or TESSA	68%	Accountant	0%
	A level	11%	4/6	16%	Savings specific product	39%	Insurance representative	3%
	O level	18%	3/6	9%	Basic banking	97%	Financial press	0%
	CSE	2%	2/6	1%	none	1%	Scheme information	75%
	Foreign/Other	3%	1/6	0%			Employer	27%
	None	6%	0/6	0%			Co-worker	0%
						None	7%	
<b>25<sup>th</sup> to 50<sup>th</sup> percentile of DC savings + No DB savings</b>  <b>(669,800 people, 12% of total)</b>	Degree level	20%	6/6	18%	Direct stock market investment	24%	IFA	6%
	Further education below degree	14%	5/6	27%	ISA, PEP or TESSA	52%	Accountant	1%
	A level	14%	4/6	25%	Savings specific product	46%	Insurance representative	5%
	O level	25%	3/6	24%	Basic banking	95%	Financial press	0%

	CSE	3%	2/6	5%	none		Scheme information	74%
	Foreign/Other	6%	1/6	0%			Employer	25%
	None	19%	0/6	0%		2%	Co-worker	0%
							None	4%
<b>Individual savings portfolios</b>	<b>Education levels</b>		<b>Score on numeracy test</b>		<b>Experience with financial products</b>		<b>Information source</b>	
<b>25<sup>th</sup> to 50<sup>th</sup> percentile of DC savings + 50<sup>th</sup> percentile or less of DB entitlement</b>  <b>(143,200 people, 3% of total)</b>	Degree level	30%	6/6	34%	Direct stock market investment	36%	IFA	4%
	Further education below degree	16%	5/6	27%	ISA, PEP or TESSA	67%	Accountant	1%
	A level	10%	4/6	30%	Savings specific product	52%	Insurance representative	7%
	O level	34%	3/6	9%	Basic banking	94%	Financial press	1%
	CSE	1%	2/6	0%	none	3%	Scheme information	76%
	Foreign/Other	3%	1/6	0%			Employer	33%
			0/6	0%			Co-worker	0%
	None	6%	0/6	0%			None	6%
<b>25<sup>th</sup> to 50<sup>th</sup> percentile of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  <b>(78,700 people, 1% of total)</b>	Degree level	38%	6/6	35%	Direct stock market investment	41%	IFA	0%
	Further education below degree	23%	5/6	54%	ISA, PEP or TESSA	49%	Accountant	0%
	A level	15%	4/6	8%	Savings specific product	28%	Insurance representative	5%
	O level	18%	3/6	3%	Basic banking	97%	Financial press	0%
	CSE	3%	2/6	0%	none	0%	Scheme information	90%
	Foreign/Other	3%	1/6	0%			Employer	23%
			0/6	0%			Co-worker	0%
	None	0%	0/6	0%			None	5%
<b>50<sup>th</sup> to 75<sup>th</sup> percentile of less of DC savings + No DB savings</b>  <b>(694,000 people, 12% of total)</b>	Degree level	23%	6/6	25%	Direct stock market investment	27%	IFA	5%
	Further education below degree	24%	5/6	32%	ISA, PEP or TESSA	56%	Accountant	0%
	A level	14%	4/6	23%	Savings specific product	46%	Insurance representative	6%
	O level	24%	3/6	16%	Basic banking	96%	Financial press	1%

	CSE	5%	2/6	5%	none		Scheme information	75%
	Foreign/Other	3%	1/6	0%			Employer	28%
			0/6				Co-worker	0%
	None	9%		0%		1%	None	6%
<b>Individual savings portfolios</b>	<b>Education levels</b>		<b>Score on numeracy test</b>		<b>Experience with financial products</b>		<b>Information source</b>	
<b>50<sup>th</sup> to 75<sup>th</sup> percentile of DC savings + 50<sup>th</sup> percentile or less of DB entitlement</b>  <b>(125,100 people, 2% of total)</b>	Degree level	34%	6/6	33%	Direct stock market investment	26%	IFA	8%
	Further education below degree	15%	5/6	43%	ISA, PEP or TESSA	59%	Accountant	0%
	A level	10%	4/6	17%	Savings specific product	59%	Insurance representative	0%
	O level	27%	3/6	7%	Basic banking	98%	Financial press	3%
	CSE	3%	2/6	0%	none		Scheme information	89%
	Foreign/Other	5%	1/6	0%			Employer	31%
			0/6				Co-worker	0%
	None	6%		0%		0%	None	2%
<b>50<sup>th</sup> to 75<sup>th</sup> percentile of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  <b>(70,600 people, 1% of total)</b>	Degree level	49%	6/6	47%	Direct stock market investment	33%	IFA	6%
	Further education below degree	17%	5/6	41%	ISA, PEP or TESSA	64%	Accountant	0%
	A level	14%	4/6	9%	Savings specific product	48%	Insurance representative	9%
	O level	11%	3/6	3%	Basic banking	88%	Financial press	0%
	CSE	6%	2/6	0%	none		Scheme information	83%
	Foreign/Other	0%	1/6	0%			Employer	23%
			0/6				Co-worker	0%
	None	3%		0%		3%	None	3%
<b>75<sup>th</sup> to 100<sup>th</sup> percentile of DC savings + No DB savings</b>  <b>(706,100 people, 12% of total)</b>	Degree level	37%	6/6	35%	Direct stock market investment	37%	IFA	14%
	Further education below degree	26%	5/6	35%	ISA, PEP or TESSA	59%	Accountant	1%
	A level	10%	4/6	16%	Savings specific product	43%	Insurance representative	8%



	O level	19%	3/6	11%	Basic banking	96%	Financial press	1%
	CSE	2%	2/6	2%	none	1%	Scheme information	75%
	Foreign/Other	2%	1/6	0%			Employer	20%
	None	5%	0/6	0%			Co-worker	0%
							None	1%
<b>Individual savings portfolios</b>	<b>Education levels</b>		<b>Score on numeracy test</b>		<b>Experience with financial products</b>		<b>Information source</b>	
<b>75<sup>th</sup> to 100<sup>th</sup> percentile of DC savings + 50<sup>th</sup> percentile or less of DB entitlement</b>  <b>(108,900 people, 2% of total)</b>	Degree level	41%	6/6	44%	Direct stock market investment	46%	IFA	9%
	Further education below degree	22%	5/6	37%	ISA, PEP or TESSA	50%	Accountant	0%
	A level	17%	4/6	13%	Savings specific product	43%	Insurance representative	2%
	O level	15%	3/6	6%	Basic banking	98%	Financial press	0%
	CSE	2%	2/6	0%	none	0%	Scheme information	80%
	Foreign/Other	0%	1/6	0%			Employer	33%
	None	4%	0/6	0%			Co-worker	0%
							None	0%
<b>75<sup>th</sup> to 100<sup>th</sup> percentile of DC savings + 50<sup>th</sup> to 100<sup>th</sup> percentile of DB entitlement</b>  <b>(76,700 people, 1% of total)</b>	Degree level	68%	6/6	51%	Direct stock market investment	37%	IFA	8%
	Further education below degree	16%	5/6	37%	ISA, PEP or TESSA	55%	Accountant	0%
	A level	13%	4/6	9%	Savings specific product	45%	Insurance representative	3%
	O level	0%	3/6	3%	Basic banking	100%	Financial press	0%
	CSE	0%	2/6	0%	none	0%	Scheme information	92%
	Foreign/Other	0%	1/6	0%			Employer	21%
	None	3%	0/6	0%			Co-worker	0%
							None	0%

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## Introduction

New pension flexibilities have brought an increased focus on issues around financial education and the ability of individuals to make the necessary decisions.

After briefly exploring the pensions decisions that UK individuals are required to make, this note considers some international examples of financial education (summarised in Chart 1) to illustrate other approaches that could be adopted in the UK.

The international examples included in this briefing note are:

- Financial education during accumulation (Denmark)
- Pensions Dashboard (Sweden)
- Sorted website (New Zealand)
- Three Pensions Days (Netherlands)
- Auto-escalation (United States)

These examples are explored in more depth in the remainder of the Briefing Note along with points of particular relevance to the UK.

## Chart 1: Overview of approaches to communication taken by a selection of countries<sup>1</sup>

Country	Approach taken to communication	Outcome
Denmark	Provision of information such as statements that includes less text and jargon following the recommendations of the Money and Pensions Panel	An evaluation round the provision of information by the Danish Insurance Association found that 74% and 66% of respondents were satisfied with the amount of information that they received about their personal pension and occupational pension respectively
Sweden	Pensions Dashboard that enables individuals to see all of their pension entitlements together	No specific evaluation: Sweden scores 81.6 on the integrity index for the Mercer Global Pension Index
New Zealand	Sorted website, with a familiar tone, that covers pensions alongside other issues	Reported saving rates in 2005 were at the highest level since 1995 with 72% of people surveyed saying that they (or someone else on their behalf) were saving for retirement (though this may not be due to the Sorted website only)
Netherlands	Three Pensions Days every October alongside the provision of information in a layered way	No specific evaluation: Netherlands scores highly (89.4 compared to an average of 71.9) on the integrity index (that includes quality of communications) for the Mercer Global Pension Index
United States	Auto-escalation: Save More Tomorrow initiative in which individuals sign up to increase their pension contributions in future years	In one US 401k (DC) scheme with SMarT features, employees increased their pension contributions from 3.5% to 13.6% of salary over a four and a half year period. Take-up has tended to be higher where individuals are provided with financial advice



## Decisions during accumulation phase

Individuals might need to take into account a variety of factors during the savings or growth phase. While some of these relate to financial factors such as investment returns and risk, they interact with other factors such as the desired retirement date and life expectancy to determine what might be a suitable accumulation strategy.

The use of defaults can be effective during the accumulation phase to address, at least partially, certain factors such as under-saving for retirement.

The emphasis of government policy has been on these defaults rather than on financial education, with an emphasis on the roll out of pension savings via automatic enrolment that relies on inertia. This is based on the fact that, for the target population, making or increasing pension contributions is likely to be in their best interests but they are unlikely to take action on this, if left to their own devices.

## Decisions around how to access pension savings

Chart 2 shows some of the factors that individuals might need to take into account when deciding

how to access their pension savings in retirement.

While this phase has sometimes been portrayed as a 'decumulation' phase, the pension funds of those individuals using drawdown products are still accumulating returns while they have the ability to make withdrawals. The pension flexibilities mean that the transition from the accumulation to the decumulation phase may become increasingly blurred.

Decisions during decumulation take into account some of the same factors as for accumulation;

## Chart 2: Factors to take into account when deciding how to access retirement income

### Factors to take into account - accessing savings

- Ways in which pension funds can be accessed, e.g. income drawdown
- Tax-free lump sum
- Types of annuity (e.g. fixed, indexed, enhanced)
- Annuity rates
- Tax rules, e.g. around trivial commutation



### Decisions

- When to retire
- When to access retirement savings
- How to access retirement savings



### Personal factors that will affect decisions around accessing retirement income

- Living circumstances (e.g. single or part of a couple)
- Factors related to life expectancy
- Likely retirement date

life expectancy, investment returns and risk. These also include other financial factors such as the level of income that is required and when health issues may occur. The combination of all of these factors makes retirement planning challenging.

For this reason, it is important that individuals are either provided with good defaults to nudge them towards decisions, or to acquire skills that allow them to address at least some of the major decisions around retirement.

### Resources available to UK individuals

An overview of resources available to a UK pension saver is shown in Chart 3. The written form (letters, pamphlets, analysis, etc.) about both the pension system in general and about their own pension provision, has generally been the medium used to convey information. However, there is a growing appreciation that this is not sufficient.

The developments in the pension world, where an increasing range of retirement patterns means that there is a greater variation in how individuals approach and deal with retirement, is generating similar issues. This means that the communication of the options available needs to engage individuals with a wide range of financial literacy if sub-optimal outcomes are to be avoided.

How do other countries address the financial awareness and education?

This report uses the Mercer Global Pension Index<sup>2</sup> to provide some insight into the effectiveness of the approaches used (where no formal evaluation has been conducted). Specifically, it uses the integrity sub-index, which considers communication amongst other areas such as regulation and governance.

Information tends to be more generic

## Chart 3: Information sources available to employers, pension professionals and individuals

**For employers/pension professionals**

**For individuals**

Pension providers

Pension Wise (The Pensions Advisory Service, Citizens Advice)  
Independent Financial Advisors

Employers, Money Advice Service, phone or web based services including non-advised guidance and online annuity rate comparison sites, Age UK

Department for Work and Pensions, Her Majesty's Revenue and Customs, The Financial Conduct Authority, Citizens Advice

The Pensions Regulator, NEST (for automatic enrolment)

Local authorities (for means-tested benefits), SAGA, Which?

Tailored information is available

Information tends to be more generic

## Financial education during accumulation – Denmark

Denmark is credited with having an effective pension system, made up of a state pension and fully funded occupational pensions based on collective agreements, as well as private pensions.

A **Money and Pensions Panel**, was launched to increase knowledge and interest about financial matters, having specifically considered how best to communicate information around pensions. This found that members preferred projections

not to include too much text. They also preferred the phrase ‘expectation of pension payments’ to ‘projections’.<sup>3</sup>

There has been an ongoing effort to engage individuals in terms of their pensions through the provision of information that can be adapted to their circumstances. Two examples of these are shown in Chart 4.<sup>4</sup>

An evaluation around the provision of information on private pensions by the Danish Insurance Association found that 74% and 66% of respondents were satis-

fied with the amount of information that they received around their personal pension and occupational pension respectively.<sup>5</sup>

The following points are of interest with respect the UK pension system:

- Information around pensions is available on the same website as information around other financial issues; which may bring the topic of pensions to the attention of someone initially looking for information on another subject.
- There is an emphasis on both practical arrangements and ade-

## Chart 4: Examples of information sources in Denmark

### Danish Insurance Association website on private pensions and insurance

- Overview of types of pension savings, what happens when you change jobs and when you retire
- On-line tools such as ‘pensions meter’ that compares levels of saving with desired retirement income, and exams that test individuals’ knowledge around pensions
- An overview of different pay-out options, e.g. guaranteed rate annuities compared to market-based annuities
- Pensions ABC that providing an overview of pensions, including costs and tax  
<http://www.forsikringogpension.dk/pension/Sider/pension.aspx>

### Citizens website -

- Includes information and interactive tools around pensions and early retirement alongside other areas such as education, housing benefit and disability
- It covers areas such as expatriation and the pension, pension notification and tax on pensions
- On-line tools such as pensions calculator  
<https://www.borger.dk/Sider/pension-og-efterloen.aspx>

quacy of savings during the accumulation phase, e.g., what to do when changing jobs or evaluating savings against desired retirement income.

- As with some of the other countries considered in this Briefing Note, it is possible for individuals to see consolidated information about their own pension entitlements, including state, occupational and private pensions.

### Pensions Dashboard – Sweden

It has been highlighted in the UK media that it will be difficult for individuals to make decisions if

they are unable to access details of all of their pension entitlements—state and private pensions—in one place.

The Swedish ‘**Pensions Dashboard**’ has been suggested as one potential solution.<sup>6</sup> This dashboard allows individuals to see information about all their pensions, both private and state entitlement.

Individuals receive an annual statement around their state pension, known as the ‘**orange envelope**’, which provides a projection of the state pension that an

individual might receive, depending on when they retire. An example of this statement is shown in Chart 5.

Where individuals have occupational or private pensions, they can supplement the orange envelope, using the Minpension system (translation: Mypension).

There has not been an evaluation of the Pensions Dashboard; however, Sweden scores 81.6 on the integrity index (that includes quality of communication) for the Mercer Global Pension Index.<sup>7</sup>

**Chart 5: Example of statement used in Sweden**  
**Annual Statement 2015**

### Your National Public Pension

According to our forecast, this is the amount of national public pension you could receive per month, before tax. The amount may vary depending on when you decide to retire.

age 61	age 65	age 68 and 4 months	age 70
SEK 10 700	SEK 13 500	SEK 16 800	SEK 18 900

### Do you have pension from several sources?

In addition to the national public pension, most individuals also have an occupational pension from their employer. Some also have private pension savings.

National Public Pension

+

Occupational pension

+

Private pension

**Your entire pension**

Log in and see your entire pension

[www.pensionsmyndigheten.se/B3](http://www.pensionsmyndigheten.se/B3)

Use electronic identification or your personal code

The following points are of particular interest with respect to the UK pension system:

- The dashboard enables individuals to see all of their pension entitlements, including state, private and occupational pensions, regardless of whether these are DB or DC pensions.
- The information is updated on a near real-time basis for most pension funds.
- The service's reach is wide—over 2 million individuals of a 9.5 million population are registered.<sup>8</sup>
- The 'Minpension' portal is owned by a subsidiary of Swedish Insurance (the Swedish

insurance trade association), is run and funded jointly by the state and pensions industry.

### Sorted website – New Zealand

This website is run by New Zealand's Commission for Financial Capability (formerly the Retirement Commission) with the primary aim of promoting saving for income in retirement (Chart 6). The Commission realised that people typically did not consider retirement until their 40s, but general information around finances is useful for people of all ages. The website covers areas such as starting work, managing debt and pensions.

The language used on the website is easy to understand and informal. Users can personalise the guidance which is interactive and makes use of games and calculators. The website also provides a blog and other ways of accessing information such as seminars.

While it is not possible to impute any increases in saving directly to the activity of the Commission or the Sorted website, reported saving rates in 2005 were at the highest level since 1995 with 72% of people surveyed saying that they (or someone else on their behalf) were saving for retirement.<sup>9</sup>

## Chart 6: New Zealand Sorted website

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The screenshot shows the Sorted website interface. At the top, there is a navigation bar with links for Home, Get sorted, Life events, A-Z guides, and Calculators. Below the navigation bar, the main content area is titled 'Living in retirement'. On the left, there is a photo of an elderly woman and a list of related guides: Having regular income, Government help, Ways to save money, Budgeting, Where to live when you get older, Protecting your assets, and Trusts. On the right, there is a section for 'Related guides' with links for Retirement income, Asset protection, Insurance, Budgeting, and Retirement planning. Below that, there is a section for 'Related life events' with links for Moving to a retirement village and Losing your partner.

Similarly reach and usage of the website has been impressive with 20% of New Zealanders saying that they had visited the website. 69% of visitors using the Sorted website said they considered it likely very likely that they would take some action or change the way they are managing their money.<sup>10</sup>

The heavy reliance on internet resources reflects the high proportion of internet access of New Zealand's population. However, the Commission did complement this with other approaches such as:

- Printed booklets;
- Partnerships with professional services firms; and
- The sponsorship of money management programmes in secondary schools.

A Freephone pilot was also held in one region in mid-2005 but this was not developed as there was no evidence that telephone-based services would be effective.

The service is heavily advertised, for instance, on other websites and portals. In 2005, 75% of its budget was spent on advertising.

A PPI report<sup>11</sup> outlined the following reasons for the Retirement Commission's success:

- It provides guidance to help people make financial decisions, e.g. it provides individuals with a list of questions that they might ask.
- It provides advice around lifetime financial planning rather than focusing on pensions.

- It is user-friendly, trusted and personalises information.
- The website is complemented by other approaches.

### **Pensionedriedaagse – Netherlands**

Three days every October 'Pensionedriedaagse' (Three Pensions Days) occurs. Pension providers, employers and advisors work together to inform the public around their pensions.

In addition, every pension scheme member is provided with a 'Uniform Pension Overview', in a consistent format. This is complemented by an on-line tracking system that allows someone to view their state and private pension provision together in one place.

There has been no specific evaluation of this approach; however, the Netherlands scores highly (89.4 compared to an average of 71.9) on the integrity index (that includes quality of communication) for the Mercer Global Pension Index.<sup>12</sup>

The following points are of interest in connection with the UK pension system:

- The Pensionedriedaagse can act as a trigger for people to consider their pension arrangements.
- Information is provided to individuals in a layered way, meaning that relatively straightforward information is provided in the first instance and, should they wish, indi-

viduals can access more complex and detailed information.

- Individuals are encouraged to consider changes in their circumstances and the ways in which these affect their pension position.
- Pension providers of workplace pensions play a large role in the provision of information to members.

### **Auto-escalation – United States**

While this is not an example that focuses on financial education, it is included here because of the role of advice in influencing individuals' choices around auto-escalation.

In the US, it has been recognised that inertia may lead most individuals who are automatically enrolled to save at the statutory minimum. There is a perceived risk that increasing contribution rates could lead people, particularly lower earners, to opt out because members might feel they could not afford to invest more. Increasing opt-out rates would undermine the aim of the automatic enrolment policy.

In the US, the Save More Tomorrow" (SMarT) initiative uses interventions based on behavioural economics, with the aim of encouraging individuals to save more without increasing opt-out rates.

The SMarT initiative commits scheme participants when they join a scheme to increase pension contributions after each pay rise.

Unlike automatic enrolment in the UK, individuals opt in to the scheme rather than opting out. Once signed up, the individual no longer has to make an active decision on increasing pension contributions, as it happens automatically.

In one US 401k (DC) scheme with SMarT features, employees increased their pension contributions from 3.5% to 13.6% of salary over a four and a half year period.<sup>13</sup> Take-up has tended to be highest where individuals are provided with financial advice. In 2009 around 59% of large US companies' DC schemes had SMarT features.<sup>14</sup>

The following points are of interest in connection with the UK pension system:

- Ideally these pre-commitment devices are introduced at a time of steady earnings growth—unlike the period that has recently occurred in the UK.
- Administrative changes would be required to payroll systems and software. However, if a large enough number of employers requested an auto-escalation facility the payroll industry may respond positively.

## Conclusion

The approaches of the countries considered here share particular approaches that could be considered in the UK:

- The inclusion of information around pensions with information around other financial topics.
- Provision of consolidated information around an individual's state and private pension entitlements. The intricacies of the state pension along with the move to the single-tier pension however may complicate this in the UK.
- Calculators that compare saving with desired level of retirement income. Some calculators are already available in the UK, however, a useful addition might be one that enables an individual to take into account all elements of their retirement assets and income.
- The provision of information in a layered way so that individuals can access more complex and detailed information if they wish.
- The tailored illustration of how a change to a retirement age can influence an individual's level of retirement income.
- Illustration of the impact of life events on the retirement savings.
- Co-ordinated approaches, such as that provided by the 'Pensionedriedaagse' where

providers, employers and advisors work together to inform the public around their pensions.



The PPI is very grateful to Partnership for supporting this Briefing Note. Editing decisions remain with the PPI who takes responsibility for any errors or omissions

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Myths and rules of  
thumb in retirement  
income





*'Myths and rules of thumb in retirement income'* is the second stage of a research project sponsored by State Street Global Advisors. It builds on the findings from the first qualitative research stage that explored how individuals approaching retirement might use their Defined Contribution (DC) pension pots.

This report is part of the PPI's Transitions to Retirement research, a series of major reports exploring how people access pension savings in light of the new pension freedoms. The research series is sponsored by Age UK, The Investment Association, Partnership, The Pensions Advisory Service (TPAS), The Pensions Regulator (TPR), The People's Pension and Fidelity.

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A report by Melissa Echaliier and Sarah Luheshi

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## Myths and rules of thumb in retirement income

Executive Summary	1
Introduction	4
1. What is a rule of thumb?	5
2. Examples of rules of thumb	8
3. Received wisdoms	16
Conclusion	27
Acknowledgements and contact details	28
References	29

## Executive summary

This PPI report, *'Myths and rules of thumb in retirement income'*, is the second stage in a research project sponsored by State Street Global Advisors. It builds on the findings from the first stage, which consisted of qualitative research with individuals approaching retirement exploring their preferences for how they might want to draw their retirement income.

These individuals were selected because they had relatively low levels of Defined Benefits (DB) pensions, and sufficiently large Defined Contribution (DC) pension pots that they might prefer to leave these invested (rather than withdrawing them in their entirety as a cash lump sum). As a result, this group was most likely to be reliant upon DC savings for their retirement income and would be adversely affected if they did not manage them effectively. This earlier research found that while these individuals have made preparations for retirement, they have not thought through their financial position or spending needs in any detail. As a result, they are unlikely to be well placed to make decisions about investments either in the run up to, or during, retirement.

This stage of this research considers how rules of thumb might help retirees to think about and manage their DC pension savings. A round table, hosted by State Street Global Advisors and conducted by the PPI, was attended by representatives from Age UK, Citizens Advice, the Money Advice Service, NEST, The Pensions Advisory Service, The People's Pension, TUC and Which?. This discussed what 'rules of thumb' are, how they differ from received wisdom and how they might support DC savers when setting their strategies for retirement. This report reflects these discussions, along with additional analysis and modelling drawing the following conclusions:

### **Rules of thumb could help individuals manage their DC pension pots**

In the absence of defaults or financial advice there is the risk that, by following what others say or what they perceive to be accepted wisdom, individuals will not always act in their best interests (although they may think they are). In such situations, rules of thumb could be used as a guide (or as a target).

Rules of thumb are not necessarily a way to achieve the optimum outcome for a particular individual. They are not intended to replace financial advice or guidance. What they are, however, is a course of action that is broadly appropriate for most people in a particular group. The central question around the use of rules of thumb is whether, for the group who use them, outcomes are better than if the rule of thumb were not used.

Round table attendees considered the *'five portions of fruit and vegetables a day'* recommendation to be an effective demonstration of a rule of thumb. It is considered easy to understand, is in the general best interests of a person and, even where individuals do not manage to eat five portions, they may take the positive action of increasing their consumption of fruit and vegetables.

There needs to be a clear distinction between a rule of thumb, which offers an appropriate course of action for many people and a received wisdom, which generally does not.

**Received wisdom may be true, but not in every case**

The two received wisdoms considered in the report ('purchase a buy-to-let property' or 'withdrawing my pension pot to find somewhere better / safer to invest') may be the best course of action for some. However, there are many instances when it will not be the right course.

Whilst the idea of purchasing a buy-to-let property is easy to understand, individuals do not necessarily do better by using their DC savings in this way – factors such as voids and on-going costs lower the yield on property. Other issues for consideration are the risk of investing in *one single* asset within *one single* asset class, and potential problems where individuals need to access their capital quickly.

Similarly, while some individuals' circumstances may mean that they benefit from withdrawing their entire DC savings at retirement, many do not do better by 'putting them somewhere safer'. Risks include giving up the benefits of some institutional funds (better governance, lower fees) in order to place their savings in potentially costlier retail investments and relying upon themselves to select the correct investment vehicle. They also risk paying a higher amount of tax when they withdraw their entire pension pot in one tax year rather than over a number of tax years.

**Rules of thumb need to be carefully phrased and the language needs to make them easy to understand**

The round table participants shared the belief that if financial rules of thumb are to be as successful as '*five a day*' these need to be conveyed using language that is both accurate and easy to understand, and financial education and literacy are essential.

Previous PPI research<sup>1</sup> identified a group of 694,000 individuals with low levels of financial education at high risk of using their DC savings in a way that is misaligned with their circumstances.<sup>2</sup> This supports the need for clear language that individuals with low levels of financial education or literacy understand.

<sup>1</sup> PPI (2014)

<sup>2</sup> These were individuals projected to have between £19,400 and £51,300 of DC savings and no DB entitlement at State Pension Age – financial literacy is not generally that high amongst this group of individuals who are likely to depend to a large extent on their DC savings in retirement.

**Certain rules of thumb could be helpful to UK individuals under the new pension flexibilities**

The two rules of thumb considered in the report ('4% rule' and 'secure a basic income') are considered to be generally in the best interests of an individual.

The '4% rule' is where an individual could withdraw this amount of their DC pension pot in the first year and, in subsequent years, the same amount indexed by inflation. The rationale behind this rule is that using it should make the fund last their lifetime. This specific rule of thumb could be helpful in the UK, as it addresses a general lack of understanding around life expectancy and awareness of the probability of living until age 90 or 100. Its strength also lies in the fact that it can be used as a guide or as a target. Even if it is not followed to the letter, it provides a reasonable basis for most people in terms of managing their expectations of income from their pension pot.

The 'secure a basic income to meet essential needs' rule could also be helpful in the UK as it addresses the risk that UK individuals will be at risk of drawing down their pensions too quickly. In terms of language, it is relatively easy to understand and it can be used as a guide or a target.

## Introduction

In light of the changes announced at Budget 2014, the PPI has embarked on a series of major research reports on *Transitions to Retirement* exploring developments in how people might convert their workplace Defined Contribution (DC) pension savings into retirement income, and the associated risks and opportunities around the new freedoms and flexibilities.

*'Myths and rules of thumb in retirement income'* is the second stage of a research project sponsored by State Street Global Advisors. It builds on the findings from the first qualitative research stage of the project that explored how individuals approaching retirement might use their DC pension pots. The individuals selected to take part in the research had sufficiently large pension pots that they might prefer to leave these invested (rather than withdrawing them in their entirety as a cash lump sum). As a result, the findings should not be taken to be representative for all DC savers.

In addition, these individuals had relatively low levels of Defined Benefit (DB) pensions and, as a result, were most likely to be reliant upon DC savings for their retirement income. They would, consequently, be adversely affected if they did not manage their DC savings effectively in retirement.

The earlier research found that while these individuals have made preparations for retirement, they have not thought through their financial position or their spending needs in any detail. This group is unlikely to be well placed to make decisions about investments either in the run up to, or during, retirement.

A round table, hosted by State Street Global Advisors and conducted by the PPI, was attended by representatives from Age UK, Citizens Advice, the Money Advice Service, NEST, The Pensions Advisory Service, The People's Pension, TUC and Which?. This discussed what 'rules of thumb' are, how they differ from received wisdom, and how they might support DC savers when setting their strategies for retirement. This report builds on these discussions, supplemented with additional analysis and modelling around some common statements around retirement, drawing conclusions around the role and use of rules of thumb.

The first chapter of this report provides an overview of the definition of a rule of thumb, and its possible application in retirement. The second chapter provides an overview and assessment of two specific rules of thumb.

The third chapter considers some of the received wisdoms that may prevent an individual making the most of their retirement income.

The fourth chapter uses the findings to draw some conclusions from this research for the pensions industry.

## Chapter one: what is a rule of thumb?

A rule of thumb is defined as:

*'A guideline that provides simplified advice regarding a particular subject. A rule of thumb is a general principle that provides practical instructions for accomplishing or approaching a certain task. Typically, rules of thumb develop as a result of practice and experience rather than scientific research or theory'.<sup>3</sup>*

Although a rule of thumb may be appropriate for most people, it may not apply to every individual and their specific set of circumstances. Generally, however, it should help individuals decide upon a course of action, without having to analyse their own current and future circumstances in detail.

Well-known financial rules of thumb include:

- Paying off your highest-interest credit cards first.
- Keeping an emergency fund equal to at least three to six months' worth of household expenses.

For the purposes of this report rules of thumb:

- Are not being suggested as a replacement for individuals to seek financial advice and / or guidance.
- Differ from a default in that an external body, such as a government or institution, generally applies a default while an individual selects and applies a rule of thumb.

The round table attendees considered the *'five portions of fruit and vegetables a day'* recommendation an effective demonstration of a rule of thumb. It is widely recognised that individuals should eat more than five portions but the objective of five is seen as realistic and not overwhelming.

This rule of thumb is a useful example because it has the following attributes:

- It is easy to understand.
- Is in the general best interests of a person. In this instance, it reflects the underlying assumption that individuals do not eat enough fruit and vegetables.
- Individuals are not likely to face any negative consequences by adopting this rule of thumb. There are relatively few individuals who would not benefit from increasing their consumption of fruit and vegetables.
- Even where individuals do not manage to eat five portions, they may take the positive action of increasing their consumption of fruit and vegetables.
- The existence of this rule is likely to have led to media coverage, which may in turn have increased awareness of the need to eat fruit and vegetables.

<sup>3</sup> <http://www.investopedia.com/terms/r/rule-of-thumb.asp>



Table 1 shows what a rule of thumb applied to income in retirement is, and is not, in the context of this report.

**Table 1**

**Rules of thumbs for the withdrawal of income from pension savings**

**They are a tool that:**

- Addresses a specific situation. For example, many individuals underestimate how long their retirement income will need to last;
- Is relatively easy to understand and follow;
- Can be used as a guide or as a target that individuals can aim for;
- Offers a better course of action than not following it.

**They are not:**

- Perfect – they will not suit everyone for every situation;
- The way to achieve the optimum outcome for that particular individual;
- A ‘once and done’ approach. Such decisions should be revisited on regular occasions.<sup>4</sup>

There may also be other advantages brought about by the communication or use of a rule of thumb, such as a more general increase in interest in or understanding around a particular issue, such as pensions (Chart 1).

**Chart 1**

## Rules of thumb - possible outcomes

PENSIONS POLICY INSTITUTE

**Better financial outcomes**

- Individual level – an individual’s retirement income should last longer
- Collective level – there may be a lower risk of individuals falling back on the state or younger family members

**Improvements to understanding around pensions**

- Individual level – an individual’s engagement with their pension savings may increase their understanding
- Collective level – media coverage of the rule of thumb may increase collective engagement and understanding

**More realistic expectations around withdrawal phase**

- Individual level – an individual’s engagement with their pension may lead to better understanding around areas such as life expectancy
- Collective level – media coverage of the rule of thumb may increase understanding around related areas

<sup>4</sup> <http://monevator.com/asset-allocation-strategy-rules-of-thumb/>

**Language used to describe any rules of thumb is central to their value**

A key conclusion of the attendees at the round table was the need to use language that is both accurate and easy to understand. PPI research found that financial literacy is not generally high amongst those who are most reliant upon their DC pensions in retirement.<sup>5</sup> This highlights the need for clear language that individuals with low levels of financial education or literacy understand.

There were discussions around rules that use percentages, such as the '4% withdrawal' rule of thumb used in the United States being difficult to understand. A number of alternatives were suggested but none really met the 'easy to understand' criteria.

Chapter two considers the extent to which two rules of thumb, in particular, might help individuals to manage their retirement income, to assess the extent to which they might be helpful, especially the question around whether outcomes are better than if the rule of thumb was not used.

<sup>5</sup> PPI (2014)

## Chapter two: examples of rules of thumb

Under the new pension flexibilities one risk is that an individual will draw down their Defined Contribution (DC) pension fund too quickly and will run out of money. This chapter considers the extent to which two specific rules of thumb might help individuals to manage their retirement income under the new pension flexibilities.

**Rule 1:** '4% withdrawal'

**Rule 2:** 'secure a basic income to meet essential needs'

### Rule 1: 4% withdrawal

**'4% withdrawal' could help individuals with DC savings to manage their retirement income**

'4% withdrawal' has been widely debated by financial advisors in the United States (US) where annuitisation has not been the norm and, consequently, individuals have to make decisions around the rate at which they withdraw their DC pension pot. Box 1 shows the underlying rationale for the 4% rule.

#### **Box 1**


##### **4% withdrawal**

- Individuals withdraw 4% of the value of their DC pension pot in the first year of retirement
- In subsequent years, they withdraw this amount indexed by inflation
- Using this approach should make the fund last their lifetime

Discussion in the US has been mainly around whether 4% is a sustainable percentage rather than a critique of the rule itself. In contrast, this chapter first assesses the extent to which this type of rule of thumb may be helpful under the UK pension flexibilities, including the extent to which 4% might be a sustainable percentage in the UK.

Chart 2 considers the 4% rule against the definition of a rule of thumb outlined in Chapter one. The extent to which this rule meets these criteria is then considered in detail.

Chart 2

<b>Comparison of 4% withdrawal against the definition of a rule of thumb</b>		
Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Yes	<ul style="list-style-type: none"> <li>International experience suggests that individuals are at risk of drawing down their pension savings too quickly</li> <li>Deals specifically with how much it may be possible to withdraw each year</li> </ul>
Relatively easy to understand and apply	Partly	<ul style="list-style-type: none"> <li>May need to be framed differently</li> <li>Individuals may need a tool / formulae to help them calculate the amount of income</li> </ul>
Tool that can work in variety of ways	Yes	<ul style="list-style-type: none"> <li>It can helpfully act as a guide or target.</li> </ul>
Offers a better course of action than not following it	Generally	<ul style="list-style-type: none"> <li>For the majority of individuals this would be a reasonable course of action</li> </ul>

### A '4% type' rule of thumb could be helpful to UK individuals under the new pension flexibilities

#### *Addresses a specific situation*

This deals with the very specific question of how much of their DC savings pot an individual can withdraw each year.

Other countries' experiences suggest that where UK individuals use drawdown products they will be at risk of drawing down their pensions too quickly, with the risk of a negative impact on their quality of life. In Australia, 25% of people aged 55 deplete their balances by the age of 70.<sup>6</sup> Similar concerns have been expressed in the US and Ireland. This suggests that a need in the UK for an approach, such as the 4% rule of thumb, to prevent individuals from running out of money in retirement.

Similarly, UK analysis, conducted by Age UK, finds that where an individual with a £29,000 pension pot withdraws £3,000 (around 10%) per year from the age of 65, they will run out of money by age 75. Age UK suggests that, even where individuals make modest withdrawals, they risk spending their later retirement without any income from private pensions.<sup>7</sup>

<sup>6</sup> Murray, D. (2014)

<sup>7</sup> <http://www.ageuk.org.uk/latest-news/pension-reforms-could-leave-many-older-people-out-of-money/>

*Relatively easy to understand and to apply*

This rule of thumb may be difficult to understand where individuals are not able to calculate percentages. Therefore, this rule may need to be framed in language that is easier for individuals to understand. Similarly, individuals may need help to calculate the initial amount of income. Both of these may be partly addressed by the provision of on-line tools to help individuals calculate their withdrawal.

*Tools that can work in a variety of ways*

The 4% rule can be used as a guide or a target. When used in the US, many retirees do not stick to 4%; instead they monitor their portfolio and alter their withdrawal amount in line with changes to the market and their needs.<sup>8</sup>

*Offers a better course of action than not following it*

UK individuals may not stick to 4%, but may also withdraw a lower amount per year than they would have done without the rule.

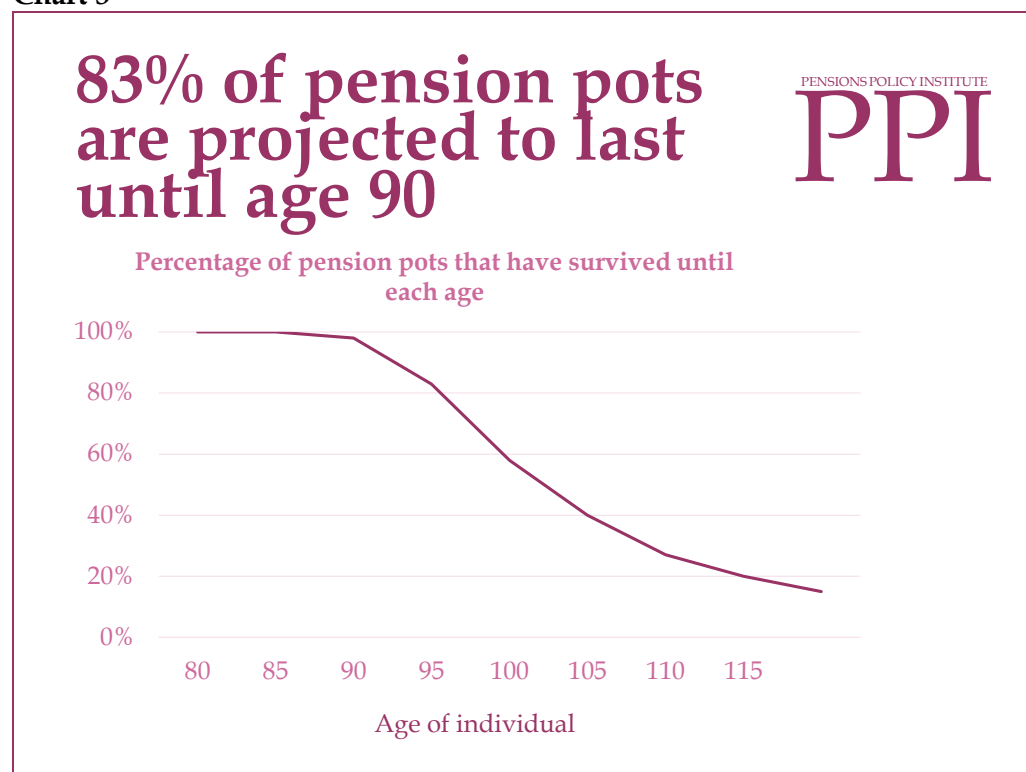
The 4% rule may alter individuals' expectations around a sustainable level of withdrawal. If the stock market performs poorly, they may then understand the need to modify their withdrawal rate so as to sustain the income over a longer period.

**4% appears to be a reasonable starting point for UK DC savers**

As part of the consideration as to whether following the 4% withdrawal rule offers a better route than not doing so we modelled the possible outcomes for a median 65 year old male whose fund is invested 60% in equities and the remainder in gilts. The PPI's Individual Model takes into account 1,000 different scenarios, stochastically considering multiple factors including equity and gilt returns. More information about the modelling approach is available in a separate appendix on the PPI website. While the first stage of this research targeted individuals with relatively large pension pots, these modelling results would apply regardless of the size of pension pot (provided that fees are calculated as a percentage of the pot).

The modelling assumed that individuals withdraw their DC pension pot from age 65. In this year, the individual withdraws 4% of their initial pot. In subsequent years they withdraw this initial amount uprated by the Consumer Price Index. On this basis, the median male has a very high probability of his DC savings lasting until age 84, which is the average life expectancy for such a 65-year-old UK male (Chart 3).

<sup>8</sup> Vanguard (2012)

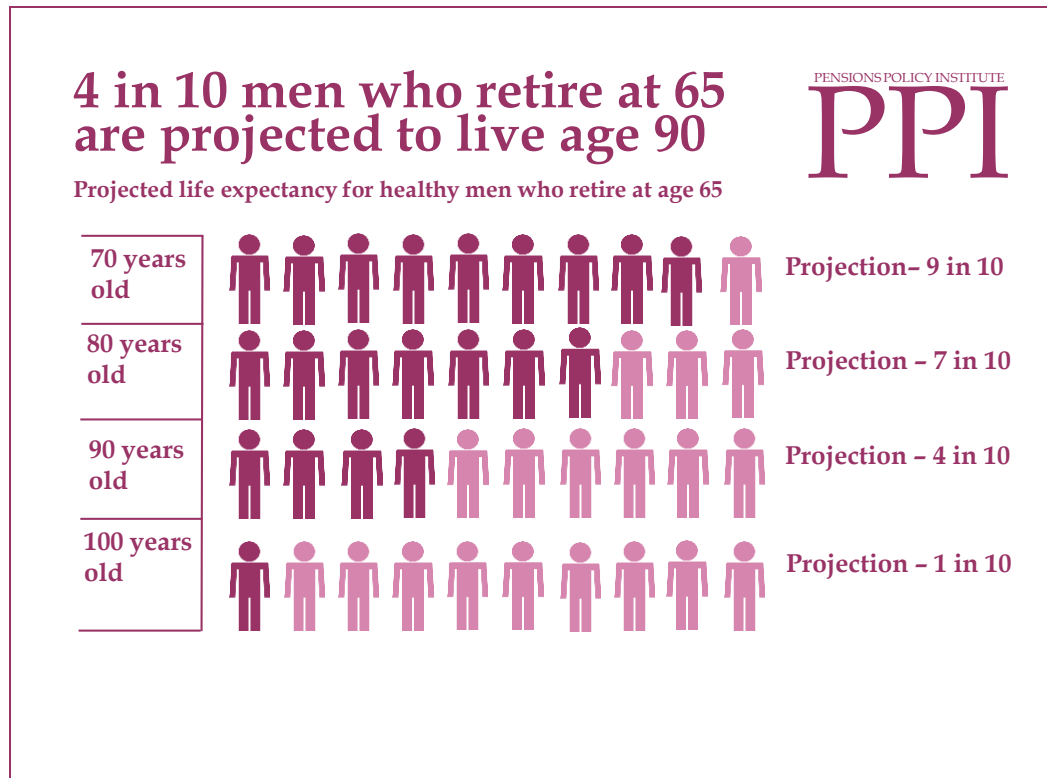
Chart 3<sup>9</sup>

Comparing the length of time a pot may potentially last, with an individual's life expectancy (for a male aged 65) highlights:

- A 65-year old male has a **9 in 10** chance of living until age 70. There is a **very high (higher than 9 in 10)** projected probability that his DC savings will last until this age.
- He has a **7 in 10** chance of living until age 80. There is a **very high (higher than 9 in 10)** projected probability that his DC savings will last until this age.
- He has a **4 in 10** chance of living until age 90. There is an **8 in 10** projected probability that his DC savings will last until this age.
- He has just under a **1 in 10** chance of living until age 100. There is a **4 in 10** projected probability that his DC savings will last until this age.

<sup>9</sup> Assumptions; an individual withdraws 4% of pension pot at age 65. Each subsequent year he withdraws this initial amount uprated by the Consumer Price Index. The pension pot is invested in 60% equities and the remainder in gilts. There is a 0.75% charge on drawdown.

Chart 4



These findings have different interpretations depending on an individual's attitude to risk and expectations around their own longevity. Chart 4 shows the projected life expectancy for healthy men who retire at age 65. Considering the individual who lives until age 90, there is a 2 in 10 probability that they will have run out of money at 90 if they apply the 4% rule. While this may seem high to risk-averse individuals, it may be lower than their probability of running out of money if they had not applied a rule of thumb.

Overall, the figures suggest that a 4% withdrawal rate might be a reasonable starting point. Further analysis of other levels of withdrawal would be required in order to reach firmer conclusions as well as consideration of the following:

- The whole pot would be exhausted without the maintenance of any capital;
- No allowance for the individual's wish to pass on an inheritance;
- What happens if the individual exhausts their DC pension pot? If they have other sources of capital, running out of money may not be such a problem. However, if they rely on the state pension or benefits only, exhausting their DC savings may be problematic;
- This approach does not necessarily guarantee the *optimum* outcome as it is not seeking to replace the need for financial advice or guidance;
- The steady stream of income may not match the profile of an individual's cost in retirement; a 'typical' pattern for costs has been noted as a u-shape consumption curve where individuals have a higher spend in early retirement, this decreases in the middle years due to a reduction in mobility.

Finally it increases again at around age 85 due to disability-related expenditure;<sup>10</sup>

- These projections assume fees of 0.75% per year; however, outcomes would be different where fees are charged at a different rate. Which? Recently surveyed drawdown providers and found that an individual with a £50,000 pension pot could be £3,000 better off after ten years where they used the least expensive provider rather than the most expensive.<sup>11</sup>
- Individuals are likely to review these arrangements on a regular basis, even where they adopt the rule of thumb, and modify their withdrawals based on a number of factors. This is particularly important where individuals' health status changes and a different approach may be appropriate.

### **Rule 2: 'Secure a basic income to meet essential needs'**

#### **Securing a basic income to cover essential needs should be a priority for individuals over other concerns, such as leaving an inheritance**

Round table participants suggested that a relevant rule of thumb would be for individuals to 'secure a basic income in order to meet essential needs' in retirement. There was particular reference to examples of individuals choosing to pass on their DC savings to their children ahead of securing their own basic income. In this report, 'securing a basic income' refers to the idea of an individual securing a level of income for life.

The previous stage of the research asked individuals to assess their essential needs in retirement.<sup>12</sup> Many were realistic about what they would require (Box 2) but underestimated how long they would need it for.

#### **Box 2: Findings from the first stage of this research - interviews and focus groups with DC savers aged 50 and over**

- When taken through a task which required them to consider their spending pattern in detail in retirement most individuals estimated that they would need around £10,000 - £15,000 for the early years of retirement, dropping to around £10,000 for the later years.
- At the same time, participants underestimated their life expectancy, thereby underestimating how long their pension pot might be required to last.

This finding is supported by research conducted by NEST that finds that the threshold for a 'comfortable' retirement is around £15,000 per year.<sup>13</sup> While individuals' definitions of a basic or comfortable income may vary,

<sup>10</sup> PPI (2009)

<sup>11</sup> <http://www.which.co.uk/news/2015/07/the-true-cost-of-pension-freedom-409249/>

<sup>12</sup> PPI (2015)

<sup>13</sup> NEST (2014)




this supports the argument for individuals to identify a ‘floor’ at which they want to secure a regular income.

**A ‘secure your basic income’ rule could be helpful to UK individuals under the new pension flexibilities but it does not fully address issues around the tendency to underestimate longevity**

Chart 5 considers ‘secure your basic income’ against the definition of a rule of thumb outlined in Chapter one.

**Chart 5**

## Comparison of secure your basic income against the definition of a rule of thumb



Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Partly	<ul style="list-style-type: none"> <li>While the rule may help individuals to think about their essential expenses, it may not address their tendency to underestimate their life expectancy</li> </ul>
Relatively easy to understand and apply	Partly	<ul style="list-style-type: none"> <li>This rule is relatively easy for individuals to understand, as they should be used to budgeting</li> <li>It may be more difficult to assess for how long they will need to secure their basic needs</li> </ul>
Tool that can work in variety of ways	Partly	<ul style="list-style-type: none"> <li>It can helpfully act as a guide or target but isn't prescriptive enough in terms of what a basic income might be to totally meet the criteria</li> </ul>
Offers a better course of action than not following it	Yes	<ul style="list-style-type: none"> <li>Enables individuals to consider what their pension pot is for and how their priorities interact</li> </ul>

*Addresses a specific situation*

As with the 4% rule of thumb, this rule responds to the fact that UK individuals will be at risk of drawing down their pensions too quickly (or using these pots for discretionary or luxury spending without securing a basic income), with the risk of a negative impact on their quality of life.

However, where individuals underestimate their own life expectancy they also underestimate how long the pot will need to last. This means that, where they think that they have secured a level of income for the rest of their life, they may still exhaust their pension pot prematurely because they underestimate the number of years for which it needs to last.

Where individuals qualify for the maximum amount of Basic and State Second Pension, they could receive £14,350 per year, which would cover many basic income needs without significant additional funding. However, under the New State Pension the annual income is currently estimated to be £8,060 per year.

Individuals may therefore need to find between £2,000 and £7,000 per year in order to secure a 'basic income'.

*Relatively easy to understand and to apply*

This rule of thumb is relatively easy to understand. However, individuals may not fully understand the extent of their consumption needs in retirement and may underestimate their costs. In addition, while individuals may feel able to assess their likely basic needs in the early years, this is more challenging for later retirement. Where these assessments are inaccurate, individuals may retain insufficient savings to meet their basic needs in later retirement.

This suggests that it would be helpful to explore supplementing this approach with the concept of replacement rates, which may still have a role in helping individuals to calculate their consumption needs in retirement. Replacement rates calculate the level of income that individuals may need in retirement to replicate their standard of living in working life.

Individuals who use this approach may also benefit from combining this with a regular review of their financial situation.

*Tools that can work in a variety of ways*

The 'Secure your basic income' rule can be used as a guide or a target or even followed to the letter. In all cases, it may dissuade individuals from some discretionary or luxury spending once they understand that they need to maintain their savings in order to ensure that they have sufficient income in future years.

*Offers a better course of action than not following it*

Ensuring that an individual has considered their minimum requirements has to be better than not, although it may generate more questions than it is possible to answer. For example, if their pension pot is insufficient to cover their basic needs for any length of time, what can they do?

More importantly, is the timing of people asking themselves this specific question (as to what their basic income needs are). If they can be encouraged to do this well before retirement, this may enable them to make up at least some of any potential shortfall in their pension pot.

Chapter three considers what is a received wisdom and discusses a couple of examples for pension decumulation.

## Chapter three: received wisdoms

The round table participants discussed other rules of thumbs. However, when these were assessed against the criteria identified in Chapter two these rules of thumb failed to meet them. It was felt that these fell into the category of a 'received wisdom'; that is:

*'A judgment that has been accepted as true or worthy, especially without firsthand corroboration'.<sup>14</sup>*

The participants felt that the key criterion that a received wisdom typically failed upon was 'offering a better course of action than not following it'. Two such wisdoms in particular emerged from the first stage of this research project:<sup>15</sup>

**Wisdom 1:** 'Better returns can be achieved by investing in property'

**Wisdom 2:** 'I can find somewhere 'better' or 'safer' for my money'

This chapter reflects findings from a review of literature and the round table discussion around these wisdoms.

### Wisdom 1: Better returns can be achieved by investing in property

While property was popular amongst participants in the first stage of this research, few had considered the costs associated with such an investment, or the risks involved.

#### **Box 3: Findings from the first stage of this research - interviews and focus groups with DC savers aged 50 and over**

##### **Accepted wisdom amongst this group was that they believed better returns could be achieved by investing in property**

- It was common for respondents to discuss accessing funds to invest in a buy-to-let property, with most talking about buying a property outright
- Property remained popular even when individuals considered the risk of investing in *one single* asset
- Individuals had not typically considered costs (except the purchase price) in their calculations, suggesting that any views on rental yield may be over-optimistic

<sup>14</sup> <http://www.thefreedictionary.com/received>

<sup>15</sup> PPI (2015)

Research conducted by the ONS supports these findings; an ONS survey found that 42% of people were considering investing in property for their retirement.<sup>16</sup> Similarly, 28% respondents considered property to be the safest way to save for retirement.<sup>17</sup>

While the preferences expressed by individuals in the first stage of this research will not necessarily translate into action, the received wisdom among many members from this research was that better returns could be achieved by investing in a buy-to-let property. This finding was particularly striking because individuals in this group typically described themselves as risk-averse, yet they were not averse to the risk of investing in one single property.

This preference was despite the fact that the average pension pot will not be sufficient to purchase a property, particularly in the South East. The Pension Advisory Service's (TPAS) experience suggests that an individual may be attracted to the idea of having a tangible asset, such as a property, without necessarily having the means to achieve it.

The rest of this section assumes that individuals purchase their property outright; however, where they wish to purchase the property with a mortgage this will have an additional impact on their level of return. Factors such as the availability of mortgages to older people and changes to tax relief on mortgage interest would also have an impact on outcomes for those wishing to purchase a buy-to-let property.

Chart 6 considers the purchase of a buy-to-let property against the definition of a rule of thumb, based on criteria used to assess the effectiveness of rules of thumb in Chapter two.

<sup>16</sup> <http://on.ft.com/1H4QTDt>

<sup>17</sup> ONS (2015)

**Chart 6**

**Assessment of purchase of a buy-to-let property against the definition of a rule of thumb**



Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Yes	<ul style="list-style-type: none"> <li>Deals specifically with the issue of generating a retirement income</li> </ul>
Relatively easy to understand and apply	Yes	<ul style="list-style-type: none"> <li>UK individuals are familiar with and generally positive towards the idea of purchasing a buy-to-let property</li> </ul>
Tool that can work in variety of ways	No	<ul style="list-style-type: none"> <li>Typically, individuals purchase a whole buy-to-let property</li> </ul>
Offers a better course of action than not following it	Not always	<ul style="list-style-type: none"> <li>It does not guarantee better returns than other forms of investments</li> <li>There are particular risks around investing in property</li> </ul>

**Received wisdom may not always be true: While the idea of purchasing a buy-to-let property is easy to understand, it does not always generate a better return**

*Addresses a specific situation*

The purchase of a buy-to-let property at retirement addresses a very specific issue of generating a retirement income.

*Relatively easy to understand and apply*

During the first stage of this research individuals made the suggestion of purchasing a buy-to-let property to provide retirement income. This demonstrates how individuals understand the concept of a buy-to-let property and would be willing or confident to go ahead and purchase such a property.

*Tool that can work in a variety of ways*

Unlike the rules of thumb considered in Chapter 2, it is not possible to apply this approach in a variety of ways; typically individuals purchase a whole buy-to-let property.

*Offers a better course of action than not following it*

While investing in property may be a suitable course of action for some individuals, it does not guarantee better returns than other forms of investments. In addition, there are particular risks around investing in property, such as:

- **There is no risk diversification**

Where money is invested in a vehicle such as a pension, the investment manager invests this across a number of different types of assets (asset classes), such as equities and bonds. In addition, within particular asset types, funds can be invested across a range of assets, e.g. they may be invested in different companies' shares. This approach aims to diversify risk so that an individual will not be disproportionately affected if the value of one particular type of asset falls.

Buying a property entails investment in *one* asset within *one* asset class, meaning that individuals could be disproportionately affected by changes in the value of this asset. Risk arises from various factors; for example, the impact of a fall in property prices on capital and the impact of a bad tenant or lengthy void periods on income. Both of these are explored further in the following sections.

- **Investing money in a buy-to-let property means it is difficult to access this money quickly<sup>18</sup>**

The purchase of property means that individuals may not be able to access their money easily or quickly.<sup>19</sup> This can be particularly problematic where house prices fall and individuals are required to crystallise any losses.

- **Individuals can under-estimate costs associated with a buy-to-let property and, as a result, over-estimate rental yields**

Along with the cost of purchasing a property, there are on-going costs associated with the renting of a property such as repairs, agents' fees, insurance and administrative costs, (e.g. tenancy deposit scheme fees). Void periods also have an impact on income - it is estimated that average void periods amount to 2.7 weeks per year.<sup>20</sup> All these factors have an impact on the levels of rental yield achieved by an individual, as does the location of the property. Charts 7 and 8 contain illustrations that compare the impact of these types of costs on rental yield for one property in London and another in Wales. These illustrations have been used for comparison because they were the areas with the lowest and highest rental yields in 2013.<sup>21</sup> In both of these illustrations, the yield is reduced by around a third by the impact of costs.

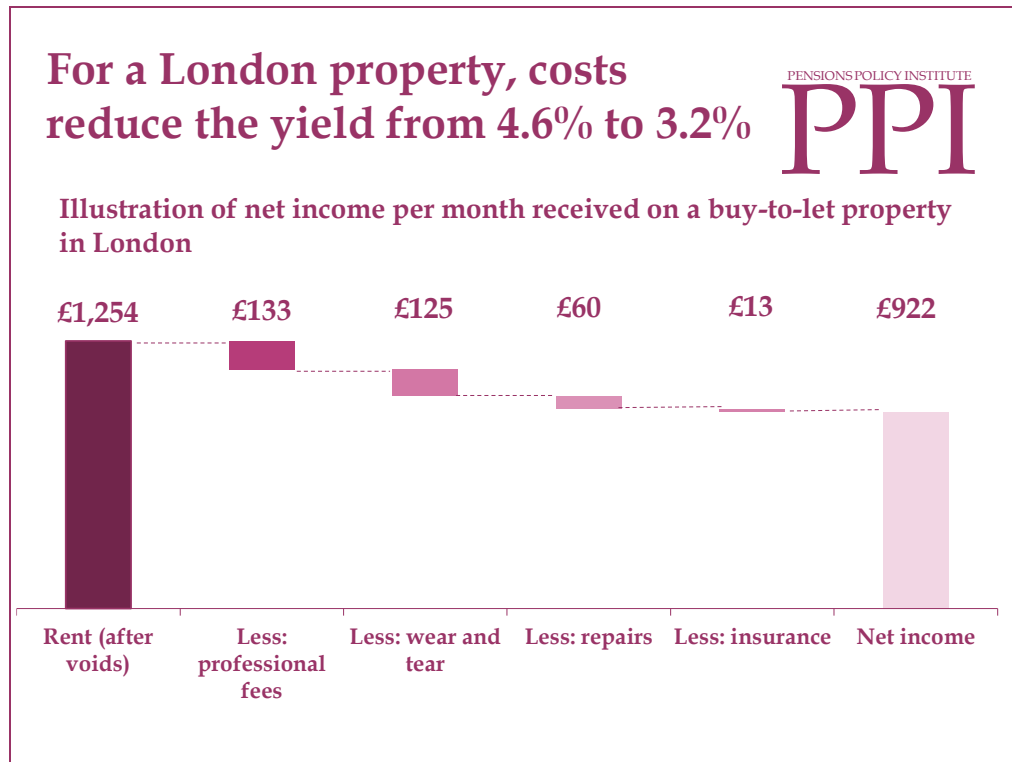
<sup>18</sup> <https://www.capitaemployeebenefits.co.uk/en/current-news/2014/04/could-a-buy-to-let-investment-replace-your-pension#sthash.k1isSsJD.dpuf>

<sup>19</sup> Which? (2015)

<sup>20</sup> [www.propertywire.com](http://www.propertywire.com) (2014)

<sup>21</sup> [Countrywide.co.uk](http://Countrywide.co.uk) (2013)

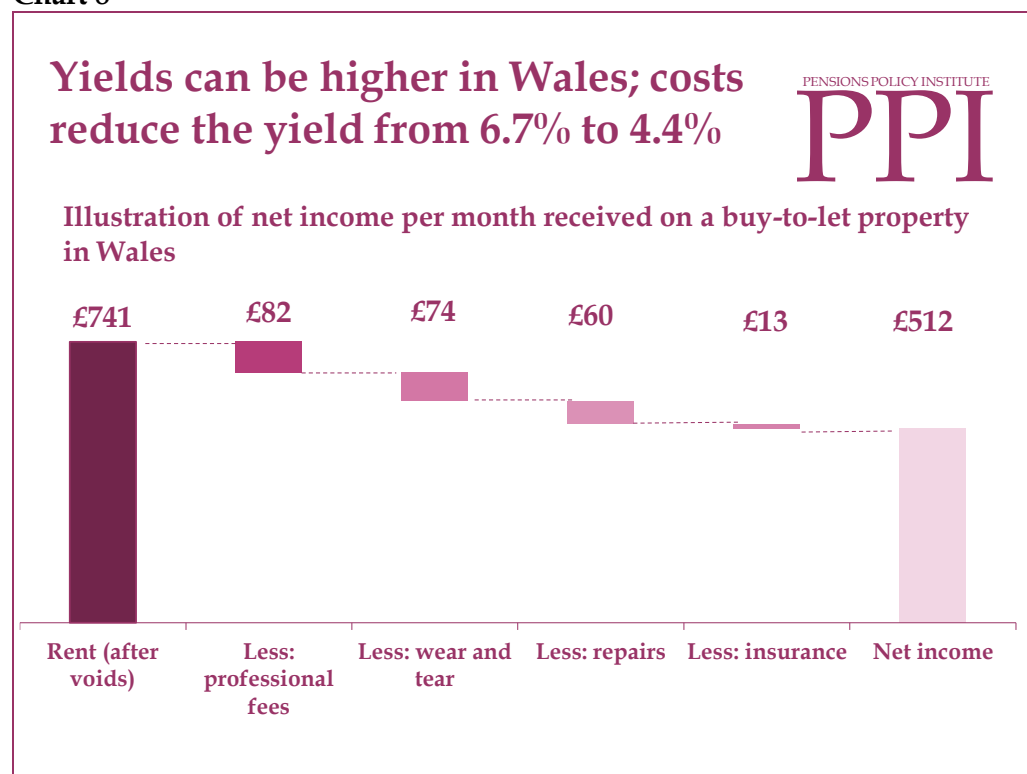
Chart 7<sup>22</sup>



Both of these illustrations assume that an individual does not take out a mortgage. The yield would reduce further with this cost.

<sup>22</sup> Data sources include: Nationwide Building Society, Countrywide.co.uk (2013) [www.propertywire.com](http://www.propertywire.com) (2014) [www.lcplc.co.uk](http://www.lcplc.co.uk), Lloyds Banking Group (2014), Property Investment Project (2015), British Gas (2014), [twww.rla.org.uk](http://twww.rla.org.uk) (2015)

Chart 8



In addition, many individuals do not factor a further reduction in yield due to income tax being payable on rental income. However, individuals would also pay income tax on other sources of income, such as withdrawals from a DC pension.

**It is important to take account of the impact of income tax on a pension pot withdrawal and capital gains tax on the sale of any second property**

There are two types of tax, in particular, to take into account in this scenario:<sup>23</sup>

- Income tax that is to be paid on withdrawals from a DC pension in order to purchase the property;
- Capital gains tax on sale of the property.

These interact to influence an individual's tax position, making a decision around whether to withdraw money from a pension pot a complicated one. Findings from the first stage of this research suggest that some individuals may not be aware of the tax treatment of withdrawals from their pension pot. Several participants were very surprised to learn that their plans to purchase a buy-to-let property could lead to a 40% tax payment.

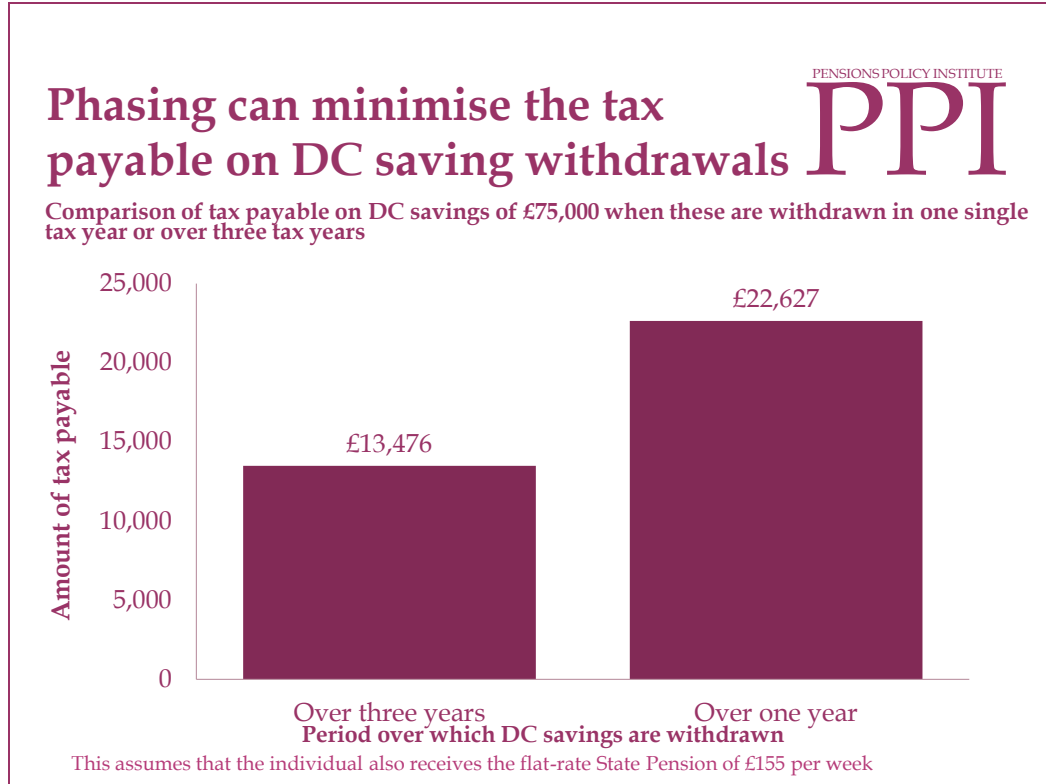
Individuals pay income tax on withdrawals from DC pensions in line with their normal tiered tax rates. Where an individual withdraws their entire DC pension pot at one time in order to purchase a property it may cross a tax threshold. As a result of this they would pay a higher rate of tax on a proportion of this than if

<sup>23</sup> Individuals are also liable for income tax on rental income



they had accessed this gradually over a number of years. Chart 9 compares the withdrawal of an entire pension pot of £75,000 (after the withdrawal of a 25% tax-free lump sum from a £100,000 pension pot) in one year versus phased withdrawals over three years.

**Chart 9**



Unlike an individual’s main residence, capital gains tax is due on the sale of a buy-to-let property. If an individual does not have capital gains from other sources and their gain on a buy-to-let property is less than the annual capital gains tax-free allowance of £11,100, capital gains tax is not of concern.

**As individuals age they may be less willing or able to manage a buy-to-let property**

Even where a property is managed by an agent, individuals may be required to undertake particular tasks such as the approval of tenants, management of the agents and completion of tax returns. This could be a particular concern where an individual experiences cognitive decline as they age.

**Wisdom 2: 'I can find somewhere 'better' or 'safer' for my money'**

**Individuals in the previous stage of this research expressed their preference for taking their money out of their pension to put into 'safer' or 'better' investments<sup>24</sup>**

Box 4 highlights findings during the first stage of this research suggesting that participants were risk adverse. However, many had little understanding of how investment choices, and factors such as inflation, would impact upon their savings.

**Box 4: Findings from the first stage of this research - interviews and focus groups with DC savers aged 50 and over**


**Received wisdom amongst this group was that their money could be either 'safer' or they could achieve better returns if they took their money out of their pension and invested it themselves**

- Many mentioned taking money out of the pension to put into 'safer' or 'better' investments - which often meant cash based investments
- There was little understanding of how investment choices and rates of return would impact on how long their pension savings would be likely to last
- There was evidence that the tax implications of drawing down all of a pot at once had been missed by some participants

Chart 10 considers the withdrawal by an individual of their entire DC savings against the definition of a rule of thumbs, based on criteria used to assess the effectiveness of rules of thumb in Chapter two.

<sup>24</sup> PPI (2015)

**Chart 10**

<b>Assessment of withdrawal by an individual of their entire DC savings against the definition of a rule of thumb</b>		
Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Yes	<ul style="list-style-type: none"> <li>Deals specifically with the question of what to do with DC savings</li> </ul>
Relatively easy to understand and apply	Yes	<ul style="list-style-type: none"> <li>Individuals understand the idea of accessing their DC savings and, in particular, putting this in cash savings</li> </ul>
Tool that can work in variety of ways	No	<ul style="list-style-type: none"> <li>According to this received wisdom, individuals withdraw their entire DC savings</li> </ul>
Offers a better course of action than not following it	No	<ul style="list-style-type: none"> <li>It does not guarantee better returns and cash investments in particular may not offer acceptable returns</li> </ul>

**Received wisdom may not always be true: While the idea of withdrawing entire DC savings is easy to understand it does not always generate a better return**

*Addresses a specific situation*

The withdrawal by an individual of their entire DC savings deals specifically with the question of what to do with DC savings.

*Relatively easy to understand and apply*

During the previous stage of this research individuals made the suggestion of accessing their DC savings and putting them somewhere ‘safer’ or ‘better’.

*Tool that can work in a variety of ways*

Unlike the rules of thumb considered in Chapter two, it is not possible to apply this approach in a variety of ways; this approach refers to individuals withdrawing their entire DC savings.

*Offers a better course of action than not following it*

While some individuals’ circumstances mean that they may benefit from withdrawing their entire DC savings at retirement, many will not necessarily do better by withdrawing such savings and putting them somewhere ‘safer’.

The following factors should be taken into account by individuals thinking about withdrawing their DC pension pots to place these in 'safer' or 'better' investments.

- **Interest rates are relatively low and, over the long-term are unlikely to offer an acceptable level of return to individuals**

Some risk might be required to deliver investment returns that provide individuals with an acceptable level of income and, in particular, protect them against inflation. Individuals who took part in the previous stage of this research initially wanted to place their DC savings in 'safer' investments. However, once they understood the possible consequences and the type of trade-offs that might be required, they indicated that they would be prepared to take some risk.

- **Individuals may end up purchasing directly from asset management companies ('retail funds') which can be more expensive than funds provided as part of their pension arrangements ('institutional funds')**

Fees for retail funds can be higher than for equivalent institutional funds. Retail funds do not generally benefit from the same economies of scale available to an institutional investor. It has been reported that annual management charges on these types of funds can be 1.5% for a fund investing in equities and that these charges can include an advisor commission and a platform administration fee.<sup>25</sup>

Individuals risk withdrawing their pension pot and investing it in a more expensive product having lost the pension wrapper around it and potentially incurring income tax.

- **It may be more difficult for individuals to stick to a particular level of withdrawal where funds are held in an easy to access bank account**

Where individuals are easily able to access their pension funds, they may not stick to a particular level of withdrawal compared to products where they are required to apply to make a withdrawal.

- **It is important to take account of the impact of tax - particularly where the individual may not be expecting to pay tax**

Individuals pay income tax on withdrawals from DC pensions in line with their normal tiered tax rates. Where an individual withdraws their entire DC pension pot at one time it may cross a tax threshold. As a result they would pay a higher rate of tax on a proportion of this than if they had accessed this gradually over a number of years.

<sup>25</sup> <http://www.thisismoney.co.uk/money/diyinvesting/article-2594308/How-decode-confusing-investment-fund-names.html>

- **In their search for better investment returns, individuals may be tempted by pension scams**

The introduction of pension flexibilities has led to heightened concerns around pension scams, with The Pensions Regulator (TPR) pointing out that the tactics used by pension scammers are constantly in flux.<sup>26</sup> Many DC savers' lack of understanding around a realistic level of return, along with their conviction that they can get better returns outside of pensions, may lead to them being particularly vulnerable to scams. Round table attendees suggested that individuals should question investments where returns in excess of 8% are promised. This is in line with TPR literature that suggests that a tactic used by scammers is the distribution of marketing materials that promise returns of over 8%. Those individuals who are swayed by this level of return may have already explored the level of annuity that they are able to purchase and are disappointed by this rate.

The TPR highlights tactics as offering free pension reviews, health checks and promises of better returns on savings.

The Pensions Advisory Service (TPAS) suggests the following as possible indicators that an offer may be a scam:<sup>27</sup>

- Individuals approached out of the blue
- Particular phrases like 'one-off investment opportunity'
- Money to be transferred overseas
- Individuals encouraged to speed up transfers of money
- No documentation being made available
- The 'special offer' will only be available for a short period of time and the proposed investment is often an unusual one (such as land or property developments)

<sup>26</sup> <http://www.thepensionsregulator.gov.uk/regulate-and-enforce/pension-scams.aspx>

<sup>27</sup> <http://www.pensionsadvisoryservice.org.uk/pension-problems/making-a-complaint/common-concerns/pension-scams>

## Conclusion:

### **Rules of thumb could help individuals manage their DC pension pots**

Without effective defaults or financial advice there is the risk that DC savers will not always act in their best interests (although they may think they are) by following what others say or what they perceive to be accepted wisdoms and facts. In such situations, rules of thumb can help by providing a guide or as a target that individuals can aim for.

### **Rules of thumb needs to be carefully phrased and the language used needs to make them easy to understand and easy to apply**

A key conclusion of the attendees at the round table was the need to use clear, accurate language to convey a rule of thumb.

### **The 4% rule of thumb could act as a realistic starting point for UK DC savers**

The 4% rule of thumb could be helpful in the UK, as it addresses a general lack of understanding around life expectancy. Its strength also lies in the fact that it can be used as a guide or as a target, and it helps to manage expectations around levels of income from pension pots.

PPI modelling suggests that, if an individual were to adopt the 4% rule, he has a very high probability of his DC savings lasting until age 84 (the average life expectancy for a male).<sup>28</sup> However, the 4% rule is not a guarantee and in some instances, the pot will run out if the individual continues with that specific course of action.

### **Received wisdom is not always true; individuals do not necessarily do better by withdrawing their DC pension pots to invest in a buy-to-let property or somewhere 'safer'**

There is a tendency for individuals to say that they will withdraw their DC pension pots and put the money elsewhere,<sup>29</sup> including in buy-to-let properties or 'safer' investments. This is of particular concern where individuals indicate that they will withdraw their entire pot in the first instance without understanding the consequences.

These individuals risk giving up the benefits of some institutional funds (better governance, lower fees) in order to place their savings in potentially costlier investments. They also risk paying a higher amount of tax when they withdraw their entire pension pot in one tax year rather than over a number of tax years.

### **A question remains around how to promote rules of thumb, and how individuals can be influenced to question received wisdoms**

It is difficult for DC savers to assess the helpfulness of different sources of guidance and information. In order to address this, the use of rules of thumb could be part of the discussion that Pension Wise has with individuals.

<sup>28</sup> This calculation assumes that a healthy 65-year old male starts to withdraw his DC savings at age 65

<sup>29</sup> PPI (2015)

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DWP	Hymans Robertson
MFS Investment Management	NEST
RPMI	Standard Life Group
The People's Pension	

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**Response to the H M Treasury/FCA ‘Call for input’  
Financial Advice Market Review (FAMR)**

## About

**The Personal Finance Society** is the largest professional body for the financial advisory profession in the UK, with 36,312 members of which 4953 are Chartered Financial Planners (as at December 2015). We promote the highest standards of professionalism for technical knowledge, client service, culture and ethical practice across the entire financial advice community for the ultimate benefit of the public, engendering confidence and trust in our profession.

Our mission is to serve the public by guiding the financial advice community towards higher levels of professionalism. This is exhibited through ethical and behavioural standards, interpersonal and business skills and technical knowledge. We support our members with achieving this goal through a wide programme of activities, including advocacy, good practice guidance, continued professional development (CPD) events, publications and related tools.

The Personal Finance Society is part of the CII Group and therefore we share the CII mission and Royal Charter to secure and justify public confidence and trust in our members and the sector more broadly.

## Executive Summary

We welcome and endorse the stated aspiration of the Financial Advice Market Review to explore how the market could work better for all consumer demographics, not just those with relative wealth.

The introduction of Government reforms providing pension freedoms has introduced and highlighted the need for advice and therefore a requirement to increase access. There is rarely a one size fits all solution and we therefore endorse a multi-integrated approach to maximise the number of consumers able to find the form of advice that they want, on a need they have, and at a price they are prepared to pay. We believe that everyone involved in the industry has a collective responsibility to make this happen.

We are therefore not convinced that the public interest will be well served by simply introducing more non-advised and non-regulated offerings which offer limited standards and consumer protection. Non-regulated solutions are also likely to introduce greater confusion and aid the increasing trend of 'scammers' which we are extremely concerned about and feel must be tackled as a feature of this review.

Financial Technology (FinTec) has a logical and evolutionary role to play in all solutions, but the much publicised emergence of so called 'Robo-advice' must be approached with some degree of caution. Technology of varying kinds have been embedded within the advice process for decades, but a degree of human interaction from accredited, trained and professionally qualified specialists will remain critical to ensure the avoidance of formulaic, future miss-selling or miss-buying.

We see an ongoing role for 'free guidance' if it results in consumers being directed to the most suitable means of delivery. It would seem logical, however, to bring all of the services under one centrally-managed public information service to eliminate duplication and ensure consistency.

We acknowledge and raise concern that some will call for an expansion of industry funded 'free guidance' services for the mass market and continue to limit the highest level of consumer support and protection via fully regulated professional advice. Non-advised solutions will undoubtedly play a role in bridging the gap, but like guidance, offers little consumer protection and therefore the opportunity must be explored to introduce a process or level(s) of regulated advice simplification.

The advice sector continues to raise concerns about rising levies and FSCS funding which urgently needs to be addressed to reduce the unfair impact on advised consumers. Putting additional cost on top to fund the expansion of 'free services' compounds the issue and is neither transparent nor fair given that the cost has to be passed on, making advice appear disproportionately expensive.

We therefore believe that there is an increasing case for greater clarity of costs which are being indirectly borne by the consumer of regulated services regarding the funding of regulatory, FSCS and 'free' information services. The introduction of a savings and investment premium tax (SIPT), similar to Insurance Premium Tax (IPT) might be a fairer and more transparent way forward, and would help alleviate the financial pressure on regulated firms and their clients.

Consumer choice between full regulated advice and non-regulated solutions offers insufficient choice and no middle ground. Consequently, the question of whether to introduce a lower cost, 'simplified' regulated advice option that affords standards and appropriate protection, or allowing non-regulated solutions to move nearer to regulated advice offering limited safeguards, will understandably polarise thinking. Either way, a fresh perspective is required to meet the core objectives of FAMR and support more consumers in their financial planning decisions.

Whilst RDR did much to improve transparency of advice 'cost' the move to fee only based advice works well for some consumers whilst disenfranchising others, especially those who believe their needs are straightforward. Solutions must be explored to offer alternative payment mechanisms, which could for example include the use of transparent fee recovery from investment/savings and the introduction of a Total Expense Ratio (TER) principal.

The current regulatory framework, either real or perceived, inhibits simplification given the liability associated with regulated advice. This has influenced a significant withdrawal from the market and acted as a brake on new entrants. The past lack of appetite to reform regulation has seen few firms take up 'simplified advice', despite it being introduced three years ago under the Retail Distribution Review (RDR), leaving consumers to fend for themselves, use un-protected, non-regulated services, or worse left to the mercy of scammers. It is essential that more is done to protect the public from such activities and in particular against the increasing level of fraudsters who masquerade as legitimate advice firms and deviously offer what appears to be an attractive, non-bureaucratic, consumer-friendly advice service from inception.

There will understandably be some concerns over any suggestion to reform regulatory process, lift restrictions or appear to reduce elements of consumer protection. However, some of those views are steeped in the past and do not reflect the evidence of past industry reforms and present market activity. Whilst we additionally acknowledge that some will question whether or not large institutions can be trusted, to exclude them is increasingly denying the public access to appropriate services and leaving the more vulnerable to fend for themselves. The greater risk is that this will only see them embroiled in unregulated and unprotected alternatives, ultimately increasing their chances of becoming victims of fraud.

Along with our colleagues at the Chartered Insurance Institute, we believe that the FAMR offers a once in a generation opportunity to explore how advice can be provided in its

broadest sense and to introduce new thinking on ways it could be made readily accessible to all who need it. Any efforts to streamline, simplify and improve the market must be done from a consumer perspective and in a way that builds confidence. They must not be allowed to re-invigorate the very problems the RDR and Thoresen Review were meant to solve, or create loopholes for the unscrupulous to exploit.

We believe that FAMR offers a unique opportunity to address the current advice-gap, facilitate the introduction of a new level of consumer-centric simplified and lower cost advice, together with simplification of terminology and language. It is essential that we secure the public's confidence and trust as an integral part of the continuing development of a more vibrant financial services sector.

We look forward to the outcome of FAMR in the hope that it will go on to be seen as a major step towards enabling consumers to take advantage of information, guidance and professional advice through better access, confidence and understanding.



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## Questions / Response

### **Q1: Do people with protected characteristics under the Equalities Act 2010, or any consumers in vulnerable circumstances, have particular needs for financial advice or difficulty finding and obtaining that advice?**

Yes. FCA Occasional paper No 8 (February 2015) makes a useful contribution to this debate. However, we would broaden the definition to include any consumer who cannot, or perceives they cannot, currently afford regulated advice which includes a personal recommendation based on the best course of action open to them as potentially vulnerable.

We do not believe that the public interest will be well served by targeting this consumer segment with more non-advised offerings alone (which will only introduce greater confusion, less choice and encourage greater opportunity for ‘scammers’). However, the increased use of financial technology could offer part of the solution, but will need an appropriate level of intervention from qualified/accredited advisers, otherwise this has the clear potential for formulaic, future miss-selling.

In addition to the above, older consumers and those with mental capacity issues clearly have a particular need for financial advice in respect of both increased complexity of issues and the challenge of cash flow management over longer time periods, brought about as a result of the Pensions Freedoms and the funding of social care following the ‘postponement’ of the ‘care cap’ to April 2020. We are particularly concerned that this group and their need for advice are addressed.

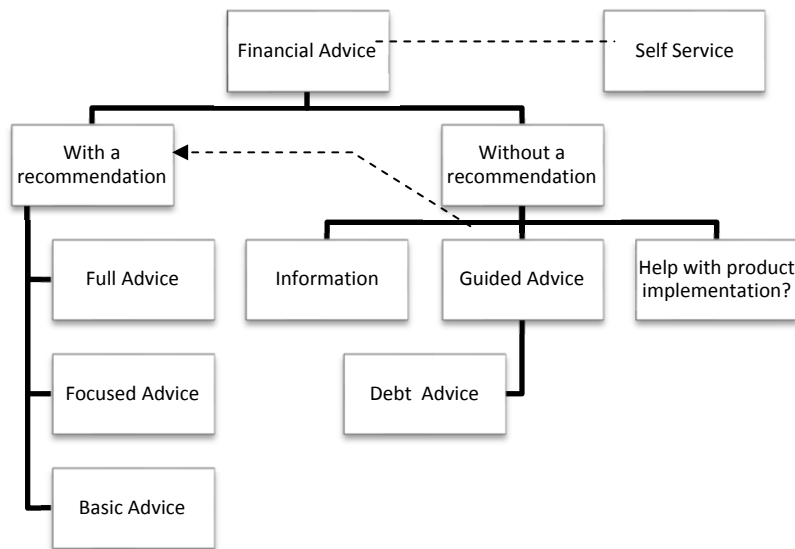
### **Q2: Do you have any thoughts on how different forms of financial advice could be categorised and described?**

#### A new advice framework

As an industry we have created regulatory/industry centric definitions for obvious reasons, but the spoken word is more intuitively interpreted as ‘advice’ by the consumer, irrespective of delivery point or mechanism. The creation, therefore, of a consumer centric advice framework (Figure 1 below), offering varying levels of advice service related to need is critical in tackling the advice gap. We must stop using industry centric terminology or definitions to satisfy or help with our own understanding and differences between regulated and non-regulated activities, given that they are rarely understood by the public.

Genuine ‘unregulated’ or non-advised activity (other than self-serve) is simply not understood by the public and the inclusion of opaque commission structures (which still persist) is misaligned with the principals of greater transparency and fair charging operated by the regulated advice profession. Worse, the public are increasingly vulnerable to fraudsters and investment scams which often look both legitimate and regulated.

Figure 1 – Consumer Centric Advice Framework

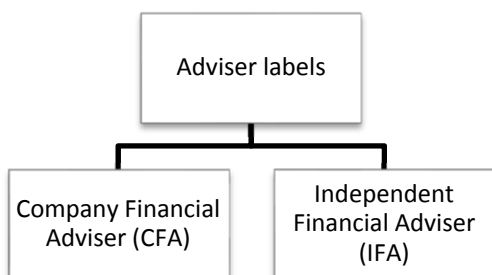


The opportunity also exists to end the debate between ‘advice’ and ‘guidance’ by accepting that from the consumer perspective, ‘advice is advice’ and the only meaningful distinction is whether the advice comes with or without a recommendation as to a course of action. In this context, we see the role of ‘guidance’ as part of a process that ends with consumers being guided to the most suitable means of delivery, not an end in itself.

Simplification of adviser labels

Beyond this, there is a need to *simplify adviser labels* consistent with consumer perception and logic. For example, we believe that there should be just two types of base level adviser: Company Financial Adviser (CFA) and Independent Financial Adviser (IFA), varied only by higher levels of professional qualification in each category, such as Chartered and Certified Financial Planner (Figure 2) – irrespective of an adviser’s title, the key to greater consumer understanding is not a range of advice labels but a clear and understandable explanation around what service is offered, the nature of any restrictions, when it will be delivered and how much it will cost.

Figure 2 – Clarity in respect of Adviser Labels





The above IFA labels would ultimately need to reflect any introduction and subsequent application of the European-wide standard for 'independent advice' to be introduced via MiFid II, but we believe the nature of the UK market is such that many forms of restricted or simplified advice would meet this requirement

That said, the current labels of Independent, Restricted, Basic and Simplified add little real value for the public and indeed in the extreme, the difference between an independent and restricted adviser can be hard to identify. Other than independent, labels are not incorporated within working titles. Any differences in the service delivered should be communicated via a clear explanation of service rather than the attachment of (often) meaningless labels.

### A revised guidance landscape

In respect of 'guided advice' (currently known as generic guidance), current low take up rates suggest there is a need for greater public awareness and access, and this need could be met by permitting a greater range of firms able to offer this service.

Expanding guidance offers potential for Advisers to offer a guided advice service similar to PensionWise and to the same standards. Consideration should be given to funding such a service via a voucher scheme funded from regulatory fines, as originally proposed by the Personal Finance Society before the 2014 budget announcement.

We acknowledge that there will be doubts as to whether or not industry in the broadest sense can be trusted to learn from past mistakes and presents a hurdle in the way of progress. However, it seems appropriate to consider the role that providers and other large institutions could play. For many consumers, their first point of contact will be the pension provider and to be referred to a third party (e.g. PensionWise) with whom the consumer has no relationship can be deemed counter-intuitive and frustrating by many consumers. We understand for some this suggestion may be a step too far, but if 'guidance' is also placed within a robust standards framework, then other outlets may be able to offer a solution with the scale to meet need.

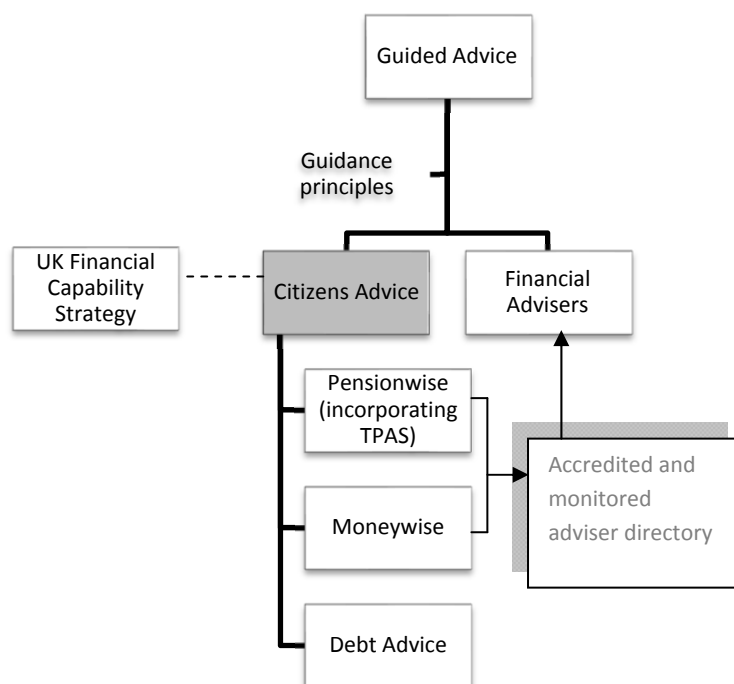
We note the widened remit for Pension Wise in respect of the Secondary Annuity Market (HM Treasury, DWP 'Creating a Secondary Annuity Market: response to call for evidence' December 2015) but further expansion of Government financial advice services doesn't seem a sustainable or broad enough solution in achieving the FAMR objectives and we encourage Government to seek industry solutions rather than taxing the industry to expand guidance through narrow and limited delivery outlets.

Any expansion in the number and nature of 'guided advice' should be accompanied by the creation and application of clear generic guidance principles to be applied to all under the Chartered Insurance Institute's STAR principle and framework.

It would seem appropriate that the MAS debt work, its consumer facing services and TPAS pension guidance should be incorporated into the longer established Citizens Advice operation, although the branding of PensionWise should be retained. A new 'MoneyWise' branded service should be established to offer comparable 'guided advice' to the under 50's at all critical life-stages, again delivered by Citizens Advice.

Effective hand-off from 'guided advice' to established delivery services and regulated advice needs to be robust and truly unbiased so the public can have absolute confidence in it. As such, hand-offs to professional advisers should be done by an accredited and monitored directory such as the one launched by the Personal Finance Society in 2015 which already has over 80% of advisers within it and also displays the annual renewal date of their respective Statements of Professional Standing (SPS). More than one directory could be adopted, but it is essential to use one which is logically in place rather than charge industry to build and maintain new ones. The role of MAS in this respect is highly questionable and unnecessary for a future, non commercial and verified advisory directory.

Figure 3 – Revised 'Guided Advice' landscape



A logical advice process

In addition to being a part of improved access, an additional advantage of enabling independent financial advisers to provide 'guided advice' is that they are often best placed to identify further client need in respect of either 'focused' or 'full advice'. We need to acknowledge however there is a clear gap between consumer 'need' and 'demand' and that if it is in the public interest to encourage consumer engagement with professional financial advisers then demand needs to be encouraged in a number of ways, including:

## 1. Regulated Retirement Advice for All

Prior to the introduction of Pension Freedoms, The Personal Finance Society proposed direct to The Treasury and Regulator in February 2014 a **National Retirement Advice Service** that included the availability of a voucher scheme to fund initial guidance by way of a retirement options report. For this to be effective, we proposed acknowledgement and regulatory endorsement of a 5 step advice process as detailed below (Figure 4)

In the case of pension guidance, Steps 1-3 would result in the production of a Retirement Options Report, detailing the options available to the individual retiree, the advantages and disadvantages of each and the level(s) of and critically the shape of retirement income available. Production of this lends itself to degrees of automation, market examples of which already exist. The consumer could then decide to stop at this point, or progress to either a 'focused retirement review' including personalised recommendation (with/ without transaction) or a more comprehensive 'full advice review' if the fact find process (Step 2) has clearly indicated this to be in the best interests of the consumer

## 2. Clarity around the cost of advice

Steps 1-3 could be delivered for a fixed fee, as evidence exists that uncertainty around the cost of advice at the point of initial engagement has a negative impact on demand.

*Figure 4 – Five stage advice process*

## Bringing it all together

As previously stated, we think it is in the public interest for all solutions to sit within a professional standards framework (STAR - standards for training, accreditation and validation) that the public deserve and can rely upon, alongside tiered levels of regulation and minimum levels of appropriate public protection. Furthermore, cost and regulatory treatment must be aligned to work in favour of consumers seeking focused or entry level advice.

**For people with straightforward needs**, who might see the payment of a fee as a barrier to engagement, it is important to explore alternative structures – otherwise the options remain regulated or non-regulated.

We believe that it is possible to collect the cost of simple ‘basic’ advice from transparent annual charges within an essential ‘vanilla’ product range, either under the principal of ‘client agreed remuneration’ or collected within a product annual management charge.

This can be done without reintroducing the flaws of commission in the past by applying the following standards...

- Product design -Ensuring the relationship between charging methodology and product is simple and straightforward to avoid consumer confusion
- Process design - Related processes to be built around transparency and openness
- Communication – Consumer fully informed of applicable charges and remuneration received for product sale/advice

Such products could be sold via the intermediated market or direct from product providers and help close the advice gap created in part by the retreat from full regulated advice by the product providers, banks and building societies.

To avoid it being seen as a political U-Turn and a return to the old broken commission model, products in this category would be subject to a standardised charging regime incorporated within the annual management charge (AMC)

**‘Focused’ advice** could additionally include the option of a fixed fee. The transaction should be separately priced to remove the link between advice and product and in itself go some way towards changing some consumer’s negative view of regulated financial advice.

Figure 5 - Post FAMR proportionate based alignment of advice type, regulation and consumer protection

Advice label	Advice Service	Personal recommendation	Adviser Qualification	Scope for robo-advice	Payment	STAR	Long stop	PII	FSCS
Full advice	Full financial planning including a personal recommendation based on whole of market concept-providing maximum consumer protection	YES	QCF Level 4	Limited due to scope of advice	Fee based (advice stages 1-3 subsidised by voucher system)	YES	15 years	YES	YES
Focused advice	Advice focused on a specific need area of investment, retirement, savings, protection or mortgage and insurance. Fact find/needs analysis only gathers information that is material to the specific issues discussed.	YES	QCF Level 4	Yes - supported by human intervention	Fee based including the availability of a fixed fee (stage 1-3 subsidised by voucher system)	YES	5 years	YES	YES
Basic advice <sup>1</sup>	Simple needs based service for savings and investment	YES	QCF Level 4	Yes - supported by human intervention	Client Agreed Remuneration (advice stages 1-3 subsidised by voucher system)	YES	2 years	YES	YES
Guided advice	An information service designed to place the consumer in an informed position. Typically this would involve detailing options in respect of a single issue (e.g. a retirement income report) but not involve a personal recommendation	NO	QCF Level 2/3	Yes – with or without human intervention	Free at the point of need via PensionWise, Moneywise or Product Provider  Nominal cost if delivered via financial advisers (advice stages 1-3 subsidised by voucher system)	YES	NO	NO	NO
1 Involving essential, simple, 'vanilla' product set (e.g. ISA, regular savings, regular pension)									

**Q3: What comments do you have on consumer demand for professional financial advice?**

Interest in financial advice, as opposed to being motivated to seek out and pay for advice, are two very different things. Research tends to point to the most powerful trigger for paying for advice is recognition by a consumer as to the limits of their knowledge on a particular financial issue. This is a key reason why facilitating ease of contact in respect of

entry level advice is fundamentally important, as qualified advisers are best placed to explain the complexities of financial issues.

Other triggers for professional financial advice can be found in life events, such as buying a home, having children, funding school fees etc.

Linked to the above is the distinction between 'need' and 'demand'. The need for professional financial advice is significant but demand is less evident. That said, increased transparency as a result of the Retail Distribution Review (RDR) has been better received by the public than many predicted and demand for professional advice has increased year on year since implementation.

There is also a general misunderstanding amongst the public about how different one adviser will be from another – this is most pronounced by those who have yet to engage with a financial adviser. There are different ways of giving financial advice and charging for it and therefore it is important consumers understand this and for consumers to shop around so they can find someone who offers the sort of service they want and need.

As a profession we need to do more to explain the value of advice in terms that the average consumer will understand, the available routes towards dealing with this and the value in monetary terms of doing so.

Factors that continue to underpin the gap between 'need' and 'demand' from a broader cross section of consumer segments, acting as a barrier to seeking advice include:

- Perception of value of advice
- Affordability (in the face of consumer debt and the cost of regulation)
- Cost (especially for those who haven't used a financial adviser before)
- Trust
- Continued use of complex and industry specific language
- Confusing advice labels
- Ineffective signposting to advice from third parties
- Lack of relevant consumer education
- Ongoing information asymmetries
- The current regulatory framework which inhibits a variation of advice service, whilst at the same time not allowing any variation of treatment or risk for varying a service to meet more straightforward advice needs.
- Product complexity
- Over-bureaucratic advice processes
- Access to advice

**Q4: Do you have any comments or evidence on the demand for advice from sources other than professional financial advisers?**

Yes. Regardless of current levels of take up, PensionWise and providers are able to demonstrate a level of demand for 'advice'.

As previously stated, our view is that the spoken word is more often than not interpreted as 'advice' by the consumer, irrespective of delivery point or mechanism. Forcing consumers down specific delivery points however, regardless of cost, is likely to suppress demand which is one reason why we suggest an increase in generic guidance availability and better alignment of cost and regulatory treatment in favour of consumers seeking focused or entry level advice.

The recent press commentary (Money Marketing 16 December 2015) in respect of Key Retirement Solutions' closing its advice arm illustrates that demand based on payment of an upfront fee is a barrier, with the firm stating that despite many of their low or no risk clients actively looking at drawdown the "economics of transacting for such clients do not work". Significant need is evident but not translating into demand due to cost, confusion and general negative perception.

Some level of demand is being reported from automated 'advice' providers, for example Nutmeg who were reported in New Model Adviser (28 August 2015) to be planning to offer financial advice 'in response to client demand'. It is interesting and unsurprising to us that their business model is now to be supported with accessible human advice going forward.

Regardless of demand, the need for advice is clear given its ability to provide consumers with the much needed answer to the key question most end up asking – "so what do you think I should do then?"

**Q5: Do you have any comments or evidence on the financial needs for which consumers may seek advice?**

Yes. Such needs are numerous and varied, many of which are generated by either periods of crisis (e.g. debt, the provision of social care etc) or key lifestyle triggers (e.g. buying a house, starting a family, saving for children's education, inheriting wealth, retirement etc). Whilst some of these needs are predictable, events tend to trigger their identification.

**Q6: Is the FCA Consumer Spotlight segmentation model useful for exploring consumers' advice needs?**

Yes, but the advice gap is complex and the use of this segmentation model is limited by the reality that for many consumers their perceptions, the type of service and specific need(s) at any given time are more important than placing them within specific segmentation models

(such as all encompassing demographic groups or broad based descriptives such as those within Consumer Spotlight).

For example, a simpler form of *needs based* segmentation could be:

- Services for those who want to do things themselves (primarily information based)
- Services for those who need a bit of help or who want to test their understanding (primarily guidance based).
- Services for those who want things done for them and are prepared to pay.
- Services for the vulnerable and those that have an urgent need.

An alternative might focus on current *levels of engagement*, such as that suggested by Europe Economics within its RDR Post Implementation Review 16 December 2015:

- The unserved – consumers who cannot afford advice as currently priced by the market.
- The unengaged – consumers who cannot easily access advice (typically served by the bank channel before RDR).
- The unwilling – consumers who do not engage with advice due to a view that it is too expensive/delivers insufficient value.

Segmentation based on attitude and perceived/actual need pervade across demographic segments and are more consumer centric than segments based on a group descriptive such as, for example, ‘busy achievers’.

**Q7: Do you have any observations on the segments and whether any should be the subject of particular focus in the Review?**

See above

**Q8: Do you have any comments or evidence on the impact that consumer wealth and income has on demand for advice?**

Yes. It is logical that people link need for advice to wealth & income. However, sufficient broad based evidence exists to demonstrate that financial advice would be hugely beneficial for almost every adult but it is the type of advice and level of service that is more relevant.

Again the distinction needs to be made between ‘demand’ and recognised ‘need’.

**Q9: Do you have any comments or evidence on why consumers do not seek advice?**

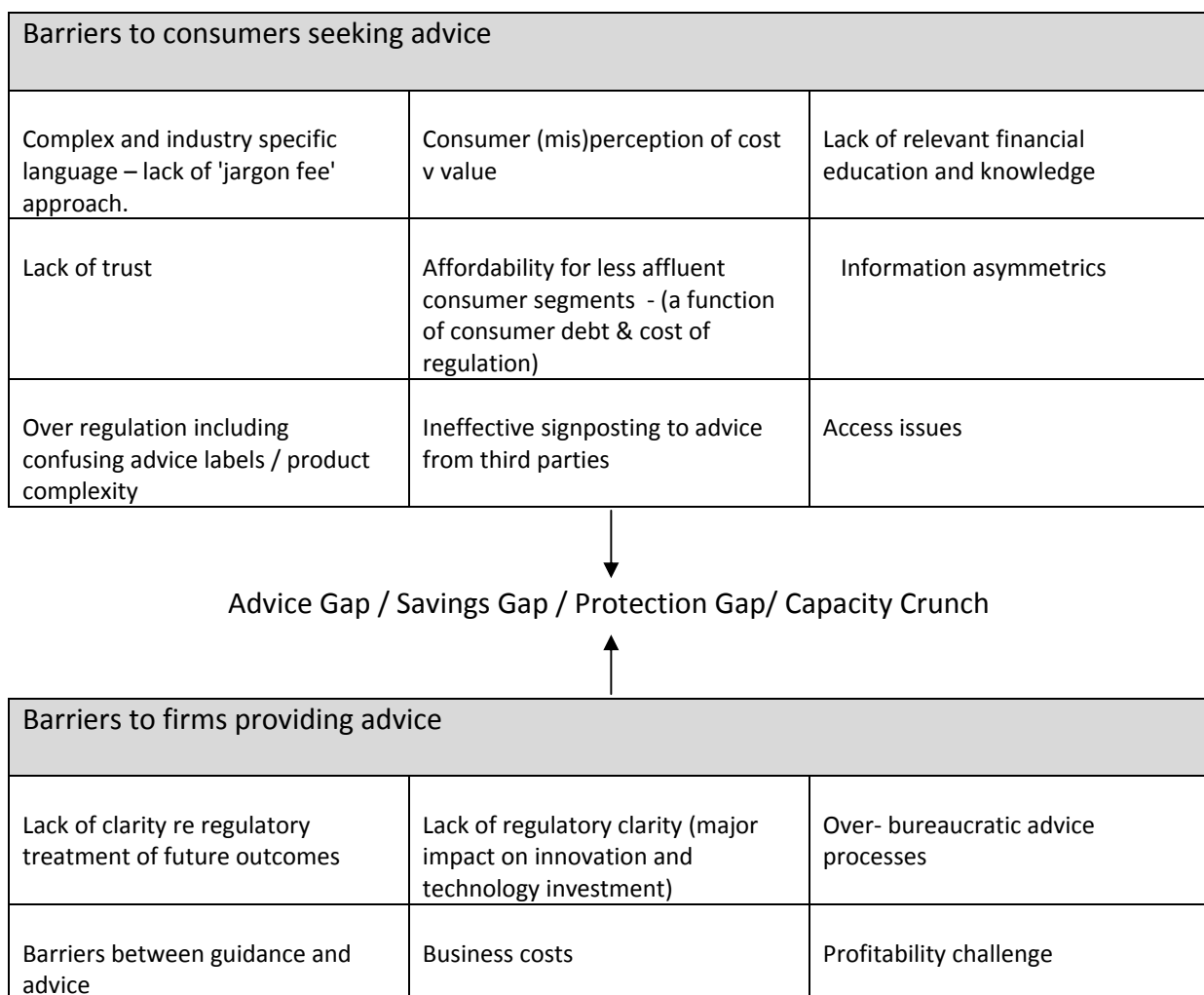
Yes. There is no single or predominant reason why there is a mis-alignment between consumer need for, and the seeking of, advice – rather it is the combination of a number of demand and supply factors in play at any given time.



That said, it's important we recognise the embedded negative perceptions derived from past miss-selling scandals as well as the role of the consumer lobbyist, claims management companies and regulatory messages designed to influence behaviour, all of which have historically focused on the misdemeanours of a small minority of the advice community and wider industry. Currently less than 0.25% of upheld complaints dealt with by FOS are attributed to regulated financial advisers.

Whilst any effective solution to reverse the advice gap will need to be multi-faceted (given the various contributory factors), its ultimate success will largely be dependent upon the extent to which it reflects and meets the varying and perceived needs of consumers as well as those predominant within the advice profession. The development of any sustainable solutions should start from the premise that they support professional standards and consumer protection, as well as being cognisant of acknowledged consumer needs and behaviour.

Figure 6 – Barriers to advice

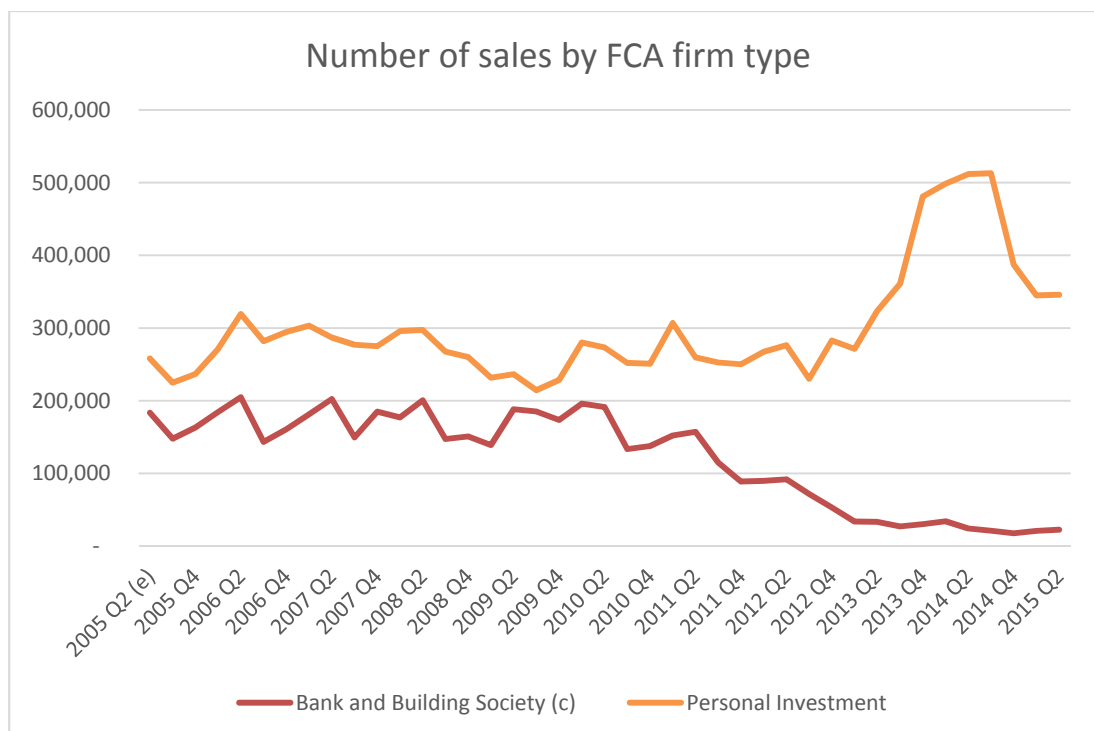


**Q10: Do you have any information about the supply of financial advice that we should take into account in our review?**

Yes. Back in the early 1980s approximately 300,000 people sold financial products (almost wholly on a commission-only basis), the majority of who worked as employees of life companies. Since then we have seen a wholesale exit from the market, predominantly to remove regulatory risk and cost from their balance sheets. More recently, following RDR we have seen advisers working for the Banks and Building Societies reduce from circa 8,658 (2011) to 3,182 (October 2014) (source FCA) although some have re-emerged as retail investment advisers. Again, this has been the result of unsustainable regulatory risk and cost. In total, based on FSA/FCA published data, we have seen a drop in overall adviser numbers from circa 40,000 (2011) to 31,000 (October 2014) at a time when the need for advice has never been greater.

What is needed now is access to professional advice that consumers trust, delivered by individuals and organisations who understands them, can meet their goals and at a price for initial engagement that isn't a disincentive for the majority.

*Figure 7 – Impact of decline in Bank and Building Society sales*



Source: FCA Quarterly PSD RI data December 2015

**Q11: Do you have any comments or evidence about the recent shift away from sales based on professional advice, and the reasons for this shift?**

Yes. Professional advice doesn't always need to lead to the sale of a product in generating a fee for a service. The advice model has shifted post RDR towards ongoing advice and fees and away from the need to transact new products that generate revenue.

Also, we are logically seeing a flight to quality in the sense that financial advisers have become more selective in who they deal with from a value perspective, but as much as from the consumers perspective as their own.

Removal of commission has taken away a key driver for product sales which in itself is not a bad outcome, but consumers with limited wealth or hard working people who want to do well for themselves would not instinctively expect to pay for advice – rather they need advice to be empowered to make a decision over which product or investment vehicle to purchase, including forms of assisted purchase.

**Q12: Do you have any comments or evidence about the role of new and emerging technology in delivering advice?**

Yes. Emerging technologies offer an opportunity for cost effective, efficient and user-friendly advice to be provided to the mass market. Currently, regulatory uncertainty is suppressing supply and deterring market participants from fully embracing this opportunity.

This said, we do not believe Robo-advice is, on its own, a 'silver bullet': Technology of varying kinds has been embedded within the advice process for decades and a degree of human interaction from knowledgeable and professionally qualified individuals will remain critical to the avoidance of formulaic, process driven future miss-selling and miss-buying.

We note with interest that in May 2015 the US Financial Regulator issued warnings to investors and advisers alike to beware the limitations of automatic investment tools, specifically economic assumptions, framed questions and depersonalised recommendations that do not properly take into account changing circumstances or investment time horizons.

'Robo-advice' in the USA has been growing rapidly but it is important to recognise the difference in regulatory treatment and ongoing liability for the supplier. We have engaged and secured input from USA regulators FINRA and CFPB – as long as regulatory standards are met, the consumer is expected to accept responsibility for making an informed decision and the outcome of that decision.

We note the Joint Committee of the European Supervisory Authorities Discussion Paper 'on automation in financial advice' (JC 2015 80 dated 4 December 2015) identifies a number of

potential risks to consumers, including a lack of ability to process information, risks relating to flaws in the functioning of tools and risks related to their widespread use.

Human interaction is and will remain fundamentally important – without it there will be a significant loss for the consumer in not having his/her emotional and psychological temperament understood and reflected in the way advice is dispensed and outcomes generated.

Robo-advice has a place, but on its own it is not an adequate solution to the advice gap, especially against a backdrop of new pension freedoms and the scale of savings crisis in the UK. More fundamental structural change to the market as suggested within this submission is, we believe, needed. Furthermore, low cost advice doesn't necessarily mean Robo-advice as the cost of non-automated advice can be reduced if regulatory bureaucracy is similarly curtailed.

**Q13: Do you have any comments on how we look at the economics of supplying advice?**

Yes. We need to start off looking at the range of advice services offered, simplify them, make their boundaries clear and distinct and ensure the cost of regulation and consumer protection are proportionate to the risks involved.

In terms of the cost of regulation the Financial Services Compensation Scheme (FSCS) is the biggest issue as its uncapped and unpredictable nature means it is impossible for firms to plan within the P&L processes.

Alternative means of funding need to be explored, such as a pre-funded system or a model based on the risks taken by individual firms. A risk-based levy would also encourage advisers to think more about the long term consequences of their business models to the ultimate benefit of consumers. We cannot keep taxing the industry to provide a form of Financial National Health Service. The introduction of a savings and investment premium tax (SIPT), similar to Insurance Premium Tax (IPT) might be a fairer and more transparent way forward, and would help alleviate the financial pressure on regulated firms and their clients.

**Q14: Do you have any comments on the different ways that firms do or could cover the cost of giving advice (through revenue generation or other means)? Do you have any evidence on the nature and levels of costs and revenues associated with different advice models?**

Yes. We have highlighted the potential for a new framework for advice (*Figure 5*) that aligns the cost and type of service with consumer needs and expectations, but also a more appropriate regulatory expectation, cost and liability.

In addition, it is possible that 'basic advice' be introduced to better support the mass market via an essential 'vanilla' product set (e.g. ISA, Personal Pension, basic savings product) where the cost of advice is paid from a standardised charge within the product or AMC. As previously suggested, this is possible without reintroducing commission and the potential for product bias associated with it, if the model is designed and rooted in absolute transparency and disclosure. In this respect, we think that adopting Total Expense Ratio (TER) is an important attribute to cost transparency.

See answer to Q2 – 'Bring it all together'

**Q15: Which consumer segments are economic to serve given the cost of supplying advice?**

Based on the current (ever increasing) cost and inherent risks associated with supplying regulated advice within the existing advice framework, the mass market has in effect been disenfranchised. A framework for advice needs to be introduced which results in the cost of supplying different levels of advice being more aligned to the needs and affordability of all consumer segments.

**Q16: Do you have any comments on the barriers faced by firms providing advice?**

We refer to our answer to question 9

Plans to expand Project Innovate by implementing a regulatory sandbox are welcomed as they should reduce the time (and cost) of getting innovative ideas to market, provide greater access to finance and enable products to be tested and introduced and allow the FCA to work with innovators to ensure consumer safeguards are built into new products and services. This said, in the continued absence of certainty in respect of future treatment of consumer outcomes, its usefulness is undermined and a key barrier faced by firms providing advice - lack of clarity re regulatory treatment of future outcomes - remains.

Plans to introduce pensions' dashboards are overdue and we would urge the Government to publish an implementation timetable as soon as possible and linked to the introduction of the new State Pension. Such an initiative should cut significant cost from the advice process, given that much of the cost is to be found in establishing client need.

**Q17: What do you understand to be an advice gap?**

Whether referred to as a needs, savings, capacity or advice gap, consumers do not have sufficient access to personalised financial advice. We agreed that a good starting point for a fair definition is 'any situation where consumers cannot get the form of advice that they want based on a need they have, and at a price they are prepared to pay'. We would add to this 'any situation where the consumer doesn't appreciate fully the benefits of advice where

advice would most likely make a positive difference to their financial wellbeing either now or at some point in the future’.

The ‘advice gap’ also directly related to ‘the savings gap’ and ‘the protection gap’, as well as a ‘capacity gap (or crunch)’ reflecting the historically reduced numbers of advisers currently available to service the mass market.

The advice gap is complex. As such, we also think there is some value in looking at the advice gap as a multi-faceted phenomenon, as suggested by Citizens Advice in the October 2015 paper ‘The Four Advice Gaps’ and the Europe Economic whose post RDR report for the FCA identified three groups that make up the advice gap:

- The Unserved (economic gap) – those with financial assets to invest, engaged with the market and willing to pay fees but unable to find advisers willing to serve them.
- The Unengaged (education gap) – those with financial assets but not engaged with the advice market because of inertia.
- The Unwilling (confidence/trust gap) – those with financial assets to invest, engaged with the market but regard the fees for full regulated advice as too high for the quality of service they expect.

**Q18: To what extent does a lack of demand for advice reflect an advice gap?**

Need is significant, but demand is not aligned and has been negatively impacted upon by a variety of issues summarised in our answers to questions 3, 9 and 17. Furthermore, the consumer response to pension freedoms is a clear indication that demand that exists isn’t always clear.

What is clear is that there needs to be greater intermediate provision of advice between information and full financial advice that can make specific product or service recommendations without having to investigate all aspects of the customer’s circumstances.

Trust and confidence has been impacted by past mis-selling scandals much of which is confined to the past and a communication strategy offering balanced information and promotion needs to be implemented to reinforce the probability that for the majority advice would give a pay-off that would be worth the fees charged. Even past mis-selling scandals only focused on a particular failure (sometimes without evidence of consumer detriment) without offering proportionality or balance – as a consequence, every activity and product falls under suspicion. This negative only reporting culture does not serve the public’s best interest, discourages engagement and distorts the decision making process.

**Q19: Where do you consider there to be advice gaps?**

The advice gap is complex. We would focus on the different levels of advice that need to be introduced to bridge the void between information/guidance and full financial advice. The distinction between consumers identifying the need for information and help in implementing or transacting a product is clear. Guidance services can only provide a limited service for those who genuinely only need information or simply want validation of facts in support of a course of action.

Other than the established service of Citizens Advice (which should incorporate the services of MAS and TPAS) the solution to increasing access to advice and services must be provided by industry developments. The majority of consumers who identify a specific need for advice usually want help to implement a solution once empowered to make an informed decision.

**Q20: Do you have any evidence to support the existence of these gaps?**

There have been a number of surveys and studies attempting to quantify variously defined advice gaps (for example, The Four Advice Gaps, Citizens Advice, October 2015) and whilst the size and definition of these gaps is open for debate, such evidence points inextricably towards it being substantial in size.

Research from the CII carried out between 2011 – 2014 suggests a significant unmet demand by consumers who have tended to self-advice or use other sources such as family and friends.

Over recent years we have seen a significant lack of any positive promotion of financial services and a significant rise in regulatory reporting that has done little to encourage consumer engagement and increased the advice gap.

At the same time the significant withdrawal from advice services from insurers, banks and building societies over the past decades as well as the inevitable movement up the value chain by regulated advisers post RDR is clear evidence to support an advice gap.

**Q21: Which advice gaps are the most important for the Review to address?**

We would argue that various gaps (advice, capacity, protection ) are all interlinked in one way or another and it is therefore difficult to exclude any from meaningful solutions to the issues the Review seeks to address. The advice models that FAMR seeks to develop must serve all types of consumers.

**Q22: Do you agree we should focus our initial work on advice in relation to investing, saving into a pension and taking an income in retirement?**

No – of course from a public interest perspective these are immediate and topical consumer needs, but they should not be dealt with in isolation from the wider needs of the public – of equal importance is general savings and of even greater importance is the need to address the protection gap. These are all interlinked and require a co-ordinated response and any effective solutions to meet FAMR should be able to be equally applied across financial advice more broadly.

A basic tenet of good financial planning is that it shouldn't be automatically restricted to one or a small number of issues. For example, a focus on taking an income in retirement should involve consideration of death benefits, IHT planning, tax and the provision and funding of social care to name three.

We suggest using an established hierarchy of needs as a guiding principle, for example EPRISM (emergency fund, protection, retirement, investment, savings, mortgage).

**Q23: Do you agree we should focus our initial work on consumers with some money but without significant wealth (those with less than £100,000 investible assets or incomes under £50,000)?**

No - a fully integrated strategy is required to treat all consumers fairly, so initial work should not be restricted to specific segments, not least because you cannot dictate what levels of service each segment should receive, requires or elect to employ.

**Q24: Are there aspects of the current regulatory framework that could be simplified so that it is better understood and achieves its objectives in a more proportionate manner?**

The COB rule book is now so extensive that it is unreasonable to expect firms to interpret and keep abreast of amendments. It is not so much that the principles of the rules are difficult to interpret, it is that negative regulatory messages designed to drive behaviours, too often creates uncertainty about correct interpretation leading to the risk of over engineering and frustration (as evidenced by ever growing suitability/reasons why letters).

The basic tenets of treating customers fairly have been lost within an ever increasing focus on process and governance. Some regulatory fines for example have been issued where a firm couldn't demonstrate that clients hadn't been disadvantaged.

What is needed is greater support and clarity for the advice market from the FCA to help the majority more positively benchmark standards and expectations in-line with the Personal Finance Society's 'good practice' hub and ongoing CPD programme. The Personal Finance



Society has been working with the FCA over the past year to deliver good practice and this approach could be extended more broadly.

We refer to <http://www.thepfs.org/knowledge/good-practice/hub/>

**Q25: Are there aspects of EU legislation and its implementation in the UK that could potentially be revised to enable the UK advice market to work better?**

European advice and regulatory standards are different to the UK and whilst it is important to align and evolve with MiFid, there does appear to be scope to improve our own financial advice framework.

**Q26: What can be learned from previous initiatives to improve consumer engagement with financial services?**

Change needs to be driven from the consumer perspective, not an industry or regulatory one.

There has been little balanced or needs based engagement with the public which would be a potential step in the right direction – constant warnings and negative promotion of a minority of failings has distorted perception and inevitable impacted public confidence and trust. Balanced promotion doesn't mean replacing negatives with positives.

Previous 'simple product' initiatives (CAT mark and Stakeholder) were not as successful as they might have been due primarily to lack of meaningful engagement with key stakeholders, lack of meaningful engagement with product manufacturers and inadequate promotion. In addition, 'Stakeholder' products failed to gain traction due to an inappropriate charge cap rendering them unprofitable and the belief that industry could simply be bullied to comply served only the needs of policy makers at that time – such lessons should be learned.

Much learning from previous initiatives was captured within Professor James Devlin's report to H M Treasury – 'Literature Review of the Lessons Learned from Previous Simple Products Initiative' (February 2011). In particular we would draw your attention to the following suggestions within the report:

- *That transparency of rewards for financial advisers is needed* - this has been delivered as a result of the subsequent RDR
- *That any fee cap must be set at a level that enables providers to make a reasonable profit* – firms should be allowed to charge transparent fair value fees without a cap.
- *That many consumers did not know what CAT standards were and therefore did not know whether the product they had bought met these standards or not* – Government funded marketing initiatives based on the type of advice would work better.

- *That any 'basic advice' should be clearly distinguishable from other forms of advice – see Figure 5*

“More thought should be given to branding, logos and other presentational matters associated with any future initiative, to ensure that brand values are clearly articulated, the associated benefits are appreciated and the products appear relevant and suitable for those in the main target market” - Professor James Devlin

In respect of Pension Freedoms, the CII research in 2014 found a considerable degree of confusion and anxiety about what consumers could do next. The relatively low take up of PensionWise is interesting when placed against research indicating the first point of contact suggested by consumers following a 'guidance' session is their product provider.

**Q27: Are there any approaches to the regulation of advice in other jurisdictions from which we could learn?**

Safe Harbour legislation exists in both the US and Australia: In the former it means employers cannot be sued if they followed certain steps when arranging employees' pension investments that later go awry; in the latter it outlines the steps financial planners can take to ensure they meet a statutory obligation to act in the client's best interest.

Consideration should be given to the concept of implementing appropriate levels of consumer protection in respect of specific need, type of advice and process/product so as not to limit access. Specifically, the Government could offer to underwrite any loss incurred by customers through a safe harbour product in a similar way to the government backed FSCS and included in an appropriate tax similar to IPT.

Following input from USA regulators FINRA and CFPB, it is evident that we share a common approach to serve the needs of our public and ensure appropriate levels of regulatory standards; supervision and consumer protection is in place, consumers take responsibility for making decisions.

The UK professional advice sector works well for wealthier consumers as a result of the higher standards put in place by our regulator, but seems to have gone beyond the point of supporting different demographics or consumers with more straight forward needs.

Both the UK and USA could learn from each other and a blend of both could better support and meet all consumer needs. We should not underestimate the significant progress made in the UK but need to consider balance of what better protects and serves the public – we should ask them what they want and what they expect, and for what cost?

**Q28: What steps can be taken to address behavioural biases that limit consumer engagement without face-to-face advice?**

The starting point in any attempt to address behavioural biases that limit consumer engagement with self serve or automated advice is in the long term financial education and in the shorter term, readily accessible targeted information, specifically in respect of the extent to which financial advice of all types can benefit the consumer and in terms that they can measure and understand.

For example, to address the consistent issue of consumers not seeking out the Open Market Option when looking to effect an annuity, it is no use drawing their attention to shopping around within a 'wake up' pack – consistent public messaging and clear signposting is needed to change behaviours. It is for this reason that we suggest one public information service for guidance to ensure consistency and increased awareness.

Clearly consumers have different levels of knowledge, experience and confidence but advice is more often than not associated with the spoken word, so we also need to recognition that for the mass market some form of human validation will be needed.

**Q29: To what extent might the different types of safe harbour described above help address the advice gap through the increased incentive to supply advice.**

The introduction of a 'safe harbour' is welcomed, but not as a substitute for the necessary overall simplification and proportionality of regulation.

The current cost of delivering advice and related unlimited liability is clearly impacting on all models of regulated advice as well as restricting the innovation of low cost entry solutions. This unsustainable regulatory burden is neither balanced, nor in the best interests of either the public or the industry that serves them.

Unlimited liability was introduced when large insurer sales forces were selling large volumes of 25 year endowments and whole of life policies. Two decades of regulatory reform has long changed the landscape and time therefore to re-apply the law of limitation.

Although the term 'safe harbour' will mean different things to different people, it is simply recognition of the need to appropriately apply regulation relative to the level of risk and the cost of an advice service (see Figure 5). TPAS, MAS and Citizens Advice for example are all operated within a safe harbour because they are deemed to be free and deliver 'guidance' or 'information' only. Unregulated non-advised processes are also deemed to be operating within a safe harbour from regulation as long as they do not stray into the territory of personal recommendations and therefore the domain of regulated advice. The lack of appetite to reform regulation has driven the wrong behaviours for too long, contracting access, discouraging new entrants and encouraging consumers into 'un-protected' services to avoid the cost associated with regulated services.

It is understandable that there will be some concern over any suggestions to reform regulatory process, lift restrictions or reduce consumer protection. However, some of these views and concerns are steeped in the past and do not reflect the evidence of past industry reforms and the activity of the present. To do nothing is increasingly denying the public access to appropriate services and leaving far more vulnerable to fend for themselves, seek unregulated and unprotected alternatives, or become victims of fraud.

**Q30: Which areas of the regulatory regime would benefit most from a safe harbour, and what liabilities should a safe harbour address?**

Safe harbour can be viewed through two lenses – safe harbour products and safe harbour processes.

Safe Harbour products would be those deemed to be the most simple or ‘vanilla’, likely catering for the consumer with relatively simple financial needs. We believe there is a market for such products that can play a part in helping to close the advice gap when part of a ‘basic advice’ regime, but that market is dependent upon improved consumer engagement as outlined in our answer to question 26.

Safe Harbour processes would be those that preclude or significantly limit potential recourse if the distributor can demonstrate they have followed a pre-determined and pre-approved set of processes before selling a specific policy and dispensing a certain piece of advice (for example, in Figure 5 we suggest a Long Stop of 2 years against a Basic Advice regime). Doing the right thing to a required standard from outset should be an implicit expectation, but carrying unlimited or even varying degrees of uncertainty can, and does, have a profound and negative commercial impact.

We welcome recent commentary that the Government and FCA are looking to clarify the extent to which advisers are protected in providing advice to insistent clients and subsequent facilitation where the advice is ignored – clarification that the proposed requirement for advice in respect of the secondary annuity market makes even more urgent. We see this as a major and growing risk for the advice profession and respectfully suggest a factsheet clarifying process is meaningless without similar written clarification from both the FCA and FOS in respect of future treatment of inevitable poor consumer outcomes that will no doubt manifest themselves over time.

**Q31: What steps could be taken to ensure that a safe harbour includes an appropriate level of consumer protection?**

We would like to see all solutions sit within a professional standards framework (STAR) with tiered levels of regulation and protection, as follows:

*Full Advice* - fee based, full financial planning including a personal recommendation - providing maximum consumer protection by PII, Standards Training Accreditation Reaccreditation (STAR) and a 15-year time limit and the FSCS.

*Focused Advice* – fee based, focused advice on a specific need area of investment, retirement, savings, protection or mortgage and insurance – including a personal recommendation, protected by PII, STAR and 5-year time limit and FSCS

*Basic Advice* – Client Agreed Remuneration, a personal recommendation and a simple needs based service for savings and investment – protected by PII, STAR and a 24-month guarantee

*Guidance Advice* – information services – protected by STAR

We would like to see levels of advice described in clear and simple terms that could be universally and intuitively understood within the UK market in much the same way that, for example, the AA star system for hotels is (5 star hotels are implicitly understood by the majority to cater for a full range of needs, provide extensive services and are relatively expensive whilst 2 or 3 star hotels are basic and meet less refined needs and smaller budgets)

In terms of safe harbour ‘vanilla’ products, consumer protection would be afforded via clarity of offering, clarity and transparency of charges and appropriate standards and proportionate consumer protection (see Figure 5).

This said, currently the ultimate safe harbour remains non advised propositions which have been indirectly encouraged as a result of the level of current regulatory costs and liabilities and we would point out again that they afford no level of consumer protection, which can never be a good consumer outcome.

**Q32: Do you have evidence that absence of a longstop is leading to an advice gap?**

The current absence of any long-stop is clearly a major contributing factor to the advice gap.

Currently the provision of financial advice is one of very few services not subject to a statute of limitations or ‘long stop’. Firms are often subject to recourse, based on advice that was correct at the point of provision. Whilst we appreciate that the provision of advice is not a one-off transactional interaction and that best practice would be to continue to monitor the advice given, being subject to recourse in perpetuity, often after many decades have passed is wholly disproportionate.

It is evident that larger institutions exited and have avoided re-entering the advice sector because of the lack of any capped liability so this has clearly been a strong influence in them not offering regulated advice. Large institutions in particular show that the financial

provision of unlimited liability within their accounts make regulated activities hugely undesirable for most shareholders.

**Q33: Do you have evidence that the absence of a longstop has led to a competition problem in the advice market e.g. is this leading to barriers to entry and exit for advisory firms?**

See answer to Q32

It is worth adding that whilst the advice sector carries unlimited liability, the FSCS operates the law of limitation in respect of firms that are no longer trading.

**Q34: Do you have any comments about the benefits to consumers of the availability of redress for long-term advice?**

We suggest this question is akin to looking through the wrong end of a telescope. Firstly, whatever direct and indirect benefits have been derived, reference to upheld FOS claims against regulated advisers indicate clearly that direct benefits have applied to a tiny percentage of advice given. Furthermore, there is little evidence of either FOS or FSCS upheld complaints involving advisers exceeding 10 years based on past adviser behaviours (let alone 15 years)

This should be contrasted with the number of consumers that have been denied the benefits and protection of regulated advice as firms have exited the market in the past few decades.

**Q35: Do you have any comments or suggestions for an alternative approach in order to achieve an appropriate level of protection for consumers?**

Whatever the alternative approach, it must result in far fewer consumers being forced down a funnel towards non-advised proposition or worse, 'scams'. We believe this is best achieved via varying the level and nature of advice services, all offering the protection of professional standards and proportionate future redress aligned to the nature of service bought.

In respect of professional standards, we refer to the CII's response to H M Treasury consultation paper on Freedom and Choice in Pensions. In it the CII outlined its view that public confidence was key to success and that the only way to generate such confidence was by ensuring that all delivering guidance should be obliged to follow an integrated set of Standards, Training, Accreditation and Revalidation (STAR). We endorse this view and its extension to FAMR and all forms of resulting guidance and advice.

In respect of standards, a minimum set should be put in place to eradicate, or mitigate to the fullest extent, any risks that any advice scenarios pose to the consumer or, equally important, the provisioning organisation. Such standards could include:

- Quality,
- Knowledge and competency
- Ease of use and accessibility
- High level design
- Delivery standards
- Technology standards
- Security standards

Full details in respect of STAR can be found within the FAMR consultation response from the CII.

**Q36: Do you have any comments on the extent to which firms are able to provide consistent automated advice at low cost? Are you aware of any examples of this, either in the UK or other jurisdictions?**

Whilst we cannot comment in any detail on the ability of specific firms able to give automated advice, there are a number of hurdles in the way of such firms, including the extent to which regulatory requirements translate well to the automated advice market – e.g. suitability requirements in COBS and whether these requirements can be satisfied by text generated from an algorithm

That said and aligned to our view that some form of human interaction will be needed, having financial advisers check advice before execution could provide the basis for initial safeguards.

Looking at cost in the round, some level of automation would seem well aligned to more simplified forms of advice (with proportionate protection) and access to ‘vanilla’ type products which together could deliver a degree of overall consistency at relatively low cost.

Again, we suggest that STAR should be applied to automated advice in the same way as all other forms of advice.

**Q.37: What steps could we take to address any barriers to digital innovation and aid the development of automated advice models?**

- Absolute clarity from the regulator as to what is and isn’t allowed
- The abolition of the distinction between ‘guidance’ and ‘advice’
- Absolute clarity in respect of the boundaries between different forms of ‘advice’

- Absolute clarity in respect of future liability for recommendation given - standards need to be in place but as long as the type of service, cost and acceptance of responsibility is transparent, the service should not have to operate in fear that it may at some future point be treated as full advice and therefore liable to enforcement and compensation.

**Q38: What do you consider to be the main consumer considerations relating to automated advice?**

Fin Tec will inevitably play an ever greater role in the advice process, with such streamlined solutions complementing rather than threatening traditional forms of regulated advice. That said, we would offer a word of caution: even though they potentially increase public access to advice and take costs out of existing forms of advice, you cannot automate critical systems without running the risk of creating another formulaic miss-selling scandal. They also provide a very attractive proposition for scammers to imitate.

As such, we recognise a number of consumer risks arising from FinTec based automated advice solutions that will need to be addressed, including:

- The service must be clearly understood by the consumer and not prone to any misinterpretations – it must be directed at the right type of consumer with appropriate needs and preferences.
- The service must prevent as far as possible consumers making unsuitable decisions as a result of a lack of information or opportunity to seek clarification.
- Clarity in respect of future liability – the software provider? The provider of the tool? The person who writes the algorithm?
- The risk of unsuitable decisions due to the limitations or assumptions with a tool.
- Assumptions and methodology used needs to be understood by consumers or there is a risk that advice may be misinterpreted or unsuitable.
- The risk of inaccurate data input without a human sense checking it.
- The risk of biases within the tools used.
- The risk of confusion as to who/what is providing the advice because of any fragmentation of the advice process (i.e. parts of the process being performed by different tools).
- The use of personal data not envisaged by the consumer.
- Consumer detriment resulting from the automated financial advice tool being ‘hacked’ and/or the underlying algorithm manipulated.
- Consumer detriment resulting from automated advice tool scams.
- The risk of unsuitable decisions due to the speed of process.
- The risk of inertia and a lack of motivation to act on advice where such advice tools do not facilitate an end to end process.
- Litigation and reputational risk due to faulty automation.



**Q39: What are the main options to address the advice gaps you have identified?**

1. Consumer education, linked to
2. A comprehensive Financial Capability Strategy for the UK
3. Consumer centric terminology and services that better reflect consumer logic and behaviour
4. The removal of artificial industry terms such as ‘guidance’ and ‘advice’, ‘restricted’ and ‘whole of market’
5. Replacement by a range of ‘advice’ models with or without a personal recommendation, where the distinction between each is clear and inclusive of the description of the service and its cost rather than its label
6. Proportionate regulation/consumer protection/reduced adviser costs of regulation
7. The controlled development of automated digital advice that addresses the main consumer issues as outlines in our answer to Question 38
8. A single a professional standards framework (STAR) to which all forms of ‘advice’ apply, with tiered levels of regulation and minimum levels of public protection
9. Clarity in respect of the risks and liabilities inherent within automated digital advice and the application of STAR to them
10. Comprehensive Government funded promotion of the above

**Q40: What steps should we take to ensure that competition in the advice markets and related financial services markets is not distorted and works to deliver good consumer outcomes as a result of any proposed changes?**

The Government and regulator must work with the intermediary sector, financial institutions, consumer bodies and charities to ensure that the different needs of consumers of financial services are at the beginning, centre and end of any solutions.

Underpinning a competitive market must be greater levels of consumer understanding and in this respect the development of an integrated UK Financial Capability Strategy is key.

**Q41: What steps should we take to ensure that the quality and standard of advice is appropriate as a result of any proposed changes?**

Crucially, the notion of outcomes must embrace the idea of broader engagement – it can’t just be about preventing detriment. For example, the review needs to address at the most fundamental level and at the very beginning, which of the following is the better outcome?

1. Ten million people accessing advice and making decent provision for their lives and in 5,000 cases something goes wrong, or...
2. Some 20 million people accessing advice and making decent provision but 20,000 cases go wrong.

The answer must be 2 or put another way, the review should focus on good outcomes for an increasing number of consumers, not ideal outcomes for (almost) all.

In terms of practical steps to take, we repeat we would like to see all advice solutions sit within one overarching professional standards framework (STAR) with tiered and proportionate levels of regulation and protection. It is essential that more is done to protect the public from being funnelled into non advised and/or 'unregulated' activities or towards an increasing number of fraudsters, who look like legitimate advice firms and offer an attractive, non-bureaucratic consumer friendly services at inception – without such steps the consequences for some individuals can be, and in all likelihood will be, devastating.

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